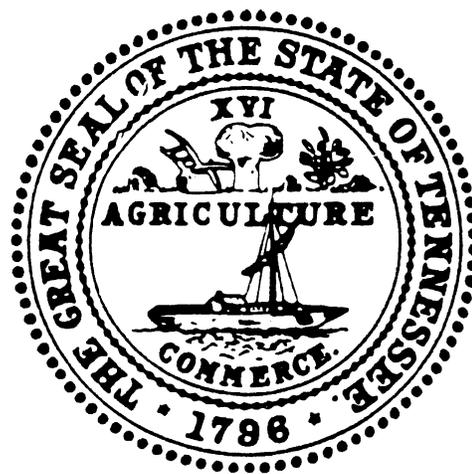


# AUDIT REPORT

Department of the Treasury

For the Year Ended  
June 30, 2007



STATE OF TENNESSEE  
COMPTROLLER OF THE TREASURY

Department of Audit  
Division of State Audit



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For more information about the Comptroller of the Treasury, please visit our website at  
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**STATE OF TENNESSEE  
COMPTROLLER OF THE TREASURY**

State Capitol  
Nashville, Tennessee 37243-0260  
(615) 741-2501

**John G. Morgan**  
Comptroller

March 20, 2008

Members of the General Assembly  
and  
The Honorable Dale Sims, Treasurer  
State Capitol  
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of the Treasury for the year ended June 30, 2007.

Consideration of internal control over financial reporting and tests of compliance disclosed a deficiency, which is detailed in the Results of the Audit section of this report. The department's management has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Sincerely,

John G. Morgan  
Comptroller of the Treasury

JGM/ajm  
07/115

State of Tennessee

# Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit  
**Department of the Treasury**  
For the Year Ended June 30, 2007

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## AUDIT OBJECTIVES

The objectives of the audit were to consider the department's internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing an opinion on the financial statements of the Baccalaureate Education System Trust-Educational Services Plan, the Chairs of Excellence Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, the Small and Minority-Owned Business Assistance Program Fund, and the State Pooled Investment Fund; to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements; to perform certain limited procedures at the Department of the Treasury as a part of our audit of the *Comprehensive Annual Financial Report* of the State of Tennessee for the year ended June 30, 2007; and to recommend appropriate actions to correct any deficiencies.

## INTERNAL CONTROL FINDING

### **Controls Over Abandoned Property Records Are Inadequate, Thus Increasing the Risk of Fraudulent Payments**

During the audit period, the Division of Unclaimed Property did not have controls pertaining to abandoned property that would be likely to prevent or detect unauthorized alterations of the files containing the original property data. The opportunity existed for individuals to make unauthorized changes to key elements of property records (such as owner name, address, social security number, and dollar value of property). Unauthorized changes made to property records could result in the payment of fraudulent claims and would hamper the division's efforts to locate the correct owners of the property. In response to the increased risks of fraud noted above, we performed a limited review of property records, searching for indications that ownership data had been altered. No discrepancies were discovered.

**Audit Report**  
**Department of the Treasury**  
**For the Year Ended June 30, 2007**

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**TABLE OF CONTENTS**

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|  | <u>Page</u> |
|--|-------------|
| <b>INTRODUCTION</b>  | 1           |
| Post-Audit Authority   | 1           |
| Background   | 1           |
| Organization   | 2           |
| <b>AUDIT SCOPE</b>   | 4           |
| <b>OBJECTIVES OF THE AUDIT</b>   | 6           |
| <b>PRIOR AUDIT FINDINGS</b>  | 6           |
| <b>OBSERVATIONS AND COMMENTS</b>   | 6           |
| Management’s Responsibility for Risk Assessment  | 6           |
| Fraud Considerations   | 7           |
| Title VI of the Civil Rights Act of 1964   | 8           |
| <b>RESULTS OF THE AUDIT</b>  | 8           |
| Audit Conclusions  | 8           |
| Report on Internal Control Over Financial Reporting and on<br>Compliance and Other Matters Based on an Audit of<br>Financial Statements Performed in Accordance With<br><i>Government Auditing Standards</i> | 10          |
| Finding and Recommendation   | 12          |
| Finding – Controls over abandoned property records are inadequate,<br>thus increasing the risk of fraudulent payments  | 12          |

