

AUDIT REPORT

Department of the Treasury

For the Year Ended
June 30, 2010



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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

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May 17, 2011

Members of the General Assembly
and
Members of the Board of Trustees
Baccalaureate Education System Trust
and
Members of the Board of Trustees
Chairs of Excellence Trust
and
Members of the Board of Claims
and
Members of the State Funding Board
and
The Honorable David H. Lillard, Jr., 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, 2010.

Consideration of internal control over financial reporting and tests of compliance resulted in no audit findings.

Sincerely,

A handwritten signature in black ink, reading "Arthur A. Hayes, Jr." in a cursive script.

Arthur A. Hayes, Jr., CPA
Director

AAH/tlh
11/018

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, 2010

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 opinions 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, 2010; and to recommend appropriate actions to correct any deficiencies.

AUDIT FINDINGS

The audit report contains no findings.

Audit Report
Department of the Treasury
For the Year Ended June 30, 2010

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Department of the Treasury For the Year Ended June 30, 2010

INTRODUCTION

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 Assistance Program; administering the Chairs of Excellence Trust; 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 School Bond Authority
State Teacher Insurance Committee
State Trust of Tennessee
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
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. 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 prepaid plan.

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 214,000 active members and 112,000 retirees with an annual payroll exceeding \$1.5 billion. The Tennessee Consolidated Retirement System is audited and reported on separately.

Deferred Compensation Division: 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 \$28.5 billion pension fund to protect the assets of the system and maximize return, and managing and investing \$7 billion of state and local government cash balances. These investments help finance, from non-tax sources, the various programs of state and local governments.

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.

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

Information Systems Division: This 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 servers, 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.

AUDIT SCOPE

The audit was limited to the period July 1, 2009, through June 30, 2010, 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 generally accepted government auditing standards.

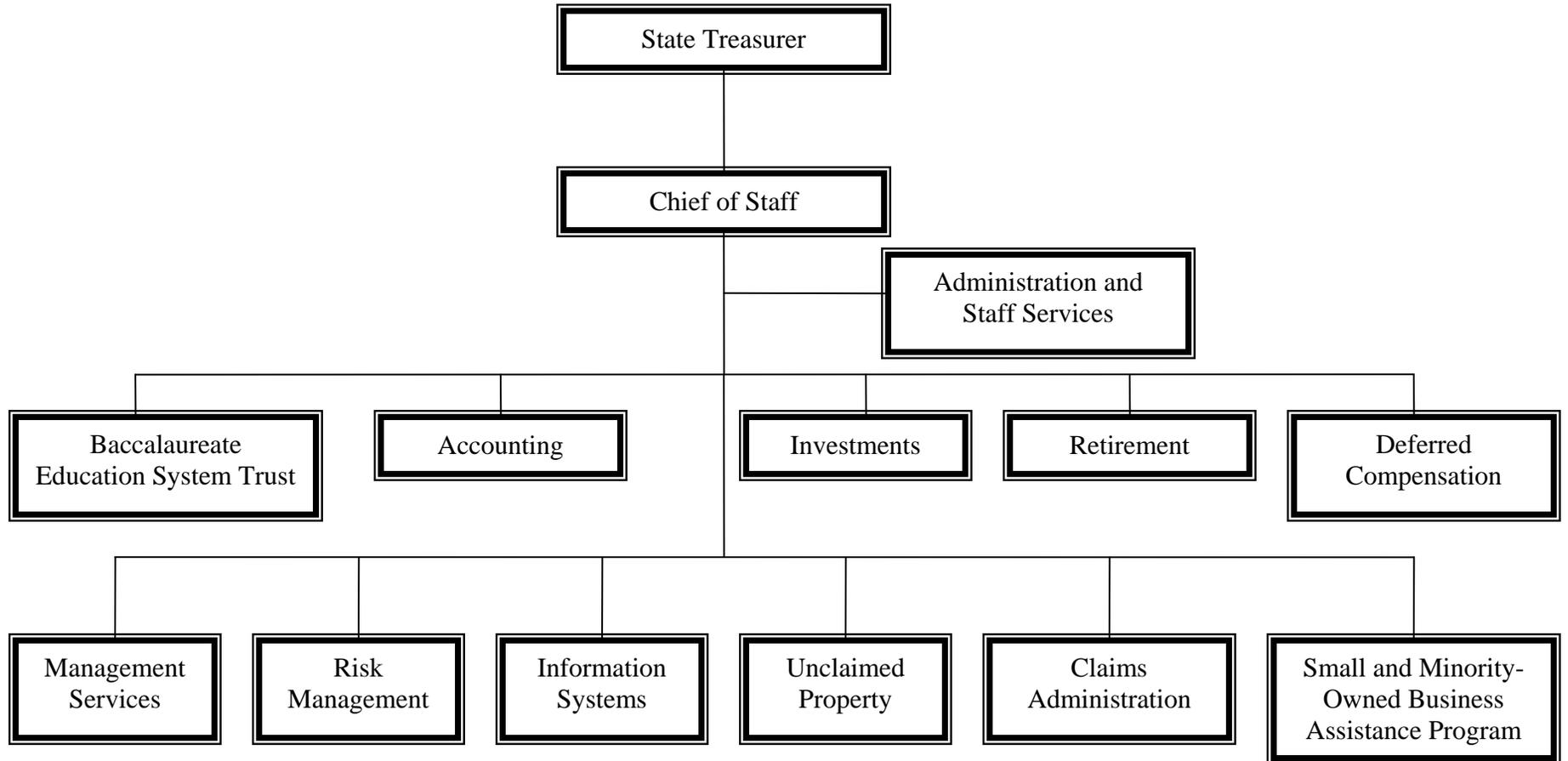
The operations of the Department of the Treasury are accounted for in the general fund of the State of Tennessee. The department administers the Tennessee Consolidated Retirement System, pension trust funds; the Criminal Injuries Compensation Fund and the Small and Minority-Owned Business Assistance 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.

OBJECTIVES OF THE AUDIT

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 opinions 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, 2010; and

Department of the Treasury
Organization Chart



4. to recommend appropriate actions to correct any deficiencies.

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 department filed its report with the Department of Audit on November 23, 2010. A follow-up of the prior audit findings was conducted as part of the current audit.

The current audit disclosed that the department has corrected the previous audit findings concerning inadequate controls over certain outgoing wire transactions and inadequate monitoring of Small and Minority-Owned Business Assistance Program loan funds.

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.

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 department filed its compliance report and implementation plan on October 29, 2010.

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.

RESULTS OF THE AUDIT

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, 2010, we considered internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing opinions 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 generally accepted government auditing standards. 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, 2010. For the complete results of our audit of the State of Tennessee, please see the *Tennessee Comprehensive Annual Financial Report* for the year ended June 30, 2010, and the *State of Tennessee Single Audit Report* for the year ended June 30, 2010.

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 generally accepted government auditing standards.



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

March 28, 2011

Members of the General Assembly
and
Members of the Board of Trustees
Baccalaureate Education System Trust
and
Members of the Board of Trustees
Chairs of Excellence Trust
and
Members of the Board of Claims
and
Members of the State Funding Board
and
The Honorable David H. Lillard, Jr., Treasurer
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

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, 2010, and have issued our reports thereon dated March 28, 2011. 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 generally accepted government auditing standards.

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 opinions 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 *deficiency in internal control* 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 and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, 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.

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 generally accepted 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/tlh