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AUDITOR OF PUBLIC ACCOUNTS

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March 8, 2006

Mr. Gerry Oligmueller, Acting Director
Department of Administrative Services
State Capitol Building, Room 1315
Lincoln, Nebraska 68509-4664

Dear Mr. Oligmueller:

We have audited the basic financial statements of the State of Nebraska (the State) for the year ended June 30, 2005, and have issued our report thereon dated December 19, 2005. We have also audited the State's compliance with requirements applicable to major Federal award programs and have issued our report thereon dated February 2, 2006. In planning and performing our audit, we considered the State's internal controls in order to determine our auditing procedures for the purpose of expressing our opinions on the basic financial statements of the State and on the State's compliance with requirements applicable to major programs; and to report on internal control in accordance with the Federal Office of Management and Budget (OMB) Circular A-l33 (the Single Audit); and not to provide assurance on internal control. We have not considered internal control since the date of our report.

In connection with our audit described above, we noted certain internal control matters related to the activities of the Nebraska Department of Administrative Services (DAS) and the DAS State Accounting Division (State Accounting) or other operational matters that are presented below for your consideration. These comments and recommendations, which have been discussed with the appropriate members of DAS's management, are intended to improve internal control or result in other operating efficiencies.

Our consideration of internal control included a review of prior year comments and recommendations. To the extent the situations that prompted the recommendations in the prior year still exist, they have been incorporated in the comments presented for the current year. All other prior year comments and recommendations (if applicable) have been satisfactorily resolved.

Our comments and recommendations for the year ended June 30, 2005, are shown on the following pages.

COMMENTS RELATED TO THE AUDIT OF THE BASIC FINANCIAL STATEMENTS

1. Reconciliation of Bank Records to the Nebraska Information System

During the audit of the Comprehensive Annual Financial Report (CAFR) of the State of Nebraska, the Auditor of Public Accounts (APA) noted the absence of reconciliation between the Nebraska State Treasurer's actual bank statements and Nebraska accounting records (in both the Nebraska Information System (NIS) and the Nebraska Accounting System (NAS), the system before NIS). This has been an issue for the Department of Administrative Services Accounting Division (State Accounting) for many years. The APA's previous comments noted monthly reconciliations have not been completed in a timely manner and reconciliations performed have shown significant unknown variances between the bank records and the accounting records, with the bank being short compared to the accounting records. Although State Accounting continues to work on correcting the reconciliation of bank records to NIS, the APA continues to note areas where improvement is still needed in the reconciliation process to ensure NIS integrity and operational efficiency. Specifically, the APA noted the status of the reconciliation process as of December 19, 2005, to be as follows:

> State Accounting has worked on the reconciliation process, but continued progress is needed. State Accounting's reconciliation process has developed into a very detailed process of analyzing bank activity, compared to activity recorded on NIS, to identify reconciling items. State Accounting has completed their reconciliation process for the months of July of 2004 and May, June, and July of 2005. The APA has reviewed these reconciliations. The months of May, June, and July show variances of $3,425,381, $3,405,702, and $3,405,862, respectively. Again, the reconciliations show the bank being short compared to the accounting records. Per inquiry of management, State Accounting has started the reconciliation process for various months of the fiscal year ended June 30, 2006; however, the reconciliation process has not been a continuous monthly process and no monthly reconciliation has been completed since July of 2005.

Good internal control requires a plan of organization, procedures, and records designed to safeguard assets and provide reliable financial information. Without a timely and complete reconciliation of bank records to NIS, there is a greater risk for fraud and errors to occur and to remain undetected.

Although State Accounting has worked on the reconciliation process, the process is still not done in a timely manner. The reconciliation continues to reflect unknown variances and shortages. Complete and timely reconciliation procedures between bank records and accounting records are required to provide control over cash and accurate financial information.

> We recommend State Accounting continue their reconciliation process in a more timely manner, and on at least a monthly basis, to ensure all financial information is correct on NIS. We also recommend, when a consistent cash variance between the bank records and the accounting records is obtained (based on at least

six months of reconciliations), DAS submit their plan for adjusting NIS to the Governor and the Legislature so they may take appropriate action to correct NIS and resolve the variances noted.

Agency Response: State Accounting fully recognizes the need to perform timely bank reconciliations. We have made tremendous strides in this area over the past two years and have hired an outside group to help us improve the system's capability to make our processes more efficient. We currently have reconciled the accounts allowing us to identify all reconciling items. We are confident future monthly reconciliations will also be fully reconciled. We will soon make adjustments to the appropriate State accounts for all errors that were discovered during the reconciliation process. Subsequently, the cash balances in NIS will be adjusted for the fixed unknown variance. The Governor and Legislature will be advised of the necessary adjustments.

We do not agree that NIS integrity needs improvement relative to cash accountability. Our current reconciliation process has proven that NIS accounts for all cash activity and has the ability to provide accurate data to allow us to complete the bank reconciliation process. The results of our reconciliation effort do not support any assertion that there are significant deficiencies in the operation of internal control over the financial reporting of the cash accounts that could adversely affect the State of Nebraska's ability to record, process, summarize and report financial data.