# Department of the Treasury For the Year Ended June 30, 2007

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## INTRODUCTION

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### POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Department of the Treasury. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

### BACKGROUND

The state treasurer is a constitutional officer elected every two years by a joint session of both houses of the General Assembly. The treasurer is charged with various responsibilities and duties, most relating to the financial operations of state government.

Among the duties of the state treasurer are accounting for the receipt and disbursement of public funds; investing available cash balances; administering the Tennessee Consolidated Retirement System; investing the pension fund; operating the state’s Unclaimed Property Program; administering the State Employees’ Deferred Compensation Program; operating the State Employees’ Flexible Benefits Plan; administering the Baccalaureate Education System Trust program; administering the Small and Minority-Owned Business Program; and directing the staff of the Division of Claims Administration and the Risk Management Division.

The treasurer is also a member of the following entities:

Baccalaureate Education System Trust Board  
Board of Claims  
Board of Equalization  
Chairs of Excellence Trust  
Collateral Pool Board  
Commission to Purchase Federal Property

Council on Pensions and Insurance  
State Funding Board  
Public Records Commission  
Sick Leave Bank Board  
State Building Commission  
State Capitol Commission  
State Insurance Committee  
State Library and Archives Management Board  
State School Bond Authority  
State Teacher Insurance Committee  
State Trust of Tennessee  
Tennessee Child Care Loan Guarantee Board  
Tennessee Competitive Export Corporation  
Tennessee Consolidated Retirement System Board of Trustees  
Tennessee Higher Education Commission  
Tennessee Housing Development Agency  
Tennessee Local Development Authority  
Tennessee Sports Hall of Fame  
Tennessee Student Assistance Corporation  
Tennessee Tomorrow  
Tuition Guaranty Fund Board  
Volunteer Public Education Trust  
Workers' Compensation Fund Board

## **ORGANIZATION**

The various duties and responsibilities of the Treasurer's office are administered and organized in the following manner:

**Administration and Staff Services:** This division provides the administrative services necessary to direct and support all operations and functions of the Treasury Department including legal counsel, human resources, and legislative and internal audit functions. Representation and support to the various boards and commissions on which the Treasurer serves are also provided through this division.

**Division of Claims Administration:** The division is responsible for handling claims filed with the state including workers' compensation claims, claims against the state for negligent acts, and claims filed under the Criminal Injuries Compensation Program.

**Division of Risk Management:** The division is responsible for maintaining adequate insurance against damage or loss for all state-owned property through a combination of a self-insurance program and other insurance policies. This division is also responsible for providing a systematic program for the control and prevention of injuries and losses.

**Division of Unclaimed Property:** Under the Unclaimed Property Program, the state takes custody of abandoned property (bank accounts, insurance policies, utility deposits, etc.) and attempts to locate the rightful owners or their heirs. Until the owners claim the property, it is used for the benefit of all the citizens of the state. Property, or its monetary equivalent, is available to be claimed by owners at any future time.

**Baccalaureate Education System Trust:** This division is responsible for administration of the state's 529 college savings and prepaid plans.

**Small and Minority-Owned Business Assistance Program:** This program is responsible for supporting outreach to new, expanding, and existing businesses unable to derive benefit from conventional means of monetary resources and insight provided by traditional lenders and financial advisors.

**Division of Retirement:** This division administers the Tennessee Consolidated Retirement System, a defined benefit pension plan for teachers, higher education employees, state employees, and local government employees. It serves over 200,000 active members and 90,000 retirees with an annual payroll exceeding \$1 billion. The Tennessee Consolidated Retirement System is audited and reported on separately.

