State of Rhode Island

AUDIT RESULT HIGHLIGHTS
and
MANAGEMENT COMMENTS

Single Audit
Fiscal Year Ended June 30, 2005

Ernest A. Almonte, CPA, CFE
Auditor General

State of Rhode Island and Providence Plantations
General Assembly
Office of the Auditor General

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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

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March 17, 2006

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

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Senator Joseph A. Montalbano
Senator Dennis L. Algiere
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Representative Robert A. Watson

We have completed our Single Audit of the State for the fiscal year ended June 30, 2005 and have issued our *Single Audit Report* separately. This communication supplements the *Single Audit Report* and includes audit result highlights as well as management comments and related recommendations. In our opinion, these management comments, while less significant than findings included in the *Single Audit Report*, still warrant communication and the attention of the State's management.

Sincerely,

Ernest A. Almonte

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Auditor General

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OVERVIEW

We performed a comprehensive audit of the State of Rhode Island for the fiscal year ended June 30, 2005. The State's basic financial statements and our *Independent Auditor's Report* thereon are presented in the *State's Comprehensive Annual Financial Report*. The *Single Audit Report* includes the State's basic financial statements, our report on internal control over financial reporting and compliance, and our opinion on compliance with requirements applicable to each major federal program and our report on internal control over compliance. The *Single Audit Report*, required by federal law, also includes findings and recommendations, relating to both the financial statements and the administration of federal programs, deemed to be reportable conditions, instances of material noncompliance, or matters required to be reported by OMB Circular A-133. The results of our audit, as communicated in various opinions, reports, and findings and recommendations, are summarized below:

Financial Statements –

- We opined on the fairness of presentation of the State's basic financial statements (government-wide, major funds and aggregate remaining fund information). Our opinions were qualified because:

  <u>Government-wide financial statements – governmental activities -</u>

  - Capital assets reported on the governmental activities financial statements are incomplete. Due to insufficient inventories of capital assets and weaknesses in accounting controls, we were unable to satisfy ourselves as to the carrying value of the furniture and equipment, depreciable intangible, and building improvement categories of capital assets and related depreciation.

  <u>Fund financial statements –</u>

  - We could not satisfy ourselves as to the completeness of accounts payable and federal receivables (amounts due from other governments and agencies) and the related expenditures and federal revenue reported for the Intermodal Surface Transportation Fund (a major fund).

  - Outstanding encumbrances at June 30, 2005 were not presented as a reserved component of fund balance within the State's major and non-major governmental funds.

  Our opinions on the State's business–type activities and the aggregate discretely presented component units included within the government-wide financial statements were unqualified.

- We issued a report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards.* This report references twenty-eight reportable conditions of which 17 are considered material weaknesses in control over financial reporting. A table on pages 4 and 5 demonstrates the wide-ranging impact of the reportable conditions on multiple functional areas of the State's operations. These reportable conditions and related recommendations are included in the State's *Single Audit Report* for the year ended June 30, 2005.

- We presented twenty-four (24) management comments and recommendations (included herein beginning on page 6) intended to improve internal control or enhance compliance with laws, regulations or contracts. In addition, we communicated one management comment relating to the operations of the Division of Taxation separately and confidentially to avoid any unintended impact on taxpayer compliance. These management comments are less significant findings than those considered to be reportable conditions, yet, in our opinion still warrant communication and the attention of the State's management.

Federal Programs –

- We issued a report on compliance with requirements applicable to each major federal program and on internal control over compliance in accordance with OMB Circular A-133. This report references 46 reportable conditions of which 6 are considered material weaknesses in internal control over compliance with federal requirements. Material noncompliance was reported for five major federal programs. These instances of noncompliance, reportable conditions, and related recommendations are included in the State's *Single Audit Report* for the year ended June 30, 2005.

DISCUSSION OF THE SIGNIFICANCE OF THE AUDIT RESULTS

Beginning with fiscal 2002, the State's ability to generate reliable and timely financial statements has been seriously compromised. This was mainly caused by:

- an inadequate accounting system that does not meet the State's financial reporting and operational needs;
- serious control weaknesses that complicate financial reporting and impede efficient audits;
- insufficient personnel resources allocated to accounting and financial reporting matters;
- a long-standing lack of investment in and management attention to building financial controls and systems that support financial reporting; and
- increasingly complex accounting and financial reporting guidelines promulgated by the Governmental Accounting Standards Board that continually raise the financial reporting standard to which the State is held.

Progress began during fiscal year 2005 towards addressing many of these long-standing issues. The State began dedicating more personnel resources and focus on issues identified in past audits as well as the preliminary planning for the implementation of an integrated accounting system. Although the majority of the reportable conditions still existed during fiscal 2005, important steps were taken towards the future implementation of many of the recommendations made in past audits.

In addition, preparation and audit of the State's financial statements were completed within eight months of the fiscal year-end, representing a significant improvement over prior years. While notable, this was largely achieved through special focus and dedication of resources to the task rather than through improvement in systems that support financial reporting. The goal for the future, which is consistent with the State's current efforts to implement an integrated accounting system, is to improve and automate the data systems that support financial reporting thereby improving both the timeliness and quality of information.

As the findings included in the *Single Audit Report* and these additional management comments indicate, the State still faces a significant challenge in reforming the State's financial systems and processes, as well as improving the overall security of the State's information technology resources. The State must continue to devote the resources necessary to ensure that many of the issues impacting the current accounting system are resolved with the implementation of a new integrated accounting system planned for fiscal 2007. Further, the State will need to further expedite its year-end financial reporting process if it hopes to have audited financial statements available within six months after the fiscal year end.

Three important themes underlie many of the fiscal 2005 findings and recommendations --

- management is responsible for preparing financial statements in accordance with generally accepted accounting principles;
- management is responsible for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements; and
- management's reliance on information technology necessitates the implementation of comprehensive systems security policies and procedures designed to ensure data integrity and reliability and protect data from loss or corruption.

Significant deficiencies in the design and operations of internal control over financial reporting (reportable conditions and material weaknesses) are described in detail in the reportable conditions included in the *Single Audit Report*. The management comments included herein are "second tier" findings which in many instances are important control issues that represent less risk to financial reporting than those deemed reportable conditions and material weaknesses.

