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UTAH STATE AUDITOR

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REPORT NO. 04-21

January 18, 2005

D'Arcy Dixon Pignanelli, Executive Director
Department of Administrative Services
3120 State Office Building
Salt Lake City, Utah 84114

Dear Ms. Pignanelli:

We have completed our audit of the financial statements of the State of Utah for the year ended June 30, 2004. Our report thereon, dated October 29, 2004, was issued under separate cover. We have not yet completed the Department of Administrative Services' (the Department's) portion of the statewide federal compliance audit for the year ended June 30, 2004. Our report on the statewide federal compliance audit for the year ended June 30, 2004 should be issued by April 2005. Any additional findings resulting from the completion of the federal compliance audit will be issued to you as a supplement to this letter.

In planning and performing our audits, we considered the Department's internal control over financial reporting and administration of major federal programs in order to determine our auditing procedures for the purpose of expressing our opinion on the State's financial statements and on the State's compliance with the requirements of its major programs and not to provide assurance on internal control. We noted certain matters involving the Department's internal control over financial reporting and administration of federal programs that we consider to be reportable conditions. These conditions are identified in the accompanying table of contents and are described in the accompanying schedule of findings and recommendations. These reportable conditions are not believed to be material weaknesses.

Reportable conditions are defined as matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting and compliance that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements or administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. We have also identified as reportable conditions those instances of noncompliance that are required to be reported in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States and Federal OMB Circular A-133.

During our audit, we also noted another matter involving the internal control over financial reporting and compliance of the Department and its operations. We are submitting for your consideration a related recommendation designed to help the Department make improvements and achieve operational efficiencies. This matter is described in the accompanying schedule of findings and recommendations.

This report by its nature focuses on exceptions, weaknesses, and problems. This should not be understood to mean there are not also various strengths and accomplishments. Our consideration of the internal control over financial reporting and administration of federal programs would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses, particularly since our review was based on our audit of the State as a whole.

This report is intended solely for the information and use of the Department and is not intended to be and should not be used by anyone other than this specified party.

We appreciate the courtesy and assistance extended to us by the personnel of the Department during the course of our audit, and we look forward to a continuing professional relationship. If you have any questions, please call Stan Godfrey, Audit Director, at (801) 538-1356.

Sincerely,

Auston G. Johnson, CPA
Utah State Auditor

cc: Kim S. Oliver, CPA, Director, Division of Finance
John C. Reidhead, CPA, Assistant Comptroller, Division of Finance
Alan F. Edwards, Director, Division of Risk Management
Stephen C. Hewlett, Assistant Director, Division of Risk Management
F. Keith Stepan, Director, Division of Facilities Construction and Management
Kenneth E. Nye, CPA, Deputy Director, Division of Facilities Construction and Management
David D. Williams, Professional Services Group Manager, Division of Facilities Construction and Management

DEPARTMENT OF ADMINISTRATIVE SERVICES
FOR THE YEAR ENDED JUNE 30, 2004

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DEPARTMENT OF ADMINISTRATIVE SERVICES

FINDINGS AND RECOMMENDATIONS FOR THE YEAR ENDED JUNE 30, 2004

1. **NONCOMPLIANCE WITH PAYROLL POLICY** (Reportable Condition)

Federal Agency: **various**
Federal Award Number: **various**
CFDA Number and Title: **various**
Questioned Cost Amount: **\$0**
Pass-through Entity: n/a

As part of our annual audit of State payroll expenditures, we reviewed the reports associated with 40 payroll expenditures to ensure that they were properly reviewed and retained. For the one expenditure selected from the Department of Administrative Services (the Department), we noted that the Division of Facilities Construction and Management did not retain the "Payroll Results Edit" or the "Time Entered After Cut-off" reports. State Accounting Policies and Procedures (FIACCT 11-17.00) require the Department to generate, review, approve, and retain certain payroll reports each pay period to ensure the accuracy and document approval of the payroll transactions entered into the SAP Payroll System (the System). Noncompliance with the policy could allow errors or misappropriations related to payroll expenditures to occur without detection.

