Washington State Auditor's Office

2003 Statewide Accountability Report

Washington
State Auditor
Brian Sonntag

Mission Statement

The State Auditor's Office independently serves the citizens of Washington by promoting accountability, fiscal integrity and openness in state and local government. Working with these governments and with citizens, we strive to ensure the proper use of public resources.

STATE AUDITOR'S OFFICE
STATE OF WASHINGTON ACCOUNTABILITY REPORT
FISCAL YEAR 2003

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March 24, 2004

Dear citizens, policymakers and other interested parties:

We are pleased to issue our statewide report on state government accountability, based on our audits in 2003.

This report reflects our continuing efforts to look at issues on a statewide basis in an effort to give a well-rounded view of state government operations.

In 2003, we continued to look at whether people receiving benefits from the state were eligible to do so; whether agencies were spending within budget restrictions; whether strong internal controls are in place in areas in which agencies grant refunds; limitations on access to payment systems; and many other areas.

I also wish to recognize agencies that made improvements in operations based on our previous year's audit findings. We appreciate that a good working relationship benefits everyone, including citizens, involved in the audit process.

I also would like to thank our staff for the diligence and professionalism they display each day. I cannot emphasize enough how much they care about their work and about serving the public.

I encourage you to contact our Office with any questions or comments you may have on this report.

Sincerely,

BRIAN SONNTAG, CGFM
STATE AUDITOR

Financial Accountability Roles and Responsibilities

The duties of public officers and agencies as they pertain to accountability over public resources are spelled out in state law, as are enforcement powers and penalties for non-compliance with financially related laws and regulations.

These responsibilities are designed as a system of checks and balances that provides the foundation for effective fiscal management, including efficient accounting and reporting, and that promotes more efficient public management.

Governor, Director of the Office of Financial Management (OFM)

The governor, through the OFM director, is to "devise and supervise a modern and complete accounting system for each agency to the end that all revenues, expenditures, receipts, disbursements, resources, and obligations of the state shall be properly and systematically accounted for." (RCW 43.88.160(1))

The accounting system is to provide accurate, timely records and reports of all financial affairs of the state and to do it in detail sufficient to allow OFM to provide a centralized financial management system. To this end, OFM maintains the accounting procedures manual to be used by state agencies.

OFM also is responsible for developing and maintaining a system of internal controls and internal audits to safeguard state resources; to ensure the accuracy and reliability of accounting data; to promote operational efficiency; and to encourage adherence to accounting and financial control polices.

The law requires OFM to report by December 31 of each year on the status of audit resolution to the appropriate committees of the Legislature, the State Auditor's Office and the Attorney General's Office. The report, called the Audit Resolution Report, is to include information on the actions taken as a result of an audit, including, but not limited to, types of personnel actions, costs and types of litigation, and value of recouped goods or services.

The law states that the Director of the Office of Financial Management will "cause corrective action to be taken within six months, such action to include, as appropriate, the withholding of funds as provided in RCW 43.88.110." (RCW 43.88.160(6)(d))

State Treasurer

The State Treasurer also has a role in management of the state's financial resources. As the chief fiscal officer, the State Treasurer is responsible for keeping the books and managing taxpayers' money from the time it is collected in taxes until it is spent on programs funded by the Legislature. The Treasurer's Office provides banking, cash management, investment, debt issuance, and accounting services for state agencies.

Importantly, the Office is to keep a correct and current account of all money it receives and disburses, by fund or account. This information is regularly updated and reported.

State Auditor

The State Auditor's Office is responsible for post-audits of state agencies. The Auditor's Office examines the financial transactions of agencies and compliance with state laws and agency policies. The Office also performs the annual State of Washington Single Audit of federal money received by agencies.

The Office has the authority to take exception to specific expenditures by agencies or to other practices related to the agency's financial transactions.

The results of these audits are reported to the agencies, the public, the Legislature and OFM. The Auditor's Office reports instances of possible misappropriation, misfeasance, malfeasance or nonfeasance to the Attorney General's Office. We also refer reports of actions that may be violations of the state ethics laws to the state Executive Ethics Board.

The State Auditor's Office does not have the authority to do performance audits, unless expressly directed to do so by the Legislature.

Joint Legislative Audit and Review Committee (JLARC)

This Committee, which is part of the Legislative Branch, may audit the financial transactions of any agency and perform management surveys and program reviews, as well as performance audits and program evaluations. It also has the authority to examine the financial records of any agency, official, or employee.

JLARC makes reports to the Legislature regarding whether agencies are making expenditures consistent with legislative intent. It may take exception to specific expenditures or financial practices of any agencies and also may make recommendations for promoting frugality and economy in agency affairs to improve fiscal management.

State Employees

State law is clear on the responsibility of state employees to comply with the law. It says:

"No state officer or employee shall intentionally or negligently: Over-expend or over-encumber any appropriation made by law; fail to properly account for any expenditures by fund, program, or fiscal period; or expend funds contrary to the terms, limits, or conditions of any appropriation made by law." (RCW 43.88.290)

The law also details the penalties for violations. It states that the Attorney General may initiate a civil action to prevent any such violation.

In addition, the Legislative Auditor, with the agreement of the Joint Legislative Audit Review Committee, may refer audit findings stemming from a performance audit or its other work to the Attorney General's Office if the Legislative Auditor suspects a violation of state law, or misfeasance, or nonfeasance on the part of any state officer or employee.

Our Audit Approach

State Auditor's Office Audits

The Washington State Auditor's Office regularly audits approximately 175 state agencies ranging from the larger, such as the Department of Social and Health Services, to the smaller, such as the Asparagus Commission. All public colleges and universities in Washington are considered state agencies, and we audit them, also. However, the results of those audits will be issued in a separate accountability report later this year.

The scope of our audits is twofold. First, financial records are audited to ensure public funds are accounted for and controls are in place to protect public resources from misappropriation, loss or misuse. Second, we audit to ensure that agencies adhere to laws and regulations relating to financial matters.

For state agencies, the Office performs audits on:

- Areas that pose the highest risk for the misappropriation, misuse or loss of public funds or for noncompliance with state laws and regulations. This report includes the results of such audits.

- The State of Washington's Basic Financial Statements. The most recent Comprehensive Annual Financial Report, which includes these statements, was issued by the Office of Financial Management in December 2003 and is available at http://www.ofm.wa.gov/cafr/2003.

- More than $10 billion in federal funds received by the state. The current State of Washington Single Audit Report will be issued by the Office of Financial Management by the end of March 2004 and will be available at http://www.sao.wa.gov/Reports/SingleAudit.

- Local funds kept by agencies that are not in the care or custody of the Office of State Treasurer. Our latest Local Funds Report was issued to the Legislature in December 2003 and is available at http://www.sao.wa.gov/reports/LocalFunds.

We also have responsibilities in two other areas:

- Investigations of whistleblower assertions filed by state employees.

- Investigations of potential frauds found during our audits or reported to us by agencies.

High Risk/Legal Compliance Audit

The Office has many competing responsibilities when conducting audits. Our high-risk approach helps to ensure our efforts are properly balanced in order to fulfill these responsibilities. We look at areas that are the most important to the citizens of Washington, our audit clients, the Legislature, and other policymakers.

Key components of our audits are the recommendations we make on how agencies can best safeguard public assets. This can include everything from improved cash-handling procedures to tagging inventory to prevent loss.

We use many techniques to detect misappropriation or misuse of public assets and violations of state laws. Some of those are described below. However, none would be effective without the strong communication skills of our auditors and a solid understanding of the financial processes of each agency we audit.

- Computer-assisted auditing techniques help us assess risk and accountability. Once we download an audit client's financial transactions, we have software applications that can help us find transactions that are most likely to be fraudulent or out of compliance with laws and regulations. These techniques often help us audit expenditures, but they can be used for any type of financial transaction.

- We use analytical procedures to identify account balances that differ from an informed expectation. We often use these procedures to audit revenue streams, looking for activity that could point to a loss or misuse of public assets. These techniques tend to be very efficient and provide strong indicators that additional work may be needed to determine whether loss or misappropriation has occurred.

- We perform surprise cash counts, which are a powerful tool for assessing the effectiveness of controls over money collected at a given location and for finding indications that loss or misappropriation may have occurred.

- We audit certain computer applications looking for security over access and other safeguards. These audits are of enormous value in pointing out conditions that could allow misappropriation or loss to occur without detection by management or conditions that could allow destruction of data. Recommendations from these audits have helped many state agencies tighten controls over access to computer systems. These audits also have helped our auditors identify areas in which assets are most at risk.

We audit several areas on a statewide basis each year. Each team that audits state agencies uses a consistent approach when looking at areas we believe present a statewide risk of error or misuse or of noncompliance with state laws and regulations. At each agency, we also audit other areas we believe to be high risk. The results of these audits of statewide and agency-specific risks are included in this report.

Comprehensive Annual Financial Report (CAFR)

The State Auditor's Office performs an annual audit of the statewide combined financial statements as required by state law (RCW 43.09.310). These financial statements are included in the Comprehensive Annual Financial Report (CAFR) prepared by, and available from, the Office of Financial Management. This report is designed to present the financial position and the results of operations of the state of Washington. The Office of Financial Management prepared the first CAFR in 1982 and released the fiscal year 2003 report in December of 2003. Our Office has audited this report since its inception and has issued unqualified opinions every year since 1987. An unqualified opinion means that the financial statements are fairly stated.

The CAFR reflects the financial activities of all funds, organizations, institutions, agencies, departments and offices that are part of the state's financial operations. For the fiscal year ended June 30, 2003, total state revenues and expenditures/expenses were approximately $35 billion each.

For the last 16 years, the state has received a Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association. This award recognizes conformance with the highest standards for preparation of state and local government financial reports.

Our audit of the financial statements is conducted in accordance with governmental auditing standards generally accepted in the United States of America, which require us to plan and perform audits to obtain reasonable assurance about whether financial statements are free of significant misstatement. An audit includes examining evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluation of the overall financial statement presentation.

The State Auditor's Office has achieved a significant reduction in audit costs in recent years by adopting a risk-based approach to our audits. Evidence obtained from high-risk audits of state agencies, which are designed to detect misappropriation, misuse or loss, also is used to support our opinion on financial statements. By leveraging the results of the high-risk work, we perform only the level of review needed to give an opinion on the financial statements. This approach allows us to complete the audit in the most efficient manner possible.

State of Washington Single Audit

The State Auditor's Office audits federal grant expenditures for the state of Washington. That audit is performed in accordance with U.S. Office of Management and Budget Circular A-133 and is referred to as the State of Washington Single Audit. The Auditor's Office has been performing this single audit since 1987. Prior to that time, federal grants were audited as a part of each agency's individual audit.

In the last five years we have reported 74 findings related to federal grants. Federal findings are reported for those cases where we find improvement is needed over internal controls; instances of significant noncompliance with federal regulations; and certain expenditures that should be questioned and possibly repaid. Historically, the majority of the federal findings have been in the area of allowable activities and allowable costs. Other areas with frequent findings are cash management, eligibility, reporting, and subrecipient monitoring.

The state received more than $10 billion in federal funds in 2003. Once received by the state, a significant amount of this federal assistance is awarded to local governments and non-profit organizations. Every local government and non-profit that spends over $300,000 in federal awards in a year must receive a federal audit. Starting in 2004, this threshold will increase to $500,000 to alleviate the burden and cost of audits for smaller entities. Our Office played a key role in getting this threshold increased.

Fraud Program

The State Auditor's Office maintains an exceptional program of fraud prevention, detection and education.

We deal with an average annual workload of 35 frauds totaling approximately $720,000 in losses each year. In the past 17 years, we have investigated approximately 600 frauds totaling over $12.2 million in losses.

In the past year, we have reported on more than $2.2 million in fraud in state agencies and local governments. This includes the second largest fraud ($839,071) investigated by our Office.

Our Fraud Investigations Manager monitors all fraud cases throughout the state. In addition, each of our audit teams has a designated fraud specialist.

Fraud prevention and detection are integral parts of our risk-based audit approach. This approach has produced meaningful information and more recommendations on how to improve accountability in government.

Our fraud training for our own staff and for financial managers in state agencies and local governments provides real value. Annually, we train more than 2,000 government employees on fraud prevention and detection. While it is difficult to quantify how much fraud is prevented by these efforts, we believe it to be a significant amount. Over the years, we have seen the number of frauds detected by managers grow, an indication that our training has helped managers detect fraud early and keep losses to a minimum. This tells us that our fraud training is extremely successful.

Following are the fraud statistics for state government for January 1, 2003, through December 31, 2003. The amounts are: state agencies ($854,305) and colleges and universities ($121,002) for a total of $975,307 in losses during this period.

Category	Total Fraud Cases	Detection By Entity	Detection By Others
State Agencies	4	3	1
Colleges and Universities	15	14	1
Total Fraud Cases	19	17	2

Excluding the second largest case ever investigated by our Office, the average loss per fraud case was $7,569.