The State appropriately desires to continue to decrease the time required to publish audited financial statements. However, consideration must be given to the impact of the multiple control weaknesses that have not been addressed and continued to exist during fiscal 2005. These control weaknesses not only complicate the accumulation of data for financial reporting purposes but prevent a controls driven audit approach where the focus is on assessing the reliability of the State's controls thereby relying on information produced under the control structure. Instead, we are forced to adopt a more substantive audit approach, which ultimately requires more audit effort thereby lengthening the audit timeframe.

CONCLUSION

Deficiencies in the State's financial reporting and management capabilities have multiple causes, many of which have been long-standing. Our audit recommendations have focused on the fact that an effective solution to these issues must be multi-faceted, requiring the State to invest increased personnel and financial system resources.

The State's focus and dedication to resolving these long-standing issues are positive signs for the future. During fiscal 2005, the State began to implement a plan to improve the State's long-term financial reporting and management capabilities. This plan includes the dedication of significant investments in personnel and an integrated accounting system.

In conclusion, the State must continue its emphasis and related investment in financial management and reporting. If continued, the benefits of these investments should not only improve the timeliness of financial reporting, but should significantly enhance the State's overall financial management.

			Functional Impact Area					
Finding	*Description*	*Material Weakness[2]*	*Financial Reporting*	*Accounting Controls*	*Financial management*	*Asset Management and Protection*	*Information Systems Security*	*Compliance With Laws and Regulations*
2005-1	*Controls Over Accounting and Financial Reporting – Statewide Accounting System*	●	■	■	■	■		
2005-2	*Controls Over Accounting Transactions – RISAIL Accounting System*	●	■	■	■	■	■	
2005-3	*Monitoring Departmental Restricted and Operating Transfer Accounts Within the General Fund*		■	■	■			■
2005-4	*Accounting Control over Investment Transactions*	●	■	■	■	■		
2005-5	*Accounting and Physical Control over Capital Assets*	●	■	■	■	■		
2005-6	*Control over Long-term Obligations*	●	■	■	■			
2005-7	*Capital Leases*		■	■	■	■		
2005-8	*Controls over Data Accumulated for Purposes of Financial Reporting from Various State Information Systems*	●	■	■	■	■		
2005-9	*Accounting Controls over Federal Revenue and Expenditures*	●	■	■	■			
2005-10	*Encumbrances*	●	■	■	■			
2005-11	*Escrow Liability Balances*	●	■	■	■			■
2005-12	*Taxation – Controls over Electronic Funds Transfer Receipts*		■	■			■	
2005-13	*RISAIL Access Controls*		■	■			■	
2005-14	*Controls Over Taxation Systems*		■	■			■	
2005-15	*Controls Over Employee Payroll System*		■	■			■	
2005-16	*Comprehensive Disaster Recovery/Business Continuity Plan*		■	■	■	■	■	
2005-17	*Comprehensive Information Systems Security Policies and Procedures*		■	■	■	■	■	

			Functional Impact Area					
Finding	*Description*	*Material Weakness[2]*	*Financial Reporting*	*Accounting Controls*	*Financial management*	*Asset Management and Protection*	*Information Systems Security*	*Compliance With Laws and Regulations*
2005-18	*Financial Reporting – Intermodal Surface Transportation (IST) Fund*	●	■	■	■			
2005-19	*Controls Over Federal Revenue Recorded Within the IST Fund*	●	■	■	■			
2005-20	*Controls over the Identification and Recording of Year- End Accruals*	●	■	■	■			
2005-21	*Indirect Cost Recovery*		■	■				■
2005-22	*Lottery Gaming Systems – Logical Access Security*		■	■	■		■	■
2005-23	*Prepare Timely Bank Reconciliations – Employees' Retirement System*	●	■	■	■			
2005-24	*Improve Controls Over Financial Reporting – Employees' Retirement System*	●	■	■	■			
2005-25	*Implement Reconciliation Controls over the ANCHOR and General Ledger Accounting Systems – Employees' Retirement System*	●	■	■	■			
2005-26	*Improve controls over Data Entry to Ensure Correct Posting of Data to Employer Accounts – Employees Retirement System*	●	■	■	■			
2005-27	*Fiscal Agent Oversight – Medical Assistance Program*	●	■	■	■		■	■
2005-28	*Automated Data Processing (ADP) Risk Analysis and System Security Review*		■	■	■		■	■

(1) *Reportable conditions* involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the State's ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements.

(2) A *material weakness* is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level, the risk that misstatements caused by error or fraud in amounts, that would be material to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

	Condition Description		Recommendations
MC-1	**Fraud Risk Factors** As required by Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit,* we assessed the State's policies and procedures designed to mitigate fraud risk factors. Management is responsible for designing and implementing systems and procedures for the prevention and detection of fraud. The risk of fraud can be reduced through a combination of prevention, deterrence, and detection measures. It is important to place a strong emphasis on fraud prevention and deterrence to persuade individuals from committing fraudulent acts. Our assessment found that the State has inadequate policies and/or procedures designed specifically for the purpose of mitigating fraud risks. In addition, several weaknesses relating to the State's internal controls over financial reporting also increase the State's overall fraud risk factors. Policies and procedures specific to the prevention, deterrence and detection of fraud within operations of the State need to be developed and implemented to safeguard assets of the State and to ensure that the State's financial reporting process is not impacted by fraud. These policies and procedures could be incorporated into the existing Fiscal Integrity Act process which requires department directors to make an annual assessment and reporting of risks facing their department or agency.		MC-1 Develop and implement policies and procedures specific to the prevention, deterrence and detection of fraud, most importantly, as it relates to the misappropriation of assets and opportunities for fraudulent financial reporting.
MC-2	**Accounting for Infrastructure Assets** In accordance with GASB Statement No. 34, the State is required to retroactively report, beginning in its fiscal year 2006 financial statements, all major general infrastructure assets. This will require the State to report the historical cost for major general infrastructure assets that were constructed or significantly reconstructed, or that received significant improvements, in fiscal years ending after June 30, 1980 and through the fiscal year ended June 30, 2002. Annual infrastructure outlays have been reported since fiscal 2002, however, the retroactive component has not been included in the financial statements. During fiscal 2005, the State began outlining a process to accumulate the necessary data to meet this reporting requirement, however, none of the required retroactive data has been accumulated to date. Further delays in accumulating this data could delay the issuance of audited financial statements for the State. Failure by the State to accurately report retroactive infrastructure in the 2006 financial statements could result in qualification of the *Independent Auditor's Report*.		MC-2 Accumulate the necessary infrastructure data to comply with GASB's retroactive infrastructure reporting requirements.

