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February 17, 2009

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, 2008, and have issued our report thereon dated December 19, 2008. We have also audited the State's compliance with requirements applicable to major Federal award programs and have issued our report thereon dated February 10, 2009. 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 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) is considered a significant deficiency. 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. This comment 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 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. 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, 2008.

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 Comprehensive Annual Financial Report (CAFR), including information provided by other agencies.

During our audit of the CAFR, we noted the following errors in its preparation:

- Administrative Services State Accounting Division (State Accounting) did not have adequate procedures to ensure the amounts submitted by State agencies on the accrual response forms were correct. Significant errors, ranging from $228,758 to $11,663,557 were noted in amounts reported by the Department of Health and Human Services and the State Treasurer. State Accounting did make correcting entries for all material amounts as recommended by the Auditor of Public Accounts (APA). A similar finding was noted in previous reports.

- There were numerous errors noted on information prepared by State Accounting to support entries made to the financial statements. The errors ranged from $7,000 to $6,795,755. State Accounting did make correcting entries for all material amounts as recommended by the APA. A similar finding was noted in previous reports.

Without adequate processes 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 continue to 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.

Management 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 many of the larger agencies to discuss this issue. Members from State Accounting are continuing to attend each exit conference and be a party to all discussions with the auditors and the agencies regarding this issue. Finally, State Accounting continues to meet with appropriate agencies to improve reporting methods.*

- *State Accounting has procedures to review work papers before they are given to the auditor. This year all work papers were reviewed by State Accounting employees. Even so, some immaterial items were overlooked. In the future, we will again put strong emphasis on making our work papers correct.*

2. Reconciliation of Bank Records to the General Ledger

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, 2008, we noted significant unknown variances between the State's accounting records and bank records with the bank records being short compared to accounting records. Previous CAFR audits noted similar issues. These variances occurred in periods prior to fiscal year 2008. For the fiscal year ended June 30, 2008, 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 2008, 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 2008 reconciliation, excluding the Child Support Payment Distribution Unit (SDU), 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 2008 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 variance to ensure proper adjustments to the general ledger.

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

A similar finding was noted in our prior audit.

> 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.
> - 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.

Management Response: State Accounting will continue to work with the SDU in identifying all old variances in order to get the general ledger correct.

3. Capital Asset Costs

Good internal control requires procedures to ensure the appropriate cost is posted for capital assets and costs are not entered twice in the accounting system.

We noted two IBM mainframes with costs totaling $3,244,300 were entered into the accounting system with a total cost of $6,488,600. After noting the above errors, the APA completed a more detailed review of asset additions for the Agency and noted an additional 24 items, costing a total of $86,242, were incorrectly entered into the accounting system with a total cost of $215,957.

When procedures are not adequate to ensure costs are properly posted to an asset, there is an increased risk the financial statements are overstated.

> We recommend the Agency implement procedures to ensure capital assets are correctly added to the accounting system.

Management Response: Central Finance has increased their understanding of the Fixed Assets process and has properly trained its staff of this process. Most of the double posting was the result of transitioning the process from one division to another. That issue has been corrected. The two mainframes have now been correctly posted and of the other twenty-four items, seventeen have been fixed and, as soon as some paperwork is finalized, the other seven will also be fixed.

4. Timesheets

Neb. Rev. Stat. § 84-1001(1) (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 may occur." In addition, good internal control requires hours actually worked be adequately documented via timesheets, time logs, etc., and that such documentation be kept on file to provide evidence of compliance with the requirements of § 84-1001. Furthermore, good internal control also requires that whenever employees accrue vacation and sick leave, adequate documentation be maintained to support the employees having "earned" the amounts recorded in the leave records. 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 Agency employee timesheets:

- For 9 of 10 employees tested, documentation was not available to support their hours were approved within a reasonable amount of time after the pay period ended. For 3 of these 9 employees, the Agency could not provide documentation to support these employees' timesheets, which had been rejected by their supervisor, to verify the employees had been paid the correct hours.

- Approximately 139 exempt employees of the Agency were not required to maintain a timesheet or other form of documentation to show at least 40 hours were worked each week.

- APA also noted other agencies, such as the Department of Motor Vehicles and the Military Department, who are using the Nebraska Information System (NIS) for their timesheets, are not documenting compliance with the above Statute.

A similar finding was noted in our prior audit.

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

> We recommend the Agency obtain supervisor approval prior to processing payroll. Furthermore, it is the APA's position the Agency does not have documentation to support they are in compliance with the above Statute and recommends a policy be established requiring all employees of the Agency maintain adequate supporting documentation, such as timesheets. If the Agency believes timesheets showing daily hours worked for exempt employees is not appropriate, the APA recommends the simple addition of signed certification to their existing leave reporting which states "I certify that I have worked or been on approved leave for at least 40 hours each week of this pay period or in accordance with separate employment contract and/or agreement." Additionally, we recommend the Agency consider adding this certification statement to NIS time entry.

Management Response:

- *During the time period selected for payroll audits, Administrative Services was without full-time, permanent, payroll staff. Because of this circumstance, during the timeframe audited, a report designed to ensure supervisory approval of employee's hours was omitted. Since that time, full-time permanent payroll staff have been hired and trained.*

  Report #R053001Z is now being run each payroll cycle. This report indicates which payroll records have not received supervisory approval. Administrative Service's human resource staff then contacts all supervisors who have not approved their employee's payroll, and those supervisors are asked to verify their employee's hours.