More information on our Fraud Program is available on our web site:
http://www.sao.wa.gov/Reports/FraudReports/FraudPage.asp

Whistleblower Program

The State Employee Whistleblower Protection Program, administered by our Office, provides state employees with a safe and confidential means to report those actions that can impair the integrity of public government and undermine the public's confidence.

The law authorizes our Office to investigate and report on assertions of improper governmental action that result from violations of federal or state law or rule; a gross waste of public funds; or actions which are of substantial and specific danger to public health or safety. The law also provides remedies to state employees who believe that workplace reprisal or retaliatory action has occurred as a result of having filed, or provided information in connection with, a report of improper governmental action that results in a whistleblower investigation. The Human Rights Commission is responsible for handling retaliation issues.

During calendar year 2003, the Whistleblower Program investigated 32 complaints that contained 54 assertions. We substantiated 48 percent of the assertions filed. For those investigations involving expenditures, we sought recovery of more than $5,942.71.

During this timeframe, the Whistleblower Program's procedures and case analysis were restructured and streamlined for better efficiency and effectiveness. This reorganization resulted in more cases being completed during the preliminary investigation stage. Cases are completed in the preliminary stage when no violations of state rule or law are found. When this occurs, the case is closed and no report is issued.

The Program continues to work hard to complete investigations in a timely manner. The Program currently averages 85 days per investigation, down from 93 days in the previous year.

In addition to recovery, the Whistleblower Program works with state agencies to develop plans of resolution to prevent improper governmental actions from reoccurring. We also have made recommendations on agency internal controls and agency-wide training. In addition to improvements in policies, procedures and internal controls, our investigations have resulted in formal training, terminations, demotions, reductions in pay, and letters of reprimand. This proactive approach results in greater public accountability and ensures that public resources are appropriately used.

Statewide Technology Audit Team

When performing audits at state agencies, auditors use our Statewide Technology Audit Team to review internal controls related to information technology. When reviewing information systems, we look for computer controls that ensure:

- Integrity of the information.
- Availability of the information.
- Management's control over the information, which includes access to the data and programs, as well as confidentiality issues.
- Audit trails that show the source of the information, including who entered the information into the system, and how it was entered.

In order to assess whether controls are present to address these areas, a review may cover both application-specific controls and general controls.

Application Controls

During a review of a specific application, the information technology auditor seeks to identify controls that ensure the accuracy and completeness of entry, processing and output of information.

General Controls

During a review of general controls in place at an agency, the information technology auditor identifies controls in the following areas:

- Organization of the agency.
- Physical security of the data.
- Electronic access.
- Backup/recovery plans.
- Application design.
- How software changes are managed.
- How the operating system is configured.

Our information technology auditors typically do not perform full application or general control reviews in which all aspects are reviewed. As with other audits performed by the State Auditor's Office, the Statewide Technology Audit Team takes a risk-based approach and looks at areas in which state resources are at the highest risk. The team also takes a cycled approach to audits, where areas not reviewed in one audit cycle may be reviewed in another.

Approach

When identifying controls in the above areas, the information technology auditor determines risks that may be present in the system and develops expectations of controls that could be put in place to address those risks. Generally, the information technology auditor is looking for controls that are programmed. Where programmed controls are not found, the auditor seeks to identify compensating controls. In the absence of compensating controls, the information technology auditor reports a control weakness to other auditors and to the agency.

Computer Assisted Audit Techniques

The Statewide Technology Audit Team assists our other auditors by obtaining information from agency computer systems that are used in our audits of individual agencies. The Team assists the other audit teams in performing computer-assisted audit techniques related to the statewide

issues audits, agency legal compliance audits, local government audits, the financial statement audit and the State of Washington Single Audit. Some of the specific tests included are:

- Payments to ineligible or ghost clients.
- Payments for non-allowable costs and incorrect amounts.
- Payments to false or ineligible vendors.
- Payments to deceased people.
- Payments to individuals with invalid identification numbers.
- Pension payments to widows/widowers who have remarried.
- Duplicate payments.
- Payments to "pseudo vendor numbers" (vendor numbers that should only be used for one-time payments).
- Reconciliation testing of the state's investment portfolios.
- Adherence to Civil Service regulations, such as status and double-fills.
- Timeliness of payments.

Significance of Reviews

Internet. In the past decade, the transition of the state's computer environments from dedicated networks to the Internet has created an increase in security risks. The CERT Coordination Center of Carnegie Mellon University tracks and traces cyber attacks around the globe and has statistics that show an upward trend in security threats (hacking), as more systems become Internet-based.

Distributed Computing Environment. In addition to the increase in risks that the Internet creates, agencies continue to move their applications from mainframe computers to client servers, creating a higher risk because desktop and networking software are designed for user-friendliness rather than security. New software vulnerabilities are identified every day. With this increase in risk, the need for highly trained IT security staff grows. Tighter budgets at the state agencies frequently result in less training for staff, which also increases risk. These responsibilities increasingly are falling to our IT auditors, who audit the security features of operating systems, database systems, firewalls, routers, and much more.

Revised ISB Security Policies and Standards. To address these new concerns, the Information Services Board revised the state's Information Technology Security Policy and Standards. The policy includes a requirement that every agency conduct an IT Security Policy and Standards Compliance Audit once every three years, with the first audit deadline set for October 2003. The audit requires a review of each agency's IT security program to ensure that the program has addressed all the required elements. Our information technology auditors performed many of these reviews.

Current Audit Challenges

Our use of computer-assisted auditing techniques (CAATS) has significantly improved audit efficiency and effectiveness. With CAATS, we are able to quickly select and review questionable transactions, such as possible duplicate payments or payments to false vendors. We also can compare data among state agencies and among state and federal records to help identify clients who may be ineligible for payments received. However, we have recently encountered some roadblocks:

- In some cases, agencies have resisted our requests for access to data. Sometimes this has occurred through delays in providing the information; other times, we have been required to go through lengthy request processes, including the signing of detailed confidentiality agreements. Some agencies have attempted to require us to pay for the information.

  Generally agencies have used confidentiality issues related to clients' personal information or the cost of providing the information as reasons for denying or delaying our records requests. However, our employees are required to maintain confidentiality regarding all audit procedures and results during the course of an audit and are aware of the on-going need for confidentiality regarding personal data, in accordance with the Governor's Executive Order 00-03, Public Records Privacy Protections.

  In addition, charging us for information would be counter-productive because the charges would be added on to the audit bill. No private entity engaging a firm to audit the entity's records would charge that auditor to obtain those records.

  These issues could be easily resolved with a reminder from the Governor to agency heads that agency records, with few exceptions, are public information and that, since the State Auditor's Office has the authority and responsibility to audit these records, agencies should provide unhindered and timely access. State agencies should be reminded that the purpose of Executive Order 00-03 is to prevent confidential information from being released, not to prevent our Office from obtaining documents needed for auditing purposes.

- In at least two significant instances during this audit period, agencies have inadvertently provided us with electronic data that they later found was inaccurate. Only after we had completed our tests, evaluated the results, and reached the end of the audits were we informed of this condition. Again, this issue could be resolved easily if agencies would check the accuracy of any data they provide at the beginning, rather than the end, of the audit.

Statewide Audit Areas

Introduction

We identified four high-risk areas for statewide reviews during our fiscal year 2003 audit:

- Claims and benefits
- Budget restrictions and fund shifts
- Refunds
- Access to Payment Systems

Below are discussions of the results of each of these statewide areas; of any other areas we reviewed; and of the federal compliance work we performed. Significant issues mentioned in the following sections are included in the Schedule of Findings in this report. In addition, we also noted some less significant issues that we communicated directly to agency managers.

Claims and Benefits

Because of the numerous claims and benefits issues in our previous audits, we included this as a statewide audit area for the third year in a row.

The state of Washington provides about $10 billion per year in benefits through various programs. The following agencies are responsible for the majority of the state's claims and benefit programs:

- Department of Social and Health Services
- Department of Labor and Industries
- Health Care Authority
- Employment Security Department

During our audit, we reviewed several areas of internal control and compliance and found that the state overpaid claimants, providers and other recipients by more than $2 million. These overpayments were caused by a variety of factors. In addition, because we were provided with inaccurate data that we could not test, we are issuing no opinion on whether at least $288,498,038 in payments to Medicaid providers for prescription drug claims were proper.

As before, we recommend that agencies responsible for processing claims and benefit payments:

- Establish and follow adequate internal control policies and procedures to ensure that all claimants, providers and other recipients are eligible for benefits.

- Initiate data sharing to detect benefit recipients who are receiving, but are not eligible for, benefits.

- Ensure that employees involved in the claims and benefit process obtain adequate training.

- Separate the duties of employees processing claim payments.

- Ensure that management provides adequate monitoring over claims processing.

- Instruct employees to obtain recipient Social Security numbers, when required, and investigate when alerted by the Social Security Administration that a number is invalid.

- Ensure timely and accurate payment of benefits.

- Ensure all disbursements have adequate supporting documentation.

- Attempt recovery of all unallowable payments identified by our audit or the agency.

The twelve findings for this statewide area begin on page 30.

Budget Restrictions and Fund Shifts

In the two-year operating and construction budgets, the Legislature determines how much state agencies are allowed to spend in both state and federal funds, and in some cases, specifies what the money must be spent for. As part of this process, the Legislature also appropriates emergency funds each year, which are available for allocation to agencies for critically necessary work. When the Legislature places spending restrictions on funds, there is a risk that one fund may be used to benefit another fund or that funds will be used for purposes other than what is intended.

As the 2001-2003 budget period was coming to an end, we focused on adjustments made between funds and budget provisos near year-end. Spending restrictions can be placed on individual funds, or by setting up provisos within a fund. Based upon our understanding of coding used by agencies when these adjustments are made, we identified high-risk transactions for review. Our objective was to ensure the adjustments were legal and appropriate.

Overall, we found that agencies' adjustments were legal and appropriate. We did note some exceptions:

- The Department of Fish and Wildlife overspent the amount of federal money it had been appropriated by the Legislature to acquire land, and then moved those excess expenditures totaling $5.8 million to appropriations that were not for land purchases. The Department did not obtain the required expenditure authority from the Governor and/or the Legislature to spend the excess federal funds on these land acquisitions.

- Emergency funds were allocated by the Governor's Office to the Office of Financial Management at the end of fiscal years 2002 and 2003, but were actually spent on projects in later fiscal years. Under state law, general fund appropriations must be spent or legally obligated during the fiscal year for which they were originally appropriated. Amounts involved were $577,500 and $155,000 respectively. A letter from the Office of Financial Management dated February 13, 2004, disagreed with our analysis regarding the emergency fund allocations.

We recommend agencies:

- Use funds/appropriations for allowable purposes, as determined by the Legislature.
- Properly monitor expenditures to ensure appropriations are not overspent.
- Consider whether projects can be completed within the fiscal year prior to making emergency fund allocations.
- Record expenditures in the proper fiscal year.

There is one finding for this statewide area, beginning on page 90.

Refunds

Many state agencies issue refunds. These refunds could be the result of a credit balance due to a customer overpayment, cancellation of a state service, or an administrative order to reduce or cancel a payment previously billed to a customer.

Inadequate internal controls over refunds increase the risk that cash collected could be misappropriated without being detected in a timely manner, if at all. Section 82.20.70 of the *State Administrative and Accounting Manual* issued by the Office of Financial Management prescribes refund guidelines for all state agencies. Sections 43.88.170, 43.01.072 through .075 of the *Revised Code of Washington* prescribe procedures that a state agency must follow when issuing refunds.

During our audit, we used computer assisted auditing techniques to identify refunds processed by the Accounting and Financial Reporting System operated by the Office of Financial Management. We reviewed internal controls over refunds at 43 state agencies and found weaknesses at 10. In addition, we audited to verify whether duties were separated between cash receipting system access; changes of address; ability to identify and initiate refunds; review of refunds prior to issuing checks; processing of refunds; reception and mailing of warrants; and management monitoring and independent review of refunds processed.

We met with agency personnel to discuss refund processes and to verify that refunds are coded as a reverse of revenue, rather than an expense. To verify that established procedures were being followed, we selected some refunds to determine if they were coded as an expense and, therefore, not subject to the normal internal controls designed for refunds.

We also selected refunds in agencies that have a large volume of customer accounts with credit balances to determine if the agency had an established threshold for the review and supervisory approval of refunds. Unless adequate segregation of duties or other compensating controls are in place, an employee could generate fraudulent refunds that are below the threshold and have it sent to his or her address, or another improper address.

Overall, we found that agencies were managing refunds properly and according to state guidelines. However, we found that the Department of Health had internal control weaknesses that were significant enough to report as a finding.

