AUDIT REPORT

Tennessee Regulatory Authority

October 2008

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

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STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

State Capitol
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John G. Morgan
Comptroller

October 14, 2008

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Tre Hargett, Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Regulatory Authority for the period March 1, 2005, through June 30, 2008.

The review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements resulted in no audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/ddb
08/071

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July 2, 2008

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

Dear Mr. Morgan:

We have conducted a financial and compliance audit of selected programs and activities of the Tennessee Regulatory Authority for the period March 1, 2005, through June 30, 2008.

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Management of the Tennessee Regulatory Authority is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts and grant agreements.

Our audit resulted in no audit findings. We have reported less significant matters involving the authority's internal control and instances of noncompliance to the Tennessee Regulatory Authority's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/ddb

State of Tennessee

Audit Highlights

Comptroller of the Treasury | Division of State Audit

Financial and Compliance Audit
Tennessee Regulatory Authority
October 2008

AUDIT SCOPE

We have audited the Tennessee Regulatory Authority for the period March 1, 2005, through June 30, 2008. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements in the areas of revenue, expenditures, equipment, payroll and personnel, conflicts of interest, and the Financial Integrity Act. The audit was conducted in accordance with generally accepted government auditing standards.

AUDIT FINDINGS

The audit report contains no findings.

Financial and Compliance Audit
Tennessee Regulatory Authority

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Financial and Compliance Audit
Tennessee Regulatory Authority

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Tennessee Regulatory Authority. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which requires 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."

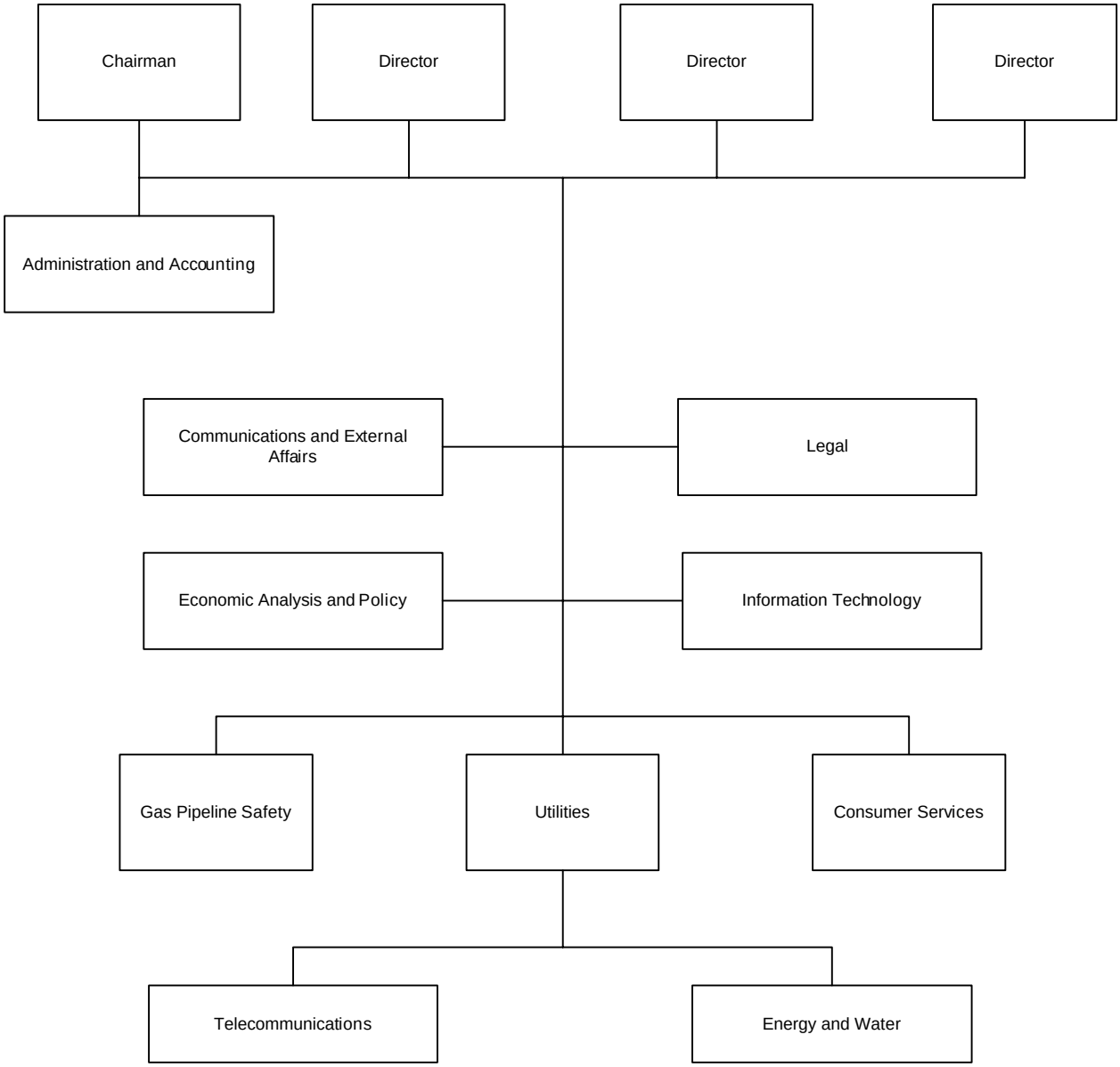
Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The Tennessee Regulatory Authority is governed by four directors. One is appointed by the Governor, one by the Speaker of the Senate, one by the Speaker of the House of Representatives, and one by joint agreement among the Governor, the Speaker of the Senate, and Speaker of the House of Representatives. Each director serves a six-year term. One director serves as the chairman of the authority. This position is rotated annually between the four commissioners. One of the duties of the chairman is to serve as the chief operating officer. The authority has jurisdiction over public utilities including electric companies, telephone companies, water companies, and natural gas companies. This jurisdiction includes approving all rates; auditing the utilities' compliance with applicable laws, orders, and policies of the authority; and inspecting natural gas pipelines.