2. General Computer Controls

The APA contracted with an accounting firm (contractor) to perform an assessment of the general computer controls (GCC) of those applications and systems supporting financial reporting and disclosure for the State of Nebraska. The project fieldwork was performed between May 1, 2005, and June 30, 2005, and a report was issued dated September 27, 2005. The following is a summary of the scope of the procedures performed and their comments and recommendations:

Summary Scope of Procedures Performed

The following outlines the procedures performed by the contractor as part of the GCC assessment:

- General inquiries were made with each of the applicable departments to determine the applications that directly and materially support the financial reporting process. The State's general computer controls are decentralized throughout the various agencies and departments.

- Procedures were performed to document and test the operating effectiveness of the GCCs. The procedures consisted of a combination of inquiry, corroboration, observation, and re-performance. Procedures were generally restricted to the following three primary areas of GCCs:
  - Information Security

- Information System Operations
- Application Development and Maintenance

The assessment related to the general computer controls for the following State of Nebraska departments:

- Health and Human Services System (HHSS)
- Department of Administrative Services (DAS)
- Nebraska Educational Telecommunications Commission (NETV)
- Legislative Council
- Education
- Department of Revenue
- State Colleges
- Retirement
- Department of Roads
- Public Service Commission

Summary of Comments and Recommendations

The contractor had comments and recommendations on the following departments and applications within those departments:

- Health and Human Services System (HHSS)
  - NFOCUS---supports an integrated service delivery platform to determine a family's eligibility for multiple programs and/or services from a single point. NFOCUS also supports the Child Welfare/Child protective services function.
  - HOME ENERGY---supports the federally funded Low Income Energy Assistance Program (LIEAP).
  - CHARTS---supports centralized collection and disbursements of Child Support Payments.

- Department of Administrative Services (DAS)
  - PACE, CSB, and VIS---are internally developed mainframe applications running DB/2 databases that interact with the State NIS system primarily to track funds, perform various charge backs to agencies, and create vouchers for payments on behalf of various agencies. PACE tracks mainframe use by agencies and bills them back accordingly.
  - NIS-Nebraska Information System---is the main accounting and information system for the State of Nebraska.
  - Mainframe Operating System---is the mainframe computer operations for the State of Nebraska.

- Education
  - The Disability Determination System (DDS)---is an Access front end interface with a visual basic program behind it, using Access data base. The DDS serves as a customer resource manager and an interface with NIS to determine payments to medical practitioners from information they provide to the social security administration pertaining to a pending disability claim.
  - QUEST---utilized by the Vocational Rehabilitation Department that tracks all expenses paid to assist physically and/or mentally disabled persons to locate jobs.
  - AID---is an internally developed Windows-based application. AID application grants payments to pre-selected students.
- Retirement---Nebraska Public Employees Retirement System (NPERS) is responsible for the administration of five retirement systems: Judges, State Patrol, State Employees, School Teachers, and County employees. NPERS utilizes the PIONEER system to track membership and enrollment functions, reconcile contributions, calculate interest and refunds, process benefits payment and annuities, and calculate cost of living increases.

Though many strong general computer controls were noted by the contractor in their report the following summarizes consistent themes where the State could make improvements in their general computer control environment:

A. <u>Excessive Access to Application, Operating Systems, and Computer Hardware (Logical and Physical)</u>

Excessive user access exists to several applications and operating systems within various State agencies. As a result, users maintain unauthorized and inappropriate access based on their job requirements. If proper segregation of duties and logical security techniques are not implemented, the potential exists for critical information resources to be unintentionally modified without proper and appropriate approval. Some examples of areas within the State to which excessive access has been granted include (but are not limited to):

- Several instances of application programmers with administrative access to the mainframe logical security tool (Remote Access Control Facility - RACF);
- Generic and unassigned 'administrator' accounts are used in several agencies to administer changes;
- ALTER access to production mainframe datasets is granted to application programmers; and,
- The SPECIAL attribute, allowing employees to update the RACF profiles, is granted to a wide range of conflicting job functions, including accountants, controllers, administrative assistants, schedulers, and programmers.

B. <u>Documentation of Policies and Procedures</u>

Formal policies and procedures over key information technology areas (i.e., security policies and procedures, change management policies and procedures, user access, network and firewall rules, etc.) do not exist for many of the Departments. Policies and procedures provide the formalized guidance for performance on specific job functions and responsibilities. Documentation helps to ensure that consistent procedures are performed across all systems within the State. Documented policies should contain general attributes which may include policy descriptions, scope, standards, enforcement, and definitions. A consistent, State-wide policy and procedure documentation standard would allow for consistent execution and communication between the various departments and personnel within those departments.

The contractor made specific comments and recommendations for each finding noted and those comments and recommendations were communicated to responsible parties at each agency. The APA communicated this summary of finding to the Director of IMservices of the Department of Administrative Services whose responsibility it is to coordinate a corrective action plan to address the comments and recommendations in the contractor's report.

> We recommend DAS develop a plan to correct the findings noted in their IT general control environment and coordinate efforts to correct the IT general control findings noted in other agencies IT general control environments.