We also noted that internal controls at some agencies could be improved. Some agencies lacked adequate policies addressing the type of approval required for large refunds and who has approval authority for refunds. Some agencies did not have adequate oversight or monitoring functions in place to ensure that a refund being issued matches the supporting documentation.

We recommend agencies:

- Maintain and follow current policies and procedures addressing refunds.
- Provide adequate management oversight.
- Retain supporting documentation for all refunds issued in accordance with state records retention schedules.
- Review the number of people that have the ability to process refunds and generate warrants for reasonableness.

There is one finding for this statewide area, beginning on page 93.

Access to Payment Systems

Background

The Agency Financial Reporting System (AFRS) is the official accounting system for the State of Washington. The Office of Financial Management (OFM) developed, maintains and requires all state agencies to enter financial data into AFRS. AFRS resides on the Department of Information Services (DIS) mainframe computer.

OFM, in conjunction with DIS, provides a control structure to limit access to AFRS. The purpose of AFRS security is to allow agencies to establish and maintain access to AFRS in order to control the processing of agency financial transactions. DIS and OFM provide some high-level access control to AFRS. However, designated staff members at each agency are responsible for determining the level of security granted to individuals within their agency.

DIS and OFM provide general statewide control for security access to AFRS. DIS is responsible for establishing and maintaining the statewide file of logon IDs. OFM is responsible for establishing and maintaining the security control structure for specific AFRS' processing systems and for granting access to AFRS for each agency's designated Agency Security Administrator(s).

Agency Security Administrator(s) have the responsibility for determining the level of security granted to each individual to meet the needs of the agency and satisfy agency internal control standards.

Audit Objective

We performed the access security audit to determine if access at the agency level is reasonable and provides adequate separation of duties over the processing of payments. This separation is necessary to reduce the risk of misuse, loss or misappropriation of public resources. Separation

of responsibilities helps prevent or detect deliberate or accidental errors caused by improper use of data files, unauthorized or incorrect use of a computer program, and/or improper use of computer resources. If the separation of duties is weak or lacking, the integrity of a computer system may be affected.

AFRS Disbursements Security Review

We reviewed reports showing all individuals with AFRS access at an agency who had access rights to key payment processing screens. The effective use of AFRS access was dependent on several factors. Among these were agency size, number of individuals involved in processing fiscal transactions, whether the agency processed transactions at multiple locations, and other operating needs of the agency.

We also considered these factors in determining the adequacy of AFRS access:

- **Is overall AFRS access reasonable?**

  Based on the size and operating characteristics of the agency, is the number of individuals with AFRS access reasonable? Do all individuals shown still work in a position that requires AFRS access? Do any groups or names indicate possible share access? Separation of duties would be weak if individuals or groups are sharing passwords.

- **Is the number of Agency Security Administrators reasonable?**

  Each agency needs a few Agency Security Administrators to establish authority for new hires, to change authority levels as duties change, and to delete access to those who leave the agency. However, because Agency Security Administrators' access authority is extensive, the number of individuals with this authority should be very limited. Medium-size or large agencies commonly have two or three Agency Security Administrators. We reviewed the AFRS Security Report to determine whether the number of individuals with Agency Security Administrator level access was reasonable considering the size of the fiscal section, location considerations and other factors.

- **Is reasonable separation of duties accomplished by limiting access to key processing screens?**

  The AFRS Security reports also show access levels for key AFRS processing screens. The processing screens reviewed were the Transaction Input; Batch Release; Error Correction; and Vendor Edit. AFRS Security reports show which individuals can view, enter and update information in the different processing screens. The reports also show individuals who can only view information on the screen and those who have no access to the screen.

  Individuals with update access in both the Transaction Input and Batch Release screens can enter transactions and release batches that create warrants and initiate electronic fund transfers. Individuals with update access for the Error Correction screen can correct and release transactions that were suspended from processing by AFRS edits. Individuals with update access to the Vendor Edit screens can establish or update information used to

set up vendor names and addresses for processing payments other than on a one-time basis.

The level of separation of duties for AFRS processing is indicated by how many people have update access to key processing screens and the number who have update access that would allow a single individual to process a transaction.

- **Are there other controls?**

  In addition to access controls, other controls should exist to help ensure an overall acceptable level of separation of duties for AFRS transactions. These could include having someone other than individuals responsible for Transaction Input and Batch Release reconcile input to output, and having transactions monitored by someone outside the AFRS processing unit.

  All agencies need operating flexibility to perform their missions. Agencies need staff with certain levels of access to enable them to perform their jobs. However, there should be a balance between the AFRS access needed to process accounting transactions and limiting AFRS access to help establish internal control. All agencies should be able to provide some separation of duties using AFRS security access.

Other Applications Security Review

A number of agencies have applications other than AFRS that are used to initiate payments to vendors. Some of these applications will produce warrants while others will interface with AFRS to produce the warrants. While AFRS reports could only be used for portions of the reviews of these applications, the same kinds of factors were considered in evaluating how the agencies controlled access.

Results of Access Security Review

We performed procedures to evaluate the adequacy of access controls to 42 applications at 36 agencies. The following table summarizes what we found.

AFRS	Other Applications	Audit Area
21	21	Applications reviewed
5	5	Internal controls considered inadequate
5	9	Weaknesses identified
5	4	Persons with access to disbursement screens can modify vendor information
5	1	Weaknesses noted related to error correction
1	1	Users share logon-ids
	5	Programmers have access to production data

We also evaluated controls over electronic access for the Department of Licensing's Unisys mainframe system. The Department runs in excess of 40 applications on this system, and relies on it to perform a variety of functions. Last year's statewide audit report addressed weaknesses

in controls over electronic access to this system. The Department obtained funding from the Legislature to migrate off the Unisys platform to a new environment. The Department began the migration project in August 2003, and expects to complete it by May 2005.

The seven findings in this area begin on page 96; these findings include similar issues related to access to other types of systems.

Other Areas

In addition to the statewide high risk areas already described, we identified other areas of risk specific to each agency audited and reviewed the internal controls and compliance as appropriate. These included contracting and purchasing, loans and grants, inventory controls, other asset safeguards, and state legal compliance.

Federal Compliance

For the fiscal year ended June 30, 2003, the state spent more than $10 billion in federal assistance. The largest single grantor was the U.S. Department of Health and Human Services, which provides funding for programs such as Medicaid, Child Care, Temporary Assistance for Needy Families, and research and development at public universities. Another large federal granting agency is the U.S. Department of Education, which provides many programs and services for school children and grants and loans for college students.

We reviewed internal controls and compliance with grant requirements for 24 federal programs for the fiscal year 2003 State of Washington Single Audit. The federal grant findings we identified are included in this report, as they also relate to legal compliance and high risk. These federal findings will also be presented in a separate single audit report and issued to the federal government in March 2004.

When evaluating the state's compliance with federal program regulations, we are required by federal audit regulations to report known and likely questioned costs exceeding $10,000 in compliance areas. Questioned costs are often reported for the following reasons:

- A violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds.

- Costs that are not supported by adequate documentation.

- Costs that appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

As noted above, the $10,000 reporting threshold is federally mandated. However, for programs such as Medicaid, which spends nearly $3 billion annually, we believe this threshold is too low. We plan to make a recommendation to the U.S Office of Management and Budget to increase the threshold for states that administer large federal programs.

Listed below are the federal questioned costs for fiscal year 2003:

Federal Grantor	State Agency	Federal Program	Questioned Costs
U.S. Department of Health and Human Services	Department of Community, Trade and Economic Development	Low Income Home Energy Assistance Program	$174,679
U.S. Department of Health and Human Services	Department of Social and Health Services	Temporary Assistance for Needy Families	$20,840
U.S. Department of Health and Human Services	Department of Social and Health Services	Medicaid	$733,107
U.S. Department of Health and Human Services	Department of Social and Health Services	Block Grants for Community Mental Health Services	$165,000
U.S. Department of Health and Human Services and U.S Department of Defense	University of Washington	Research and Development Cluster	$35,977
U.S. Department of Housing and Urban Development	Department of Community, Trade and Economic Development	Home Investment Partnerships	$287,376
U.S. Department of Labor	Employment Security Department	Unemployment Insurance	$826,277
U.S. Department of Labor	Employment Security Department	Workforce Investment Act	$27,517
TOTAL			**$2,270,773**

Nine findings related only to specific federal compliance weaknesses begin on page 216.

Internal Controls

Internal control is broadly defined as a process designed to provide reasonable assurance about:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

Internal controls are the policies and procedures that provide reasonable assurance that management's specific objectives will be achieved and are composed of the following:

- Control environment, or management's overall attitude towards the importance of controls.

- Risk assessment, or management's process to identify and analyze relevant risks to public resources.

- Control activities, or management's procedures to ensure reports are reviewed for accuracy, completeness and authorization; physical controls are in place over cash receipts and equipment; contractor performance is monitored; and duties are segregated for those who handle assets.

- Information and communication, or management's methods to identify and communicate on a timely basis information employees need to perform their duties.

- Monitoring, or management's evaluation of whether controls are operating as intended and whether they are achieving objectives.

One significant method agencies can use to strengthen controls is to have an internal audit function, as described in a law passed in 1993. It requires the Office of Financial Management (OFM) to:

> …develop and maintain a system of internal controls and internal audits comprising methods and procedures to be adopted by each agency….Each agency head or authorized designee shall be assigned the responsibility and authority for establishing and maintaining internal audits following the standards of internal auditing of the institute of internal auditors….

OFM has provided internal control and auditing policies in Section 20.10 of its *State Administrative and Accounting Manual*. These policies assign to agency heads or authorized designees the responsibility and authority for deciding whether an agency should establish an internal audit program.

In this time of scarce state resources, internal controls are often the first activities to be cut back. Last year, we recommended to agency managers that they carefully consider the potential results before deciding to accept the risk of fewer controls. For instance, ignoring controls over eligibility determinations can result in higher costs when funds are provided to those who are not eligible to receive benefits. We also recommended that OFM**,** which has oversight of state government budgeting and accounting, analyze our Schedule of Audit Findings for areas in which additional guidance or training relating to internal controls may be helpful to agencies.

Almost every agency audit we performed this year included some review of the applicable controls and a determination as to whether these controls were adequate and were operating effectively. For the most part, we found this to be the case. However, many of our findings relate in some way to weaknesses in controls.

Last year we reported 24 findings, one of them with seven major subsections; this year we are reporting 60 findings. We attribute this significant increase in part to the concern we first expressed last year, that internal controls would be among the first sacrifices made when agency budgets were reduced. We are repeating our previous recommendations and further recommending that agencies with no internal audit programs consider carefully whether such a program would be beneficial in the long run.

Internal control findings are interspersed in their appropriate areas in the findings section.

Agency Control Improvements

As we completed our various audits this year, we did note several significant internal control improvements related to previous weaknesses we had reported.

Health Care Authority

The Authority has made important changes to its controls over payments for health care. During this current audit, we found the Authority has worked aggressively to establish new and appropriate procedures in the areas of overpayments, eligibility reviews and income verifications. The Authority stated that it has identified more than $4.1 million in overpayments for the 2001-2003 biennium and recouped more than $2.3 million. We are reporting no findings for the Authority in this audit.

Department of Social and Health Services

Division of Child Care and Early Learning

The Division has made significant improvements in its review of child care payments issued to clients and vendors. The Division is now performing very effective and timely reviews of case files and payment alert reports to identify possible overpayments. So far, it has identified and worked to recoup approximately $3 million in fiscal year 2003 overpayments.

Western State Hospital

The Hospital is in the process of making dramatic improvements in controls over the inventory and distribution of medications. This year we found the Hospital has considerably improved its procedures for safeguarding the pharmacy inventory on the admissions wards by purchasing two machines for a state-of-the-art medication and supply dispensing system that controls access to pharmacy inventory. The Hospital plans to acquire machines for all of its wards by June 2004.

Department of Natural Resources

The Department made significant improvements in controls related to charging overhead costs to its restricted funds, resolving issues from a finding in the past two audit reports. The Department allocated $26.2 million of overhead in fiscal year 2003. Each year the Department allocates its overhead costs to various funds, many of which are restricted for a specific purpose. It is important that the Department allocate these costs in a manner that ensures each fund pays only its fair share of these costs. The Department now monitors where these costs are charged to ensure each fund pays only its share.

Recommendations to the Legislature

Claims and Benefits

In our fiscal year 2001 and 2002 State Accountability Reports, we disclosed that the state lacks a centralized process to determine whether individuals are eligible for benefits or whether they are receiving benefits through some programs that would make them ineligible for others. We recommended that the state develop a centralized process to determine if individuals are eligible to receive benefits and to cross match information between agencies.

During the current audit, we found the state still lacks this process. Because of the difficulty involved and the amount of time required, agencies are often unwilling to prepare, review and investigate data matches that can flag possible problems. Additionally, sometimes data matches are impossible. For instance, Social Security numbers could be used in this process; however, some state programs do not require that these numbers be provided as a condition for receiving assistance, while others that require them sometimes do not ensure their accuracy.