An organization chart of the authority is on the following page.

Tennessee Regulatory Authority
Organization Chart



AUDIT SCOPE

We have audited the Tennessee Regulatory Authority for the period March 1, 2005, through June 30, 2008. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements in the areas of revenue, expenditures, equipment, payroll and personnel, conflicts of interest, and the Financial Integrity Act. The audit was conducted in accordance with generally accepted government auditing standards.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Tennessee Regulatory Authority filed its report with the Department of Audit on December 14, 2007. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the Tennessee Regulatory Authority has corrected previous audit findings concerning segregation of duties, coding of equipment purchases, incomplete personnel records, inadequate monitoring of temporary employees receiving retirement benefits, outdated conflict-of-interest policy, and Title VI plan submission.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

REVENUE

Our objectives for reviewing revenue internal controls and procedures were to determine whether

- significant variances in the annual amount of the various fees and penalties collected were adequately explained;
- revenue transactions were properly supported, approved, recorded, and reconciled in the accounting system; and

- cash and checks collected during the audit were deposited timely and intact.

We interviewed key authority personnel and reviewed supporting documentation to gain an understanding of the authority's internal controls and procedures over revenue. We compared collections for each fee and penalty type for the prior four fiscal years, and obtained and verified explanations from management for any significant variances. We selected a nonstatistical sample of revenue transactions from the State of Tennessee Accounting and Reporting System (STARS) for the period March 1, 2005, through February 29, 2008, to determine whether the revenue transactions were properly supported, approved, and recorded. We also reviewed a reconciliation of the authority's revenue records with the STARS monthly revenue reports. Sample items were also tested to determine whether cash and checks were deposited timely and intact.