**Deferred Compensation:** This division oversees the administration of the State of Tennessee Deferred Compensation Program, which allows state employees to accumulate tax-deferred savings to supplement retirement income. In addition, the division oversees the operation of the Optional Retirement Program for higher education employees and the Old Age and Survivors Insurance Program.

**Investment Division:** This division has two primary functions: investing the \$32 billion pension fund to protect the assets of the system and maximize return, and managing and investing \$8 billion of the state's cash balances. These investments help finance, from non-tax sources, the various programs of state government.

**Accounting Division:** This division reconciles all state depository bank accounts, provides accounting support, and maintains subsidiary and general ledger accounting for programs administered by the Treasurer's Office, including the Tennessee Consolidated Retirement System, the Local Government Investment Pool, the Division of Claims Administration, and the Investments Division.

**Fiscal Services Division:** This division is responsible for coordinating the department's budget and for performing procurement, payroll, accounts payable, content management, communications, facilities management, remittance processing, funds transfer, and other administrative support functions.

**Information Systems:** The Information Systems Division is composed of an administrative unit that leads the planning, project management, policy recommendations, and

security for the department. The operations unit manages the network; supports the server, desktop hardware, and systems software; and operates the help desk. An additional unit focuses on support of mainframe operations, automation of job execution, file transfer, and back-end processes.

An organization chart for the Department of the Treasury is on the following page.

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## AUDIT SCOPE

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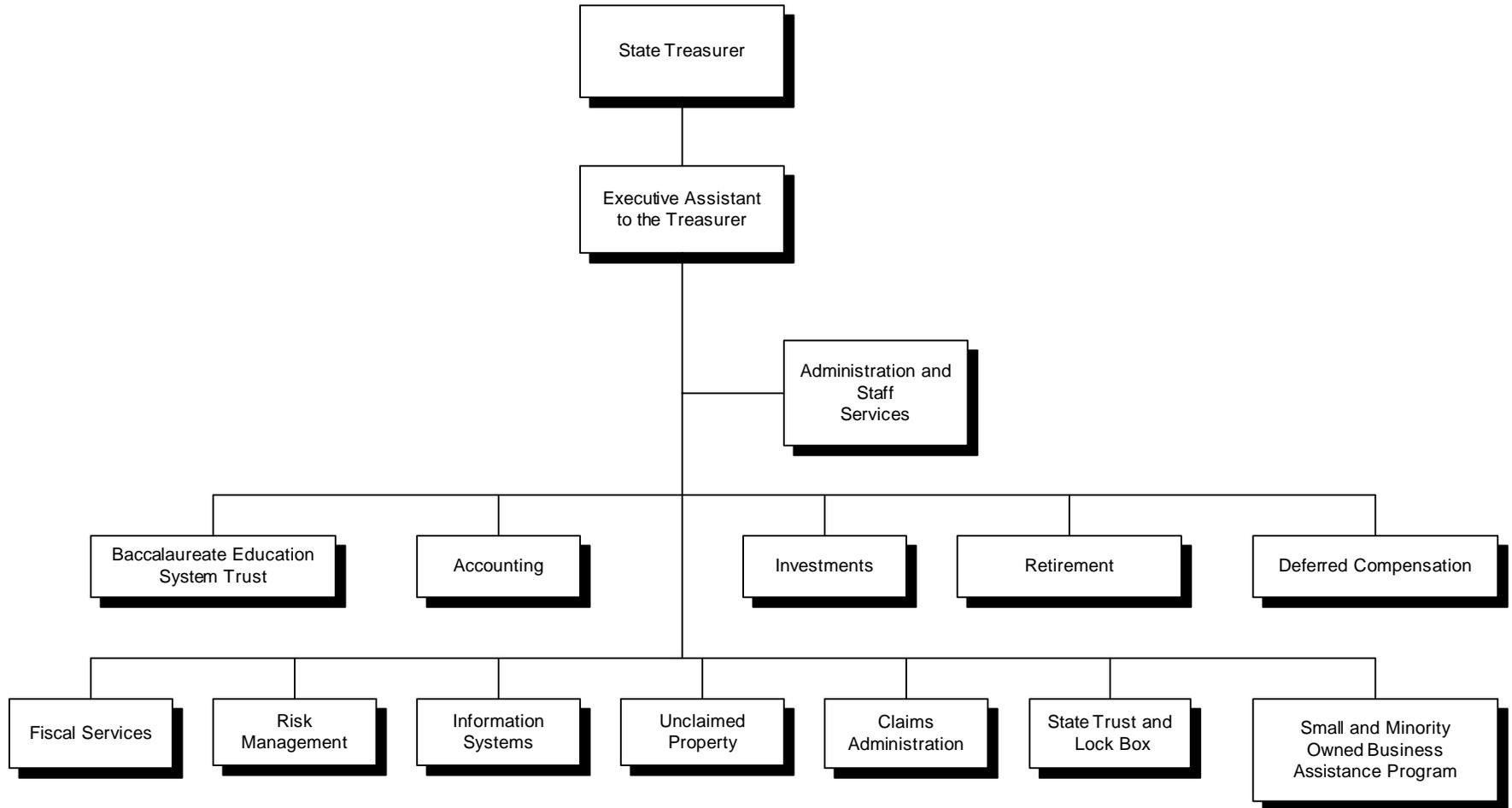
The audit was limited to the period July 1, 2006, through June 30, 2007, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The operations of the Department of the Treasury are accounted for in the general fund of the State of Tennessee. The department administers the Tennessee Consolidated Retirement System, pension trust funds; the Criminal Injuries Compensation Fund and the Small and Minority-Owned Business Assistance Program Fund, special revenue funds; the Risk Management Fund, an internal service fund; the Chairs of Excellence Fund, a permanent fund; the Baccalaureate Education System Trust-Educational Services Plan, a private-purpose trust fund; the Flexible Benefits Plan, an employee benefit trust fund; and the State Pooled Investment Fund, an external investment pool (which includes the Local Government Investment Pool).