Last year, we recommended the Legislature consider requiring any person receiving state resources to be given, on first contact, an individual identifying number. From then on, individuals would be required to present this number whenever applying for any other state assistance or for employment with the state. With this kind of identification, any state agency could perform data matches for any of its clients with any other state agency to determine if continuing or additional assistance is proper and necessary.

House Bill 2045, calling for a state agency work group to evaluate the feasibility and challenges of such a centralized process, passed the House on March 15, 2003. However, no such bill passed through the Senate. We continue to strongly recommend that the Legislature again consider a process providing for state identification numbers.

State Grants

As we describe later in this report, the state currently has little or no criteria available for agencies authorized to award grants composed solely of state funds. Therefore, agencies use whatever procedures and forms they feel are appropriate, with no overall assurance that the grants are being adequately procured and monitored. Because there is no workable definition of the term “state grant”, agencies define it in a variety of ways, depending on their particular circumstances. In addition, agencies do not generally code these grants in a manner that allows easy identification of the total amount of state grants provided.

We commend the Office of Financial Management (OFM) for its efforts over the past two years to assist with some of these state grant issues. Working with an interagency advisory group, OFM has recently developed a definition of “state grant”, along with descriptions of some state grant characteristics, procedures, and best practices. However, OFM states it does not have any authority over state grants and, therefore, will be providing this information, including the definition, only as guidance.

We recommend the Legislature consider whether OFM should have more authority in this area and, if so, provide it with the resources it needs to establish adequate controls over procuring, monitoring and accounting for state grants.

Child Care Background Checks

As we discuss in Finding 03-12, RCW 74.15.030(1)(b) requires that the Department of Social and Health Services fingerprint and perform a criminal history records check of child-care licensee applicants, their employees and others who will have unsupervised access to the children only if they have resided in this state for less than three years. The Department is to use information obtained from this activity to determine eligibility for a license and to determine the character, suitability, and competence of those persons to care for children. If a person states he/she has lived here longer than three years, no such background check is required.

Because of the wording of this law and the costs that may be involved, the Department's position is that it is not required to and does not perform criminal history records checks of anyone stating he or she has lived here longer than three years. However, families placing their children in licensed child care facilities may believe that a license conferred by the Department indicates the Department has performed background checks. To help reduce potential liability issues, we recommend the Legislature consider whether the three-year timeframe should be modified and additional resources provided to the Department to strengthen its licensing procedures.

Looking Toward the Future

We are already in the process of planning our work for fiscal year 2004 and have identified some specific changes in our audit approach:

Medicaid

Expenditures for Medicaid are by far the most significant in the state, reaching more than $5.6 billion during fiscal year 2003. These expenditures are made mostly by the Department of Social and Health Services and consist almost equally of state and federal funds. The federal Department of Health and Human Services requires an audit of controls and compliance of this program every year as part of any single audit of federal funds. Since we began performing the single audit of the state of Washington in 1987, we have completed the Medicaid audit as one of the approximately 24 federal programs we review every year.

Because of the risks inherent in this program, the expenditures involved, the many detailed compliance requirements, and the results of our audits during the past few years, we are experimenting with a new approach to this program for fiscal year 2004. We intend to treat it as a separate audit, on an equal level with our audits of the largest agencies and with the related larger audit budget it deserves. Some of the increased audit budget will be shifted here from the reductions we expect in the small agency audits described below. We anticipate that this larger budget and the experienced, knowledgeable staff we have assigned to the audit will pay dividends in the recommendations we will be able to develop for use by the state.

Small Agency Audits

Until now, we have audited every agency separately, with smaller, less risky agencies being scheduled on two-, three-, or even four-year cycles. As with most agencies, our Office's budget has been cut, and we are being asked to become even more efficient with our auditing methods and procedures.

Accordingly, we are revising the way in which we audit most of the smaller agencies. Beginning with the fiscal year 2004 audit, we will analyze revenues, expenditures, and risk for all of these agencies as a group and determine at that point where and how to focus our efforts. We expect to achieve a significant reduction in time for these audits, while still providing coverage where the risk is highest. Any audit hours saved beyond those required by our reduced budget will be reassigned to audits of agencies with higher risks.

Combined Fund Drive

In the past, we received legal advice that this fund within the Department of Personnel was not a public fund subject to audit by our Office. Funds for this account come from state employees' voluntary payroll deductions and are distributed to various charities according to the wishes of the donors. Millions of dollars have moved through this fund since 1985, yet it has never been audited, though it is included in the state's financial statements and the receipts and donations are handled by Department of Personnel employees.

Recently, the Legislature, at the Department's request, changed this fund to a Treasurer's Trust account in the custody of the State Treasurer's Office and the Department has issued regulations to administer the fund drive. Subsequently, we were advised that we now have the authority to audit the fund. This year, we will be determining whether the Department has established proper internal control procedures to safeguard these assets, whether receipts are being accounted for correctly, and whether contributions are going to the designated charities.

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Agency Findings

Claims and Benefits

03-01 The Department of Social and Health Services, Medical Assistance Administration, did not provide the State Auditor's Office reliable records needed for audit in a timely manner.

Background

The Department of Social and Health Services is responsible for administering the state of Washington Title XIX Medicaid program (CFDA 93.778), which receives nearly $3 billion in federal funds annually. Most of the state's Medicaid claims are processed through the Medical Management Information System (MMIS). The Department contracts with a vendor for certain services relating to MMIS. These services include facility management services, operation, records retention, data security and keeping all system files, programs and documentation current.

Description of Condition

The Department acquired data from MMIS for the period July 1, 2002 through December 31, 2002 from the vendor on April 2, 2003. This data was to be used during our Medicaid audit. Specifically, we planned to determine the number of prescription drug claims that were paid for services rendered after a person's death. This was to be a follow-up up on issues identified in our 2002 audit. Our 2002 audit revealed, among other things, that the majority of claims submitted for services rendered after death were for prescription medications.

We obtained a valid sample pursuant to the American Institute of Certified Public Accountants Statement on Auditing Standards No. 39. We selected 210 clients out of 10,809 who were provided prescription medicine services and found 148 potential exceptions with related questioned costs of $10,277,374. Fifty percent of these costs were paid with federal Medicaid funds.

After we presented our preliminary results to the Department, it informed us that we had been given inaccurate data that contained mismatched names and Social Security numbers. We estimated these errors affected at least 30 percent of the population. Approximately four months later, the Department confirmed that the data errors were caused by the vendor and gave us a new set of data.

After receiving the new data, we evaluated the explanation sent by the Department's vendor and performed some comparative testing on the original and new data sets to determine whether we could rely on the Department's explanation and whether we could rely on our preliminary audit results. Initially, we did not find any differences in the total number of records or total amounts of claims paid. However, a more detailed analysis revealed the data sets were different for Social Security number, date of birth, and name matches. We concluded that we could not rely on the original data because our sample was based on Social Security numbers.

While analyzing the two data sets, we found inconsistencies in the Department's explanation for the mismatch:

- Many of the Social Security numbers that Medical Assistance Administration stated should have been matched to a name were not in the original data set.

- The vendor who performed the data collection for Medical Assistance claimed that the mismatch was due to an incorrect Patient Identifier Code matched to the wrong Social Security number. We did not see the mismatch for all clients.

- Medical Assistance claimed that 32 percent of the Patient Identifier Codes were mismatched, yet its own spreadsheet detailing the purported errors in our testing attributable to the mismatches showed an error rate of approximately 85 percent.

- Medical Assistance claimed that the individuals that we initially questioned had valid Social Security numbers and were not deceased. However, as described in finding 03-04 of this report, we noted that internal controls over Social Security numbers were not much improved from our 2002 audit.

The purpose of our sample was to test prescription drug claims to determine whether claims were paid for services rendered after a client's death. The universe of all MMIS transactions from July 7, 2002 through December 31, 2002 was the same for both data sets: 17,379,976 records for a total amount of $1,537,429,678.72.

From the universe, all records for prescription drugs were extracted. A comparison revealed the following differences:

New Data:
Total number of records for all prescriptions (fill date section not blank): 5,783,093

Total paid amount for all these records is $288,498,037.77

Original Data:
Total number of records for all prescriptions (fill date section not blank): 5,792,060

Total paid amount for all these records is $291,004,403.55

Because of the differences, we could not be assured that we had obtained all the data pertaining to prescription drug claims. In addition, we could not identify the specific cause of the differences due to the inconsistencies in the Department's explanation. As a result, we did not continue our analysis of the two data sets and concluded we could not offer an opinion on compliance.

Cause and Effect of Condition

The Department provided the State Auditor's Office with data that contained errors and mismatches. Therefore, we offer no opinion on compliance as it relates to allowable costs and eligibility of clients for whom prescription drug claims were charged to the federal government

for the period July 2002 through December 2002. The payments attributable to prescription drug claims could not be determined, but are at least $288,498,038. The necessity of this disclaimer is due to a client imposed scope limitation and is based on the following facts:

- We could place no reasonable assurance that the results of our sample using the original data were accurate.

- The Department did not take timely action to notify us of the faulty data. Thus, when a new data set was provided, we lacked adequate time and resources to complete our audit.

Recommendations

We recommend that the Department establish monitoring procedures that would enable it to supervise the performance of its MMIS vendor with more scrutiny. The system processes millions of claims annually. The proper disposition of these claims and the federal reimbursement received by the state is predicated, in large part, on the effective operation of the MMIS system and performance of the vendor.

Department's Response

The Department of Social and Health Services, MAA, concurs with and accepts responsibility for the delivery of the erroneous data to the SAO. Since the data was manipulated by SAO and the data file of SAO exceptions contained additional data from the Social Security Administration's Death Index, it was difficult for MAA to immediately determine the reasons for the discrepancies and identify the source of the error. This condition impacted the length of time that it took for the Department to discover the error. Upon discovery, the error was immediately communicated to SAO.

DSHS has implemented the following contract/vendor and internal control procedures as corrective actions to address these issues:

- *The contract management plan with the MMIS vendor ACS will be amended to strengthen the quality assurance requirements regarding reporting and data analysis activities and to assure that datasets produced by ACS are complete and reliable;*

- *The MAA Information Services Division has implemented processes for the review and retention of datasets requested by entities outside of MAA. MAA analysts now have the ability to load and review large data sets and MAA is developing and implementing a set of protocols that will govern the internal review of data prior to distribution.*

While DSHS accepts responsibility for the delivery of erroneous data, it should be noted that DSHS provided SAO with the following documentation, which provided evidence that the pharmacy claims were paid for clients who were not deceased:

- *A technical explanation of the error was provided by the MMIS vendor, ACS;*

- *A detailed review of the claims and clients in question and provided SAO with documentation regarding the status of each client on the exception list;*

- *The State Online Query (SOLQ) was utilized to verify Social Security numbers for clients as listed in the MMIS.*

For claims where exceptions correctly identified claims paid for deceased clients, claims were reviewed and action taken consistent with MAA policy.

Auditor's Concluding Remarks

We appreciate the Department taking responsibility for the delivery of erroneous data to our Office. However, we do not agree with the Department's statement that the data was manipulated by the State Auditor's Office, which caused the Department's delay in notifying us of the faulty data set. In its response, the Department stated it provided our Office with evidence that the pharmacy claims were paid for clients who were not deceased. Because we are disclaiming our opinion, we did not audit this information and cannot validate the Department's claim. The Department should provide this information to the U.S. Department of Health and Human Services (HHS) as part of the audit resolution process. However, we would offer to HHS:

- A technical explanation as to the reasons why the data set was faulty does not prove that no claims were paid after the date of death.

- The "detailed review" that the Department stated it provided was a spreadsheet of its representations. The Department provided no additional supporting documentation to corroborate its claims that a client was alive at the time services were rendered.

- Verification of a Social Security number can be performed on a deceased person as well as on one that is alive. Verifying a Social Security number does not prove that a person was alive at the time that medical services were rendered.

Applicable Laws and Regulations

American Institute of Certified Public Accountants, Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Paragraph 10.43 and 10.44 states, in part:

> The auditor is able to express on an unqualified opinion only if he or she has been able to apply all the procedures the auditor considers necessary in the circumstances. Restrictions on the scope of the audit – whether imposed by the client or by circumstances such as the timing of the auditor's work, an inability to obtain sufficient competent evidential matter, or an inadequacy of the accounting records – may require auditors to qualify their opinion or to disclaim an opinion.
>
> When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on compliance.

03-02 The Department of Social and Health Services, Medical Assistance Administration, received federal Medicaid funds for unallowable services provided to undocumented aliens.

Background

As a requirement for receiving federal Medicaid funds (CFDA 93.778), the Department of Social and Health Services must provide medical benefits to otherwise eligible residents of the United States who are citizens, aliens lawfully admitted for permanent residence, and certain aliens who have been granted lawful temporary resident status.

