NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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February 2, 2012

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, 2011, and have issued our report thereon dated December 29, 2011. 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 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 the Department 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.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or combination of control deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider Comment Number 1 (Review of CAFR Information) and Comment Number 2 (Health and Pharmacy Benefit Procedures) to be significant deficiencies.

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 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, 2011.

1. Review of CAFR Information

A good internal control plan requires an adequate review of information used to prepare the Comprehensive Annual Financial Report (CAFR), including the information provided by other agencies.

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

- The Department of Administrative Services State Accounting Division (State Accounting) did not have adequate procedures to ensure the amounts submitted by State agencies were correct. The errors included an overstatement of $1,606,134 by the Department of Health and Human Services and an understatement of $2,527,597 by the Department of Labor.

- Errors were also noted on information prepared by State Accounting to support entries made to the financial statements. Errors ranged from $116,501 to $8,575,906.

- The new Governmental Accounting Standards Board (GASB) Statement Number 54 (Statement), *Fund Balance Reporting and Governmental Fund Type Definitions*, was not adequately implemented. Several assigned fund balances did not have supporting documentation and were later determined to be restricted fund balances, the fund balances recorded in error were over $36 million. Furthermore, several disclosures were not adequately prepared in compliance with the Statement. The Auditor of Public Accounts (APA) had to work extensively with State Accounting in order for the Statement to be implemented properly.

- The Derivative Financial Instruments disclosure was not in compliance with the GASB Statement Number 53, *Accounting and Financial Reporting for Derivative Instruments*. The disclosure did not include all derivative investments held by the State and Synthetic Guaranteed Investment Contracts (SGIC) was not included.

State Accounting did make correcting entries and revised disclosures for all material amounts as recommended by the APA. A similar finding was noted in previous reports.

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 continue to work with and train State agency personnel to ensure accrual information are supportable and have a sound accounting base. State Accounting should also have procedures in place to review and verify the information is supportable, reasonable, and accurate. We also recommend State Accounting ensure an adequate review and the proper implementation of internally prepared documentation to ensure accuracy.

Management Response: *State Accounting has and will continue to work extensively with agencies to ensure that the amounts the agencies submit with the accrual questionnaires are correct. State Accounting has met with many of the larger agencies to discuss this issue and to help the agencies implement proper procedures for several years. 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. 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, but some errors were still not discovered. State Accounting will again put strong emphasis on making our work papers correct and significant progress has been made in accrual reporting over the years.*

2. Health and Pharmacy Benefit Procedures

The Agency's procedures for the Eligibility Audit for Health and Pharmacy Benefits states, "Each month 14 members are randomly chosen for the Eligibility Audit, 11 from the BCBS (Blue Cross Blue Shield) files and three from the ESI (Express Scripts, Inc.) files…Verification includes: verify that the employee is enrolled in the Medical plan that the claims were paid under, when the plan started and or stopped and any dependents covered including their age." A good internal control plan and sound business practice require verification procedures to ensure insurance claims paid by the State are proper and for eligible individuals only.

The APA selected 15 employees to test from the Agency's eligibility audits. We reviewed the Agency's documentation for verification of the employees' eligibility and all dependents of that employee enrolled in the plans. Of the 15 employees tested, 8 employees had dependents in the plans. The following issues were noted:

- DAS did not begin dependent eligibility testing until November 2010. Prior to this it was unknown if dependents covered in the plans were proper. Three of eight employees, with dependents, selected for testing by the APA were prior to dependent eligibility testing.
- Beginning in March 2011, eligibility procedures for ESI claims were no longer performed by the Agency. The Agency requested the member name and ID numbers be removed from reports provided by ESI, without this information the Agency was unable to perform eligibility procedures. It is unknown why the Agency requested the information be removed.

- One employee, with two dependent children over the age of 19, was tested by the Agency. The Agency obtained class schedules for both dependents to verify eligibility, however, the schedules did not identify the student's name, therefore, it was unknown if they were for the dependents tested and the Agency did not perform further procedures to verify.

- One employee was a retired State Patrol member and was eligible for continued health insurance coverage. The member's spouse was also covered under the plans. The Agency did not perform eligibility procedures to ensure the spouse was properly eligible for the plan.

- Two employees selected for testing by the APA had not responded to the Agency's request for information. The Agency stated their alternate procedures were to contact the member via telephone and contact the employing State agency. However, the Agency did not document further contact made with the individuals or the State agency, therefore, it was unknown if there were any further attempts made to obtain information to verify eligibility.

- During our review of user controls outlined in the ESI Statement on Auditing Standards Number 70 (SAS 70), we noted the Agency did not reconcile ESI invoices to reports detailing claims to ensure only eligible claims were paid. The Agency also did not review the Eligibility Summary and Error reports or reconcile the reports to transactions sent to ESI in order to identify input errors.

Without adequate procedures to ensure individuals in the health and pharmacy plans are eligible there is increased risk ineligible claims will be paid. Furthermore, when user controls identified in the SAS 70 are not addressed there is an increased risk of error in data supplied to and from ESI.