Recommendation:

We recommend that the Department generate, review, approve, and retain required payroll reports each pay period to document that payroll transactions entered in the System are accurate and approved in accordance with State Accounting Policies and Procedures.

Department's Response:

We believe the instance cited in your finding to be very much an anomaly, and one that can and will be quickly corrected. In this particular instance, the individual responsible for the reports was on vacation and did not make arrangements for the back-up person to follow through with the required reports. To avoid this happening again, a checklist spreadsheet has been created and processes have been established which include a review to ensure that the work has been done.

DAS [the Department] has asked that the divisions follow outlined procedures to ensure that reports are completed and filed. Training is given to each new technician and periodic notices with policies attached are sent as reminders.

Anticipated Correction Date: *Immediately.*

Contact Person: *Dave Williams, Financial Manager, 538-3293.*

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2. RESERVES IN EXCESS OF FEDERAL GUIDELINES (Reportable Condition)

Federal Agency: **various**
Federal Award Number: **various**
CFDA Number and Title: **various**
Questioned Cost Amount: **\$0**
Pass-through Entity: n/a

The Risk Management Fund held working capital reserves in excess of federal guidelines at June 30, 2004. Federal guidelines permit internal service funds such as Risk Management to have a reasonable working capital reserve (generally no more than 60 days of normal cash expenses). As of June 30, 2004, the Risk Management Fund working capital reserves of \$10.9 million represented approximately 154 days of normal cash expenses. Excess working capital reserves of \$6.6 million could result in a federal liability, as federal programs share an interest in the reserves.

Recommendation:

We recommend that the Risk Management Fund eliminate excess working capital reserves through adjusting rates and/or making refunds.

Department's Response:

Corrective Action: Risk Management records a liability in its books based on actuarial estimates for the eventual final costs for reported and unreported claims that occurred prior to year end. During the past year, at your request, we reevaluated the calculation of these types of reserves. The calculation previously was based on a statistical 80% confidence level and during the last fiscal year, management adopted a 55% confidence level in order to better comply with applicable accounting guidelines. This change resulted in a reduction in the claims liability and thus an increase in the working capital reserves. While State "reserves" are assumed to be adequate in the most likely scenario, they are now less likely to cover all the costs actually incurred in "worst case" situations. The reduction in the liability this year resulted in one-time income for Risk Management, and that one-time income is included in retained earnings as of June 30, 2004.

The amount of the reserves is equal to the actuarial calculations made by the CPA firm of Deloitte and Touche, specifically by their actuarial division in Los Angeles. As soon as Risk Management became aware of the financial impact of the change in the statistical confidence level, it was reported to your office, the Governor's Office of Planning and Budget, the Legislative Fiscal Analyst's Office and the statutorily-established Internal Service Fund Rate Committee at their next meeting. After discussing the options for adjusting rates or making refunds, the Rate Committee approved the suggestion that rather than returning it to state

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agencies or temporarily reducing insurance rates, \$4.5 million of retained earnings be made available for appropriation by the Legislature in the 2005 session.

Since appropriation of retained earnings usually results in a liability to the Federal Government, in August 2004, Risk Management with the assistance of State Finance accrued the potential liabilities to the Federal Government and recorded the liability effective as of the end of the 2004 fiscal year. This calculation also included an estimate of the federal liability resulting from the appropriation of \$3.35 million of Risk Management retained earnings in the 2004 legislative session.

Even though these estimated federal liabilities are recorded in the state's financial records, Risk Management continues to work with State Finance who is in contact with the federal cost negotiators to ensure that the appropriate federal share of any amount taken out of the fund is returned to the Federal Government.

In summary, the situation reported results from a change in claims estimates that produced a one-time source of money for the legislature to be able to appropriate. We expect that working capital reserves will be within federal guidelines once the Legislature has appropriated the money from the fund and the federal portion has been returned to the Federal Government.