- *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.*

  According to the Fair Labor Standards Act, exempt employees must receive the full salary for any week in which the employee performs any work without regard to the number of days or hours worked, unless certain exceptions are met. These allowable exceptions include certain deductions of one or more full days, but only if there is a bona fide plan, policy, or practice of providing compensation for a loss of salary.

  Additionally, 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.

Auditor's Response: We believe documentation is required to support compliance with State Statute 84-1001.

5. <u>Nebraska Information System</u>

Good internal control includes a plan of organization, procedures, and records designed to safeguard assets and provide reliable financial records. A system of internal control should include proper segregation of duties so no one individual is capable of handling all phases of a transaction from beginning to end. 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.

We noted the following in regards to internal controls over information technology:

- Twenty-eight users had the ability to both prepare and approve their own batches in NIS. Daily integrity reports are being developed in NIS to list voucher batches created and posted by the same NIS user ID as well as changes made to vendor bank accounts; however, these reports had not been finalized. A similar finding was noted in the prior audit. Individuals with the ability to both prepare and approve accounting transactions increase the risk unintended or unauthorized transactions may be processed. Individuals with this access may also be able to process financial transactions without anyone else's knowledge or involvement.

- Two NIS application developers maintain administrator access to the AS400 production environment and also had spool control authority within the AS400 which was not required as a part of their job responsibilities. When developers have access to the AS400 production environment, there is an increased risk they will circumvent the standard change control process and implement modifications that may not be consistent with management's intentions.

We recommend the following:

- The Agency continue to work on the implementation of a review of integrity reports to ensure batches prepared and approved by the same users are appropriate. The ability to both initiate and approve transactions should be eliminated when not necessary for the performance of daily State business.
- The Agency establish a proper segregation of duties to ensure developers cannot modify the production environment directly and implement procedures to monitor AS400 access to ensure individuals require this access as part of their job responsibilities. If a proper segregation of duties cannot be established, compensating controls should be implemented to detect unauthorized changes.

Management Response:

- *Segregation of duties is maintained through a variety of controls, including agency internal controls, business unit security and batch management. Users' ability to prepare and approve/post their own transactions is limited because of these three controls working together. Of the twenty-eight employees on the list provided, ten no longer have the ability to prepare and approve/post their own transactions. Seven employees are 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 circumventing the posting of unauthorized transactions. The remaining eleven employees are all AS or Treasurer employees who, by virtue of their duties, must have access to view all agencies and all their transactions. Nevertheless, a daily integrity report has been developed in NIS to list voucher batches created and posted by the same NIS User ID. This same report also includes information when bank account information is updated in conjunction with a voucher being created and posted by the same ID. This report is run on the scheduler every two hours and is currently being reviewed by State Accounting for further follow-up with the agencies and to ensure these employees are not abusing their access. The focus has been placed primarily on the voucher batches because this is the only way cash can leave the State of Nebraska. The other batch types could ultimately cause money to move between funds of the Agencies, but the Agencies would discover this through their normal monitoring of their cash balances.*

- *Two reports created from the AS400 are now being reviewed daily by the NIS Administrator. One report shows login to the NIS Production AS400 and the other shows file changes made to files on the AS400. The logins are reviewed for propriety and the file changes are reviewed to ensure they match the requests made each day through the NIS Functional team and the NIS Administrator.*

6. 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.

The Agency has developed a detailed Continuity of Operations Plan (COOP) for the Agency which encompasses all divisions. Alternate facilities have been selected; however, the details surrounding operations at the alternate facilities had not been tested. A similar finding was noted in the prior audit.

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 the Agency 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.

Management 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. Mr. Carlos Castillo, AS Director, serves 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.

OTHER ITEMS – New Accounting Standards

Governmental Accounting Standards Board (GASB) 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.

GASB 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.

GASB Statement No. 52, ***Land and other Real Estate Held as Investments by Endowments.*** This Statement, effective for fiscal years beginning after June 15, 2008, establishes consistent standards for the reporting of land and other real estate held as investments by essentially similar entities. It requires endowments to report their land and other real estate investments at fair value. Governments also are required to report the changes in fair value as investment income and to disclose the methods and significant assumptions employed to determine fair value, and other information that they currently present for other investments reported at fair value. This Statement does not apply to lands granted by the Federal government in connection with a state being admitted to the United States.

GASB Statement No. 53, ***Accounting and Financial Reporting for Derivative Instruments.*** This Statement, effective for fiscal years beginning after June 15, 2009, addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. A key provision in this Statement is that derivative instruments covered in its scope, with the exception of synthetic guaranteed investment contracts (SGICs) that are fully benefit-responsive, are reported at fair value. The objective of this Statement is to enhance the usefulness and comparability of derivative instrument information reported by state and local governments. This Statement provides a comprehensive framework for the measurement, recognition, and disclosure of derivative instrument transactions.

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.

Signed Original on File	Signed Original on File
Pat Reding Assistant Deputy Auditor	Don Dunlap Assistant Deputy Auditor