When medical services are rendered to undocumented aliens, federal matching funds are available only for emergency medical services, including obstetrical services that have been provided at the time of delivery. Emergency medical services are defined in the U.S. Code of Federal Regulations and the Medicaid State Plan. Non-emergency medical services provided to undocumented aliens cannot be charged to the federal government. The Department and the federal government defines "emergency medical condition" as the sudden onset of a medical condition so severe that without immediate medical attention, it would be expected that there would be serious jeopardy to a person's health; serious impairment of bodily functions, or a serious dysfunction of any bodily organ or part.

Description of Condition

From July 2002 through December 2002, Department records show that 9,717 undocumented alien clients received medical services. Of those served, we judgmentally selected 169 patients in six service categories to determine whether all Medicaid-funded services provided to these clients were emergencies as the law stipulates.

We found that non-emergency procedures, routine medical services and durable medical equipment were provided to undocumented aliens and paid for with Medicaid funds. We found payments for adult day care, massages, dental fillings, routine eye exams, regular office visits and in-home care, as well as supervision of normal pregnancies and routine postpartum follow-up. Medicaid payments were made for eyeglasses and contact lenses, breast pumps, dentures, contraceptive devices, disposable incontinence garments, and replacement wheels for wheelchairs. We found payments for conditions such as menopause, cough, breast feeding, and nearsightedness.

The results of our review were as follows:

Service	Total Clients	*Total Paid*	Clients Receiving Unallowable Services	Questioned Costs (includes state and federal funds)
Nursing Home	42	$1,098,425.23	36	$977,156.64
Dental Services	62	$410,697.54	57	$138,493.09
In-Home Care	38	$399,335.95	36	$162,261.30
Adult Day Health	8	$84,381.85	8	$47,900.06
Community Inpatient	8	$48,368.93	2	$1,315.41
Personal Care	11	$28,284.29	9	$9,034.52
Totals	**169**	**$2,069,493.79**	**148**	**$1,336,161.02**

The Department initially stated that many of these services, especially those related to maternity, were paid for with state funds. To substantiate this, we traced the claims for routine dental care and other supportive care for two undocumented alien maternity clients. Although we found coding that identified undocumented aliens, we were unable to find account coding that would differentiate between emergent and non-emergent procedures. Instead, we found all services were being claimed as allowable costs for Medicaid matching funds. Additionally, the Department could provide no evidence for its representation that services for routine pre-natal and post-natal maternity services were paid using state funds, that the services provided originated from an emergency condition or that related care provided to undocumented aliens months after an emergency condition is an allowable Medicaid expenditure under the law.

Cause of Condition

- Social Security numbers are not consistently verified prior to admitting clients into the Medicaid program. The Department's client eligibility database shows Social Security numbers for many undocumented aliens. Further, the Department does not heed the federal alerts notifying staff of invalid Social Security numbers.

- In its eligibility manual, the Department lists certain medical diagnoses that are pre-authorized as an emergency. If a client who is an undocumented alien has a medical diagnosis that is not on the list, staff members are instructed to refer the case to Department medical consultants. We found these referrals are not being made in a consistent manner.

- Department staff informed us the procedure manuals contain insufficient and unclear guidance and are often too technical for non-medical personnel to understand.

- Medical consultants are slow to respond to staff questions about whether a condition is an emergency.

- The Department's accounting system does not differentiate undocumented aliens who have received emergency services from those who have received non-emergency services.

Effect of Condition

Federal Medicaid funds are paying for non-emergency medical services for persons that are not eligible for Medicaid due to their undocumented alien status. We found 88 percent of the undocumented aliens tested were provided services for non-emergency conditions. The cost for these services was $1,336,161. Additional questioned costs related to the two maternity clients described above were $6,259. We are questioning both the federal and state portions of the costs, which each total $671,210

Recommendations

We recommend that the Department:

- Develop internal controls that would require employees to verify applicant's Social Security numbers and heed alerts sent by the Social Security Administration pertaining to invalid Social Security numbers.

- Develop clear policy and procedure manuals.

- Establish internal controls that ensure staff make consistent referrals to medical consultants for diagnoses that are not listed in the eligibility manual and ensure that consultants respond promptly.

- Develop an accounting system that would differentiate emergency from non-emergency procedures so that the appropriate funds could be used to pay for the designated services.

- Work with the U.S. Department of Health and Human Services to determine if any unallowable costs charged to Medicaid must be returned.

Department's Response

The Department of Social and Health Services, Medical Assistance Administration, partially concurs with this finding.

First, DSHS would like to state that the State Auditors Office fails to recognize that there are legitimate reasons why State may be unable to obtain the correct SSN:

1. *Certain programs (e.g., AEM) do not require SSNs;*

2. *Food Assistance rules require DSHS to provide expedited benefits and this can prevent the Department from obtaining the SSN;*

3. *The Department apprises SSA that two different people have the same SSN; but SSA fails to correct the situation;*

4. *Sometimes a worker may suspect that the client is using an invalid SSN, but finds it necessary to enter it into ACES so it can cross-match with other systems for income data;*

Therefore, depending on the type of assistance or the need to expedite benefits, a SSN may not always be available. When Social Security numbers are received they are entered into the system. DSHS does not wait for the application to be approved while verifying the Social Security number. When the Social Security number is entered into ACES it is verified in the interface. Currently the interface runs monthly.

With regard to the audit "cause of condition" items that refer to medical diagnosis and referrals, the procedure manuals and medical staff responses, DSHS staff need to review the cases tested by the State Auditors Office to determine which programs and services are being addressed and have been identified as being in error. Once DSHS has had an opportunity to review the cases tested by the State Auditors Office, it will then address each of the items/areas that have been identified as needing to be strengthened, if applicable.

The absence of services to a client who meets the functional criteria for nursing facility care and COPES services could reasonably be expected to result in:

- *placing the patient's health in serious jeopardy,*
- *serious impairment to bodily functions, or*
- *serious dysfunction of any bodily organ or part.*

If we do not provide services to these individuals, especially the nursing home clients, they will end up in the hospital with medical expenses at a much higher cost of care. CMS also defines nursing facilities as medical institutions.

Also, the Yakima Superior Court in Gutierrez v. DSHS, ruled against the Department and MAA's medical consultant and found that the law does not require successful and appropriate medical treatment for an emergency condition to then lose coverage because it keeps the individual in an improved medical condition. In other words, just because a client's emergency condition has stabilized, does not mean that the client loses eligibility. If the emergency condition continues, so does the medical eligibility.

Second, given these elements of the program, DSHS does not concur with the questioned cost of $671,210. Nursing home and COPES clients by nature of their functional assessment meet the emergency medical condition criteria

With regard to improving the current structure/system, the Department is taking several steps to improve accuracy of SSNs:

1. *ACES is convening a work group to review options to improve accuracy. This would include further automating how we query SSA systems.*

2. *Based on the above review, the Department will provide additional training to financial workers on how to improve accuracy of SSNs.*

3. *When the Social Security number is entered into ACES it is verified in the interface. Currently the interface runs monthly, it will be changed to daily process.*

The Department will also be reviewing the coding used to identify emergent and non-emergent procedures for areas of improvement and its procedure manuals for easy of use.

Auditor's Concluding Remarks

The federal statutes are clear that an individual must have a valid Social Security number in order to be eligible for Medicaid benefits. The reasons offered by the Department as to why it has not ensured adequate controls do not reverse federally mandated requirements. Our position in response to the Department's reasoning is as follows:

- Programs such as Alien Emergency Medical do not negate the Department's obligation to ensure the validity of the Social Security number for Medicaid applicants.

- Federal food assistance programs are not linked to Medicaid and thus the eligibility rules for these are not applicable to the Medicaid program.

- The Department stated it informs the Social Security Administration of two persons having the same Social Security number. In our audit, we have never encountered this situation nor has the Department brought this condition to our attention at the time of our fieldwork.

- When staff suspects that a client is using an invalid Social Security number, we have found in most cases that the Medicaid application is approved and benefits are immediately given. Our audit revealed that Department computer systems have received up to five Social Security numbers for some of its clients. In the cases that we have reviewed, the Department has never attempted to obtain the correct Social Security number.

As noted in the finding, Department staff are able to ensure the validity of each applicant's Social Security number using the State On-Line Query (SOLQ). SOLQ is a database provided by the federal government; one of its purposes is to verify Social Security numbers. In the Community Service Offices that we visited this year, we found that staff rarely use SOLQ to verify an applicant's Social Security number at the time of application. This is true for the application process at headquarters, as well. Management is aware that this control is consistently bypassed.

The federal statute is explicit in its definition of emergent. For undocumented alien clients, the federal statute is also clear that only emergent services are eligible for federal financial participation. The expectation that a condition may eventually become emergent in the absence of routine or rehabilitative medical services is not a component of the criteria. Additionally, the federal statute does not contain a provision that deems conditions that meet the "functional" criteria for nursing home care and in-home care as equivalent to emergent conditions.

With respect to Gutierrez v. DSHS, the State Auditor's Office takes no position as to what care or how much care the state should render to its undocumented alien clients. However, the federal government has stipulated that, for this population, it will only provide federal financial participation for conditions that are emergent. Therefore, if the State wishes to provide routine and rehabilitative care to its undocumented alien clients, it should do so using only state funds. Utilizing federal funds for these activities may be viewed by the U.S. Department of Health and Human Services as a disregard for federal statutes, which may jeopardize future federal funding or which may result in increased federal scrutiny for Washington's Medicaid program.

Applicable Laws and Regulations

Title 42, Code of Federal Regulations, Section 435.404(a)(4)(b) provides the following guidance:

> The agency must only provide emergency services (as defined for purposes of section 1916(a)(2)(D) of the Social Security Act), and services for pregnant women as defined in section 1916(a)(2)(B) of the Social Security Act to otherwise eligible residents of the United States not described in paragraph (a)(3) and (a)(4) of this section who have been granted lawful temporary or lawful permanent resident status...

Section 1916(2)(D) of the Social Security Act provides that emergency services are defined by the Secretary:

> ...the State plan shall provide that in the case of individuals... who are eligible under the plan...(2) no deduction , cost sharing or similar charge will be imposed under the (State) plan with respect to ...(D) emergency services (as defined by the Secretary)...

Emergency services as described by the Secretary are as follows in Washington Administrative Code 388-500-0005:

> Emergency medical condition means the sudden onset of a medical condition (including labor and delivery) manifesting itself by acute symptoms of sufficient severity (including severe pain) such that the absence of immediate medical attention could reasonably be expected to result in:
>
> > Placing the patient's health in serious jeopardy;
> > Serious impairment to bodily functions; or
> > Serious dysfunction of any bodily organ or part.

Washington Administrative Code 388-500-0005 defines emergency medical expense requirements as follows:

> A specified amount of expenses for ambulance, emergency room or hospital services, including physician services in hospital, incurred for an emergency medical condition that a client must incur prior to certification for the medically indigent program.

The Department's *A-Z Eligibility Manual* describes what constitutes an emergency medical condition. It states, in part:

> 1. ...In order to be eligible for the Alien Emergency Medical (AEM) program, a person must:…a. Have an emergency medical condition. (Refer to the list of emergency medical condition in the Medically Indigent section); ...

Washington Administrative Code 388-438-0110 describes alien emergency medical as follows:

> An alien who is not eligible for other medical programs, is eligible for emergency medical care and services:
>
> (1) Regardless of their date of arrival in the United States;
>
> (2) Except for citizenship, meets Medicaid eligibility requirements as described in Washington Administrative Code 388-505-0210, 388-505-0220 or Washington Administrative Code 388-505-0110; and
>
> (3) Limited to the necessary treatment of an alien's emergency medical condition as defined in Washington Administrative Code 388-500-0005, except that organ transplants and related medical care services are not covered.

Washington Administrative Code 388-424-0010 describes alien status and eligibility requirements for medical benefits. Paragraph (3) states the extent of those services:

> An alien who would qualify for Medicaid benefits but is ineligible solely because of his or her alien status, can receive medical coverage as follows:
> (a) State-funded categorically needy (CN) scope of care for …(i) Pregnant women, as specified in Washington Administrative Code 388-462-0015

Washington Administrative Code 388-462-0015 states that care to pregnant women who do not meet eligibility requirements due to citizenship status will be provided under state funded programs solely:

> A pregnant woman is eligible for CN scope of care under the state-funded pregnant woman program if she is not eligible for programs in subsection (2) of this section due to citizenship, immigrant or Social Security Number requirements.

Revised Code of Washington 43.20A.550 states that rules and regulations that are in conflict with federal law are deemed inoperative:

> …Any section or provision of law dealing with the department which may be susceptible to more than one construction shall be interpreted in favor of the construction most likely to comply with federal laws entitling this state to receive federal funds for the various programs of the department. If any law dealing with

the department is ruled to be in conflict with federal requirements which are a prescribed condition of the allocation of federal funds to the state, or to any departments or agencies thereof, such conflicting part of chapter 18, Laws of 1970 ex.sess is declared to be inoperative solely to the extent of the conflict.