This audit included all of the above funds except for the Tennessee Consolidated Retirement System, which is reported on in a separate audit report. The following allotment codes within the State of Tennessee Accounting and Reporting System were covered by this audit:

|  |        |
|--|--------|
| State Treasurer's Office                             | 309.01 |
| Certified Public Administrators                      | 309.02 |
| Small and Minority-Owned Business Assistance Program | 309.05 |
| Criminal Injuries Compensation                       | 313.03 |
| Risk Management Fund                                 | 313.10 |
| Unclaimed Property                                   | 313.20 |

# Department of the Treasury Organization Chart



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## OBJECTIVES OF THE AUDIT

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The objectives of the audit were

1. to consider the Department of the Treasury's internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing an opinion on the financial statements of the Baccalaureate Education System Trust-Educational Services Plan, the Chairs of Excellence Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, the Small and Minority-Owned Business Assistance Program Fund, and the State Pooled Investment Fund;
2. to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements;
3. to perform certain limited procedures at the Department of the Treasury as a part of our audit of the *Comprehensive Annual Financial Report* of the State of Tennessee for the year ended June 30, 2007; and
4. to recommend appropriate actions to correct any deficiencies.

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## PRIOR AUDIT FINDINGS

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There were no findings in the prior audit report.

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## OBSERVATIONS AND COMMENTS

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### MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the entity is protected from fraud, waste, and abuse. Since new programs may

be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the entity. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic. The assessment and the controls should be reviewed and approved by the head of the entity.

## **FRAUD CONSIDERATIONS**

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

## **TITLE VI OF THE CIVIL RIGHTS ACT OF 1964**

Section 4-21-901, *Tennessee Code Annotated*, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by October 1 each year. The agency filed its compliance report and implementation plan on October 1, 2007.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds. The Tennessee Title VI Compliance Commission is responsible for monitoring and enforcement of Title VI.

