NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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February 28, 2008

Mr. Carlos Castillo, Director
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, 2007, and have issued our report thereon dated December 28, 2007. We have also audited the State's compliance with requirements applicable to major federal award programs and have issued our report thereon dated February 13, 2008. 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 or compliance matters related to the activities of Administrative Services (the Agency) 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 Agency's management, are intended to improve internal control or result in other operating efficiencies.

Our consideration of internal control included a review of the 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 (Review of CAFR Information) relating to the audit of the basic financial statements, is considered a material weakness. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Agency's internal control. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Agency's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the financial statements that is more than inconsequential will not be prevented or detected by the Agency's internal control. Comment Number 2 (Reconciliation of Bank Records to Nebraska Information System) relating to the audit of the basic financial statements, is considered a significant deficiency. These comments will also be reported in the State of Nebraska's Statewide Single Audit Report Schedule of Findings and Questioned Costs.

A separate evaluation of the State's significant Information Technology (IT) systems was completed. Some findings, as noted below, were reported as a part of the audit of the Comprehensive Annual Financial Report (CAFR). Additional findings and recommendations were reported to management in a separately issued confidential summary of findings and recommendations.

Draft copies of this letter were furnished to the Agency 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 Agency 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.

The following are our comments and recommendations for the year ended June 30, 2007.

COMMENTS RELATED TO THE AUDIT OF THE BASIC FINANCIAL STATEMENTS

1. Review of CAFR Information

Good internal control requires an adequate review of information used to prepare the CAFR, including information provided by other agencies.

During our audit of the CAFR for fiscal year 2007, we noted numerous errors in the preparation of the CAFR. 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. In addition, State Accounting did not always understand how some State agencies were preparing their accrual information. Errors in amounts reported to State Accounting were noted at the Department of Roads, the Department of Education, the Department of Revenue, and the Department of Health and Human Services and ranged from $420,000 to $29.2 million. State Accounting did make correcting entries for all material amounts as recommended by the APA. Management has indicated there was an inadequate amount of staff to perform this review. This was noted in our previous management letter.

- There were numerous errors noted on information prepared by State Accounting to support entries made to the financial statements. Errors included a transposition of numbers resulting in a $9 million dollar overstatement and a $2.9 million overstatement due to a workpaper not being updated for 2007. State Accounting did make the appropriate corrections for all material amounts as recommended by the APA.

- State Accounting did not have procedures to analyze documents processed as prior year obligations (P9s) by State agencies after September 30. APA noted $33 million in P9s were processed from October 2006 to June 2007. Other entries were made to record the majority of the obligations.

Without adequate processes and procedures in place to ensure the accuracy of the CAFR there is a greater risk material misstatements may occur and remain undetected.

> We recommend State Accounting obtain an understanding of how State agencies prepare key accrual information, and work with and train State agency personnel to ensure accrual information is supportable and has a sound accounting base. Once State agencies submit their information to State Accounting, State Accounting should have procedures in place to review and verify the information is supportable, reasonable, and accurate. We also recommend State Accounting ensure an adequate review of internally prepared documentation to ensure accuracy. Finally, we recommend State Accounting implement procedures to analyze historical prior year payments made after September to ensure payables recorded are complete.

Agency's Response:

- *State Accounting has and will continue to work with agencies to ensure that the amounts the agencies submit with the accrual questionnaires are correct. Prior to distribution of the financial reporting package, State Accounting met with the Department of Roads and the Department of Health and Human Services to discuss ways to improve the reporting of accruals for the CAFR. State Accounting also met with the Department of Revenue, and had discussions with the Department of Education during CAFR preparation. To improve our process, members from State Accounting are attending each exit conference to be a party to all discussions with the auditors and the agencies regarding this issue. Finally, State Accounting will meet with appropriate agencies again to refine reporting methods, and will develop other procedures to improve reporting.*

- *State Accounting has procedures to review workpapers before they are given to the auditor, but this year some workpapers were not reviewed beforehand in an effort to save time in order to meet auditor deadlines. In the future, State Accounting will ensure all workpapers are completely reviewed.*