Agency Response: The Chief Information Officer, in cooperation with the Nebraska Information Technology Commission and its Councils, will address the deficiencies identified in the contractor's report with each agency affected. Additionally, common themes and/or issues that may indicate the need for Statewide direction and/or policy will be identified and addressed. NITC policy standards will be created as needed.

Contact Person: Brenda Decker

Anticipated Completion Date: The corrective action will be continuous and ongoing.

3. <u>IT Disaster Recovery, Continuity of Operations, and Continuity of Government Planning</u>

In planning the audit of the State of Nebraska's financial Statement for the fiscal year ended June 30, 2005, the APA reviewed documentation regarding the State's IT Disaster Recovery, Continuity of Operations (COOP), and Continuity of Government (COG) planning.

IT Disaster Recovery, COOP, and COG planning are critical to ensure ongoing State operations in case of a disaster. In our review of documentation provided and discussion with DAS IMservices Division staff, and with the Nebraska Emergency Management Agency (NEMA) staff, the APA determined the following as it relates to the State of Nebraska being prepared to continue operations in the event of a disaster:

IT Disaster Recovery Plan

The APA obtained from the DAS IMservices Division a copy of their <u>Contingency Plan For Disaster Recovery</u> dated September 22, 2005. The plan provided in general terms the disaster recovery procedures, but did not provide any detail how the State would proceed in case of a disaster. Additional documentation provided by DAS noted the State does have a disaster recovery site available in case an event disables the main computer operations; however, DAS staff indicated many parts of the plan to get this disaster recovery site in operations have not been tested. In addition, the disaster recovery plan does not incorporate a plan that encompasses other large agencies that have significant IT operations.

COOP/COG Plan

The DAS COOP/COG plan is being developed by NEMA. NEMA contracted with a vendor to assist them in developing the plan. As of September 30, 2005, the contracted vendor has completed two of four phases of their agreement with the State. The first two phases completed were to conduct training sessions with DAS to ensure that all participants understand the goals and functions of a COOP plan and collecting and analyzing organizational components needed to develop a COOP Plan. In phase three and phase four, the contractor will take the information provided in phase two and develop a draft and final COOP plan and conduct a training session with all COOP relocation team members.

Per discussion with NEMA, the DAS COOP/COG does not cover the rest of the State but the template developed by DAS could be used by other State agencies to develop a COOP/COG for their agency. This phase is only now being discussed.

When IT Disaster Recovery and COOP/COG plans have not been developed and are not fully tested, there is a greater risk that in the event of a disaster the State would not be prepared to continue to do business in a timely manner.

> We recommend the State continue to implement formal, comprehensive business continuity and disaster recovery plans that are fully tested in order to be better prepared in the event of a major disaster.

Agency Response: We will continue to implement our ongoing plans and efforts relative to disaster recovery and continuity of operations and government planning.

4. <u>Accounting Environment and Staffing</u>

<u>Accounting Environment</u>

During the past few years, there have been significant changes in the accounting environment in response to corporate scandals. New procedures for auditor's responsibility for fraud have been introduced in SAS 99, *Consideration of Fraud in a Financial Statement Audit.* Further, a new accounting monitoring board, the Public Company Accounting Oversight Board, and accounting requirements with respect to public companies have been introduced with the passing of the Sarbanes - Oxley Act in July 2002. This Act does not currently apply to governments; however, we encourage the State to review these new rules and look for ways to enhance accountability and responsibility. Establishing an audit committee would be a good starting point. Periodic review of the adequacy and scope of internal accounting controls and procedures, their implementation, and the prompt "follow-up" of auditor recommendations should all be undertaken. The Act requires certification by management over the internal accounting control environment and, while this is not required of governments, it is a good standard to judge the current internal control system. We encourage the State to gauge the effects of the Act and determine what ways the State could apply sections of the Act to enhance accountability and responsibility. In addition, the Government Finance Officers Association (GFOA) makes the following recommendations regarding the establishment of audit committees by state and local governments:

- Every government should establish an audit committee or its equivalent. Reliable audits are essential to the credibility of financial reporting by state and local governments. The audit committee is a practical tool that a government can use to enhance the independence of the external auditor and, hence, the reliability of the financial statement audit.

- The audit committee should be formally established by charter, enabling resolution, or other appropriate legal means.

- The members of the audit committee collectively should possess the expertise and experience in accounting, auditing, financial reporting, and finance needed to understand and resolve issues raised by the independent audit of the financial statements. When necessary or otherwise desirable, members of the audit committee should be selected from outside the government to provide the needed expertise and experience.

- A majority of the members of the audit committee should be selected from outside of management. At the same time, the audit committee should include at least one representative each from the executive and legislative branches of the government.

- An audit committee should be large enough to ensure that its members possess all of the skills needed to realize the committee's objectives. At the same time, the audit committee should be small enough to operate efficiently. Therefore, as a general rule, an audit committee should be composed of no less than five and no more than seven members.

- Members of the audit committee should be educated regarding both the role of the audit committee and their personal responsibility as members, including their duty to exercise an appropriate degree of professional skepticism.

- The audit committee should oversee the resolution of audit findings.