03-03 The Department of Employment Security paid at least $221,677 in unemployment insurance benefits to claimants who were not eligible. In addition, we estimated that payments totaling more than $546,000 were made to claimants during the first week of unemployment, which is prohibited by state law.

Background

The Department pays more than $2.3 billion a year in benefits to unemployed workers.

Description of Condition

During our audit, we reviewed unemployment insurance benefit payments and found that at least $221,677 in benefits were paid to claimants who were not eligible for benefits due to incarceration, invalid Social Security numbers or because they already were receiving benefits for an on-the-job injury.

We found:

- Fifteen claimants received benefits while incarcerated, which makes them ineligible for unemployment benefits. The claimants were paid $84,062.

- Ninety-two claimants who received benefits used invalid Social Security numbers or Social Security numbers belonging to deceased individuals. These claimants are not eligible according to the Department's benefit eligibility policies. These payments totaled $96,352.

- Five claimants received both unemployment and workers' compensation benefits for the same time period. This is a violation of state law. These payments totaled $35,944.

- The Department made duplicate benefit payments to claimants on 13 occasions, resulting in overpayments of $5,319.

In addition to the overpayments described above, we found that the Department paid several claimants during their first week of unemployment, which is prohibited by state law. When we examined this area, we produced a report that compared the weeks of unemployment to the benefit payment weeks and found 3,763 matches. We selected 60 of the 3,763 claimants and found that 25 (42 percent) were paid during the first week of unemployment. Since the amount paid totaled $992,888 over a nine-month period, we estimate that the amount would have been more than $1.3 million for a 12-month period. Therefore, we estimate that $546,000 (42 percent of $1.3 million) was paid to claimants during their first week of unemployment.

Cause of Condition

In September 2002, the Department obtained the ability to cross-match claimants' Social Security numbers with data from the Social Security Administration. However, the Department stated that it did not have the necessary resources to use the results to identify claimants with invalid Social Security numbers until April 2003. The Department does not

have procedures to identify incarcerated claimants, deceased claimants and claimants receiving industrial insurance benefits.

The General Unemployment Insurance Design Effort (GUIDE) system is the Department's unemployment insurance benefit payment system. An error in the system caused several claimants to be paid for their first week of unemployment, which is prohibited by law. This error has caused claimant overpayments since the system went on line in 1997. Management has been aware of this error since 1997 but considers the overpayments administrative errors. These claimants have not been asked to return the overpayments.

Department management agreed that the instances in which claimants received duplicate payments for the same benefit week were the result of processing errors.

Effect of Condition

Without adequate internal controls over the disbursement of unemployment insurance benefits, the Department cannot ensure that benefits are being paid to eligible claimants. In fiscal year 2003, we estimate that more than $767,677 was paid to ineligible claimants.

Recommendations

We recommend the Department:

- Continue its effort to cross-match its Social Security data with data from the Social Security Administration to identify claimants with invalid Social Security numbers.

- Consider obtaining Social Security number data for deceased individuals from the Social Security Administration.

- Consider sharing or obtaining data with other public entities to match Social Security numbers on incarcerated claimants and claimants receiving conflicting benefits.

- Improve the benefit payment system to prohibit duplicate payments and payments during the claimant's first week of unemployment.

Department's Response

We appreciate the work performed by the State Auditor's Office on our Unemployment Insurance benefit payment processes. As usual, the audit has identified things that we can do to improve the UI program. Our agency currently performs extensive cross matches, data mining and other fraud prevention and detection efforts for the UI program. Over the last two years we have had substantial budget cuts from the U.S. Department of Labor and supplemental budget requests to enhance our fraud prevention and detection efforts were not funded by the Legislature. However, our Office of Special Investigations and their fraud prevention and detection efforts continue to be recognized as a leader in the nation, by the USDOL and other states.

In response to the issues identified by the auditor the agency has taken the following actions:

Fifteen claimants received benefits while incarcerated, which makes them ineligible for unemployment benefits. The claimants were paid $84,062.

The incarcerated claimants have been denied further benefits and have been assessed with overpayments.

We would appreciate assistance from the State Auditor's Office in demonstrating how this cross match was accomplished and whether our agency would be able to negotiate a similar cross match. In order for it to be an effective prevention tool the entire benefit payment file would need to be run on a weekly basis. We do not know how many Social Security Numbers were initially identified by the auditors, nor the level of effort expended to arrive at the 15 claimants identified in this report. Our concern is whether implementing a cross match of this type would be cost effective given that the agency's investigative unit is already at capacity. As such, the Department would be unable to accomplish this additional workload without the federal grantor (U.S. Department of Labor) or the Legislature providing more funding.

Ninety-two claimants who received benefits used invalid Social Security Numbers or Social Security Numbers belonging to deceased individuals. These payments totaled $96,352.

Of the ninety-two claimants cited by the auditors as using Social Security numbers of the deceased or numbers that were invalid, the agency had already identified and written overpayments on the majority of these individuals prior to the SAO audit.

On September 27, 2002, the first cross match of Unemployment Insurance (UI) benefit data with Social Security Administration (SSA) records was completed. Although the department was receiving a report of cross match results from the SSA, our mainframe system required reprogramming to support the process.

The agency had three major concerns when the cross match process was started:

1) No funding for investigators;

2) The agency's ability to handle the increased workload;

3) The reliability of SSA data.

Because of these concerns a decision was made not to stop payment of claims initially until eligibility could be verified. During the first four to six months of the new cross match process the agency was working through the learning curve to iron out issues, answer questions, and finalize the process.

The numbers provided by the SAO demonstrates the effectiveness of the new cross match process and reduces the risk of making payments to ineligible individuals:

Month/Year	*Number of claimants using SSN belonging to a deceased person*
October 2002	*11*
November 2002	*41*
December 2002	*26*
January 2003	*16*
February 2003	*6*
March 2003	*2*
April 2003	*3*

As reflected above, the number of claimants using an SSN belonging to a deceased person that were not detected immediately was significantly reduced.

At the end of April 2003 the Social Security cross match process was completed with reprogramming of the agency's mainframe system, by adding a Social Security Number Verification Indicator Field and a screen for secondary verification of numbers in question. With these system improvements issue stops are automated. This results in a denial of benefits when we can do so legally.

The Department would like to point out that the new procedures for the Identity Claims Unit, assigned to investigate Social Security cross match issues, are written to reflect the requirements of the O'Brien class action court decision, as is the programming in our benefit payment system (GUIDE). Also, federal law governing administration of the UI program requires that claimants be paid "when due". It is not legal for the agency to withhold these payments until we hear back from the Social Security Administration. Fifty-five of the claims identified in this audit were covered under the O'Brien decision.

The Department does have a procedure to identify claimants using Social Security Numbers of the deceased or numbers that are invalid. The Department is continuing efforts to obtain on-line access to Social Security data. On-line access will allow the Department to determine in an even more timely and accurate manner whether the number being used by a claimant is invalid or belongs to a deceased person.

In addition, the Department is also considering obtaining Vital Statistics information through the Department of Social and Health Services to assist in accurately identifying claimants who use Social Security Numbers belonging to deceased persons.

Five claimants received both unemployment and workers' compensation benefits for the same time period. This is a violation of state law. These payments totaled $35,944.

These payments were found during the SAO benefit audit cross match and have been thoroughly investigated by the agency. In each case, individuals did receive benefits to which they were not entitled. All have had overpayments assessed and fraud has been investigated. In some cases the individuals filed regular claims and did not inform our agency they had received, or were

receiving, time loss payments. In the remaining cases, the individuals had been released from time loss, filed unemployment claims, then returned to time loss and did not inform the agency of that return.

Our system of communication with Labor and Industries works well for all cases where an individual informs us they have received time loss payments. Also, in most instances Labor and Industries informs us when they reinstate time loss payments.

We are currently in communication with Labor and Industries to determine if there is a method in which we can find cases of nondisclosure on the claimant's part. We are also looking at a better method of communication as to when an individual is released from then returns to time loss payments.

The Department made duplicate benefit payments to claimants on 13 occasions resulting in overpayments of $5,319.

These exceptions were caused by claimants being paid for the same week on two different claims – one for regular UI benefits and another for Temporary Extended Unemployment Compensation (TEUC). This issue was identified as a GUIDE incident (system error) by the agency and it was subsequently corrected. Several of these duplicate payments were identified as overpayments by the agency prior to the audit and subsequently recovered. As of April 3, 2004 the TEUC program will be eliminated.

The Department paid several claimants during the first week of unemployment…

There were a number of circumstances that contributed to this exception. Many of these included cases where claimants were paid TEUC when they should have qualified for a new claim. Others were claims that were backdated in the system, late claims, and changes in the effective date of the claim, etc. that weren't handled correctly. Some of these were human error some were system errors.

We have identified a way to prevent these exceptions from continuing with an automated solution. This solution has been prioritized and work will begin on it shortly.

Auditor's Concluding Remarks

We appreciate the Department's efforts in addressing this finding and will review the agency's progress toward improving internal controls during our next regular audit.

Applicable Laws and Regulations

RCW 50.20.010 (1) states in part:

> An unemployed individual shall be eligible to receive waiting period credit or benefits with respect to any week in his or her eligibility period only if the commissioner finds that: . . . (c) He or she is able to work, and is available for work in any trade, occupation, profession, or business for which he or she is reasonably fitted [and] (d) He or she has been unemployed for a waiting period of one week.

RCW 50.20.085 states:

> An individual is disqualified from benefits with respect to any day or days for which he or she is receiving, has received, or will receive compensation under RCW 51.32.060 or 51.32.090.
>
> RCW 51.32.060 is the state law providing compensation for permanent total disability in the case of an industrial accident, which is referred to as workers' compensation pensions.
>
> RCW 51.32.090 is the state law providing compensation for temporary total disability in the case of an industrial accident, which is referred to as workers' compensation time loss.

WAC 192-110-005 (3) states in part:

> The first week you are eligible for benefits is your waiting week. You will not be paid for this week . . .

Unemployment Insurance Procedures Manual, Section 5100.00, General Information -- Initial Claim, states in part:

> Without a Social Security number (SSN), a claim for unemployment insurance cannot be completed. A correct SSN is essential to establish an unemployment insurance claim. During the initial claim process, verification of identity will occur . . . SSNs that have never been issued, belong to another individual or belong to a deceased person will be flagged . . .

Section 20.20.20.a of the Office of Financial Management's *State Administrative and Accounting Manual* states, in part:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

03-04 The Department of Social and Health Services, Medical Assistance Administration, has not established sufficient internal controls to ensure that Medicaid payments are made only for persons with valid Social Security numbers and are not made on behalf of deceased individuals or persons using the Social Security numbers of deceased individuals.

Background

The Department of Social and Health Services is responsible for administering the state of Washington's Title XIX Medicaid program (CFDA 93.778), which receives nearly $3 billion in federal funds annually. Medicaid expenditures include medical assistance payments for eligible recipients for services such as hospitalization, prescription drugs, nursing home stays, outpatient hospital care and physician services. Eligibility for Medicaid is based on many factors; however, a valid Social Security number is required in most cases for an individual to be eligible for Medicaid. This is true for children as well.

Description of Condition

During our 2002 audit, we analyzed the validity of Medicaid clients' Social Security numbers as well as claims that could have been paid on behalf of a person who had died. During that audit, we sampled 639 Medicaid recipients and found that 50 percent had exceptions related to the validity of the client's Social Security number. For example, we identified invalid Social Security numbers, Medicaid payments for services rendered after individuals had died, and clients who were using a Social Security number that was assigned to a deceased person. Factors contributing to these conditions included Department staff not heeding or investigating alerts sent by the Social Security Administration; the Department's reliance on family members to voluntarily inform it of a client's death; and computer errors that occurred when client data was being transmitted between the Department's client eligibility system and the Medical Management Information System.

During our current 2003 audit, we attempted to determine if the Department had established controls that would ensure that only claimants with valid Social Security numbers were enrolled in the program and that people who were deceased were promptly removed from Medicaid eligibility. We have found that the Department does not have effective procedures that are universally applied that would enable all the Community Service Offices to be notified of a client's death in a consistent and timely manner. Additionally, the Department and the Department of Health do not communicate for the purpose of obtaining notice of client deaths.

We also found that the internal controls that would ensure the validity of Social Security numbers were inconsistent from one Community Service Offices to another. We reviewed the controls at 11 Community Service Offices and found the following weaknesses:

- Sixty-four percent of the offices we visited were not verifying Social Security numbers at time of application.

- Eighteen percent did not provide training to staff on how to use the tools that would assist in determining the validity of a client's Social Security number.