Based on our comparison of fee and penalty collections, we determined that significant variances were adequately explained. We determined that revenue transactions were properly supported, approved, recorded, and cash and checks were deposited timely and intact. Based on our review of the reconciliation process, we determined that the revenue recorded on the authority's records reconciled with the STARS reports.

EXPENDITURES

Our objectives for reviewing expenditure internal controls and procedures were to determine whether

- access to the State of Tennessee Accounting and Reporting System (STARS) and the State of Tennessee On-Line Purchasing System (TOPS) was properly restricted;
- expenditure transactions were properly supported, approved, recorded, and reconciled in the accounting system;
- payments were made in a timely manner;
- expenditures complied with applicable policies and procedures;
- expenditures for travel complied with the Comprehensive Travel Regulations;
- contracts were established in accordance with purchasing guidelines, and contract payments complied with contract terms;
- cellular phone use was in agreement with the authority's policies and procedures;
- payment card use was in compliance with the *State of Tennessee State Payment Card Manual* and the purchases were adequately supported, approved, and were reasonable and necessary for conducting state business;
- authority voucher registers were reconciled to the Department of Finance and Administration reports; and

- federal grants were recorded in accordance with Department of Finance and Administration's Policy 20, *Recording of Federal Grant Expenditures and Revenues*.

We reviewed applicable policies and procedures, interviewed key authority personnel, and reviewed supporting documentation to gain an understanding of the authority's internal controls over expenditures. We reviewed the STARS and TOPS security files to determine which employees were recognized users. We reviewed all users to determine whether these employees' levels of access properly related to their job duties. We selected a nonstatistical sample of expenditures for the period March 1, 2005, through February 29, 2008, to determine whether expenditure transactions were properly supported, approved, and recorded; payments were made in a timely manner; and expenditures complied with applicable policies and procedures. Sample items related to travel were tested for compliance with the Comprehensive Travel Regulations, and sample items related to contract payments were tested for compliance with contract terms and purchasing guidelines. We interviewed key authority personnel and reviewed cellular phone bills for June 2005, July 2006, August 2007, and January 2008 to determine that calls and charges were in accordance with the authority's policies and procedures. We reviewed the applicable rules and regulations, interviewed key authority personnel, and reviewed supporting documentation to gain an understanding of the controls and procedures over payment cards. We selected a nonstatistical sample of payment card purchases for the period March 21, 2005, through January 15, 2008, to determine whether purchases were properly supported, approved, and reasonable and necessary for conducting state business. In addition, while performing testwork on the original sample of payment card purchases, we noted unusual vendors and vendors who sold goods that were readily available on statewide contract. Reconciliation procedures were discussed with management, and we compared the authority's expenditures records with the STARS reports. A reconciliation of voucher registers with the Department of Finance and Administration's STARS reports was also reviewed to determine if any unusual reconciling items were identified. We reviewed the authority's revenues and expenditures for the Gas Pipeline Safety grant to ensure they were in compliance with Policy 20.

Based on our review of the STARS and TOPS security files, we determined that all users were employees and that these employees' levels of access appeared reasonable based on their job duties. The expenditure items tested in our sample were properly supported, approved, and recorded; payments were made in a timely manner; and expenditures complied with applicable rules and regulations. Expenditure items in the sample related to travel were made in compliance with the Comprehensive Travel Regulations, and items related to contract payments were made in compliance with contract terms and purchasing guidelines. Cellular phone calls and usage were in compliance with the authority's policies and procedures. Based on our interviews and examinations of supporting documentation, we determined that payment card purchases were adequately supported, approved, and appeared to be reasonable and necessary for conducting state business. The authority's expenditure records reconciled with STARS reports. No unusual items were identified during the review of a reconciliation of voucher registers with the Department of Finance and Administration's STARS reports. Revenues and expenditures for the Gas Pipeline Safety grant were recorded in accordance with Policy 20.