	Condition Description		Recommendations
MC-3	<u>Disclosure of Deposit and Investment Risks</u> Generally accepted accounting principles (GAAP) require various disclosures in the notes to the financial statements regarding deposits with financial institutions and investments. Beginning with fiscal 2005, additional disclosures were required due to the implementation of GASB Statement No. 40, *Deposit and Investment Risk Disclosures*. Since the Office of the General Treasurer is responsible for cash deposits and investments, much of the information required for disclosure is within their control. A work-group comprised of staff from the Offices of Accounts and Control and the General Treasurer should be established to accumulate all the information needed to meet the GAAP disclosure requirements for deposits and investments. The work-group should also accumulate required information to make deposit and investment risk disclosures for amounts held by trustees. Such amounts included within the caption "Funds on deposit with fiscal agent" on the financial statements totaled nearly $500 million at June 30, 2005.		MC-3 Establish a work-group to accumulate all the information needed to meet the GAAP disclosures for deposit and investment risks.
MC-4	<u>Government–wide Statements – Accounting for Debt Premiums, Discounts and Issuance Costs</u> In accordance with GAAP, any premium or discount resulting from issuance of debt is deferred and amortized over the life of the related debt in the government-wide financial statements. The Office of Accounts and Control amortizes these amounts using the "straight-line" method rather than the effective interest method preferred by GAAP. When the amount of premium or discount is small the difference in amortization methods is immaterial, however, issuances in recent years by the State have resulted in significant premiums upon issuance. For example, debt issuances during fiscal years 2004 and 2005 have resulted in $31 million and $18 million in premiums, respectively. Accumulation of this data and calculation of the annual amortization amount is not accumulated within a comprehensive debt accounting system. A comprehensive debt accounting system should also be used to account for related debt issuance costs.		MC-4 Accumulate premiums and discounts from issuance of debt within a comprehensive debt accounting system. Amortize these amounts using the effective interest method.
MC-5	<u>State Budget</u> The annual budget enacted by the General Assembly encompasses multiple funds (General, ISTEA, University and Colleges, TDI, Unemployment Insurance) in a comprehensive format by governmental function. For budgetary control purposes, the budget must be recorded within the accounting system and be segregated by distinct fund. The Budget Office should explore the possibility of including the fund information within the budget document to facilitate recording the budget within the accounting system and preparation of budget to actual comparisons for financial reporting purposes (which are prepared on a fund basis).		MC-5 Explore the possibility of including fund information within the budget document to facilitate recording the budget in the accounting system and preparing budget to actual comparisons.

	Condition Description		Recommendations
MC-6	<u>Revenue Recognition</u> Revenues of the State should be recognized in the financial statements consistent with generally accepted accounting principles (GAAP). The applicable recognition principles are based on the revenue type, the type of fund the revenue is recorded in, and the applicable financial statement (government-wide or fund perspective). One class of revenue transactions is considered "derived tax revenue" transactions resulting from assessments imposed by the State on exchange transactions – these include personal income, corporate income and sales taxes. Other employment related taxes (unemployment insurance and temporary disability taxes) collected by the State's Department of Labor and Training also represent assessments imposed on exchange transactions. GAAP requires that revenue from these taxes be recognized as the underlying exchange transaction occurs. Revenue should also be recognized net of estimated refunds and estimated uncollectible amounts. The State has generally adopted accounting policies to meet GAAP criteria, however, we noted instances during our fiscal 2005 audit where policies for accruing revenues earned by fiscal year end but not received at June 30 were not consistently applied. Consistent application of policies is necessary to ensure revenue recognition is appropriate and consistent between years. Additionally, some tax revenues collected are later refunded, however for certain taxes, no estimate is made of the likely refunds for certain taxes. Instead refunds, when paid, are later deducted from receipts of another period. One such tax is the tax on financial institutions. A large refund was paid in fiscal 2004 representing tax receipts collected during fiscal 2003. A large refund is still owed the taxpayer and will be either refunded or applied to future tax liabilities. Without some estimate of likely refunds, tax revenues reflected in the State's financial statements in a particular year can be either materially overstated or understated. Accounting policies were revised for fiscal 2001 to reflect the provisions of GASB Statement No. 33 - Accounting and Financial Reporting for Nonexchange Transactions. These policies should be reexamined for all material revenues to ensure that revenue recognition policies are consistently applied in accordance with GAAP.		MC-6 Reexamine revenue recognition policies to ensure compliance with GAAP.

	Condition Description		Recommendations
MC-7	<u>Comprehensive Annual Financial Report - Management's Discussion and Analysis</u> "Management's Discussion and Analysis" (MD&A) is a required component of the State's basic financial statements. Its purpose is to provide users of the financial statements with a narrative introduction, overview, and analysis of the basic financial statements and to highlight and explain significant changes. Management is also required to discuss other facts, transactions, and events known as of the date of the *Independent Auditor's Report* that could have a significant impact on the future financial resources of the State. The State should enhance its discussion within MD&A of significant events and transactions that take place after year-end and their anticipated impact on the State's future financial condition. Such enhancements would improve the overall usefulness of the MD&A and ensure that all required elements, as defined by generally accepted accounting principles, (GAAP) have been included.		MC-7 Expand the State's discussion of other facts, transactions, and events within Management's Discussion and Analysis to enhance its usefulness and ensure compliance with GAAP.
MC-8	<u>Medicaid Claims Liability Estimation Process</u> The State estimates a liability for amounts owed at year-end to medical providers through the Medical Assistance Program. The estimation methodology employed by the State includes utilizing expenditure data and an average lag period for the various medical service types (inpatient hospital, outpatient, pharmacy, etc.) determined by the Medical Assistance claims payment system to estimate amounts owed at year-end. In addition, the State's calculation also includes information submitted by the various State departments (Mental Health, Retardation, and Hospitals, Children, Youth, and Families, Elderly Affairs, etc) to derive a net liability (claims due providers minus any cost offsets such as drug rebates) to record in the State's accounting system. Although the net liability reported by the State in recent years has been fairly stated, specific results for individual claim types have reflected significant differences. These differences, in many instances, have been noted for several years and suggest that the State's current estimation process should be refined to minimize the risk of reporting a misstated claims liability in future years. We have had specific discussions with officials of the Department of Human Services during recent audits regarding specific segments of the estimation process that require improvement. The State now has multiple years of claims processing data that it can analyze to assist the refining of the estimation process.		MC-8 Address claim-type issues noted during recent audits to improve the Medical Assistance Claims Liability estimation process. These issues related to specific claim types that have been omitted and those where estimates do not tend to support actual claims payment results in recent years.