- The audit committee should present a written report of how it has discharged its duties and met its responsibilities to the governing board and management annually. It is further recommended that this report be made public.

Staffing

State Accounting had two employees that were responsible for the preparation of the Comprehensive Annual Financial Report (CAFR). Since much of the CAFR is not generated by NIS, the preparation of the CAFR is very time consuming and complicated.

The CAFR has a deadline of December 31 to meet GFOA reporting requirements and these staffing levels make it difficult to make that timeframe.

> We recommend the State consider establishing an audit committee and State Accounting consider increasing staff assigned to the preparation of the CAFR.

Agency Response: We will review and consider the merits of establishing an audit committee and, subject to the limitation of appropriations and personal services, consider your recommendations to increase the accounting staff assigned to the preparation of the CAFR.

5. Capital Assets Historical Cost

During our audit we selected ten buildings and ten land parcels and requested supporting documentation for their historical costs from State Accounting. State Accounting was unable to provide the cost information. While the individual agencies may have support for the assets; there is no centrally located, readily available supporting documentation for historical cost or additions and deletions that have been made to the asset.

During the APA's attestation examination of the Game and Parks Commission for the fiscal year ended June 30, 2005, it was noted accurate records for land holdings were not maintained. The report noted, land values were not accurately recorded on NIS. The Game and Parks Commission holds $46,044,776 or approximately 89% of the total land held by the State.

A good system of internal control requires adequate documentation be maintained to describe the capital assets held by an entity. This supporting documentation should be readily available and would include support for the historical value, as well as support for any additions and deletions to the assets. As State Accounting is responsible for the annual financial statements, ensuring that capital assets are accurately reported is also their responsibility. Good internal control also requires all land owned by the State should be listed correctly on NIS.

When documentation of capital asset values are not adequately maintained there is greater risk that values may be misstated.

> We recommend:
>
> - State Accounting work with the DAS State Building Division and the individual agencies to establish policies to ensure correct values of capital assets are reported and maintained.

- State Accounting maintain supporting documentation of capital assets historical values in one centralized location. This documentation should include support for how the historical values were determined. Any additions increasing the assets value or size should be supported by copies of actual invoices or similar documentation. There should also be documentation for any deletions decreasing the assets value or size.

- State Accounting work with the Game and Parks Commission to implement procedures which will ensure land values are accurately recorded on NIS.

Agency Response: State Accounting will review existing fixed asset policies, make appropriate changes, and review them with DAS State Building Division and other individual agencies to ensure the correct values of all appropriate capital assets are recorded in NIS.

State Accounting recognizes that it may be preferable to have the historical values of capital assets be in one centralized location. However, currently the historical cost information is maintained by each agency for their fixed assets. At this time we believe it is not economically feasible to have State Accounting collect and maintain the information in the State Accounting office. All documentation, including support for historical cost and invoices, will be maintained at the agencies.

State Accounting is working with the Game and Parks Commission and State Building Division to ensure that Game and Parks land is recorded in NIS. Even though such land had not been recorded in NIS, State Accounting used the land listing from the Game and Parks land accounting system and properly included such land in the CAFR. In accordance with our policy, State Accounting advised Game and Parks that all of their land must be recorded in NIS. As of January, 2006 all of the land is now recorded in NIS.

6. Fund Classification

In preparing the CAFR for the State of Nebraska, State Accounting converts the State's budgetary fund types to those presented in the basic financial statements in accordance with Generally Accepted Accounting Principles (GAAP). In our review of the GAAP fund classification we noted the following:

Department of Environmental Quality (DEQ) Drinking Water and Clean Water State Revolving Funds (SRF)

State Accounting reports the various funds of DEQ Drinking Water and Clean Water SRF as special revenue funds. It may be more appropriate to report these funds as enterprise funds. GAAP (Governmental Accounting Standards Board (GASB) Statement 34, paragraph 67) states activities **are required** to be reported as enterprise funds if any one of the following criteria is met. Governments should apply each of these criteria in the context of the activity's **principal revenue sources**. (Also see below Footnote 33 of GASB Statement 34, paragraph 67).

a. The activity is financed with debt that is secured by a pledge of the net revenues from fees and charges of the activity. Debt that is secured by a pledge of net revenues from fees and charges and the full faith and credit of a related primary government is not payable solely from fees and charges of the activity.

b. Laws or regulations require that the activity's costs of providing services, including capital costs (such as depreciation or debt service), be recovered with fees and charges, rather than with taxes or similar revenues.

c. The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs (such as depreciation or debt service).

> **Footnote 33** of GASB 34 paragraph 67: These criteria do not require insignificant activities of governments to be reported as enterprise funds. For example, state law may require a county's small claims court to assess plaintiffs a fee to cover the cost of frivolous claims. However, taxes, not fees, are the principal revenue source of the county's court system, and the fees in question cover only the cost of frivolous small claims court cases. In this case, the county would not be required to remove its court system or the small claims court activity from its general fund and report it in an enterprise fund. Conversely, a state department of environmental protection regulation may require a water utility to recover the costs of operating its water plant, including debt service costs, through charges to its customers—the utility's principal revenue source. Because these charges are the activity's principal revenue source and because the water utility is required to recover its costs, the utility should be reported as an enterprise fund.