EQUIPMENT

Our objectives for reviewing equipment internal controls and procedures were to determine whether

- access to the Property of the State of Tennessee (POST) system was properly restricted;
- equipment on the POST inventory listing could be physically located;
- description, tag number, serial number, and locations recorded in POST were correct;
- proper procedures were followed for equipment that was lost or stolen; and
- equipment and sensitive item expenditures were properly recorded in the State of Tennessee Accounting and Reporting System (STARS) and recorded in POST.

We interviewed key authority personnel and reviewed supporting documentation to gain an understanding of the authority's internal controls over equipment including those related to lost or stolen equipment. We reviewed the POST security file to determine which employees were recognized users and to determine whether these employees' levels of access properly related to their job duties. We selected a nonstatistical sample of equipment purchases for the period March 1, 2005, through February 29, 2008, from STARS to determine whether the equipment item could be physically located and whether the description, tag number, serial number, and location recorded in POST were correct. In addition, we determined whether the equipment items were properly recorded in STARS. We examined the documentation of the one item that was lost during the audit period to determine if proper procedures were followed for lost or stolen equipment. We also randomly selected equipment from the authority's location to determine whether the equipment had been recorded in POST.

Based on our review of the POST security file and users' job duties, recognized users were employees and their levels of access appeared reasonable based on their job duties. Based on our nonstatistical sample of equipment purchases, equipment was physically located and the description, tag number, serial number, and location in POST were correct, and equipment purchases were correctly recorded in STARS. Proper procedures were followed for lost or stolen equipment. Based on our randomly selected equipment items from the authority's location, equipment had been recorded in POST.

PAYROLL AND PERSONNEL

Our objectives for reviewing payroll and personnel internal controls and procedures were to determine whether

- access to the State Employee Information System (SEIS) was properly restricted;
- gross pay agreed with personnel records, deductions were properly supported, salaries were charged to the proper cost center, time records were signed by the employee and

approved by the supervisor, and leave was accrued and taken in accordance with applicable guidelines;

- newly hired employees or employees who changed positions during the audit period met the qualifications for the jobs held, civil service employees were hired from the appropriate list, the initial wage was within the salary range, and the amount paid was properly computed;
- final pay for employees terminated during the audit period was properly computed, and the employee did not appear on the next succeeding payroll register;
- supplemental pay transactions were reasonable, supported, and properly approved; and
- the guidelines in Section 8-36-805, *Tennessee Code Annotated*, were followed for employees who were Tennessee Consolidated Retirement System (TCRS) retirees.

We interviewed key authority personnel and reviewed supporting documentation to gain an understanding of the authority's internal controls over payroll and personnel. We reviewed the SEIS security files to determine which employees were recognized users and to determine whether these employees' levels of access properly related to their job duties. We selected a sample of payroll transactions for the period March 1, 2005, through March 31, 2008, from SEIS to determine whether gross pay agreed with personnel records, deductions were properly supported, salaries were charged to the proper cost center, time records were signed by the employee and approved by the supervisor, and leave was accrued and taken in accordance with applicable guidelines. Additionally, we reviewed the personnel files to determine whether newly hired employees or employees who changed positions during the audit period met the qualifications for the jobs held, civil service employees were hired from the appropriate list, the initial wage was within the salary range, and the amount paid was properly computed. For employees included in the sample who terminated employment, we reviewed the final pay calculation and the subsequent payroll register to determine whether final pay was properly computed and the employee did not appear on the next succeeding payroll register. We selected a sample of supplemental pay transactions for the period March 1, 2005, through March 31, 2008, to determine whether the transactions were reasonable, supported, and properly approved. Finally, we interviewed the personnel director and reviewed personnel files to determine whether guidelines in Section 8-36-805, *Tennessee Code Annotated*, regarding employees who are TCRS retirees were followed by the authority.