	Condition Description	Recommendations
MC-9	<u>Reporting Debt Service Expenditures</u> Section 35-3-25 of the RI General Laws requires all debt service charges to be included within the budget for the Department of Administration. The colleges and university report annual debt service amounts to the Department of Administration, however such amounts include debt service for the institutions' auxiliary enterprises. This debt was issued by the respective institutions, is reported on their separately issued financial statements, and is repaid with revenues of the institutions. These debt service expenditures are included in the Department of Administrations' budget but are actually paid directly by the colleges and university. Consequently, the financial statements for the general fund reflect debt service expenditures (and an offsetting "transfer in") that are not related to debt outstanding of the primary government. For fiscal 2005, the colleges and university reported debt service payments of more than $8 million. Both expenditures and revenue are artificially inflated in the General Fund. Although the General Laws require all debt service payments to be budgeted within the Department of Administration, there are debt service payments of the primary government that are not included within the Department of Administration's budget (e.g., debt service on the GARVEE and Motor Fuel bonds).	MC-9 Report only debt service payments related to the primary government within the State's governmental funds.
MC-10	<u>Transactions with Component Units</u> The State does not currently attempt to align transfer amounts between the primary government and discretely presented component units. This results in transactions being reported inconsistently between the primary government and component units within the State's financial statements. These inconsistencies are caused by differences between the manner in which the component unit records the transaction and how it is coded in the State accounting system. For example, transactions reported as transfers in the general fund may be reported as expenses within component units. Timing differences also cause inconsistencies between the financial statements of the primary government and the component units.	MC-10a Improve natural account coding of transactions with component units in the accounting system. MC-10b Provide guidance to the State's Component Units on recording transactions with the primary government.

	Condition Description	Recommendations
MC-11	<u>Comprehensive Annual Financial Report – Component Unit Note Disclosures</u> The notes to the financial statements should communicate information essential to the fair presentation of the basic financial statements that is not displayed on the face of the financial statements. GASB Codification section 2300.105 states that "Determining which discretely presented component unit disclosures are essential to fair presentation is a matter of professional judgment and should be done on a component unit-by-component unit basis. A specific type of disclosure might be essential for one component unit but not for another depending on the component unit's significance relative to the total component units included in the component units column and the individual component unit's relationship with the primary government". The State's note disclosures relating to component units could be enhanced by consistently applying the GASB criteria (highlighted above) and evaluating all disclosures against this standard. For instance, certain relatively insignificant component unit transactions or balances were disclosed while others of a more significant nature were omitted within the State's fiscal 2005 financial statements. Where certain component units constitute a high percentage of total component unit activity, the State does not report relevant disclosures for at least these significant component units. For example, disclosures of cash and investments were not made for any discretely presented component units even though three component units constituted the majority of component unit assets.	MC-11 Disclose significant transactions relating to discretely presented component units in accordance with generally accepted accounting principles.
MC-12	<u>Taxation – Estimated Receivables</u> The Division of Taxation established personal income tax receivables on the taxation receivable system for various taxpayers based on estimated data received from the Internal Revenue Service (IRS). This data usually reflects additional income information identified by the IRS but does not take into consideration any deductions, exemptions, filing status, or cost basis that the taxpayer may have as a complete or partial offset to the identified income. This often results in an inflated receivable balance being reported by the Division. The Division's receivable system does not currently differentiate between these types of receivables and those derived from a taxpayer's filing of a tax return. Although we could not determine how much of the receivable balance was derived from estimates, we did identify $1.9 million of estimated receivable balances in fiscal 2004 that were ultimately reduced to $3,500 in fiscal 2005. Similarly, $195,000 of estimated receivables was reduced to $968 in fiscal 2006. The Division should consider coding these receivables separately. This would allow more detailed analysis of these balances and an appropriate allowance for financial reporting purposes.	MC-12a Distinctly code tax receivable balances based on data received from the IRS. MC-12b Once identified, determine whether the allowance on receivable balances derived from IRS data is adequate.

	Condition Description	Recommendations
MC-13	<u>Taxation – Corporate Tax Refunds Miscoding</u> Most tax refunds are recorded as contra-revenue (natural account 5xxxxx) on the State accounting system except for Corporate tax refunds, which are recorded as negative revenues (natural account 4xxxxx). The inconsistency with Corporate tax refunds is due to an error in the batch import program used to load the data disk supplied by Taxation to the State accounting system. The refunds payable calculations for the financial statements were impacted because of this inconsistency.	MC-13 Revise the batch import program to properly record corporate tax refunds as contra-revenue on the State accounting system.
MC-14	<u>Taxation – Writeoffs</u> The Division of Taxation (Division) has established a policy whereby all receivables outstanding greater than 2000 days are automatically coded for write-off without considering whether payments are being made on these accounts. The Division should conduct an analysis of receivables outstanding greater than 2000 days and change their policy to write-off only inactive accounts where there is only remote chance of collection.	MC-14 Refine the tax receivable write-off policy to include provision for balances determined to be uncollectible in addition to the criteria of balances more than 2000 days old.
MC-15	<u>Taxation – Accounting for the Distribution of Motor Fuel Taxes</u> The General Laws establish the distribution formula for motor fuel taxes collected by the State. The Division of Taxation is responsible for the actual distribution of motor fuel cash receipts while the Office of Accounts and Control is responsible for financial reporting aspects. Changes in the distribution formula were made at the beginning of fiscal 2005. Differences existed in how the Division of Taxation interpreted and applied the rate changes and distribution formula changes compared to the Office of Accounts and Control. At issue is whether the changes are effective for the month the Division of Taxation collects the revenue or the month the underlying taxable event occurs (e.g., taxes collected by wholesalers in June are paid to the Division of Taxation in July). The accounting and distribution of motor fuel taxes should be consistent.	MC-15 Distribute motor fuel cash receipts in the same manner in which Accounts and Control accounts for motor fuel revenue for financial reporting purposes.