State Accounting considers the language of Footnote 33 above to apply in that the SRF funds are insignificant relative to the State's operation.

State Accounting also maintains the SRF's principal revenue source is Federal assistance not fees. Federal assistance does not meet any of the three criteria in paragraph 67 of GASB 34. The APA believes these funds would be more appropriately reported as enterprise funds, but does agree with State Accounting's position that it would not be required by GAAP; however, the APA also believes fees--as described above--will eventually be the primary source of revenue for the SRF. While at the present time Federal grant funding and State match funding are the principal revenue source for these programs, it is our understanding that Federal grant funding and State match funding will eventually end. Fees then would be the principal source of revenue.

> We recommend State Accounting review the classification of these funds and determine if reporting these funds as enterprise funds may be more appropriate. If State Accounting decides to continue to report these funds as special revenue funds, we recommend they monitor, on an annual basis, the activity of these funds and reclassify them as enterprise funds when fees become the major revenue source.

Private-purpose Trust Funds

The State of Nebraska reports the following budgetary funds as private-purpose trust funds: Welfare Club, Dormant Trust, and Canteen Amusement Trust funds at the Health and Human Services System (HHSS), Store/Canteen and Welfare & Club funds at the Department of Corrections, and Vocational Rehabilitation and Workers Comp Trust funds at the Workers' Compensation Court. The APA noted GAAP (GASB Statement 34, paragraph 72) requires private-purpose trust funds to report all trust activity under which principal and income benefit individuals or private organizations. Other accounting guidance reviewed by the APA to determine the type of activity to be reported as private-purpose trust funds included the Governmental Accounting, Auditing and Financial Reporting (GAAFR) manual issued by the GFOA (pages 117 and 118, and the Q&A question number 7.266 out of the Comprehensive Implementation Guide-2004)**.**

All guidance reviewed indicated, "the use of private-purpose trust funds normally should be limited to situations where ***specific*** benefits accrue to ***specific*** individuals, organizations, or governments."

The 2003 GFOA's review of the State's Fiscal Year End June 30, 2003 CAFR suggested certain private-purpose trust funds have a public purpose and should be considered as special revenue funds. The APA's review of these funds also concluded that these funds have a public purpose and should be considered as special revenue funds and these funds do not benefit a specific individual with a specific purpose.

Our basic understanding of the source of the Vocational Rehabilitation funds is an assessment against insurance companies and self-insurers and any interest earned on those funds. The use of the funds is to provide rehab services to outside persons so they can obtain gainful employment. The canteen and welfare revenues come from vending sales, donations, and gifts at State facilities. These funds generally are used for the general benefit of inmates and patients for personal activities at State facilities. They are **NOT** designated for the benefit of specific inmates or patients.

State Accounting's position is: "*Special revenue funds are designed for when the general government collects revenue for a specific purpose. The use of the funds is to provide rehab services to outside persons so they can obtain gainful employment. This is not part of any State program and does not replace any State program, and the services would not be provided without such private funds. The canteen and welfare funds come from vending sales at the prisons, donations, and gifts. There are no State funds involved and without such outside sources of funds, there would be no disbursements by the inmates for personal activities at the correctional facilities.*" As such these funds are more appropriately reported as private-purpose funds and will be reported as such in the fiscal year end June 30, 2005, CAFR.

> We recommend State Accounting reconsider their position and reclassify these funds as special revenue funds in accordance with GAAP.

Agency Response: We will continue to monitor the Clean Water State Revolving Funds classification on an annual basis. As to the private-purpose trust funds, we continue to believe our position as stated in the management letter is proper and that our reporting is in accordance with GAAP.

7. Restricted Net Assets

State Accounting had no clear documentation or reasoning used to breakdown net assets between restricted and unrestricted. In addition, there was no documentation the restricted and unrestricted net assets calculation was reviewed and approved.

Sound accounting practices require adequate documentation to support all practices and require all significant calculations be reviewed and approved.

Failure to document procedures and review calculation over classifications of net assets could result in misclassifications.

> We recommend State Accounting implement procedures to ensure adequate documentation is maintained.

Agency Response: State Accounting will provide the documentation of the process used to determine the classification of net assets.

8. CAFR Accruals

Numerous accrual amounts submitted by various agencies to State Accounting were incorrect, and the incorrect amounts were reported in the CAFR. State Accounting did make correcting entries for all material amounts as recommended by the APA; however, for the fiscal year ended June 30, 2005, uncorrected amounts resulted in accounts receivable being overstated by $3,103,117 and accounts payable being overstated by $6,339,276.

Good internal control requires information being provided by other entities be adequately reviewed before entering into the accounting records.

Failure to book the correct accrual amounts could result in incorrect financial statements.

> We recommend State Accounting work with individual agencies to ensure amounts submitted on accrual questionnaires are correct. We also recommend State Accounting implement procedures to review and verify the amounts submitted as accruals.