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## **RESULTS OF THE AUDIT**

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### **AUDIT CONCLUSIONS**

#### Internal Control

As part of the audit of the financial statements of the Baccalaureate Education System Trust-Educational Services Plan, the Chairs of Excellence Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, the Small and Minority-Owned Business Assistance Program Fund, and the State Pooled Investment Fund for the year ended June 30, 2007, we considered internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing an opinion on the financial statements, as required by auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Consideration of internal control over financial reporting disclosed no material weaknesses.

In addition to our audit of the financial statements of the funds noted above, we also performed certain limited procedures at the Department of the Treasury as a part of our audit of the *Comprehensive Annual Financial Report* of the State of Tennessee for the year ended June 30, 2007. The results of those procedures disclosed a significant deficiency, which is detailed in the Finding and Recommendation section of this report. For the complete results of our audit of the State of Tennessee, please see the State of Tennessee *Comprehensive Annual Financial Report* for the year ended June 30, 2007, and the State of Tennessee *Single Audit Report* for the year ended June 30, 2007.

Compliance and Other Matters

The results of our audit tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.



STATE OF TENNESSEE  
**COMPTROLLER OF THE TREASURY**  
DEPARTMENT OF AUDIT  
DIVISION OF STATE AUDIT

SUITE 1500  
JAMES K. POLK STATE OFFICE BUILDING  
NASHVILLE, TENNESSEE 37243-0264  
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**Report on Internal Control Over Financial Reporting and on  
Compliance and Other Matters Based on an Audit of  
Financial Statements Performed in Accordance With  
*Government Auditing Standards***

December 7, 2007

The Honorable John G. Morgan  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Baccalaureate Education System Trust-Educational Services Plan, the Chairs of Excellence Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, the Small and Minority-Owned Business Assistance Program Fund, and the State Pooled Investment Fund as of and for the year ended June 30, 2007, and have issued our reports thereon dated December 7, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the department's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the

The Honorable John G. Morgan  
December 7, 2007  
Page Two

United States of America such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

However, we noted certain matters involving the internal control over financial reporting, which we have reported to the department's management in a separate letter.

#### Compliance and Other Matters

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the department's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We did, however, note certain less significant instances of noncompliance, which we have reported to the department's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee, the audit committees, management, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,



Arthur A. Hayes, Jr., CPA  
Director

AAH/ajm

## **FINDING AND RECOMMENDATION**

### **Controls over abandoned property records are inadequate, thus increasing the risk of fraudulent payments**

#### **Finding**

Tennessee statutes set out several responsibilities for the Department of the Treasury regarding intangible property that has been abandoned and subsequently transferred to the custody of the department. Treasury is responsible for the safekeeping of abandoned property (Section 66-29-116, *Tennessee Code Annotated*). Treasury also has a responsibility to determine that claims for this property by apparent owners are valid before paying them (Section 66-29-123) and to notify the apparent owners of the property using the last known name and address (Section 66-29-114[a]). Each of these responsibilities requires that Treasury ensure the accuracy of records pertaining to all abandoned property, particularly with respect to key data such as owner name, address, social security number, and value of the property transferred. The amount of abandoned property in the custody of Treasury at June 30, 2007, exceeded \$346,000,000.

During the audit period, the Department of the Treasury, Division of Unclaimed Property, did not have controls pertaining to abandoned property that would be likely to prevent or detect unauthorized alterations of the files containing the original property data. The opportunity existed for individuals to make unauthorized changes to key elements of property records (such as owner name, address, social security number, and dollar value of property). Unauthorized changes made to property records could result in the payment of fraudulent claims and would hamper the division's efforts to locate the correct owners of the property.

Controls to prevent or detect tampering with the reports electronically submitted by holders of abandoned property have been inadequate. If an individual had made unauthorized changes to these reports, it is unlikely that controls would have detected them. Just as importantly, there was no control in place to secure the data contained in the original file sent by the reporting entity in such a way as to enable an individual to later compare the original data transmitted to the data that existed in Wagers, which is the system used to manage abandoned property data.