	Condition Description		Recommendations
MC-16	<u>Taxation – Controls over the Recording of Accounts Receivable Correction Adjustments</u> The Division of Taxation (Division) should strengthen controls over Accounts Receivable Correction (ARC) transactions posted to their mainframe systems. Controls are not in place to ensure that the total of ARC transactions posted matches the amount approved for data entry. The lack of data entry controls could result in an ARC transaction being incorrectly posted to the mainframe system and not being detected by management.		MC- 16 Improve data entry controls over ARC transactions.
MC-17	<u>Taxation – Reconciliation of Cash Receipts posted to the Taxation Mainframe System with RISAIL</u> The Division of Taxation (Division) does not reconcile receipts posted to its mainframe system with receipts reported in the RISAIL accounting system. Although the Division does reconcile their cash receipts ledger to RISAIL, controls would be improved if the Division reconciled receipts reported within the Taxation mainframe system with RISAIL. RISAIL data is the basis for much of the information utilized by the State for financial reporting and the reconciliation of that data with the Taxation mainframe system (Division's official record for tracking tax payments and refunds) would provide enhanced control over the State's reporting of tax revenue. For example, the State's withholding payment for the pay period ended February 25, 2005 was not posted to the Taxation Mainframe system. This type of error would be identified with reconciliation between the two accounting systems.		MC-17 Develop the reporting capability within the Taxation mainframe system to facilitate reconciling receipts reported by Taxation's mainframe system with the RISAIL accounting system.
MC-18	<u>Taxation – W-3 Reconciliations</u> Employers are required to file an annual W-3 reconciliation between the withholding payments due compared to the actual amounts paid to the Division of Taxation. Most W-3 data is calculated electronically by the Taxation Mainframe system from the W-2 file submitted by the employer. During fiscal 2005, there were 17,801 W-3 transactions posted to the employer accounts on the Taxation Mainframe and 17,309 of these transactions were calculated electronically by the system for tax year 2003. W-3 reconciliations for tax year 2003 were due on February 28, 2004, but were not posted until January 18, 2005, almost 11 months later. When the W-3 data is posted, reports detailing overpayments, underpayments, and discrepancies are run. Because these reports are not run timely, the Division is unaware of potential taxes, interest, and penalties that may be due. The Division should process the W-3 reconciliations more timely to identify and collect any underpayments.		MC-18 Process W-3 reconciliations more timely to identify and collect any underpayments.

	Condition Description		Recommendations
MC-19	<u>Allowance for Uncollectible Accounts – Department of Labor and Training</u> The estimated allowance for uncollectible ES, TDI, and JDF taxes was calculated at rates of 65%, 69%, and 81%, respectively in fiscal 2005. These allowance rates have not been recalculated in recent years, and may not accurately estimate the amount of uncollectible employer taxes. Allowance methodologies should continually be assessed by the State to ensure that they accurately reflect current receipt trends.		MC-19 Develop current allowance rates for uncollectible employer taxes using recent historical data.
MC-20	<u>Recording Cash Receipts – Department of Labor and Training</u> Cash receipts totaling $592,917 for employer taxes received on or before June 30, 2005 were erroneously recorded as fiscal 2006 revenue. These amounts were initially deposited in DLT's combined tax account in June 2005 and moved to the respective Employment Security and TDI tax accounts in July 2005. The General Treasurer's office used the July dates when preparing the receipt vouchers instead of the date the funds were deposited in the combined tax account causing the revenue to be posted in the wrong fiscal year.		MC-20 Ensure that DLT tax receipts are posted in the appropriate fiscal year based on the actual data received.
MC-21	<u>Improving Cash Reconciliation Efficiency</u> The General Treasurer's Office should continue to explore options to further automate the cash reconciliation process with the State's financial institutions. Electronic matching could be facilitated by aligning transaction detail between the bank and the State's accounting system to minimize any differences. Further, the State should examine its existing configuration of bank accounts with the objective of streamlining the number of accounts and the amount of inter-account transactions. Opportunities for automating the reconciliation process should be explored as the State implements a new integrated accounting system.		MC-21a Explore options to automate as much of the reconciliation process as possible with the State's financial institutions by aligning the manner in which transactions are processed by both the bank and accounting system to allow electronic matching for reconciliation purposes. MC-21b Assess the existing configuration of bank accounts with the objective of streamlining the number of accounts and the amount of inter-account transactions.

	Condition Description		Recommendations
MC-22	<u>Coordinated Financial Management</u> The State should consider appointing a Chief Financial Officer with the intent of better coordinating and controlling the financial management, including financial reporting, aspects of State operations. This position should be empowered with the resources and the authority to ensure that all agencies comply with coordinated financial management and financial reporting policies and procedures. Various units of State government perform financial management functions with the Budget Office, the Office of Accounts and Control and the Office of the General Treasurer assuming primary responsibility. Other agencies are responsible for a significant amount of the State's financial operations – for example the Department of Human Services is responsible and has its own systems to administer a significant portion of the overall State budget. Many of the control weaknesses related to financial reporting stem from a lack of coordination of the State's various operating units. Because the current statewide accounting system is not integrated, many independent accounting system and departmental systems contain essential data for financial management and financial reporting purposes. Certain of these data sources are redundant while others are not reconcilable or consistent with other data sources. Significant effort will be required to integrate these data sources into a comprehensive integrated financial management system. Improvement is also needed in enforcing uniform policies and procedures among state agencies. A Chief Financial Officer with the authority to prioritize and align resources to meet the State's overall financial management objectives could coordinate these efforts.		MC-22 Consider appointing a Chief Financial Officer to coordinate the financial management, including financial reporting, aspects of State operations.

