STATE OF NEBRASKA
Auditor of Public Accounts

Mike Foley
State Auditor
Mike.Foley@apa.ne.gov

P.O. Box 98917
State Capitol, Suite 2303
Lincoln, NE 68509
402-471-2111, FAX 402-471-3301
www.auditors.state.ne.us

March 7, 2007

Mr. Carlos Castillo, Director
Department of Administrative Services
State Capitol; Room 1315
Lincoln. Nebraska 68509-4664

Dear Mr. Castillo:

We have audited the basic financial statements of the State of Nebraska (the State) for the year ended June 30, 2006, and have issued our report thereon dated December 21, 2006. We have also audited the State's compliance with requirements applicable to major federal award programs and have issued our report thereon dated February 6, 2007. 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-l 33 (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 Department of Administrative Services (Department) 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 the Department'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.

Comment Number 1--*Reconciliation of Bank Records to Nebraska Information System* and Comment Number 2--*General Computer Controls - Mainframe Operating System* are considered reportable conditions. A reportable condition is a significant deficiency in the design or operation of internal control over financial reporting that, in our judgment, could adversely affect the State of Nebraska's ability to record, process, summarize, and report financial data consistent with the assertions of management in the basic financial statements. These comments will also be reported in the State of Nebraska's Statewide Single Audit Report Schedule of Findings and Questioned Costs.

Draft copies of this letter were furnished to the Department to provide them an opportunity to review the letter and to respond to the comments and recommendations included in this letter. All formal responses received have been incorporated into this letter. Where no response has been included, the Department declined to respond. Responses have been objectively evaluated and recognized, as appropriate, in the letter. Responses that indicate corrective action has been taken were not verified at this time, but will be verified in the next audit.

Our comments and recommendations for the year ended June 30, 2006, are shown on the following pages.

COMMENTS RELATED TO THE AUDIT OF THE BASIC FINANCIAL STATEMENTS

1. Reconciliation of Bank Records to Nebraska Information System

During the audit of the Comprehensive Annual Financial Report (CAFR) of the State of Nebraska, we noted the lack of a timely and complete reconciliation between the State Treasurer's bank statements and the accounting records on the Nebraska Information System (NIS). This has been an issue for the Department of Administrative Services Accounting Division (State Accounting) for many years. Our previous comments noted monthly reconciliations were not completed in a timely manner and showed significant unknown variances with bank records short compared to accounting records. Although State Accounting continues to work on the reconciliation of bank records to NIS accounting records, we continue to note areas where improvement is needed in the reconciliation process to ensure NIS integrity and operational efficiency. Specifically, we noted the status of the reconciliation process as of December 2006, the end of fieldwork for the CAFR, to be as follows:

- State Accounting's June 2006 reconciliation, excluding the Child Support Payment Distribution Unit (SDU), was complete and indicated a consistent variance of $1,065,210. This variance of $1,065,210 was believed to be from prior fiscal years. State Accounting's reconciliation shows bank records short compared to accounting records.

- State Accounting had completed the reconciliation for July and August of 2006; however, these reconciliations were not completed in a timely manner. The APA did not receive the completed August reconciliation until December 19, 2006. The variance for these months was consistent with June 2006.

- Previous reconciliations for the SDU as of June 2006, showed a variance of $1,592,201. SDU staff have gone back to the beginning of the SDU in December 2001 and explained the entire variance noted. This work was completed in December 2006. State Accounting had not completed its review of the SDU reconciliation to determine the effect on the overall State reconciliation as of December 2006, and as such the APA has not reviewed the SDU reconciliation in detail.

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 accounting records, there is a greater risk for fraud or errors to occur and to remain undetected.

We recommend the following:

- State Accounting continue the reconciliation process to ensure all financial information is correct on NIS and work to complete the reconciliations in a more timely manner.
- State Accounting review the SDU reconciliation to determine the effect on the overall State reconciliation.
- When a consistent cash variance between bank records and accounting records is obtained, State Accounting should submit the shortage amount to the Governor and the Legislature. The Governor and the Legislature should then develop a plan to correct NIS accounting records and resolve the shortage noted.

Department's Response: We will continue to work on completing the bank reconciliation in a timely manner and will adjust the cash balances when the old variance balance is known.

2. General Computer Controls - Mainframe Operating System

Administrator Access

Good internal control requires a segregation of duties restricting programmers' ability to grant themselves and others access to the application production environment. Good internal control also requires individuals with the ability to make security changes not be allowed to audit those changes.