The lack of such a control is particularly important since there has been only limited control over changes which might be made later, after the data have been loaded into the Wagers system. On occasion, Treasury personnel receive corrections and revisions to the original reports submitted. As part of their normal duties, they will edit the property data that have already been entered into Wagers and revise it based on correcting documentation that has been submitted. Wagers does not, however, track changes made to property records. Thus, an individual could make unauthorized changes to the owner and address fields of property records without that change being recognized in Wagers as a change. Management is unable to generate any sort of report from the system which will identify changes made to records (such as all edits to owner names, addresses, and social security numbers).

During the audit period, management became aware of these control deficiencies from their own risk assessment. Management proceeded to take corrective measures to the extent practical at the time. Newly established procedures require that for any change made to data already loaded into Wagers, two individuals must be involved. Access to Wagers has been segregated such that no one individual has the ability to both “unclear” a record (make that record available for edit) and make the actual change. However, management has not yet been able to establish a control to prevent or detect unauthorized changes made to data prior to its entry into Wagers.

In response to the increased risks of fraud noted above, we performed a limited review of property records, searching for indications that ownership data had been altered. Specifically, we requested records from Wagers for the last three fiscal years and considered the reasonableness of any claim payments in which a single claimant received property from ten or more property holders. While there were numerous payments meeting this criteria, none stood out as particularly suspicious. We also chose a sample of original electronic property reports and compared selected records to data in Wagers. We did not encounter any records in Wagers that did not match original reports. As discussed above, however, such a review is unlikely to detect unauthorized changes made to the original property report files themselves. In an attempt to identify any owner or property value data that may have been changed from the original data file, we designed a test to confirm directly with the original property holder key owner data (name, tax ID number, property value, etc.) for selected paid claims. We requested and received assistance from Treasury’s Internal Audit staff in this confirmation process. No discrepancies were discovered.

### **Recommendation**

Management identified these control weaknesses through its risk assessment process and subsequently began to remedy them. In order to address the potential for tampering with property data files, management has contacted the vendor for the Wagers database software and requested that a mechanism be developed that would allow property holders to submit encrypted or secured reports using a secure website. Although the data could be previewed before being loaded into Wagers, key data would not be accessible for editing. If numerous errors were detected in the file, the entire report would be rejected prior to being loaded into Wagers, and appropriate personnel would request a corrected version from the holder who submitted the report. Once this mechanism is in place, Unclaimed Property should require that all property reports submitted electronically be submitted via the website. We recommend that, whatever the mechanism, the division ensure the integrity of the original data submitted by property holders. This data should also be maintained so as to enable a reviewer to compare the information in Wagers to the information originally submitted.

Since Treasury personnel will sometimes need to edit property data that have already been loaded into the Wagers system, management has also contacted the software vendor with a request that a tracking system be implemented that will allow management to monitor all

changes made to data. Management intends to use this tracking system to enable an individual not involved in the report receipting process to review all changes made to property records. We recommend that management continue its efforts to implement a tracking system and a procedure for review of changes to property data. However, we reiterate that the value of any procedure to match changes against source documentation will depend largely on the integrity of the source documentation. Management should ensure that the documentation supporting changes to property records—whether submitted electronically or not—is maintained securely.

### **Management's Comment**

Management concurs. The Unclaimed Property Division completed an internal risk assessment in June 2007 and identified the internal control issues that were outlined in this audit report. Management immediately began the process of identifying possible solutions and evaluating the effectiveness of the various solutions. After determining the most effective set of solutions that would resolve the control issues, management submitted a request to implement the solutions to the third party vendor that developed the unclaimed property system we are using. This same system is used in a majority of state unclaimed property programs which are facing the same control issues. We have emphasized the urgency to implement these changes to our third party vendor and requested that these modifications be completed as quickly as possible. Once these modifications are made to the software, the internal control issues will be resolved.