

Department of the Treasury

**For the Year Ended
June 30, 1997**

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January 13, 1998

Members of the General Assembly
and
The Honorable Steve Adams, 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, 1997.

Consideration of the 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.

Very truly yours,

W. R. Snodgrass
Comptroller of the Treasury

WRS/th
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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, 1997

AUDIT OBJECTIVES

The objectives of the audit were to consider the Department of the Treasury's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the general-purpose financial statements of the State of Tennessee and the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Local Government Investment Pool, the Flexible Benefits Plan, the Deferred Compensation Fund, the Baccalaureate Education System Trust, and the Bond Refunding Fund; to determine compliance with laws, regulations, contracts, and grants; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDING

Bank Collateral Pool Lacks Sufficient Controls

The Bank Collateral Pool board failed to develop written rules and procedures to ensure the accuracy of public deposits reported by participating banks (page 10).

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit
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Audit Report
Department of the Treasury
For the Year Ended June 30, 1997

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Department of the Treasury For the Year Ended June 30, 1997

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.

LEGISLATIVE HISTORY

The State Treasurer, a constitutional officer, is elected by a joint session of the General Assembly for a two-year term. Although no duties are prescribed by the constitution, the functions and duties of the office are assigned through various statutes. These functions and duties include maintaining accountability for and management of public funds and administering the Tennessee Consolidated Retirement System, the Local Government Investment Pool, the Uniform Disposition of Unclaimed Property Act, the Criminal Injuries Compensation Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust, and the state’s Deferred Compensation and Flexible Benefits Plans. The Treasurer also administers the settlement of claims against the state through the Tennessee Claims Commission and the Division of Claims Administration.

The Treasurer is required by statute to be a member of many boards and commissions, including the following:

Board of Equalization
Board of Trustees of the Tennessee Consolidated Retirement System
Funding Board
Public Records Commission
State Building Commission
State Insurance Committee
State School Bond Authority

Tennessee Competitive Export Corporation
Tennessee Housing Development Agency
Tennessee Local Development Authority
Tennessee Student Assistance Corporation

ORGANIZATION

The department is divided into nine major sections: Staff Services, Investments, Financial Control, Information Systems, Management Services, Tennessee Consolidated Retirement System (TCRS), Accounting, Unclaimed Property/Claims Administration, and Risk Management. The TCRS is audited and reported on separately.

The **Staff Services** section includes personnel administration, budgeting and fiscal control, research and development of special projects, internal audit, and legal services.

The **Investments** section invests the pension fund to maximize the return on investments and to protect the retirement system's assets. This section also invests the state's available cash in certificates of deposit in state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, various U. S. Treasury and agency obligations, and certain obligations of the State of Tennessee.

The **Financial Control** section is responsible for maintaining general ledger accounting and reporting for the Tennessee Consolidated Retirement System, the Chairs of Excellence Program, the Local Government Investment Pool, and the Cash Management Investment Program. The section is also responsible for reconciling approximately 200 bank accounts and maintaining the state's warrant reconciliation system (Account Reconciliation Package, or ARP).

The **Information Systems** section provides the department with data processing services, and **Management Services** provides centralized services, including physical facilities management, forms control and copying, safekeeping, remittance receiving, and operation of the Federal Reserve wire transfer facility used to send, receive, and transfer funds for the State Trust of Tennessee.

The **Accounting** section is responsible for maintaining detailed accounting records for all divisions of the department. The **Unclaimed Property/Claims Administration** section takes custody of abandoned property (bank accounts, insurance policies, etc.) and attempts to locate the rightful owners or heirs. The Division of Claims Administration administers the Workers' Compensation program for state employees and the Criminal Injuries Compensation Fund. The division reviews and determines eligibility for payment from the Criminal Injuries Compensation Fund. Payments are made as funds become available.

The **Risk Management** section administers a variety of insurance programs for the state. These programs provide protection to the state against property damage, boiler explosion, and employee dishonesty.

An organization chart of the department is presented on the following page.

AUDIT SCOPE

The audit was limited to the period July 1, 1996, through June 30, 1997, and was conducted in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The Department of the Treasury is part of the primary government of the State of Tennessee and is accounted for in the general fund. The department administers the Tennessee Consolidated Retirement System, a pension trust fund; the Criminal Injuries Compensation Fund, a special revenue fund; the Claims Award Fund, an internal service fund; the Chairs of Excellence Fund, a nonexpendable trust fund; the Local Government Investment Pool, the Baccalaureate Education System Trust and the Flexible Benefits Plan, expendable trust funds; and the Deferred Compensation Fund and Bond Refunding Fund, agency funds.

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 divisions and allotment codes within the State of Tennessee Accounting and Reporting System were covered by this audit:

State Treasurer's Office	309.01
Unclaimed Property	309.04
Criminal Injuries Compensation	313.03
Claims Award Fund	313.10

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the Department of the Treasury's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the general-purpose financial statements of the State of Tennessee and the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Local Government Investment Pool, the Baccalaure-

ate Education System Trust, the Flexible Benefits Plan, the Deferred Compensation Fund, and the Bond Refunding Fund;

2. to determine compliance with laws, regulations, contracts, and grants; and
3. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, “Audits of States, Local Governments, and Non-Profit Organizations,” it included tests of compliance with applicable federal laws and regulations and consideration of internal control used in administering federal financial assistance programs. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and OMB Circular A-133.