Agency Response: State Accounting will continue working with state agencies to ensure that the amounts the agencies submit to State Accounting are correct. State Accounting communicates to the agencies the importance of providing correct financial information for the CAFR and encourages the agencies to discuss with State Accounting any questions they may have about the *accrual questionnaire. State Accounting will continue to perform an analytical review of the data submitted by the agencies. Such review will include comparing the current year with prior years. Additional reviews may be performed and the criteria used for the selection of such reviews could be based on materiality and/or prior incorrect submissions.*

9. <u>Accounts Payable</u>

Accounts payables were misstated because of construction contract payments at various agencies. The misstatements were the result of the following:

- The payable was determined based on the date the agency received an invoice and not on the date the services were actually provided. This resulted in an understatement of the accounts payables.

- The payable was based on an estimate of how long the payment process took and not when the services were provided. A review of selected July 2005 payments indicated the estimate processing time was overstated and, therefore, the accounts payables were also overstated.

GAAFR states, "Under accrual accounting, expenses are recognized as soon as the liability is incurred, regardless of the timing of the related cash flows." GASB 34 Q&A #163 states, for reimbursement-based grants, providers should recognize liabilities when all eligibility requirements are met. Reimbursement eligibility requirements are met when recipients incur allowable costs, not when those costs are submitted for reimbursement.

Failure to correctly record accounts payable results in inaccurate financial statements.

> We recommend accounts payables be based on the date the recipients incur the costs and not on the date the costs are submitted for reimbursements. We further recommend State Accounting consider establishing a policy as to when a payable is recorded.

Agency Response: State Accounting will provide formal communication with all State agencies, boards and commissions relating to the proper recording of prior year payable transactions (P9s). State Accounting will also provide both verbal and written instructions, to include a presentation on prior year payables at a Business Users Group meeting. State Accounting will also work with agencies (including the NE Department of Roads) that have construction contract payments to ensure that the Accounts Payable Department is preparing the proper document for contract payments.

10. Compensated Absences

The State's compensated absences liability was calculated using information obtained from NIS for all agencies except the State Patrol. The State Patrol did not use NIS to calculate its compensated absence balance, and instead used their leave system's information. As of June 30, 2005, the State Patrol's compensated absence balance was $6,834,197.

Good internal control would include requiring all agencies to utilize NIS in calculating their compensated absences balance. Failure to record all compensated absence balances on NIS increases the risk of stating incorrect or inaccurate balances on the financial reports.

> We recommend State Accounting require the State Patrol to utilize NIS to record leave earnings, leave usage, and compensated absences balances.

Agency Response: As of January 2006, the State Patrol has completed entering its leave balances into NIS and is utilizing NIS as its official record for leave.

11. Federal Fund Balance

NIS has established Federal funds to account for all Federal grant activity. Agencies often had to expend State General Fund monies for Federal grant programs and then were reimbursed by the Federal government. These reimbursements were sometimes deposited into a Federal fund and not returned to the General Fund.

The amounts owed from the Federal funds to the General Fund were not being tracked or recorded on NIS. Therefore, State Accounting estimated $44,474,727 was due to the General Fund from the Federal funds at year end. In addition, State Accounting did not ensure the General Fund received the monies due from the Federal funds.

Good internal control requires tracking obligations between funds and ensuring those obligations are met.

> We recommend State Accounting develop procedures, in conjunction with the agencies, to record amounts owed from Federal funds to the General Fund and ensure all amounts due are paid in a timely manner. Procedures should be supportable and might include establishing a set amount as working capital and when Federal fund balances exceed this amount the surplus be returned to the General Fund.

Agency Response: State Accounting will do further research of this issue, including a review of appropriation implications, in order to determine possible changes to our current accounting procedures.

12. <u>Pre-audit Procedures</u>

During our testing of statewide expenditures, we reviewed the pre-audit procedures at the agency level and noted the following:

- HHSS had no pre-audit form or other means of pre-audit documentation for NFOCUS, MMIS, or IGT payments. NFOCUS and MMIS are computer sub-system payments and there was no established policy or procedure documented for their pre-audit. These sub-systems process millions of dollars in transactions annually.

- The Public Service Commission had the pre-audit form for the payment tested on file, but the form was not signed or approved.

Nebraska State Accounting Manual, General Policy #16 states, "<u>Pre-audit</u> - State Statute Section 81-1111, R.R.S. 1999, now allows the DAS Director to authorize agencies to perform their own pre-audits, subject to monitoring by State Accounting. A separate Pre-Audit Agreement between State Accounting and the agency, laying out the terms of the performance of the pre-audit, must be in place for this authorization. For all agencies not authorized to perform their own pre-audit, State Statute Section 81-1111, R.R.S., requires the accounting division to pre-audit and control all payment vouchers equal to or exceeding $1,500. Appropriate charges to agencies will be made by State Accounting to perform these services. The State Accounting Administrator has the authority to waive pre-audit on those vouchers totaling less than $1,500 . . . ."

DAS's pre-audit guidelines states, "Pre-audit is a three-step process - three different people need to review each document that is required to be pre-audited (See Statute 81-1111). This three-step process usually consists of a person collecting the necessary support and entering the document into NIS, a second person who reviews and approves the document on-line and a third person (usually called the pre-auditor) who ensures the document meets Statutory requirements, State Accounting Policies, Agency policies, and who then posts the document on NIS. Statute requires that documents equal to or greater than $1,500 be pre-audited in addition to those documents with 'sensitive' coding."

