NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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February 10, 2014

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

Dear Mr. Oligmueller:

We have audited the basic financial statements of the State of Nebraska (State) as of and for the year ended June 30, 2013, in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States and have issued our report thereon dated December 30, 2013. In planning and performing our audit, we considered the State's internal control over financial reporting (internal control) as a basis for designing audit procedures for the purpose of expressing our opinions on the basic financial statements of the State, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

In connection with our audit described above, we noted certain internal control or compliance matters related to the activities of the Nebraska Department of Administrative Services (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.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified a certain deficiency in internal control that we consider to be a significant deficiency.

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. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or combination of 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) to be a significant deficiency.

This comment 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 systems was completed. Those findings and recommendations were reported to management in a separately issued confidential summary thereof.

Draft copies of this letter were furnished to the Agency to provide management with an opportunity to review and to respond to the comments and recommendations contained herein. 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, 2013.

1. Review of CAFR Information

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

The Department of Administrative Services State Accounting Division (State Accounting) prepares the CAFR annually. In order for the State to receive the Government Finance Officers Association (GFOA) Certificate of Achievement for Excellence in Financial Reporting, the CAFR needed to be completed by December 31, 2013. Therefore, the Auditor of Public Accounts (APA) provided a list of items to be prepared by State Accounting, with dates for submission to the APA for testing, to ensure the CAFR would be completed timely. Throughout the audit, several items were not submitted timely.

For instance, State Accounting requested financial information from all State agencies to be provided by August 6, 2013. The APA requested this information be submitted for testing, with supporting documentation, by September 27, 2013. However, the last of the information was not provided until October 29, 2013, over one month late, and supporting documentation was not included. Instead, the APA had to request the needed information directly from the agencies. This led to delays and inaccurate information.

Several other items that require substantial testing, such as the investment disclosures, infrastructure supplementary information, and outside trust fund statements, were provided up to 30 days late. When information that should be received in October or November is not received until December, there is an increased risk State Accounting will not be able to review the information thoroughly, which could lead to errors. In addition, audit procedures cannot be completed timely, which could result in the CAFR being issued late.

Furthermore, the draft report submitted by State Accounting was incomplete and inaccurate and was not provided timely. This was partly due to errors noted in the late information submitted to the APA, which required adjustments in the financial statements or note disclosures. State Accounting provided the first draft on December 12, 2013, and three drafts thereafter, that required revisions for formatting and incorrect information, such as hidden rows on the financial statements, combining statements not agreeing to other statements, etc. The final draft was not provided until December 30, 2013.

During testing of the CAFR, we noted the following:

- State Accounting did not have adequate procedures to ensure the amounts submitted by State agencies were correct. The errors ranged from an overstatement of $13,643,401 by the Department of Health and Human Services for incorrect payables to an understatement of $351,213,506 by the Department of Roads for infrastructure work in progress that was not reported.

- Errors were also noted in information prepared by State Accounting to support entries made to the financial statements and information to generate footnotes. Errors consisted of misclassifications of investment disclosures for $4,282,100, an understatement of allowance for doubtful accounts disclosure totaling $2,308,014, a misclassification of cash payments in the Lottery Statement of Cash Flows for $507,000, and the omission of $544,819 in capital assets for land purchased during the fiscal year.

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 procedures in place to ensure the accuracy of the financial reports and information used to prepare the CAFR, there is a greater risk material misstatements may occur and remain undetected. Furthermore, when information is not submitted to the APA on a timely basis, there is an increased risk the CAFR will not be completed by December 31, in accordance with the GFOA requirements.

> We recommend State Accounting implement procedures to ensure information is complete, accurate, and submitted timely to the auditors. Furthermore, we recommend State Accounting continue to work with State agency personnel to ensure accrual information is supported and has a sound accounting base. State Accounting should also have procedures in place to review and verify that information is supported, reasonable, and accurate.

Agency 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. In this regard, State Accounting will meet with and assist many larger agencies to design, develop, implement, and monitor proper procedures, as needed, so that accurate and timely reporting can be done after the year end. For the upcoming year, members from State Accounting will also attend exit conferences at various agencies to understand and enhance accounting procedures.

State Accounting will develop and communicate with agencies and APA, a newly structured schedule for 2014 for the completion of reports for timely submission to APA.