- *State Accounting has analyzed accounts payable transactions recorded after our cutoff time in prior years, and determined that amounts were either immaterial or reflected in other CAFR accrual entries. Thus, this year no such review was performed and when the auditors performed such a review, they only found $1.6 million of items that should have been recorded as applying to the previous year. This adjustment was passed. We will continue to do an overall review but maintain that a detailed review is not time-justified.*

- *However, we do not concur that these errors rise to the level of the possibility of material misstatements of the financial statements, especially when considering the amount of the questioned items and the fact that the State assets exceeded $12 billion and the State expenses exceeded $6 billion. Furthermore, prior to the release of the financial statements, State Accounting does a complete review of all reported amounts, compares them to the prior year and to budget amounts, and then researches all questionable amounts, which is a process designed to catch any possible misstatements.*

Auditor's Response: The APA followed Statement on Auditing Standards No. 112 *Communicating Internal Control Related Matters Identified in an Audit* when evaluating the identified control deficiencies to determine whether the deficiencies were significant deficiencies or material weaknesses. The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. The procedures noted above by the Agency, in and of themselves would not detect misstatements due to accruals which had never been reported by agencies and should have been.

2. Reconciliation of Bank Records to Nebraska Information System (NIS)

Good internal control requires a plan of organization, procedures, and records designed to safeguard assets and provide reliable financial information.

During the audit of the CAFR of the State of Nebraska for the fiscal year ended June 30, 2007, we noted significant unknown variances between the State's accounting records and bank records with the bank records short compared to accounting records. Previous audits of the CAFR have noted similar issues. These variances occurred in periods prior to fiscal year 2007. For fiscal year 2007 cash activity for each month was reconciled. However, the old variances have not been completely identified in order to allow proper adjustments to the accounting records.

As of December 2007, the end of fieldwork for the CAFR, we noted the status of the State's reconciliation process to be as follows:

- State Accounting's June 2007 reconciliation, excluding the Child Support Payment Distribution Unit (SDU), was complete, showed bank records short compared to accounting records, and indicated a consistent variance of $1,065,210. This variance had not changed since it was identified in June 2005.

- The SDU reconciliation at June 2007 showed no variance between the bank records compared to the accounting records; however, State Accounting made an adjustment of $1,893,449 to the CAFR financial statements to account for prior years' bank transfers that have not yet been transferred from the State's bank account to the SDU bank account.

- State Accounting and the SDU continue to work on identifying the old variances to ensure proper adjustments to the general ledger.

Until the old variances can be properly identified, the general ledger can not be corrected. Once corrected, the reconciling items can be removed from the monthly reconciliations.

We recommend the following:

- State Accounting and the SDU continue to work on identifying the old variances to ensure the general ledger is correct.
- State Accounting review the SDU reconciliation to determine the effect on the overall State reconciliation.
- When the old cash variances have been identified, State Accounting should work with the Governor and the Legislature to develop a plan to adjust the general ledger in order to resolve the shortage noted.

Agency's Response: State Accounting will continue to work with the SDU in identifying all old variances in order to get the general ledger correct. We do not concur that this should be reported as a significant deficiency in the current year due to the fact that we are currently properly reconciling all balances and are only trying to resolve old unidentified balances. In addition, these old unidentified amounts are less than $2 million, clearly not a material amount, and thus there is no likelihood these items could cause a material misstatement of the financial statements.

Auditor's Response: The APA followed Statement on Auditing Standards No. 112 *Communicating Internal Control Related Matters Identified in an Audit* when evaluating the identified control deficiencies to determine whether the deficiencies were significant deficiencies or material weaknesses.

3. Nebraska Information System

Good internal control requires general and application controls of computer systems supporting financial data to be in place and working effectively to reduce the risk of financial data being misstated due to error or fraudulent acts. Good internal control also requires a proper segregation of duties so no one individual has the ability to carry out all phases of a transaction from beginning to end.

We noted the following instances where internal controls over information technology were not in place or were not operating as intended by management:

- Seventy-two employees maintained the ability to both create and approve various accounting transactions at their agency. Without a proper segregation of duties, employees have the capability to prepare and post unauthorized transactions in NIS causing a loss or misappropriation of assets due to error or fraud.