> We recommend the Agency establish procedures to ensure individuals in the health and pharmacy plans are eligible and claims paid are accurate and proper. We also recommend the Agency implement procedures to ensure user controls identified in the ESI SAS 70 report are considered and documented.

Management Response: *The Department of Administrative Services Wellness and Benefits division implemented an internal dependent audit process in November 2010 to randomly audit approximately 10-15 employees each month. Administrative Services will continue to improve the process to ensure that a sufficient review is in place to conduct these monthly checks of dependent eligibility. Beginning next plan year, Administrative Services will be requiring random audits to be conducted by our health care administrator. In addition, over 8,000 employees with enrolled dependents on July 1, 2011 were subject to a comprehensive dependent audit conducted by a specialized dependent audit firm.*

The Department of Administrative Services Wellness and Benefits division has a review process in place for invoices from Express Scripts. In an effort to improve this review process, the division is working with Express Scripts to design a report that will allow dependent eligibility to be reviewed.

3. <u>Timesheets</u>

Neb. Rev. Stat. § 84-1001(1) (Reissue 2008) 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, a good internal control plan requires hours actually worked to be adequately documented, for example, 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, a good internal control plan requires employees that accrue vacation and sick leave have adequate support that the employees "earned" the amounts recorded in the leave records.

During testing of payroll we noted approximately 262 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. The Agency used the State's accounting system, EnterpriseOne, for time entry and leave exceptions; exempt employees were only required to record leave used in EnterpriseOne.

A similar finding was noted in our prior audit.

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

> It is the APA's position that the Agency does not have documentation to support they are in compliance with State Statute and recommends a policy be established requiring all employees maintain adequate supporting documentation, such as timesheets or certifications.

Management Response: *Exempt employees are required to only enter their leave exceptions into the EnterpriseOne 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.

4. Private Purpose Trust Fund Classification

GASB Statement Number 34, paragraph 72, states, "Private-purpose trust funds, such as a fund used to report escheat property, should be used to report all other trust arrangements under which principal and income benefit individuals, private organizations, or other governments."

Furthermore, Governmental Accounting, Auditing, and Financial Reporting, Specialized Guidance for Private-Purpose Trust Funds 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. The use of private-purpose trust funds normally should be limited to situations where specific benefits accrue to specific individuals, organizations, or governments. For example, it would not be appropriate to use a private-purpose trust fund to account for the revenues of prison pay phones that will provide benefits to inmates generally."

The State of Nebraska reports the Canteen and Welfare fund and Vocational Rehabilitation fund as Private Purpose Trust Funds. The Canteen and Welfare fund generates revenues from vending sales, donations, and gifts at State facilities for the use of inmates or patients of the Department of Correctional Services and Department of Health and Human Services. The Vocational Rehabilitation fund revenues are generated through assessments against insurance companies and self-insurers to provide rehabilitation services to outside persons so they can obtain employment. Neither fund's revenues were designated for the benefit of specific individuals and therefore, should not be reported as Private Purpose Trust Funds but instead as Special Revenue Funds.

Without adequate documentation to support fund presentation in the financial statements there is a risk of financial statement misstatements.

> We recommend State Accounting reconsider their classification and present these funds as Special Revenue Funds in accordance with standards.

Management Response: *State Accounting will review these funds again and make adjustments if determined necessary.*

Other Items-New Accounting Standards

GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements.*

This Statement, effective for fiscal years beginning after December 15, 2011, establishes recognition, measurement, and disclosure requirements for service concession arrangements (SCAs) for both transferors and governmental operators, requiring governments to account for and report SCAs in the same manner, which improves the comparability of financial statements. As used in the Statement, an SCA is an arrangement between a transferor (a government) and an operator (governmental or nongovernmental entity) in which (1) the transferor conveys to an operator the right and related obligation to provide services through the use of infrastructure or another public asset (a "facility") in exchange for significant consideration and (2) the operator collects and is compensated by fees from third parties.

GASB Statement No. 61, ***The Financial Reporting Entity: Omnibus an amendment of GASB Statements No. 14 and No. 34.***
This Statement, effective for fiscal years beginning after June 15, 2012, modifies certain requirements for inclusion of component units in the financial reporting entity. It results in financial reporting entity financial statements being more relevant by improving guidance for including, presenting, and disclosing information about component units and equity interest transactions of a financial reporting entity.

GASB Statement No. 62, ***Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements.***
This Statement, effective for fiscal years beginning after December 15, 2011, will improve financial reporting by contributing to the GASB's efforts to codify all sources of generally accepted accounting principles for state and local governments so that they derive from a single source. This effort brings the authoritative accounting and financial reporting literature together in one place, with that guidance modified as necessary to appropriately recognize the governmental environment and the needs of governmental financial statement users.

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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 recommendations that we hope will be useful to the Agency.

This report 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 and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

Signed Original on File

Pat Reding, CPA, CFE
Assistant Deputy Auditor