State Accounting has procedures in place to review work papers before they are given to the APA. We will review those procedures for adequacy and effectiveness and will make necessary changes, if needed. Please note that significant progress has been made in accrual reporting over the years.

2. <u>Supplies Inventory</u>

A good internal control plan requires procedures for reviewing inventory balances at year end to ensure balances are reasonable and proper.

The Department of Administrative Services Printing Division recorded its supplies inventory on the State accounting system. The APA questioned the balance in the system because it increased from $245,993 at fiscal year ended June 30, 2012, to $4,583,236 at June 30, 2013. The Agency then researched the increase and determined it was caused by an incorrect quantity in an adjusting entry. The Agency made a correcting entry in October 2013 to bring the balance to the correct level of $220,558. It is unknown if the Agency would have identified the error and properly adjusted the balance for financial statement presentation had the APA not questioned the balance.

When adequate reviews of inventory balances, along with needed entry adjustments to the State accounting system, are not performed, there is an increased risk of misstated financial statements.

> We recommend the Agency implement procedures to ensure inventory transactions are adequately reviewed, and ending balances are reasonable.

Agency Response: The error was created due to a "unit of measure" change when entering a sales order into the system. The print shop has had some turnover and as a result, the new employee thought they were performing their due diligence. We have provided training to the employees at the print shop and in central finance. The financial posting that is performed by central finance now has additional controls in place. Central Finance no longer posts any batch over $1,500 without an email confirmation from the print shop, and this confirmation is attached to the posting and kept on file. This should identify and allow correction of any future inadvertent "unit of measure" changes.

3. Cash Deposits Reconciliation

A good internal control plan and sound accounting practices require adequate documentation to support cash reconciliations and identify variances to be researched and resolved.

State Accounting performed a reconciliation to support the carrying value of the cash deposits recorded in the notes to the financial statements. The reconciliation contained an unknown variance of $191,098. During the APA's review, one reconciling item was found for which State Accounting was unable to provide a reasonable explanation for its inclusion. When this item was removed from the reconciliation, there remained an unknown variance of $6,420,390.

State Accounting then provided a second, alternative reconciliation with an unknown variance of $196,633. Again, after reviewing that reconciliation, the APA questioned a particular line item within the reconciliation, and State Accounting was unable to explain its purpose. When this item was removed, there remained an unknown variance of $1,689,783.

Consequently, there was not a complete and accurate reconciliation of cash deposits at fiscal year ended June 30, 2013, which gives rise to questions regarding the accuracy of the carrying value of the cash deposits in the notes. Without proper support for cash reconciliations and any variances noted, there is an increased risk that the recorded amount of the cash deposits will be improper.

> We recommend State Accounting perform a reconciliation for cash deposits and ensure all line items contained therein are reasonable and supported.

Agency Response: State Accounting determined an alternate method to calculate the deposits in January 2014.

4. Lack of Service Organization Controls Report for Risk Management

The Department of Administrative Services Risk Management Division (Risk Management) uses a service organization to authorize, process, and pay workers compensation claims for the State. The service organization's operations are significant to the State's financial statements; therefore, a Service Organization Control (SOC) report is obtained, by the service organization, annually. The SOC report provides a description of the service organization's system, a written assertion that the service organization's system was designed and implemented as of a specified date, the controls related to the control objectives were suitably designed to achieve the objectives, and an auditor's report that expresses an opinion. The SOC report can then be relied upon by user auditors (such as the APA) to obtain an understating of the nature and significance of the services and the effect on the State's internal control.

A good internal control plan requires the SOC report to be performed and obtained prior to year end for use by the State and user auditors.

Risk Management did not obtain a SOC report from the workers compensation service organization prior to December 31, 2013, for the APA's review and reliance. As a result, the APA had to perform additional testing procedures in order to ascertain whether claims were processed properly. The last SOC report obtained was for the fiscal year ended June 30, 2012.

When SOC reports are not obtained, there is an increased risk the State's controls will be inadequate to ensure claims paid were accurate and in compliance with the State's policies.

> We recommend the Agency implement procedures to ensure SOC reports of a service organization are received and reviewed in a timely manner. In instances where the reports are not able to be received, the Agency should implement procedures to reduce the risk of erroneous claim payments through increased documented reviews of payments.