The Department of Administrative Services Information Technology Services Division granted SPECIAL access privileges to 34 individuals to administer security within their designated agency. The SPECIAL attribute enables employees to modify the security access of individuals, including themselves. Seventeen of the users were programmers who had been granted the ability to administer security for their designated application.

In addition, certain individuals who had the SPECIAL attribute also had the AUDITOR attribute. The AUDITOR attribute allows the individual to audit changes in security settings. Two system programmers who had the SPECIAL attribute also had the AUDITOR attribute. This finding was noted in the prior audit report.

Allowing access to the SPECIAL attribute could result in inappropriate changes to access for the individual and other individuals in their group. Allowing users both SPECIAL and AUDITOR attributes increases the risk security changes will not be reviewed.

We recommend SPECIAL access be removed for all end users and application developers. Access to the SPECIAL attribute should be limited to the Security Administrator to ensure appropriate segregation of duties. We also recommend the SPECIAL and AUDITOR functions be performed by separate individuals to ensure security changes are subject to review.

Department's Response: Effective August 2006, in response to the outside consultant's report, the Office of the Chief Information Officer changed the access to the SPECIAL attribute and removed it for all end users and application developers. The z/OS team of the CIO's Office are the only people with SPECIAL access. Additionally, all AUDITOR functions were removed for all users EXCEPT the State Security Officer of the Office of the CIO. We believe these changes will meet all future internal control issues identified in this report.

<u>Programmer Access to Production</u>

Good internal control requires the ability to update code and data within production environments be limited to personnel whose job does not include programming responsibilities. Application programmers had ALTER access which allows direct access to the production environment. This finding was noted in the prior audit report.

Allowing programmers ALTER access increases the risk unauthorized or untested changes could be migrated to the production environment and intentionally or unintentionally corrupt data or processing.

> We recommend ALTER access be removed for all application programmers and limited to employees whose responsibilities do not include programming.

Department's Response: Application programmers with ALTER access is a decision made by the agency owning the program. The reasons for these decisions by each agency were documented in their responses to the outside consultant's report. The Office of the Chief Information Officer will continue to work with agencies to take appropriate corrective action regarding this audit point.

3. <u>Staffing – Internal Controls</u>

Good internal control requires an adequate segregation of duties to ensure no one individual is capable of handling all phases of a transaction and procedures to ensure information being provided by other agencies is adequately reviewed before entering into the accounting records. Sound accounting practices require a staff be large enough to manage workload requirements while maintaining accuracy. Good internal control also requires adequate documentation be maintained to describe the capital assets held by an entity. This 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.

During our audit of the CAFR for fiscal year 2006, we noted State Accounting had an inadequate amount of staff assigned to perform the required work efficiently and effectively. Specifically the following was noted:

- State Accounting did not have adequate procedures to ensure the amounts submitted by State agencies on the accrual response forms were correct. Several accrual amounts submitted to State Accounting were incorrect, and the incorrect amounts were entered into the accounting records and subsequently reported in the CAFR. State Accounting did make correcting entries for all material amounts as recommended by the APA. This was noted in our previous management letter.

- There was not a proper segregation of duties over the processing of 3 of 5 CAFR journal entries tested. One individual prepared the workpaper and entered, approved, and posted the entries on NIS.

- State Accounting did not have procedures to ensure the historical cost of the State's building and land reported in the CAFR was accurate. State Accounting did not maintain or review supporting documentation for the historical cost recorded by State agencies in the State accounting system. A similar finding was noted in our previous management letter.

Failure to maintain adequate staff could result in timeliness issues and lack of review of work. We noted several errors which may have been avoided with more review. Failure to book the correct accrual amounts could result in incorrect financial statements. There is also an increased risk for fraudulent entries to the State's financial statements when an adequate segregation of duties is not maintained. When documentation of capital asset values is not adequately maintained there is a greater risk values may be misstated.

We recommend the following:

- State Accounting reallocate staff resources to allow for a more manageable workload and increased accuracy.
- State Accounting implement procedures to review and verify the amounts submitted as accruals and work with State agencies to ensure amounts submitted are complete and accurate.
- State Accounting implement procedures to ensure one individual does not handle all phases of the journal entries for CAFR reporting purposes.
- State Accounting maintain supporting documentation of capital assets historical values to ensure amounts recorded are accurate.

Department's Response: We will review our staff workload and will put more time towards reviewing agency responses. We also are working on more communication with agencies prior to year end so the data we receive is more accurate.

We believe that there are no internal control issues involved with one person making journal entries to the CAFR financial statements in as much as an analysis is completed to ensure all changes in balances are explainable.

We further believe that the State does have supporting documentation for the historical values of all material capital assets.