- Two NIS application developers maintain administrator access to the AS400 environment and the supporting database. Application developers with access to the database and the production environment have the ability to circumvent the standard change control process and implement modifications that may not be consistent with management's intentions.

- The NIS application is a highly customized application and supports multiple financial processes. However, we noted a detailed understanding of the technical and functional application configuration is limited to a small number of key personnel. A succession plan does not exist in the event key personnel were to become unavailable. Without a succession plan, the level and depth of resources supporting NIS may not be able to provide consistent and on-going support over an extended period of time. Specifically, critical systems operation and maintenance activities may not be performed efficiently or effectively when key personnel are unavailable.

- Ten users in the NIS application support group and 20 employees of Administrative Services State Accounting Division and Materiel Division had access to approve and post batches for all users in the State. With 30 employees having access to approve and post batches for all users in the State there is a greater risk of unauthorized transactions being processed and going undetected. Currently, the NIS application support group, State Accounting, and Materiel Division do not have monitoring procedures in place to ensure unauthorized transactions are not processed by employees who have this access.

We recommend the following:

- Responsibility of creating and approving/posting transactions be separated so no one individual has the ability to both prepare and approve transactions.

- Developers obtain approval prior to moving changes into production. A documented review of audit logs should be conducted for changes made to ensure only authorized changes are occurring.

- Management consider initiating cross training, additional hiring, outsourcing, or other remedial actions to ensure continuity of operations in the case key personnel become unavailable.

- Management review those users that have been granted access to approve and post batches for all users in the State to determine whether assigned access is consistent with the users' job responsibilities and when it is determined the access is required, a monitoring system be developed to help ensure only authorized transactions are processed.

Agency's Response:

- *Segregation of duties is maintained through a variety of controls, including agency internal controls and batch management. Users' ability to prepare and approve/post their own transactions is limited because of these controls working together. Of the seventy-two employees on the list provided, twenty-nine no longer have the ability to prepare and approve/post their own transactions. Twenty-three employees are DHHS – Procurement staff and that agency has other compensating internal controls in place. There are eight employees from small agencies with limited resources. Due to the size of these agencies, one person may need to prepare, another person approve, and the originator post. Pre-audit procedures in place at these agencies assist in preventing the posting of unauthorized transactions.*

  Daily integrity reports are being developed in NIS to list batches created and posted by the same NIS User ID. These reports will be reviewed for further follow-up with the agencies. In addition, agencies have been instructed to conduct a review of their general ledger detail reports which would allow them to detect transactions not authorized by their agency.

- *The NIS Administrator is required to approve any changes made in the Production environment by a developer prior to the modifications being made. We are working towards an e-mail notification from the AS/400 when these changes occur. These developers have limited access to the production environment from the Graphical User Interface (GUI) side of NIS.*

- *The NIS Team meets on a biweekly basis to discuss current projects. This assists the NIS Team to determine where tasks intertwine between the modules of NIS. Information is shared among the team and problem solving is normally done with multiple team members in order to share information. The NIS Team continues to work on cross-training between modules. The NIS Administrator has named two individuals to serve in a back-up capacity in her absence.*

  Documentation does exist for the NIS weekly maintenance activities. In addition, there is support from the Office of the Chief Information Officer for the AS400 and the Intel servers.

- *The NIS application support group must have full access to perform the duties of supporting NIS. Many State Accounting employees must have full access in order to manage all accounting matters of the state's central accounting system. Since your audit work was completed, State Accounting has modified the security of its employees to assist in addressing this comment. In addition, a review is currently being performed of those employees with statewide business unit access to determine if it is necessary for their job functions. There will be a move towards position IDs for the statewide access and their daily IDs would have access to only Administrative Services information.*

In order to address the possibility of misappropriated funds in the form of cash leaving the State, an integrity report is being developed to determine when bank account information is updated in conjunction with a payment group being created by the same User ID.

4. **Federal Fund Balance**

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

Amounts owed from the federal funds to the General Fund were not being tracked or recorded in NIS and State Accounting did not have procedures in place to ensure the General Fund received the monies due from the federal funds. At June 30, 2007, State Accounting determined $34,258,328 was due to the General Fund from the federal funds.

A failure to track obligations between funds may lead to misappropriation of State funds.