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 of the Treasury filed its report with the Department of Audit on June 17, 1997. A follow-up of the prior audit finding was conducted as part of the current audit.

REPEATED AUDIT FINDING

The current audit disclosed that the Department of the Treasury has not corrected the previous audit finding concerning controls over the Bank Collateral Pool. This finding is repeated in this report.

OBSERVATIONS AND COMMENTS

Tennessee Code Annotated, Section 4-21-901, 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 June 30, 1994, and each June 30 thereafter. For the year ending June 30, 1997, the Department of the Treasury filed its compliance report and implementation plan on December 30, 1997.

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 ground of race, color, or national 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 State Planning Office in the Executive Department was assigned the responsibility of serving as the monitoring agency for Title VI compliance, and copies of the required reports were filed with the State Planning Office for evaluation and comment. However, the State Planning Office has been abolished. The Office of the Governor is currently evaluating which office in the executive branch will be the new monitoring agency.

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.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the general-purpose financial statements of the State of Tennessee and the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Local Government Investment Pool, the Baccalaureate Education System Trust, the Flexible Benefits Plan, the Deferred Compensation Fund, and the Bond Refunding Fund for the year ended June 30, 1997, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the state's financial statements as required by generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. A reportable condition, along with a recommendation and management's response, is detailed in the finding and recommendation. Consideration of internal control disclosed no material weaknesses.

Compliance

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

**Report on Compliance and on Internal Control Over Financial Reporting
Based on an Audit of the Financial Statements
Performed in Accordance With *Government Auditing Standards***

December 17, 1997

The Honorable W. R. Snodgrass
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the general-purpose financial statements of the State of Tennessee and the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Local Government Investment Pool, the Baccalaureate Education System Trust, the Flexible Benefits Plan, the Deferred Compensation Fund, and the Bond Refunding Fund, as of and for the year ended June 30, 1997, and have issued our reports thereon dated December 17, 1997. The Department of the Treasury and the funds it administers are part of the primary government of the State of Tennessee.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

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 grants, 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 that are required to be reported herein under *Government Auditing Standards*.

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

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable condition was noted:

- Bank Collateral Pool lacks sufficient controls

This condition is described in the Finding and Recommendation section of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

We also noted other matters involving the internal control over financial reporting that we have reported to the department's management in a separate letter.

The Honorable W. R. Snodgrass
December 17, 1997
Page Three

This report is intended for the information of the General Assembly of the State of Tennessee and management. However, this report is a matter of public record, and its distribution is not limited.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/th

FINDING AND RECOMMENDATION

Collateral Pool lacks sufficient controls

Finding

In 1990, the Collateral Pool was established to allow financial institutions and local governments statewide to participate in a collateral pool to provide an effective, efficient, low-risk system of collateralizing public funds. *Tennessee Code Annotated* prescribed the formation of a board to oversee the operations of the pool and attached the board, for administrative purposes, to the Department of the Treasury. The department began administering the pool in November 1995. Currently, the pool has approximately 42 participating financial institutions.

The previous audit indicated that the department was not confirming the amount of public funds deposited in participating pool financial institutions and, therefore, could not ensure that adequate collateral was pledged. Management concurred with the audit finding and stated that the Collateral Pool Board would develop new procedures for confirming the amount of public deposits in financial institutions participating in the pool. However, the Collateral Pool Board has not developed these new procedures. As a result, the department has no procedures for confirming the amount of public funds deposited in participating pool financial institutions.

If a collateral pool member financial institution becomes insolvent, the other pool members are assessed for any deficiency of collateral of the insolvent member. The amount of the assessment is designed to make the public depositors whole. As a result, the risk of loss to a collateral pool member is increased if other pool members have not pledged collateral at the required target level.

Recommendation

The Collateral Pool Board, in conjunction with the department, should develop and implement written procedures to confirm the amount of public funds deposited in participating pool financial institutions. The Collateral Pool Board should consider requiring the participating financial institutions to provide an annual certification from an independent certified public accountant attesting to the accuracy of the monthly reports received during the fiscal year. Or, the board could consider having the department perform audits of participating financial institutions to ensure the accuracy of the monthly reports.

Management's Comment

Management concurs. The bank collateral pool is in the process of developing procedures to provide confirmation of the amount of the public deposits held by collateral pool financial

institutions. First, legislation was enacted by the General Assembly in April 1997 to repeal the previous requirements in the statute and to authorize the collateral pool board to establish appropriate procedures. Next, we then contacted two states with similar collateral pool programs to review their procedures. Moreover, we met with internal and external auditors in the banking industry to determine the possible options available to confirm public deposits. From the information gathered from the other states and from the banking auditors, a survey to participating collateral pool members was conducted to determine the most viable and reasonable method to confirm public deposits. We are now in the final steps of summarizing the information gathered so that the collateral pool board may adopt formal procedures.

It should be noted that there are many controls in the collateral pool to protect public deposits. These controls include strict admission requirements, quarterly monitoring of the financial condition of participating banks, pricing of collateral, monitoring sufficiency of collateral, monitoring of acceptable collateral, monthly reconciliation of collateral with third-party custodians, and obtaining additional information relative to certain financial data of participating financial institutions. The risk of default or insolvency of a collateral pool participant is considered highly unlikely.