4. Federal Fund Balance

Good internal control requires procedures to track obligations between funds and procedures to ensure those obligations are met.

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 $37,900,082 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. This was noted in our previous management letter.

> We recommend State Accounting develop procedures, in conjunction with State 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.

Department's Response: State Accounting will continue to research this issue, including appropriation implications, in order to determine possible changes to our current accounting procedures.

5. Continuity of Operations Planning

Sound business practice requires a formal comprehensive business continuity plan be developed and tested to ensure ongoing operations in the event of a disaster.

The Department of Administrative Services (Department) had developed a detailed Continuity of Operations (COOP) Plan for the Department which encompasses all divisions, including the Information Technology Services Division and the Nebraska Information System. Alternate operating facilities had been selected for use in the event of a disaster; however, the details surrounding the actual operation at those facilities had not been formulated or tested. A similar finding was noted in our prior management letter.

When COOP plans have not been fully developed or tested, there is a greater risk in the event of a disaster the State would not be prepared to continue to do business in a timely manner.

> We recommend the Department continue to implement a formal, comprehensive business continuity plan that is fully tested in order to be better prepared in the event of a major disaster.

Department's Response: The Department of Administrative Services (DAS) has developed a detailed Continuity of Operations Plan (COOP) with sections identified for each Division and their specific needs, including the Nebraska Information System and the Chief Information Officer. The DAS COOP project for implementation and testing of this plan continues with efforts focusing on further refinement of the plan, training, and partnering with other entities. DAS continues to work in association with NEMA, the Nebraska Emergency Management Agency, who is the lead agency in State of Nebraska homeland security efforts. DAS also continues to participate in the NEMA sponsored annual Terrex exercises.

6. Capitalization of Building Expenditures

AICPA Audit and Accounting Guide State and Local Governments 7.14 states, "expenditures that extend the useful lives of capital assets beyond their initial estimated useful lives (preservation costs) or improve their efficiency (improvements) or capacity (additions) are capitalized." Sound accounting practices would require a review of individual projects to determine whether each project's costs should be capitalized.

Nebraska State Accounting Manual, AM-005, Policies, Section 28, under the general heading of CAPITAL OUTLAY states, "Building additions: a. Building additions are defined as projects that add square footage to an existing building and the accumulated costs are $100,000 or greater … Building Improvements: a. Building Improvements are defined as projects which extends the life of a building and the accumulated costs are $100,000 or greater. These improvements do not add square footage to the existing building."

During our review of expenditures we noted the following:

- State Accounting's policy did not include capitalizing assets when the expenditure improved the efficiency of the building.

- State Accounting's policy did not include specific criteria or guidelines for determining what expenditures would extend the life of a building or improve the efficiency of a building.

- State Accounting had made a general determination that all 309 Task Force expenditures were for repairs and maintenance; therefore, did not capitalize any of these costs. The 309 Task Force is a division of DAS with oversight provided by the Committee on Building Maintenance. The 309 Task Force is responsible for Deferred Repair projects, projects related to Fire/Life-Safety, ADA (American's with Disabilities Act), and Energy Conservation for all State buildings. A review of individual projects by State Accounting to determine if the expenditures extended the life or improved the efficiency of the building was not done. As of June 30, 2006, the 309 Task Force had $23,570,071 in active projects that exceeded the State's capitalization threshold that were not reviewed by the 309 Task Force to determine if any of those expenditures should have been capitalized.

Without a more specific written policy and a review of individual projects, there is a risk the assets of the State are under-valued and the financial statements are not correctly presented.

We recommend the following:

- State Accounting revise their written policy to include capitalizing assets when the efficiency of the building is improved.
- State Accounting revise their written policy to include specific criteria to be used to determine when the life of a building is extended or when the efficiency of a building is improved.
- State Accounting monitor the revised policy to ensure its proper implementation.
- The Department review each 309 Task Force project and make a determination on whether the project should be capitalized.

Department's Response: State Accounting will add to its written policy that a building improvement that enhances a capital assets functionally either by effectiveness or efficiency should be capitalized. However, we believe that under our current policy all material improvements that should have been capitalized were capitalized.

State Accounting does not include more policy specific criteria or guidelines for determining what expenditures would extend the life of a building, because State Accounting allows agency staff, like architects and engineers, to use their professional judgment as to whether the life of the building has been extended. Whether the life is extended or not has to be evaluated project by project. However, we will add a statement in our manual that if agencies have a question as to whether or not to capitalize an expenditure, they should call State Accounting.