> We recommend State Accounting develop procedures to record amounts owed from federal funds to the General Fund and ensure all amounts due are paid in a timely manner.

Agency's Response: If amounts due to the General Fund from federal funds were recorded in the general ledger, State Accounting thinks this may violate the constitution in extending the credit of the State. We believe the method currently being used, where agencies use General Fund appropriations in advance of receiving federal reimbursements, does not violate the constitution.

Auditor's Response: The amounts due the General Fund should be tracked in some manner; this would not have to be through the general ledger.

5. Timesheets

Neb. Rev. Stat. Section 84-1001(1) R.R.S. 1999 states, "All state officers and heads of departments and their deputies, assistants, and employees, except permanent part-time employees, temporary employees, and members of any board or commission not required to render full-time service, shall render not less than forty hours of labor each week except any week in which a paid holiday occurs." In addition, sound business practice as well as good internal control, requires hours actually worked be adequately documented, for example, via timesheet, time logs, etc., and such documentation kept on file to provide evidence of compliance with the requirements of Section 84-1001.

Furthermore, good internal control also requires that whenever employees accrue vacation and sick leave, adequate documentation should be maintained to support the employees' having "earned" the amounts recorded in the leave records by documenting no less than forty hours of work each week. Good internal control requires employee hours worked be approved by a direct supervisor and the approval be documented.

During our testing of payroll we noted the following in regards to Administrative Services employee timesheets:

- Seven of ten employees tested did not have documentation of a supervisor's approval of the employee's time entered on NIS. A similar finding was noted in our prior audit.
- Approximately, 140 exempt employees at Administrative Services were not required to maintain a timesheet or other form of documentation to show at least 40 hours were worked each week.
- For one employee tested, Administrative Services could not provide documentation to support that the employee whose timesheet had been rejected by their supervisor, had been paid the correct hours.

Without adequate records, or supervisory approval, to support hours worked, there is an increased risk for fraudulent or inaccurate payment of regular hours worked and/or accumulation of leave.

> We recommend Administrative Services obtain supervisor approval prior to processing payroll. Furthermore, it is the APA's position Administrative Services does not have documentation to support they are in compliance with the above Statute and recommends Administrative Services establish a policy requiring all Administrative Services employees maintain adequate supporting documentation, such as timesheets, to ensure all staff render not less than forty hours of labor each week as required by Statute. Administrative Services has indicated in the past that exempt employees will not be required to keep timesheets showing daily hours worked. If Administrative Services believes timesheets showing daily hours worked for exempt employees is not appropriate the APA recommends a "Certification" document be used to meet the above statutory requirement. That document, signed by the employee and employee's supervisor, would include leave used by the employee during the period and a statement such as: "I certify that the employee has worked or been on approved leave for at least 40 hours each week of this pay period."

Agency's Response:

- *Of the seven employees, four employees did not have supervisory approval because the supervisor(s) did not approve the time record before the deadline. The remaining three employees have a logical reason why there was no supervisory approval. The first employee, who is paid monthly, should not have been included on this list as they have different approval deadlines than bi-weekly paid employees reviewed in this audit. However, this employee remained on the auditor's findings. The second employee had a sudden death in the family a few days before the time record deadline. At that time, the* *supervisor was waiting on a call from the employee on their status. A call was received, before the deadline, that the employee needed bereavement leave for five days. The supervisor rejected the timesheet the employee had partially completed in order to enter bereavement leave. Approval for bereavement leave was obtained prior to the payroll processing deadline. The HR office provided the approval from the approving supervisor to auditors. The third employee's supervisor was a rather new employee to Administrative Services and was not yet fully trained or established in NIS to approve time for this employee.*

- *Exempt employees are required to only enter their leave exceptions into the NIS time entry time keeping program. If there are no leave exceptions, the approving supervisor does not approve a time record and the system pays them standard hours.*

  Exempt employees do not track, earn or receive overtime compensation for extra hours worked. These employees are paid a salary for performing the whole job and not for actual hours worked. However, they are required to record and seek approval for any leave exceptions or if they are in a leave without pay status.