Agency Response: The Office of Risk Management did provide to the Auditor on October 28, 2013 a bridge letter from FARA. This letter confirmed that the controls in place were still active and had not changed significantly from the date of the last SOC report (June 30, 2012). With respect to this year, the Office of Risk Management has confirmed with FARA that the SOC report for the period ending June 30, 2014 must be available by November 30, 2014.

<u>Other Items – New Accounting Standards</u>

GASB Statement No. 65, ***Items Previously Reported as Assets and Liabilities.***
This Statement, effective for financial statements for periods beginning after December 15, 2012, establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities.

GASB Statement No. 66, ***Technical Corrections–2012–an amendment of GASB Statements No. 10 and No. 62.***
This Statement, effective for financial statements for periods beginning after December 15, 2012, aims to improve accounting and financial reporting for a governmental financial reporting entity by resolving conflicting guidance that resulted from the issuance of two pronouncements, Statements No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, and No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*.

GASB Statement No. 67, ***Financial Reporting for Pension Plans-an amendment of GASB Statement No 25.***
This Statement, effective for financial statements for fiscal years beginning after June 15, 2013, aims to improve financial reporting by state and local governmental pension plans. This Statement results from a comprehensive review of the effectiveness of existing standards of accounting and financial reporting for pensions with regard to providing decision-useful information, supporting assessments of accountability and inter-period equity, and creating additional transparency. This Statement replaces the requirements of Statements No.

25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 50, *Pension Disclosures*, as they relate to pension plans that are administered through trusts or equivalent arrangements (hereafter jointly referred to as trusts) that meet certain criteria. The requirements of Statements 25 and 50 remain applicable to pension plans that are not administered through trusts covered by the scope of this Statement and to defined contribution plans that provide postemployment benefits other than pensions.

GASB Statement No. 68, *Accounting and Financial Reporting for Pensions-an amendment of GASB Statement No. 27.*
The primary objective of this Statement, effective for fiscal years beginning after June 15, 2014, aims to improve accounting and financial reporting by state and local governments for pensions. It also improves information provided by state and local governmental employers about financial support for pensions that is provided by other entities. This Statement results from a comprehensive review of the effectiveness of existing standards of accounting and financial reporting for pensions with regard to providing decision-useful information, supporting assessments of accountability and inter-period equity, and creating additional transparency.

GASB Statement No. 69, *Government Combinations and Disposals of Government Operations.*
This statement, effective for financial reporting periods beginning after December 15, 2013, establishes accounting and financial reporting standards related to government combinations and disposals of government operations. As used in this Statement, the term *government combinations* includes a variety of transactions referred to as mergers, acquisitions, and transfers of operations. This Statement requires the use of carrying values to measure the assets and liabilities in a government merger. This Statement also provides guidance for transfers of operations that do not constitute entire legally separate entities and in which no significant consideration is exchanged.

GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees.*
This statement, effective for fiscal years beginning after June 15, 2013, will enhance comparability of financial statements among governments by requiring consistent reporting by those governments that extend nonexchange financial guarantees and by those governments that receive nonexchange financial guarantees. This Statement also will enhance the information disclosed about a government's obligations and risk exposure from extending nonexchange financial guarantees.

GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date – an amendment of GASB Statement No. 68.*
This statement, effective for fiscal years beginning after June 15, 2014, addresses an issue regarding application of the transition provisions of Statement No. 68, *Accounting and Financial Reporting for Pensions.* The issue relates to amounts associated with contributions, if any, made by a state or local government employer or nonemployer contributing entity to a defined benefit pension plan after the measurement date of the government's beginning net pension liability. This Statement amends paragraph 137 of Statement No. 68 to require that, at transition, a government recognize a beginning deferred outflow of resources for its pension contributions, if

any, made subsequent to the measurement date of the beginning net pension liability. Statement 68, as amended, continues to require that beginning balances for other deferred outflows of resources and deferred inflows of resources related to pensions be reported at transition only if it is practical to determine *all* such amounts.

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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 suggestions that we hope will be useful to the Agency.

This communication is intended solely for the information and use of management, the Governor and State Legislature, and others within the Agency and is not intended to be, and should not be, used by anyone other than these specified parties. However, this communication is a matter of public record, and its distribution is not limited.

SIGNED ORIGINAL ON FILE

Pat Reding, CPA, CFE
Assistant Deputy Auditor