State Accounting will continue to ask the 309 Task Force to review the projects funded by them to determine if any should be capitalized. However, based on the mission of the 309 Task Force, their projects generally are deferred repair and maintenance projects.

7. 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 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 and Club funds at the Department of Correctional Services, and Vocational Rehabilitation and Workers Comp Trust funds at the Workers' Compensation Court. The APA noted GAAP requires (GASB Statement 34, paragraph 72) 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 & 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 Government Finance Officers Association's (GFOA) review of the State's fiscal year ended 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 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, State Accounting feels these funds are more appropriately reported as private-purpose funds and were reported as such in the fiscal year ended June 30, 2006, CAFR.

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

Department's Response: We firmly believe that we are correct in reporting these funds (which are immaterial) as trust funds due to the fact that these moneys are not the State's moneys and do not serve a public purpose that should be supported by the State. To report them as special purpose funds would give that appearance.

8. Imprest Payroll Fund Reconciliation

Good internal control requires a reconciliation of fund activity to ensure the correct amount of money is being received, is being paid out to the correct vendor, and the account balance yet to be paid is correctly stated and supported.

The Imprest Payroll Fund is 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 fiscal year ended June 30, 2004, examination of the Department 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 considerable progress has been made in the reconciliation process but a monthly reconciliation process still has not been completed.

When a reconciliation between amounts collected from other State agencies and the amount paid to vendors is not performed there is a significant risk of errors occurring and a 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.

Department's Response: We have now developed a complete reconciliation process and have completely reconciled all the activity for January 2007 and will continue to do so for each month in the future.

9. Inadequate Controls over Timesheet Approval

Good internal control requires employee hours worked be approved by a direct supervisor and the approval be documented.

We noted 52 employees tested from the Department did not have documentation of a supervisor's approval of the employee's time entered on NIS for the biweekly pay period tested. Prior to the NIS 8.10 update in April 2006, a personnel assistant of the Department had the ability to approve time entered on NIS by employees without a supervisor's approval in order to process their payroll. After April 2006, the Department had developed procedures that would not allow the personnel assistant to approve employee's hours worked.

Without adequate controls to verify hours worked, there is an increased risk of misstated regular hours and leave, resulting in inaccurate leave balances and possible overpayments.

We understand the Department has taken corrective action on this issue, which includes developing a procedure whereby there are back up approvers when supervisors are unable to approve in a timely manner. We recommend the Department continue to use the procedures that have been implemented.

10. Accounting Environment

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. An audit committee is a means for a governing body to provide independent review and oversight of the government's financial reporting process, internal controls, and independent auditors. An audit committee also helps to ensure management properly develops and adheres to a sound system of internal controls and ensures procedures are in place to objectively assess management's practices. 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.

As noted in our previous management letter, we encourage the State to gauge the effects of the Sarbanes - Oxley Act and determine what ways the State could apply sections of the Act to enhance accountability and responsibility. The GFOA Committee on Accounting, Auditing and Financial Reporting Recommended Practice Audit Committees (1997, 2002, and 2006) lays out some guidelines for governments when establishing audit committees. The GFOA Recommended Practice is available on the GFOA website.

Other Items--New Accounting Standards

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

This statement, effective for fiscal years beginning after December 15, 2005, 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.

Statement No. ***45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.***
This statement, effective for fiscal years beginning after December 15, 2006, establishes standards for the measurement, recognition, and display of other postemployment benefit expenditures and assets and liabilities, including applicable note disclosures and required supplementary information.

Statement No. 48, ***Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.***
This statement, effective for fiscal years beginning after December 15, 2006, establishes criteria that governments will use to ascertain whether the proceeds received should be reported as revenue or as a liability. The criteria should be used to determine the extent to which a transferor government either retains or relinquishes control over the receivables or future revenues through its continuing involvement with those receivables or future revenues.

Statement No. 49, ***Accounting and Financial Reporting for Pollution Remediation Obligations.***
This statement, effective for fiscal years beginning after December 15, 2007, addresses accounting and financial reporting standards for pollution (including contamination) remediation obligations, which are obligations to address the current or potential detrimental effects of *existing* pollution by participating in pollution remediation activities such as site assessments and cleanups. The scope of the document excludes pollution *prevention* or *control* obligations with respect to current operations, and future pollution remediation activities that are required upon retirement of an asset, such as landfill closure and postclosure care and nuclear power plant decommissioning.

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 Department 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 Department, 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 Department employees for the courtesy and cooperation extended to us during our audit.

Sincerely,

Pat Reding, CPA

Pat Reding
Assistant Deputy Auditor

Don Dunlap CPA

Don Dunlap
Assistant Deputy Auditor