Based on our review of the SEIS security files, we determined that recognized users were current employees and their levels of access appeared reasonable based on their job duties. Our sample of payroll transactions indicated that gross pay agreed with personnel records, deductions were properly supported, salaries were charged to the proper cost center, and leave was accrued and taken in accordance with applicable guidelines. Based on our sample testwork and our review of administrative time records, we determined that time records were signed by the employee and approved by the supervisor. Our review of the personnel files indicated newly hired employees or employees who changed positions during the audit period met the qualifications for the jobs held, civil service employees were hired from the appropriate list, the initial wage was within the salary range, and the amount paid was properly computed. Testwork

indicated that the final pay for employees included in the sample who terminated employment during the audit period was properly computed, and the terminated employees did not appear on the next succeeding payroll register. Our review of supplemental pay indicated supplemental pay transactions were reasonable, supported, and properly approved. Finally, our review of personnel files and discussions with the personnel director indicated that the guidelines related to retired employees in Section 8-36-805, *Tennessee Code Annotated*, were followed.

CONFLICTS OF INTEREST

Our objective in reviewing the conflict-of-interest policies and procedures was to determine whether the policies and procedures were followed and were in compliance with state law.

We interviewed key authority personnel, reviewed supporting documentation to gain an understanding of the authority's policies and procedures, and reviewed the applicable state law regarding conflicts of interest. We examined conflict-of-interest forms for all directors; individuals involved in obtaining, approving, and overseeing contracts; and gas pipeline safety inspectors.

Based on our review, we determined that the authority has a conflict-of-interest policy for its employees and it complies with state law. No potential conflicts of interest were noted from the review of the conflict-of-interest forms.

FINANCIAL INTEGRITY ACT

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to submit a letter acknowledging responsibility for maintaining the internal control system of the agency to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30 each year. In addition, the head of each executive agency is required to conduct an evaluation of the agency's internal accounting and administrative control and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

Our objectives were to determine whether

- the authority's June 30, 2007; June 30, 2006; and June 30, 2005, responsibility letters and December 31, 2007, internal accounting and administrative control report were filed in compliance with Section 9-18-104, *Tennessee Code Annotated*;
- documentation to support the authority's evaluation of its internal accounting and administrative control was properly maintained;
- procedures used in compiling information for the internal accounting and administrative control report were in accordance with the guidelines prescribed under Section 9-18-103, *Tennessee Code Annotated*; and

- corrective actions have been implemented for weaknesses identified in the report.

We interviewed key employees responsible for compiling information for the internal accounting and administrative control report to gain an understanding of the authority's procedures for complying with Section 9-18-104, *Tennessee Code Annotated*. We reviewed the June 30, 2007; June 30, 2006; and the June 30, 2005 responsibility letters and the documentation supporting the December 31, 2007, internal accounting and administrative control report to determine whether they had been properly submitted to the Comptroller of the Treasury and the Department of Finance and Administration. We also reviewed the procedures used in compiling information for the December 31, 2007, internal accounting and administrative control report to determine if they were in accordance with the guidelines prescribed under Section 9-18-103, *Tennessee Code Annotated*. To determine if corrective action plans had been implemented, we interviewed management and reviewed corrective action for the weaknesses identified in the report.

We determined that the Financial Integrity Act responsibility letters and internal accounting and administrative control report were submitted on time except for the June 30, 2006, letter which was submitted on July 11, 2006; support for the internal accounting and administrative control report was properly maintained; and procedures used were in compliance with *Tennessee Code Annotated*. Corrective actions had been implemented for weaknesses identified in the report.

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 beginning with the Title VI compliance report and implementation plan due in 2007. Prior to 2007, the Title VI compliance report and implementation plan was due by June 30 each year. The Tennessee Regulatory Authority filed its compliance reports and implementation plans on October 31, 2007; June 30, 2006; and June 30, 2005. The October 1, 2007, report was submitted 30 days late.

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. A summary of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report Submission of Title VI Implementation Plans, issued annually by the Comptroller of the Treasury.

OBSERVATIONS AND COMMENTS

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.

APPENDIX

ALLOTMENT CODES

The Tennessee Regulatory Authority has one division and allotment code: 316.11.