- *The one employee whose timesheet was rejected was an exempt employee in a supervisory status. The approving manager had left Administrative Services and another manager was temporarily approving time and inadvertently and unknowingly rejected the time record. HR uploaded the time record without noticing this issue until after payroll was processed. HR did verify with the approving manager the 79 hours of regular pay and one hour of vacation leave was paid properly.*

Auditor's Response: Leave exception reporting does not document those exempt employees rendered 40 hours of work each week as required by statute. We again suggest the Agency implement some type of procedure as noted in our recommendation.

6. Revolving Funds Classification

Governmental Accounting Standards Board (GASB) Statement Number 34, paragraph 68 states "*Internal service funds* may be used to report any activity that provides goods or services to other funds, departments or agencies of the primary government …" National Council on Governmental Accounting (NCGA) Statement 3 states special revenue funds are used to account for the proceeds of specific revenue sources that are legally restricted to expenditure for specified purposes. GASB Statement Number 34, paragraph 59 states internal service fund activity and other similar internal events should be eliminated in the Government-Wide Statement of Activities.

During our testing of payroll at Administrative Services, we noted one of twenty-five employees whose pay was incorrectly coded to a special revenue fund. This employee's pay should have been coded to an internal service fund as the employee's job function was to provide a service within State government.

Further testing of State Accounting's CAFR fund classifications revealed 20 NIS revolving funds were incorrectly classified as special revenue funds when they should have been classified as internal service funds. In aggregate, these funds contained $5.48 million in revenues and $5.22 million in expenditures for fiscal year 2007. State Accounting eliminated the activity of these funds from the Government-Wide statements.

As a result of this incorrect fund classification there is an increased risk the special revenue fund financials were overstated and the internal service fund financials were understated.

> We recommend State Accounting review the CAFR fund classifications for all NIS revolving funds and ensure the fund classifications are proper.

Agency's Response: We have 20 revolving funds that we have classified as special revenue funds, a type of government fund. These are immaterial funds with less than .1% of the State's activity. GASB Statement 34 states that the provisions of the statement need not be applied to immaterial items. The Governmental GAAP Guide states there is no circumstance under which an Internal Service Fund must be used. This guide also states that such activity may also be accounted for in another governmental fund, which we have chosen to do.

The comment also stated that one employee's pay was coded to one of these special revenue funds and not to an internal service fund. For the same reasons as pointed out in the previous paragraph, this pay was correctly coded.

7. Continuity Planning

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

Administrative Services has developed a detailed Continuity of Operations (COOP) Plan for the Agency which encompasses all divisions. Alternate facilities have been selected; however, the details surrounding operating at the alternate facilities have not been tested.

When COOP plans have not been fully developed or 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 Administrative Services 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.

Agency's Response: The Continuity of Operations Plan developed by Administrative Services contains detailed information including essential operations targeted for priority restoration, staffing and other resources required for plan activation. Also included are lines of succession for those with administrative, management and essential responsibilities. Administrative Services continues to participate in annual statewide Homeland Security

Exercises where the ability of strategically selected aspects of the plan is tested. During the most recent exercise the Administrative Services Director, Deputy Director and an Administrator all participated in the exercise from the State Emergency Operations Center. Mr. Castillo, Director, served as and continues to serve as a member of the State's Homeland Security Policy Group. The testing of Continuity of Operations Plans is a developmental process building on the exercising of targeted components of the plan. Administrative Services continues to move progressively towards more significant exercises of the plan and simulations of outages and restorations.

8. <u>Capital Assets Historical Costs</u>

A good system of internal control requires adequate documentation be maintained to describe the capital assets held by an entity. The 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.

During our 2005 and 2006 CAFR audits we noted State Accounting did not have readily available supporting documentation for historical cost or additions and deletions that had been made to building and land assets. As of June 30, 2007, State Accounting still had not established a central location to maintain supporting documentation for historical cost or additions and deletions that have been made to building or land assets.

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

> We recommend State Accounting work with Administrative Services State Building Division and the individual agencies to establish policies to ensure correct values of capital assets are reported and maintained. We also recommend State Accounting maintain supporting documentation of capital assets' historical values in one centralized location or work with and monitor individual State agencies to ensure supporting documentation is maintained. 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.