Failure to perform the pre-audit function could result in misappropriation of State funds.

> We recommend DAS implement procedures to ensure all documents are pre-audited as required by their policies and the pre-audit process is documented.

Agency Response: State Accounting is currently reviewing these pre-audit procedures and will work with HHSS to implement any necessary changes.

13. Imprest Payroll Fund Reconciliation

During our fiscal year ended June 30, 2004, examination of DAS, we noted State Accounting did not perform a reconciliation of their Imprest Payroll Fund. This fund is the State's statewide payroll fund used to process payroll for all State employees and to account for all payroll deductions such as Federal and State income taxes, other Federal taxes, and all other employee and State payroll benefit deductions. During our review of this fund, we noted a monthly reconciliation between the amounts collected from all State agencies for employees' salaries, their payroll deductions, plus the State's share of these payroll deductions, to the amount paid to employees and vendors for these deductions had been started on a monthly basis; however, no monthly reconciliation has been completed since NIS began processing payroll in January 2003.

Based on inquiry of management, some progress has been made in the reconciliation process but a monthly reconciliation process still has not been completed.

When reconciliations between amounts collected from other State agencies and what is paid out to vendors is not performed, there is a significant risk of errors occurring and greater risk of irregularities occurring and going undetected.

> We recommend State Accounting establish a monthly fund reconciliation process that will provide assurance all money processed through the Imprest Payroll Fund is accounted for properly.

Agency Response: We currently are in the process of completely reconciling this fund and will continue to do so until the fund, and all the related sub accounts, is properly reconciled.

14. Other Items - New Accounting Standards

Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*

This Statement establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This Statement also clarifies and establishes accounting requirements for insurance recoveries.

Governments are required to evaluate prominent events or changes in circumstances affecting capital assets to determine whether impairment of a capital asset has occurred. Such events or changes in circumstances that may be indicative of impairment include evidence of physical damage, enactment or approval of laws or regulations or other changes in environmental factors, technological changes or evidence of obsolescence, changes in the manner or duration of use of a capital asset, and construction stoppage. A capital asset generally should be considered impaired if both (a) the decline in service utility of the capital asset is large in magnitude and (b) the event or change in circumstance is outside the normal life cycle of the capital asset.

The provisions of this Statement are effective for the State's 2006 fiscal year. Earlier application is encouraged.

Statement No. 43, *Financial Reporting for Postemployment Benefit Plans and Other Pension Plans*

This Statement establishes uniform financial reporting standards for other postemployment benefits (OPEB) plans and supersedes the interim guidance included in Statement No. 26. *Financial Reporting For Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans.* The approach followed in this Statement generally is consistent with the approach adopted in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, with modifications to reflect differences between pension plans and OPEB plans.

The standards in this Statement apply for OPEB trust funds included in the financial reports of plan sponsors or employers, as well as for the stand-alone financial reports of OPEB plans or the public employee retirement systems, or other third parties that administer them. This Statement also provides requirements for reporting of OPEB funds by administrators of multiple-employer OPEB plans, when the fund used to accumulate assets and pay benefits or premiums when due, is not a trust fund. A related statement, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, addresses standards for the measurement, recognition, and display of employers' OPEB expense/expenditures and related liabilities (assets); note disclosures; and, if applicable, required supplementary information (RSI). The measurement and disclosure requirements of the two statements are related and disclosure requirements are coordinated to avoid duplication when an OPEB plan is included as a trust or agency fund in an employer's financial report. In addition, reduced disclosures are acceptable for OPEB trust or agency funds when a stand-alone plan financial report is publicly available and contains all required information.

The requirements of this Statement for OPEB plan reporting are effective *one year prior* to the effective date of related Statement 45 for the employer (single-employer plan) or for the largest participating employer in the plan (multiple-employer plan). The requirements of the related Statement are effective in three phases based on a government's total annual revenues, as defined in that Statement, in the first fiscal year ending after June 15, 1999—the same criterion used to determine a government's phase for implementation of Statement No. *34*, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.*

Plans in which the sole or largest participating employer is a *phase 1 government* (those with total annual revenues of $100 million or more) are required to implement this Statement in financial statements for periods beginning after December 15. 2005. Plans in which the sole or largest participating employer is a *phase 2 government* (total annual revenues of $10 million or more but less than $100 million) are required to implement this Statement in financial statements for periods beginning after December 15, 2006. Plans in which the sole or largest participating employer is a *phase* 3 *government* (total annual revenues of less than $10 million) are required to implement this Statement in financial statements for periods beginning after December 15, 2007. If comparative financial statements are presented, restatement of the prior year financial statements is required. Early implementation of this Statement is encouraged.

Statement No. 44*, Economic Condition Reporting: The Statistical Section.*

This statement amends the portions of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles,* that guide the preparation of the statistical section. This statement establishes new requirements for presenting the statistical section in a CAFR.

The statistical section presents detailed information, typically in ten-year trends, that assists users in utilizing the basic financial statements, notes to basic financial statements, and required supplementary information to assess the economic condition of a government.