Anticipated Correction Date: July 1, 2005, when the new legislatively approved budget year begins.

Contact Person: David Lamb, Director of Administrative Services for Risk Management, (801) 538-3213.

3. **INADEQUATE CASH RECEIPTING CONTROLS**

The Department's Division of Risk Management (the Division) does not have written cash receipting procedures. We noted the following cash receipting weaknesses:

- a. **Incomplete Initial Receipt Records:** The Division does not have a control procedure to ensure that all cash and check payments received are deposited and accounted for properly. A mail log or written receipt is not prepared for all payments received. Maintaining complete initial receipt records is necessary to ensure that all receipts are deposited and accounted for properly.
- b. **Untimely Deposits:** Some subrogation payments are not deposited until the final claim amount is determined in order to ensure full payment is received. *Utah Code*, Section 51-4-1 requires the Division to deposit all collections of state money and other funds no later than once every three banking days unless they have received a written variance from the State Treasurer. Delays in depositing cash receipts causes

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noncompliance with State law, greater risk of loss or misappropriation, and lost interest income.

- c. **Inadequate Safeguarding of Cash Receipts:** We observed that subrogation checks that are being held prior to deposit are kept in a folder at the front desk. Although access to the office is limited to those with security badges or those who are admitted in at the front desk, proper safeguarding of cash receipts is necessary in order to prevent misappropriation and/or mishandling of funds.

State Policy (FIACCT 13-00.00) requires each department to “establish written departmental procedures that provide for good internal controls to ensure that all monies received are properly receipted, safeguarded, deposited, and recorded in the State’s accounting system (FINET).” Adequate cash receipting controls are necessary in order for individuals who have access to cash or checks received to be accountable for the propriety of processing those funds, to prevent and/or detect the misappropriation of funds, and to comply with State policy.

Recommendation:

We recommend that the Division comply with State policy by establishing written cash receipting procedures which include the following:

- a. **Maintaining complete initial receipt records to ensure that all receipts are deposited and accounted for properly.**
- b. **Depositing receipts in a timely manner in accordance with *Utah Code*, Section 51-4-1, or obtaining a written variance from the State Treasurer.**
- c. **Establishing control over and safeguarding of all cash receipts.**

Department’s Response:

- a. *The Division does not receive a significant amount of currency (the average is only about \$100 per month) and checks that belong to Risk Management as payment in full for money due are recorded in the mail log and receipt book, and then they are deposited timely, in accordance with state laws and policies.*

A few checks are received in the mail that do not belong to Risk Management. In addition, checks are sometimes received that are less than the full required payment and some of these partial payment checks state that depositing them will settle the state’s claim in full. This is occurring more frequently as some outside insurance companies try to get the State to accept less than is due. These checks are not deposited, but they are assigned to be investigated by the claims adjuster that initially

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handled the case. The checks are not automatically returned. At your recommendation, we have put procedures in place that would have these checks recorded in our cash receipt log with other checks, even though the checks may not belong to Risk Management or they may never be deposited because they do not represent settlements that the State is willing to accept.

- b. In October, 2004, we requested and we have now received a Certificate of Variance from the State Treasurer which allows us more than three days to investigate and resolve insurance premiums that are incorrect and investigate “subrogation payments received by the Division of Risk Management that are less than the amounts due, and being held pending adjuster negotiations with the insurance companies.” We will continue to work vigorously to ensure that Risk Management is paid the amounts that are due, while at the same time not taking any actions that would eliminate the possibility of collection in full.*
- c. All receipts of currency are deposited timely. The checks are the ones referred to in comments 3a and 3b above, and they are kept in locked areas that are, as you correctly stated, “limited to those with security badges or those who are admitted in at the front desk.” We have implemented additional procedures to ensure that the checks that are currently in locked, secured areas are further protected by being placed in a cash box, which is in a secured file drawer.*

Anticipated Correction Date: Immediately.

Contact Person: David Lamb, Dir. of Administrative Services, Risk Management, 538-3213.