Agency's Response: The supporting documentation for historical cost, additions and deletions are not maintained by State Accounting. Those records are maintained at the state agency which owns and maintains the respective facilities. For instance, to verify the historical cost of a cabin on land owned by the Nebraska Game and Parks Commission, one would visit their headquarters located in Lincoln to see that respective file. In order to help auditors perform *their review of capital assets, we will work to create a listing of locations where each agency maintains their capital asset historical information. We were not informed during the audit that there was a lack of material supporting documentation at each agency.*

9. 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:

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 Department of Health and Human Services (DHHS), Store/Canteen and Welfare & Club funds at the Department of Correctional Services, and Vocational Rehabilitation and Workers Compensation 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 Government Finance Officers Association (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 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 rehabilitation 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 will be reported as such in the fiscal year end June 30, 2007 CAFR.

This has been noted in our previous management letters.

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

Agency's Response: For all of these funds in question, State Accounting's position is that they are immaterial funds and as such GASB 34 provisions do not have to be applied. Furthermore, insignificant activities do not have to be reported as special revenue funds. GASB 34, paragraph 69 does lend support for treating these funds as fiduciary funds in that the assets of these funds cannot be used to support the government's own programs, and thus cannot be special revenue funds. As the GAAFR, page 117, states, "the term 'private-purpose' is best understood as referring to the absence of a public purpose rather than to the presence of a private benefit."

10. <u>Vendor Address Book</u>

Sound business practice and good internal control requires procedures to ensure duplicate address book files are not set up and any known duplicates be removed from the database.

Our review of address book files as of February 2007 noted several vendor address book entries with the same name and address as well as vendors with no Federal Tax Identification Number (FTIN).

When duplicate address book numbers are present there is an increased risk the incorrect address book number could be selected for payment.

> We recommend Administrative Services review the vendor address book files and ensure any duplicate address book entries are removed.

Agency's Response: We acknowledge that there are still businesses that have duplicate numbers in the address book. However, some vendors require multiple address book numbers. We maintain various search types in our address book, such as one for payees, one for vendors, one for welfare payments, etc. Many businesses need a separate address book number for each of these search types. We also need separate address book numbers for the same vendor for tax *refunds, ACH payments, payments to separate locations, etc. Thus, there will always be valid reasons why a certain businesses have more than one address book number. That being said, we will continue to review the listings in our address book to delete unneeded address book numbers.*

As to parties that have an address book number but no FTIN, we are working very hard to eliminate these, but only where appropriate. For instance, when we make a refund to citizens who have sent in money for the chance to obtain a hunting license, there is no reason to obtain an FTIN to refund the money. Currently we have no "PP" search types (vendor payments) without an FTIN and only a few "V" search types (vendors using purchase orders) without an FTIN. We will continue to review all search types to ensure all address book accounts that need an FTIN have one in the system.

11. <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. 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.

<u>OTHER ITEMS – New Accounting Standards</u>

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.

Statement No. 50, ***Board Pension Disclosures an amendment of GASB Statements No. 25 and No. 27.***
This statement, effective for fiscal years beginning after June 15, 2007, more closely aligns the financial reporting requirements for pensions with those for other postemployment benefits (OPEB) and, in doing so, enhances information disclosed in notes to financial statements or presented as required supplementary information (RSI) by pension plans and by employers that provide pension benefits. The reporting changes required by this Statement amend applicable note disclosure and RSI requirements of Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,* and No. 27, *Accounting for Pensions by State and Local Governmental Employers,* to conform with requirements of Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.*

Statement No. 51, ***Accounting and Financial Reporting for Intangible Assets.***
This statement, effective for fiscal years beginning after June 15, 2009, requires that all intangible assets not specifically excluded by its scope provisions be classified as capital assets. Accordingly, existing authoritative guidance related to the accounting and financial reporting for capital assets should be applied to these intangible assets, as applicable. This Statement requires that an intangible asset be recognized in the statement of net assets only if it is considered identifiable. Additionally, this Statement establishes a specified-conditions approach to recognizing intangible assets that are internally generated.

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 letter is intended solely for the information and use of the Agency, the Governor and State Legislature, others within the Agency, Federal awarding agencies, pass-through entities, and management of the State of Nebraska. However, this letter 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.

Pat Reding, CPA
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Assistant Deputy Auditor

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