	Condition Description		Recommendations
MC-23	<u>Subrecipient Monitoring – Review of Single Audit Reports</u> Subrecipients assist the state in carrying out various programs funded with state and/or federal monies and include such entities as municipalities, community action programs and local educational agencies. Monitoring of subrecipients, which is required when the State passes through federal funds to another entity, varies depending on the nature of the program or activity but always should include review of subrecipient audit reports. Federal regulations (OMB Circular A-133) require any entity that expends $500,000 or more in federal assistance [direct or pass-through (e.g., State)] have a Single Audit performed. Copies of the Single Audit must be provided to the pass-through entity and the federal government. Receipt and review of subrecipient audit reports is now performed on a decentralized basis as responsibility is vested in numerous departments. The State can improve its subrecipient monitoring practices by centralizing the audit report review function for the reasons outlined below: ❑ Many subrecipients receive funding from multiple departments of the State – each is required to receive and review the same audit report. ❑ Specific agencies reviewing the audit reports do not consider noted deficiencies from the perspective of the risks that they pose to all state and federal funds passed through to the subrecipient. One large subrecipient of the State, which receives significant funding from multiple departments and agencies, has been very late in presenting its audit reports and those audit reports have highlighted serious deficiencies. ❑ There is no centralized database detailing which entities receive funding from the State, which are required to have a Single Audit performed, and the status of the audits. ❑ Effective subrecipient monitoring requires that individuals reviewing the audit reports be trained in governmental accounting and auditing requirements (specifically the Single Audit Act and OMB Circular A-133). This level of proficiency is difficult to achieve and maintain at all the departments and agencies now required to review subrecipient audits. We have reported various deficiencies in the process used to review subrecipient audit reports. Considerable advantages can be gained by centralizing the subrecipient monitoring function within one unit of State government. This will raise the level of assurance that subrecipients comply with applicable laws and regulations and both state and federal funds are spent as intended. It will also reduce the amount of resources devoted to this effort and achieve other efficiencies.		MC-23a Centralize subrecipient monitoring procedures related to receipt and review of Single Audit Reports within one agency. This function should be staffed with individuals trained in governmental accounting and auditing matters to allow effective review of the Single Audit Reports. MC-23b Build a database of all subrecipient entities that receive state and/or federal grant funding.

	Condition Description		Recommendations
MC-24	<u>Drawdowns of Federal Funds</u> Each agency administering a federal program is responsible for drawing federal funds for that program. Federal regulations govern the timing of these draws of federal cash – the federal government generally prohibits drawing cash before expenditures are actually made. Federal grant revenue for the State approximates $2.0 billion this year. Consequently, the timing of receipt of these funds has a significant impact on the State's overall cash management. We have reported for many years that the State does not have adequate controls in place to ensure compliance with federal cash management requirements. In many instances, agencies do not draw federal cash as frequently as permitted by federal regulations thereby adversely impacting the State's overall cash management. We believe responsibility for the drawing of federal funds should be vested in the Office of the General Treasurer where cash management for federal programs could be integrated with other cash management objectives. The function of drawing federal cash should be automated as part of a comprehensive integrated accounting system. As allowable expenditures are recorded for federal programs in the State's accounting system, cash would be drawn by electronic funds transfer into the State's bank accounts.		MC-24 Vest responsibility for drawing federal funds with the Office of the General Treasurer. Automate the drawing of federal funds as part of the implementation of a comprehensive integrated accounting system.

The following statements issued by the Governmental Accounting Standards Board (GASB) will impact the State's financial reporting beginning in Fiscal 2006 and subsequent years. Advance planning is important to ensure that required information is available to implement these new standards when required.

GASB Statement	Description	Effective Date	Implementation Issues
Statement No. 42 – *Impairment of Capital Assets and for Insurance Recoveries*	This Statement establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This Statement also clarifies and establishes accounting requirements for insurance recoveries.	Effective for periods beginning after December 15, 2004 Fiscal Year 2006	State may need to assess their major reported capital assets for potential impairment. For assets determined to be impaired, the State will need to adjust asset carrying amounts and/or estimated useful lives.
Statement No. 43 – *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*	This Statement establishes uniform financial reporting standards for "other postemployment benefits" (OPEB) plans and supersedes the interim guidance included in Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans.* The approach followed in this Statement generally is consistent with the approach adopted in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,* with modifications to reflect differences between pension plans and OPEB plans.	Effective for periods beginning after December 15, 2005 Fiscal Year 2007	Statement No. 45, which is closely related to Statement No.43, includes the majority of implementation issues relating to OPEB financial reporting requirements. The applicability of Statement No.43 will be relevant if the State opts to account for its OPEB plan in a trust fund. The State should begin considering the accounting treatment of its OPEB plan in preparation of the future implementation of Statements No. 43 and 45.

GASB Statement Title	Description		Effective Date		Implementation Issues
Statement No. 44 – *Economic Condition Reporting: The Statistical Section – an amendment of NCGA Statement 1*	This Statement amends the portions of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, that guide the preparation of the statistical section. The Statistical Section presents detailed information, typically for ten-year periods, that assists users in identifying trends and utilizing the basic financial statements, notes to basic financial statements, and required supplementary information to assess the economic condition of a government.		Effective for periods beginning after June 15, 2005 Fiscal Year 2006		This Statement may change the data required to be included in the Statistical Section of the State's CAFR. Because this Statement adds new information and clarifies many existing required elements, the State will need to identify required changes to its current Statistical Section to avoid delays in the preparation of the fiscal 2006 CAFR.
Statement No. 45 – *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*	This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers. The basic purpose of this Statement is to require accounting for OPEB in a manner similar to pension benefits, which means reporting the costs related to such benefits in the period in which the exchange occurs in contrast to when the benefits are paid (often many years later).		Effective for periods beginning after December 15, 2006 Fiscal Year 2008		This Statement will require the State to: ❑ Recognize the cost of OPEB benefits when the related services are received by the employer. ❑ Provide information about the actuarial accrued liabilities for promised benefits associated with past services and whether and to what extent those benefits have been funded. ❑ Provide information useful in assessing potential demands on the employer's future cash flows.