The statistical section is a required part of a CAFR, although governments are not required to prepare a statistical section if they do not present their basic financial statements with in a CAFR. These circumstances are not altered by this Statement. However, this Statement does apply to any statistical section that accompanies a government's basic financial statements. The provisions of this Statement are effective for statistical sections prepared for periods beginning after June 15, 2005.

Statement No. 45*, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.*

This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures and, if applicable, RSI in the financial reports of state and local governmental employers.

The approach followed in this Statement generally is consistent with the approach adopted in Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers,* with modifications to reflect differences between pension benefits and OPEB. Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* addresses financial statement and disclosure requirements for reporting by administrators or trustees of OPEB plan assets or by employers or sponsors that include OPEB plan assets as trust or agency funds in their financial reports.

Postemployment benefits (OPEB as well as pensions) are part of an exchange of salaries and benefits for employee services rendered. Of the total benefits offered by employers to attract and retain qualified employees, some benefits, including salaries and active-employee healthcare, are taken while the employees are in active service, whereas other benefits, including postemployment healthcare and other OPEB, are taken after the employees' services have ended. Nevertheless, both types of benefits constitute compensation for employee services.

This Statement generally provides for prospective implementation—that is, that employers set the beginning net OPEB obligation at zero as of the beginning of the initial year. Implementation is required in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999. The definitions and cutoff points for that purpose are the same as those in Statement No. 34, *Basic Financial Statements—Management's Discussion and Analysis— for State and Local Governments.* This Statement is effective for periods beginning after December 15, 2006, for phase 1 governments (those with total annual revenues of $100 million or more); after December 15, 2007, for phase 2 governments (those with total annual revenues of $l0 million or more but less than $100 million); and after December 15, 2008, for phase 3 governments (those with total annual revenues of less than $10 million). Earlier implementation is encouraged.

Statement No. 46, *Net Assets Restricted by Legislation, an amendment of GASB Statement* No. 34

GASB Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis-for State and Local Governments,* requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets. In the process of applying this provision, some governments have had difficulty interpreting the requirement that those restrictions be "legally enforceable." The confusion over this phrase has resulted in a diversity of practice that has diminished comparability.

This Statement clarifies that a legally enforceable enabling legislation restriction is one that a party external to a government - such as citizens, public interest groups, or the judiciary - can compel a government to honor. The Statement states that the legal enforceability of an enabling legislation restriction should be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specified by the enabling legislation or if a government has other cause for reconsideration. Although the determination that a particular restriction is not legally enforceable may cause a government to review the enforceability of other restrictions, it should not necessarily lead a government to the same conclusion for all enabling legislation restrictions.

This Statement also specifies the accounting and financial reporting requirements if new enabling legislation replaces existing enabling legislation or if legal enforceability is reevaluated. Finally, this Statement requires governments to disclose the portion of total net assets that is restricted by enabling legislation. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2005.

Statement No. 47, *Accounting for Termination Benefits*

This Statement establishes accounting standards for termination benefits.

In financial statements prepared on the accrual basis of accounting, employers should recognize a liability and expense for *voluntary* termination benefits (for example, early-retirement incentives) when the offer is accepted and the amount can be estimated. A liability and expense for *involuntary* termination benefits (for example, severance benefits) should be recognized when a plan of termination has been approved by those with the authority to commit the government to the plan, the plan has been communicated to the employees, and the amount can be estimated. For financial reporting purposes, a *plan of involuntary termination* is defined as a plan that (a) identifies, at a minimum, the number of employees to be terminated, the job classifications or functions that will be affected and their locations, and when the terminations are expected to occur and (b) establishes the terms of the termination benefits in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated. If a plan of involuntary termination requires that employees render future service in order to receive benefits, the employer should recognize a liability and expense for the portion of involuntary termination benefits that will be provided after completion of future service ratably over the employees' future service period, beginning when the plan otherwise meets the recognition criteria discussed above.

In financial statements prepared on the modified accrual basis of accounting, liabilities and expenditures for termination benefits should be recognized to the extent the liabilities are normally expected to be liquidated with expendable available financial resources.

The requirements of this Statement are effective in two parts. For termination benefits provided through an existing defined benefit OPEB plan, the provisions of this Statement should be implemented simultaneously with the requirements of Statement 45. For all other termination benefits, this Statement is effective for financial statements for periods beginning after June 15, 2005. Earlier application is encouraged.

Agency Response: We have noted the new accounting standards and will implement them according to the required GASB timetable.

Our audit procedures are designed primarily on a test basis and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. Our objective is, however, to use our knowledge of the Agency and its interaction with other State agencies and administrative departments gained during our work to make comments and suggestions that we hope will be useful to you.

This report is intended solely for the information and use of the Agency, the Governor and State Legislature, Federal awarding agencies, pass-through entities, and management of the State of Nebraska. However, this report is a matter of public record and its distribution is not limited.

We appreciate and thank all of the Agency employees for the courtesy and cooperation extended to us during our audit.

Sincerely,

Don Dunlap CPA

Don Dunlap
Assistant Deputy Auditor