- One hundred percent of the offices have no system in place to inform management of the Social Security number alerts that have existed or currently exist.

- One hundred percent of the offices have no mechanism to prevent the deletion of an alert by staff without management's knowledge.

- Twenty-six percent of the offices have no management oversight of the alerts sent by Social Security Administration.

As part of our audit, we also reviewed Medicaid funds paid through the Department's Social Service Payment System. We selected 29 individuals who appeared to have been provided services after their dates of death. We found that providers for eight of these clients received payments for services they reported to have provided after the individual's death. Medicaid payments in these instances amounted to $73,415 of which $20,463 remained yet to be recouped or resolved as of June 30, 2003.

Cause of Condition

- The Department is largely dependent on the provider or the family to report a client's death.

- Alerts sent by the federal government informing the Department of a client's death are not heeded in a timely fashion or are overridden by staff. Additionally, workers are able to clear alerts without management's knowledge and management does not monitor the status of alerts issued.

- The Department knows it has computer problems during the transfer of some data from the Automated Client Eligibility System to the Medical Management Information System.

- The Department has the capability of verifying the validity of a Social Security number with the State On-Line Query (SOLQ) at the time of application. This control is not always used by staff members largely because they are not consistently and timely trained in the use of SOLQ.

- The Department of Social and Health Services and the Department of Health do not have a system to alert the Department of the clients who have died.

Effect of Condition

In order to be eligible to receive Medicaid, an individual must have a valid Social Security number or must have applied for a number. With few exceptions, each claim paid on behalf of a client with an invalid Social Security number is an unallowable cost. Also, the Department's inability to identify deceased clients in a timely manner allows providers to continue to submit claims on behalf of people who are deceased without timely detection.

In addition to evaluating the internal controls over Social Security numbers in the Department's Medical Management Information System, we reviewed claims paid through the Department's Social Service Payment System. Of the 29 clients selected, we found eight for whom Medicaid

funds were paid for services rendered after the client was deceased. As a result, we are questioning $10,232 in federal funds and an equal amount in state funds related to these claims.

Recommendations

We recommend the Department develop and follow procedures that:

- Require staff to verify Social Security numbers for all Medicaid clients.
- Require staff to heed alerts sent by the Social Security Administration.
- Make it impossible for staff to delete alerts without management's approval and/or knowledge.
- Resolve the computer interface problems between the Automated Client Eligibility System and Medical Management Information System.
- Establish a system with the Department of Health that will provide notification of clients' deaths in a timely manner.

We also recommend the Department work with the U.S. Department of Health and Human Services to determine if any unallowable costs charged to Medicaid must be reimbursed.

In addition, when establishing controls to ensure the validity of Social Security numbers, we recommend the Department consider the state identity theft law, Revised Code of Washington 9.35.020, that takes effect July 1, 2004.

Department's Response

The Department of Social and Health Services, Medical Assistance Administration, partially concurs with this finding.

There are valid reasons why States may be unable to obtain or verify the correct SSN:

1. *Certain programs (e.g., AEM) do not require SSNs;*
2. *Food Assistance rules require DSHS to provide expedited benefits and this can prevent the Department from obtaining the SSN;*
3. *The Department apprises SSA that two different people have the same SSN; but SSA fails to correct the situation;*
4. *Sometimes a worker may suspect that the client is using an invalid SSN, but finds it necessary to enter it into ACES so it can cross-match with other systems for income data;*

Therefore, depending on the type of assistance or the need to expedite benefits, verification of SSNs is not an eligibility factor for assistance programs.

With regard to improving the current structure and internal controls, the Department is taking several steps to improve accuracy of SSNs for both living and deceased individuals:

1. *ACES is convening a work group to review options to improve accuracy. This would include further automating how we query SSA systems,*

2. *DSHS will conduct a review of current procedures with regard to reviewing SSNs for validity and identify areas that could be strengthened;*

3. *Based on the above reviews, the Department will provide additional training to financial workers on how to improve accuracy of SSNs.*

4. *When the Social Security number is entered into ACES it is verified in the interface. Currently the interface runs monthly, it will be changed to daily process.*

5. *The recommendation to resolve the interface problems between ACES and MMIS has already been addressed. The Department has modified the ACES-MMIS interface in July 2003.*

The Department has reviewed the transactions tested by the State Auditors Office and concurs with the questioned costs identified in the amount of $10,232.00.

Auditor's Concluding Remarks

The federal statutes are clear that an individual must have a valid Social Security number in order to be eligible for Medicaid benefits. The reasons offered by the Department as to why it has not ensured adequate controls do not reverse federally mandated requirements.

- Programs such as Alien Emergency Medical do not negate the Department's obligation to ensure the validity of the Social Security number for citizens applying for Medicaid.

- Federal food assistance programs are not linked to Medicaid and thus the eligibility rules for these are not applicable to the Medicaid program.

- The Department stated it informs the Social Security Administration of two persons having the same Social Security number. In our audit, we have never encountered this situation nor had the Department brought this condition to our attention at the time of our fieldwork.

- When staff suspects that a client is using an invalid Social Security number, we have found in the majority of cases that the Medicaid application is approved and benefits are immediately given. Our audit revealed that Department computer systems have received up to five Social Security numbers for some of its clients. In the cases that we have reviewed, the Department has never attempted to obtain the correct Social Security number.

As noted in the finding, Department staff are able to ensure the validity of each applicant's Social Security number using the State On-Line Query (SOLQ). SOLQ is a database provided

by the federal government; one of its purposes is to verify Social Security numbers. In the Community Service Offices that we visited this year, we found that staff rarely use SOLQ to verify an applicant's Social Security number at the time of application. This is true for the application process at headquarters, as well. Management is aware that this control is consistently bypassed.

Applicable Laws and Regulations

The Code of Federal Regulations is precise in its directives regarding obtaining and verifying Social Security numbers as a condition of eligibility for Medicaid determination. Title 42, Code of Federal Regulations, Section 435.910(a) specifically states, pertaining to eligibility, the following:

> The agency must require, as a condition of eligibility, that each individual (including children) requesting Medicaid services furnish each of his or her Social Security numbers (SSNs)…

Regarding the agency's responsibility for the verification of SSNs, Title 42, Code of Federal Regulations, Section 435.910(g) states:

> The agency must verify each SSN of each applicant and recipient with SSA, as prescribed by the commissioner, to insure that each SSN furnished was issued to that individual and to determine whether any others were issued.

Title 42, Code of Federal Regulations, Section 435.910 states:

> …(e) If an applicant cannot recall his SSN or SSNs or has not been issued a SSN the agency must--
>
> (1) Assist the applicant in completing an application for an SSN;
> (2) Obtain evidence required under SSA regulations to establish the age, the citizenship or alien status, and the true identity of the applicant; and
> (3) Either send the application to SSA or, if there is evidence that the applicant has previously been issued a SSN, request SSA to furnish the number.
>
> (f) The agency must not deny or delay services to an otherwise eligible applicant pending issuance or verification of the individual's SSN by SSA.

For the redetermination of Medicaid eligibility and Social Security numbers, Title 42, Code of Federal Regulations, Section 435.916(a) states:

> The agency must redetermine the eligibility of Medicaid recipients, with respect to circumstances that may change, at least every 12 months….

Title 42, Code of Federal Regulations, Section 435.920 (a)-(c) states:

> (a) In redetermining eligibility, the agency must review case records to determine whether they contain the recipient's SSN or, in the case of families, each family member's SSN.
> (b) If the case record does not contain the required SSNs, the agency must require the recipient to furnish them and meet other requirements of 435.910.

If the agency initially established eligibility without verification of the SSN, Title 42, Code of Federal Regulations, Section 435.920(c) requires:

> For any recipient whose SSN was established as part of the case record without evidence required under the SSA regulations as to age, citizenship, alien status, or true identity, the agency must obtain verification of these factors in accordance with 435.910.

The Medicaid State Plan identifies the above references as being applicable to Washington State's coverage and eligibility criteria when it states the following:

> The Medicaid agency meets all requirements of 42 CFR Part 435, Subpart J for processing applications, determining eligibility, and furnishing Medicaid.
>
> [*Subpart J of the CFR encompasses all citations from subsection 435.900 through 965 and thus would include the regulations cited above.*]

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states:

> The auditee shall:…
>
> > (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs….

03-05 The Department of Social and Health Services, Economic Services Administration, should improve compliance with eligibility requirements for the Temporary Assistance to Needy Families Program.

Background

The Department of Social and Health Services, Economic Services Administration, is responsible for administering the federal Temporary Assistance to Needy Families program (CFDA 93.558). Federal regulations require each state to maintain a certain amount of state-funded expenditures each year or face financial penalties. For assistance payments to clients, the Program spent $107,796,402 in federal funds and $172,975,130 in state funds during state fiscal year 2003.

The program is designed to provide time-limited assistance to needy families with children and to promote job preparation and work opportunities for the parents. As long as minimum requirements are met, states have flexibility in designing programs and determining eligibility requirements and may use grant funds to provide cash or non-cash assistance. To be eligible under federal requirements, a family generally includes a child under 18 living with the parent(s) and must qualify as needy under a state's criteria. The state also has specified that, with certain exceptions, applicants must provide Social Security numbers in order to receive Program benefits.

During the fiscal year 2002 audit, we identified weaknesses related to compliance with eligibility requirements and reported them in the Statewide Accountability Report and in the State of Washington Single Audit Report.

Description of Condition

During our current audit of the Program, we selected clients who received benefits from July 1, 2002 through May 31, 2003. We again found instances of noncompliance with eligibility requirements in the following areas:

a. From the population of Program recipients, we judgmentally selected 19 active recipients who were 17 years or older, had an average monthly income of $2,500 or more, and received over six months of Program assistance. We compared income records of these families on record at the Employment Security Department, along with the number of family members, with the amounts of Program assistance provided. According to state regulations (Washington Administrative Code 388-478-0035), a family of 10 or more cannot have income in excess of $2,566 a month and still receive Program benefits. We found 10 instances (53 percent of the selected cases) in which the Department paid families more than they were eligible to receive, considering their income and number of family members. Total overpayments in these 10 cases amounted to $37,124.

b. We reviewed the validity of Social Security numbers for 28 Program recipients. We selected only those who were active recipients, had a Social Security number of a person reported to the Social Security Administration as deceased before July 1, 2002, and had received over six months of assistance. Through the use of the Department's access to the Social Security Administration's State On- Line Query system, we found 10 instances in which the Social Security numbers could not be verified as accurate. Total Program payments to these ineligible recipients amounted to $9,787. Also, we found 13 instances

in which invalid numbers appeared to have been entered because of Departmental error, rather than because of inaccurate information provided by clients. Program payments in these instances, which we determined were probably valid in spite of the incorrect numbers, totaled $14,402.

c. We found instances in which Program recipients did not have a Social Security number at all. From these recipients, we selected only those who were active recipients, were 18 years or older, and had received over six months of Program assistance. Of the 26 we reviewed, we found 24 U.S. citizens or qualified aliens who had applied for a Social Security number and therefore are eligible for Program assistance. We found two cases in which payments were made to undocumented aliens who provided accurate information but who did not meet the state requirement of being a qualified alien for at least a five-year period. Program payments in these 2 cases totaled $2,118.

Cause of Condition

a. The Department stated this condition was caused by clients providing inaccurate income data, or not promptly advising Department workers of a change in income. In addition, the lag between the availability of Employment Security Department data and comparing it against Program income eligibility contributes to staff not always identifying overpayment cases.

b. The Department stated this condition was caused by staff inattention to detail when entering data, primarily due to time constraints in processing cases. Contributing factors also include staff turnover and lack of continued training.

c. These two cases were likely caused by a discrepancy in the Department's manual. The manual indicates these clients were exempt from the five-year requirement; however, the official version of the Washington Administrative Code does not exempt them. In addition, the Department stated the complexity of non-citizen eligibility for Department benefits contributes to the two errors noted.

Effect of Condition

Clients who may not be eligible are receiving both state and federal benefits. In addition, failure to use all resources available for verifying eligibility could leave the Department susceptible to fraud and could lead to a reduction in federal grant funds. The Department estimates that, for the $49,029 identified above, $20,840 was charged to the federal program and $28,189 was charged to state funds. Accordingly, we are questioning these amounts.

Recommendations

We recommend the Department:

a. Periodically compare information provided by recipients with applicable records maintained with other state agencies and investigate any discrepancies.

b. Require employees to follow state regulations regarding Social Security numbers and investigate and resolve invalid numbers.

c. Ensure its manual accurately reflects the applicable current Washington Administrative Codes.