GASB Statement Title	Purpose and Description		Effective Date		Implementation Issues
Statement No. 46 – *Net Assets Restricted by Enabling Legislation – an amendment of GASB Statement No. 34*	This Statement attempts to clarify the GASB Statement No. 34 requirement that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets. This Statement clarifies that a legally enforceable enabling legislation restriction is one that a party external to a government – such as citizens, public interest groups, or the judiciary – can compel a government to honor. This statement also specifies the accounting and financial reporting requirements if new enabling legislation replaces existing enabling legislation or if legal enforceability is reevaluated. Finally, this statement requires governments to disclose the portion of total net assets that are restricted by enabling legislation.		Effective for periods beginning after June 15, 2005 Fiscal Year 2006		This statement will require the State to ensure that restricted net assets conform with new financial reporting guidance.
Statement No. 47 – *Accounting for Termination Benefits*	This Statement establishes accounting standards for termination benefits. This Statement outlines the required accounting for voluntary and involuntary termination benefits on both an accrual and modified-accrual basis. In addition, this Statement requires employers to disclose a description of the termination benefit arrangement, the cost of the termination benefits, and significant methods and assumptions used to determine termination benefit liabilities.		Effective for periods beginning after June 15, 2005 Fiscal Year 2006		Current termination practices suggest that this Statement may not significantly impact the State's financial reporting. In these rare instances, the State will need to differentiate between more normal reimbursement for unused compensatory time and amounts paid as termination benefits such as severance pay.

The following corrective action plan was developed by the State's management in response to our management comments.

	Action Planned	Contact Person(s)	Planned Completion Date
MC-1	The State Controller will develop and implement policies and procedures to prevent, deter and detect fraud in conjunction with the Financial Integrity and Accountability policies and procedures.	Lawrence Franklin, Jr.	9/30/2006
MC-2	The State Controller is working with the State Department of Transportation, Department of Mental Health, Retardation and Hospitals and Department of Environmental Management to accumulate the necessary infrastructure data to comply with GASB's retroactive infrastructure reporting requirements by June 30, 2006.	Lawrence Franklin, Jr.	6/30/2006
MC-3	GASB Statement No. 40 was implemented by the State in FY 2005. During the course of the implementation we observed some disclosures that need to be enhanced for FY 2006. These items have been documented and we are working to insure the necessary data is gathered and added to the note. In addition, we will gather the information needed to comply with the recommendation concerning "Funds on deposit with fiscal agent".	Peter Keenan	9/30/2006
MC-4	The DBC software product currently being implemented will allow premiums and discounts to be accumulated and amortized under the interest method.	Peter Keenan	6/30/2006
MC-5	The Budget Office prepares two types of budget documents for release to the public and the General Assembly: the annual appropriations act, a legal document which includes proposed supplemental appropriations for the current year and recommended amount for the budget year by appropriation line item, and six technical/policy documents that provide descriptive explanations and account detail relating to appropriation line item expenditures. The annual appropriations act is structured to present supplemental appropriations and budget year appropriations programmatically by source of funds and line item for each department. The document shows the general revenues, federal funds, restricted receipts, and other funds appropriations for each program in each department. Other funds appropriations are further broken out to show the source of other funds, such as the Rhode Island Capital Fund, Gasoline Tax, Temporary Disability Insurance Fund, Employment Security Trust Fund, and University and College Funds. For most departments, all appropriation line items are within the General Fund, however, for several departments a portion of the appropriation line items in the department are either a separate fund (e.g., Temporary Disability Insurance Trust Fund and Employment Security Trust Fund) or part of a separate fund. Federal funds appropriation lines in RIHEAA, RI Public Telecommunications Authority, and RIDOT are part of separate funds. Rhode Island Capital Fund, which is actually in the Bond Capital Fund, is budgeted generally in the General Fund and cash is transferred in as a resource. However, for the Board of Governors/Higher Education it is budgeted in the Board of Governors/Higher Education Fund. If the appropriations act is restructured to appropriate monies by fund, *the document would lose its programmatic integrity.* Besides the General Fund, appropriations would be spread across numerous funds, including the University-College Fund, the Temporary Disability Insurance Fund, Intermodal Surface Transportation Fund, State Employees Retirement Fund, the Public Telecommunications	Rosemary Gallogly	

	Action Planned	Contact Person(s)	Planned Completion Date
	Authority Fund, the Higher Education Assistance Authority Fund, and various others. Due to space limitations associated with the printed appropriations act, additional columns cannot be reasonably added to show appropriations for each fund. For these reasons, the Budget Office believes it is *not practical* to show appropriations by fund in the appropriations act. Furthermore, it would *not enhance* programmatic presentation of appropriations. As noted above, the Budget Office publishes six budget documents that provide descriptive explanations and account detail relating to line items in the appropriation act. These include the Executive Summary, the Budget, the Technical Appendix, the Personnel Supplement, the Capital Budget, and the Budget As Enacted. The Technical Appendix provides a detailed listing of expenditures by department, program, and account that make up the appropriation line items. The data shown for each account include a nine-digit legacy account number, an eight-digit RISAIL account number, an account name, two years of expenditure history, the enacted appropriation for the current year, the revised appropriation for the current year, and the recommended appropriation for the budget year. Associated with each eight-digit RISAIL account number is an additional four-digit fund/agency number prefix, where the first two digits represent the "fund" identifier and the last two digits represent the "agency or department number" identifier. A "1073" prefix for example, indicates that the account is in the General Fund (digits 10) and the part of the Department of Labor and Training (digits 73). A "6473" prefix indicates the account is in the Employment Security Trust Fund (digits 64) and, again, part of the Department of Labor and Training. While historically the Budget Office has not included the fund/agency prefix identifier with each RISAIL account number listed in the Technical Appendix, the Budget Office will do so in the future to enhance comparisons of budget to actual expenditures by fund when the RIFANS system provides ease in reporting function. Also, the Budget Office will provide in the Technical Appendix a summary page showing expenditures by fund. The Budget office is not in a position to obligate that such a schedule would be provided by the General Assembly for the enacted budget. However, the Budget Office could likely produce one from the enacted budget database.		
MC-6	New techniques to better estimate taxes receivable and related liabilities for estimated refunds payable are currently being developed by Accounts and Control.	Peter Keenan	7/31/2006
MC-7	We will review the existing format of the Management Discussion and Analysis to insure it complies with the GASB requirements.	Peter Keenan	9/30/2006
MC-8	D. H. S. continues to review and evaluate the Medicaid expenditure data and the average lag period to process all Medicaid claims to determine the liability at June 30, the end of the State Fiscal Year. The complexity of the Medicaid Program along with ongoing policy changes at the State and Federal level has an effect on this process. All medical service types of expenditures are included in this process. The larger service types, hospitals and pharmacy appear to be the area of concern of the auditors. D. H. S. will address these concerns as we estimate the Medicaid liability.	Ronald Lebel	6/30/2006

	Action Planned	Contact Person(s)	Planned Completion Date
MC-9	The Budget Office has complied with 35-3-25 of the RI General Laws which requires that all debt service be included in the budget of the Department of Administration. This has required paper transactions at year end for the Higher Education auxiliary enterprises. The Budget Office agrees that compliance with this law results in a double count on the financial statements, with debt service expenditures being reflected in DOA and on the Higher Education statements. The Budget Office is concerned that making the recommended change would result in a violation of the law.	Rosemary Gallogly	
MC-10a MC-10b	Recommendation MC-10a was implemented in FY 2005. Recommendation MC-10b- We disagree; using the RI Economic Development Corporation (RIEDC) as an example RIEDC receives funds from the State for at least three purposes: 1. operating assistance 2. legislative grants which are reimbursements for specific actions performed that are in line with their corporate purpose (goods and services) 3. pass through funds (debt service related to Fidelity bonds). RIEDC may show the total as payments from the State on their financial statements. In the State's financial statements, where we are required to disclose significant transactions with discretely presented component units, we believe that it is appropriate to present only the operating assistance.	Peter Keenan	NA
MC-11	We will review the content of the notes to insure they comply with the GASB requirements.	Peter Keenan	9/30/2006
MC-12a MC- 12b	Tax receivables based on data from IRS are presently coded in "9200" batches. A report has been requested from programmers to measure impact. We will review with Auditor General's staff to determine whether the allowance on receivable balances derived from IRS data is adequate.	R. Gary Clark	
MC-13	This batch import program will be converted from legacy account numbers to RISAIL account numbers by June 30, 2006. The account number conversion will resolve this audit finding.	Lawrence Franklin, Jr.	6/30/2006
MC-14	This policy has been changed to exclude part pay accounts.	R. Gary Clark	
MC-15	After reviewing this issue with The Office of Accounts and Control and the Budget Office, it was determined that the two methods would remain as one method: accounts on a cash basis and the other accounts on an accrual basis.	R. Gary Clark, Lawrence Franklin, Jr., Rosemary Gallogly	
MC-16	This would require substantial re-writes to all systems and additional personnel to reconcile these entries. We would like to do both but it does not appear economically feasible. We have controls in place where supervisors must initial the ARC's sent to Data Entry based on previous audit recommendations.	R. Gary Clark	

	Action Planned	Contact Person(s)	Planned Completion Date
MC-17	The Division of Taxation is currently conferring with Auditor General's staff.	R. Gary Clark	
MC-18	The Division of Taxation agrees with this management comment. The "electronic W-3 files" are actually magnetic media W-3 files such as tapes, cartridges and diskettes. We will reconcile the magnetic media W-3's when completed and the paper W-3 files when completed at a later date. This year all the 2004 tax year W-3 reconciliations were posted by August 1, 2005.	R. Gary Clark	
MC-19	The Employer Tax Section of the RI Division of Taxation will provide the Controller's Office with recent collection experience in order to update the allowance for uncollectible employer taxes.	R. Gary Clark	
MC-20	The General Treasurer's office has been informed and concurs that fiscal year end cut-off procedures are necessary to ensure revenue is recorded in the proper fiscal year based upon the actual revenue receipt date.	Catherine Avila	
MC-21a MC-21b	Limitations within the State's current accounting system produced disappointing results during early attempts to initiate electronic matching of transactions, with a success rate of barely 25-30% from bank transactions to Buyspeed transactions. Treasury has continued to explore electronic matching with the State's financial institutions however, and certain of the banks' newly enhanced on-line systems are able to capture all transactions flowing through the banks and make them available to Treasury electronically. Once implemented, the State's new Oracle integrated financial system is projected to facilitate electronic matching of these transactions. This will assist reconciliation, provided that DOIT is able to integrate the data-feed within Oracle, conform to banking formats to take full advantage of electronic matching capabilities and future enhancements, and produce the appropriate reports to allow reconcilers to manually research and clear exceptions. Treasury was asked to assess the existing configuration of bank accounts to streamline the number of accounts within the context of the Oracle implementation. Treasury has recommended a significantly reduced number of accounts to achieve a comparable reduction in the number of inter-account transactions with the implementation of the State's new integrated financial system.	Catherine Avila	
MC-22	The state will consider and review the creation of a Chief Financial Officer position consistent with current priorities and budgetary constraints.	Jerome Williams	N/A
MC-23a MC-23b	The Department of Administration is seeking to establish a central federal grants monitoring/ cash management unit within the Office of Accounts and Control. This unit will provide technical assistance to smaller agencies regarding federal grant requirements. This unit will perform central cash management tasks and central subrecipient montoring related to federal grants.	Jerome Williams / Lawrence Franklin, Jr.	6/30/2006
MC-24	The Department of Administration is seeking to establish a central federal grants monitoring/ cash management unit within the Office of Accounts and Control. This unit will provide technical assistance to smaller agencies regarding federal grant requirements. This unit will perform central cash management tasks and central subrecipient montoring related to federal grants.	Jerome Williams / Lawrence Franklin, Jr.	6/30/2006