Department's Response

a. DSHS concurs that the selected cases were overpaid TANF cash benefits. However, State of Washington statute RCW 74.08.060 stipulates that applicants be assessed for financial assistance within 45 days. Given this state's mandated guideline to provide timely assistance, the delay in up-to-date information through Employment Security Department directly affects our ability to make 100% accurate eligibility decisions at the time of application with the information available. In order to comply with State guidelines, DSHS workers are faced with providing time sensitive, necessary assistance to clients, while diligently following State mandated guidelines. The 19 judgmentally selected cases are not representative of the caseload as they were not randomly selected.

b. The State Auditor's Office reviewed the validity of Social Security numbers for 28 program recipients. There were 10 instances where the Social Security numbers could not be verified as accurate. This resulted in ineligible recipients receiving $9,787. Economic Services Administration concurs with this finding. The department currently has the means to validate recipients' Social Security numbers and is addressing this issue through continued staff training. Future system enhancements will reduce these types of errors. The 28 selected cases are not representative of the caseload.

c. The auditors tested 26 program recipients that did not have a Social Security number at all. The auditor's noted 2 cases totaling $2,118 where the clients provided accurate information, but did not meet state regulations for eligibility. Economic Services Administration concurs with the auditor's finding where undocumented aliens provided accurate information, but due to an error in the DSHS manual, these clients were authorized Program assistance. The DSHS on-line manual has been corrected to align with WAC, as it should have before these two instances.

Auditor's Concluding Remarks

We had not intended for our test selection results to be representative of the entire TANF recipient population. We used Computer Assisted Audit Techniques to select the clients that we believed were most likely to be ineligible for the benefits they received.

We appreciate that the Division is addressing this finding by providing staff training, system enhancements, and correction of the manual. We will review this area during our fiscal year 2004 audit.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states in part:

> The auditee shall…
>
> > (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs…

Subpart A, Section 105 of the Circular states in part:

> …a questioned cost means a cost that is questioned by the auditor because of a finding:
>
> > (1) Which resulted from a violation or possible violation of a provision of law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds.

Subpart E, Section 510 of the Circular states includes the following as audit findings the auditor shall report in a schedule of findings and questioned costs:

> (a)(3) Known questioned costs which are greater than $10,000 for a type of compliance requirement for a major program.

Washington Administrative Code 388-478-0035 describes the maximum earned income limits for Program beneficiaries relative to the number of family members.

Washington Administrative Code 388-476-0005 states in part:

> (1) With certain exceptions, each person who applies for or receives cash, medical or food assistance benefits must provide to the department a Social Security Number (SSN) or numbers if more than one has been issued.
>
> (2) If the person is unable to provide the SSN, either because it is not known or has not been issued, the person must:
>
> > (a) Apply for the SSN;
> > (b) Provide proof that the SSN has been applied for; and
> > (c) Provide the SSN when it is received.
>
> (3) Assistance will not be delayed, denied or terminated pending the issuance of an SSN by the Social Security Administration. However, a person who does not comply with these requirements is not eligible for assistance.

Washington Administrative Code 388-424-010 (2) states in part:

> Qualified aliens who first physically entered the U.S. after August 21, 1996 cannot receive TANF, Medicaid, or SCHIP for 5 years after obtaining status as a qualified alien, unless they are any of the following:
>
> (a) An alien as described under WAC 388-424-0005 (3)(b), (d), (e), (g), or (h)…

03-06 The Department of Social and Health Services, Medical Assistance Administration, has not established sufficient internal controls to ensure the eligibility of families enrolled in the Medicaid Basic Health Plus program.

Background

Basic Health Plus is a Medicaid program (CFDA 93.778) for children of low-income households. Members pay no monthly premiums or co-payments. The Department, with federal participation, pays the entire cost of coverage. Our 2001 audit revealed multiple weaknesses in the internal controls over client eligibility:

- The Department did not require the annual re-certification form to be returned unless the parent/guardian's income changed. It assumed no income change if the form was not returned.

- The Department performed an inadequate number of re-certification reviews to determine compliance with eligibility requirements.

- When it did perform re-certification reviews, the Department did not require proof of income.

- The Department did not ensure that clients were within the program's income limits upon application.

In 2001, we judgmentally selected 60 clients and found that 27 did not meet the net income standards for Medicaid eligibility, which is a 45 percent exception rate.

In our 2002 audit, we found that the Department was in the process of restructuring controls and training staff. However, the majority of corrective actions did not occur before fiscal year 2002 had ended and the internal control weaknesses that were found in 2001 continued in 2002. We reported findings in both years.

Description of Condition

During our current audit, we reviewed the actions taken by the Department to address these weaknesses and found it had made some significant improvements. Most notable among these was the Job Operating Instruction Manual that the Department has developed to assist staff in transitioning to the new income verification requirements. Furthermore, the State's 2003-2004 supplemental budget included provisions requiring the Department to verify household income for individuals receiving medical benefits under Family and Children's Medical, to review eligibility every six months and to require parents/guardians to report household income changes immediately.

The majority of these corrective actions, however, were not taken before fiscal year 2003 ended. Despite the changes that were made, unaddressed weaknesses continue. These include:

- For self-employed households, income information is not corroborated with an independent source such as tax returns from the state's Department of Revenue or the

Internal Revenue Service. Although the Department requires receipts for expenses, for self-employed clients the Department continues to accept a self-declaration of income.

- Although income changes must be reported immediately, the Department could not provide evidence of procedures that ensure that this is occurring in a consistent manner.

- Federal eligibility review quotas have not been achieved.

In addition, the state Health Care Authority informed us it sends the Department a monthly report of subscribers that are being dis-enrolled due to noncompliance with the Authority's recertification process. The Department is not using these reports as a control.

Also, as part of our follow-up work, we reviewed five wage-earning clients and five self-employed clients. We found that three of the wage-earning clients and all five of the self-employed clients were either currently ineligible for benefits or the Department could not provide the documentation to substantiate their initial eligibility.

Cause of Condition

- The Department has not completed its corrective action plan.

- The Department has not addressed remaining internal control weaknesses.

- The Department reports that eligibility review quotas have not been achieved because of heavy caseloads and a lack of staff.

Effect of Condition

The Department is not complying with requirements that it make Medicaid payments only for eligible clients. As a result, we question $17,118, of which $8,559 was paid in federal funds and $8,559 in state funds for eight families who did not meet the income requirements.

Recommendations

We recommend the Department:

- Establish controls for weaknesses that have not yet been addressed.

- Provide adequate resources so that sufficient monitoring can be achieved.

- Work with the U.S. Department of Health and Human Services to determine if any unallowable costs charged to Medicaid must be reimbursed.

Department's Response

The Department partially concurs with this finding. DSHS does not concur with the part of finding regarding internal controls and we reaffirm our prior years audit response with additional clarification to statements made in this audit finding regarding internal controls:

Internal Controls:

- *MEDS does work with HCA on reported income changes during the certification period and is followed up at annual review time. It is an expectation for both Basic Health (BH) and Medical Assistance Administration (MAA) staff to follow Chapter 5, section 5-02 Basic Health Plus Pregnancy Medical Change of Circumstances – Change in Household/Income in the BH/MAA Policy and Procedure Manual.*

- *There is not a requirement to verify income unless it is questionable. Self-declaration of household circumstances is provided under MAA's policy distributed to the field on December 3, 1998. DSHS is notified of household income by BH.*

- *MEDS follows established DSHS policies for corroborating client income as outlined in the Eligibility A-Z Manual, WAC 388-406-0030 (3); WAC 388-490-0005 (2), (3), (4), (5) (a), (b), (c), (8) (a), (9), (10); WAC 388-458-0001. Income can be verified via pay stubs, statement from employer, SEMS data, bank statements, collateral contact, SOLQ. These procedures are already established and staff follows them in order to corroborate a client's income declaration if necessary.*

- *MEDS has always corroborated a client's income declaration if the declared income is at or above 200% FPL, by pending the application or review and requesting proof of income.*

- *Changes in income do not affect a child's Medicaid eligibility during their certification period.*

The Department does concur that case auditing for Basic Health Plus was not in compliance with our internal corrective action plan governing Adequate Resources. We will update the plan to ensure additional oversight of the existing corrective action plan. It is important to clarify that this relates to case auditing by MEDS lead workers and supervisors. The audit plan was developed without any advance knowledge Department policies would be changing, or they would lose staff, which required their leads to carry caseloads, while training new staff at the same time. This is not an excuse, but reality. Due to these unanticipated workload impacts, the auditing was reduced because we had new client service.

The Department will contact CMS, as we did due to the previous audit findings, to verify treatment of questioned Medicaid dollars with regard to eligibility.

The Department does appreciate the auditor's comment that we had made some significant improvements based upon actions taken by the Department in response to the previous audit. We specifically appreciate the mention of MEDS' Job Operating Manual as a "notable" improvement. We take great pride in the fact we developed this manual internally in an effort to assist our staff, using clear and understandable language, with the daily process of determining Medicaid eligibility. It is not only a resource for our staff, but helps in our ability to provide excellent customer services to those we serve.

Auditor's Concluding Remarks

Grantees receiving federal awards must establish and maintain internal controls designed to reasonably ensure compliance with Federal laws, regulations, and program compliance requirements. While controls have improved in this area, there still exist significant weaknesses that the Department is reluctant to address. These are as follows:

- The Health Care Authority sends a monthly report to the Department of clients who no longer meet the income standards for Basic Health. During our fieldwork, we found that the Department does not act upon the information in these reports.

- The Department believes it is not required to verify income unless it is questionable. However, according to federal requirements listed above, verification of income is mandatory.

- The Department does not follow income verification procedures for all clients.

- The Department should strengthen controls by corroborating income for <u>all</u> clients, not just those who report incomes 200 percent above federal poverty levels. Doing so is equivalent to accepting self-declaration for all those reporting less than 200 percent of the federal poverty level. If the Department does not monitor incomes at all levels, clients may perceive little risk of the Department detecting false income data.

A disregard for control weakness that threatens program integrity may jeopardize future federal funding or may result in increased federal scrutiny for Washington's Medicaid program.

Applicable Laws and Regulations

Title 45, Code of Federal Regulations, Section 92.20(a) states:

> A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds.

Revised Code of Washington 43.88.160(4) states:

> …the director of financial management, as agent of the governor, shall:
>
> (a) Develop and maintain a system of internal controls and internal audits comprising methods and procedures to be adopted by each Department that will safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies for accounting and financial controls.

The state of Washington Office of Financial Management's *State Administrative and Accounting Manual* addresses basic principles of internal control in Section 20.20.20.a. as follows:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

The U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, Attachment A, Section C(1)(d) provides that costs are allowable under federal awards if they meet the following criteria:

> Conform to any limitations or exclusions set forth in these principles, Federal laws, terms and conditions of the Federal award, or other governing regulations as to types or amounts of cost items.

Title 42, Code of Federal Regulations, Section 435.916(b), states in part:

> …The agency must have procedures designed to ensure that recipients make timely and accurate reports of any change in circumstances that may affect their eligibility.

As it pertains to requesting information for the determination of eligibility, Title 42, Code of Federal Regulation, Section 435.948, states in part:

> (a)…the agency must request information from the sources specified in this paragraph for verifying Medicaid eligibility and the correct amount of medical assistance payments for each applicant (unless obviously ineligible on the face of his or her application) and recipient. The agency must request -
>
> (1) State wage information maintained by the SWICA (State Wage Information Collection Agency) during the application period and at least on a quarterly basis.
> (2) Information about net earnings from self-employment, wage and payment of retirement income, maintained by SSA and available under Section 6103(1)(7)(A) of the Internal Revenue Code of 1954 for applicants during the application period and for recipients for whom the information has not previously been requested.
> (3) Information about benefit and other eligibility related information available from SSA under titles II and XVI of the Social Security Act for applicants during the application period and for recipients for whom the information has not previously been requested;
> (4) Unearned income information from the Internal Revenue Service available under Section 6103(l)(7)(B) of the Internal Revenue Code of 1954, during the application period and at least yearly;
> (5) Unemployment compensation information maintained by the agency administering State unemployment compensation laws (under the provisions of section 3304 of the Internal Revenue Code and section 303 of the Act) as follows:
>
> (i) For an applicant, during the application period and at least for each of the three subsequent months;
> (ii) For a recipient that reports a loss of employment, at the time the recipient reports that loss and for at least each of the three subsequent months.
> (iii) For an applicant or a recipient who is found to be receiving unemployment compensation benefits, at least for each month until the benefits are reported to be exhausted.

(6) Any additional income, resource, or eligibility information relevant to determinations concerning eligibility or correct amount of medical assistance payments available from agencies in the State or other States administering the following programs as provided in the agency's State plan:

(i) AFDC;
(ii) Medicaid;
(iii) State-administered supplementary payment programs under Section 1616(a) of the Act;
(iv) SWICA;
(v) Unemployment compensation;
(vi) Food stamps; and Any State program administered under a plan approved under Title I (assistance to the aged), X (aid to the blind), XIV (aid to the permanently and totally disabled), or XVI (aid to the aged, blind, and disabled in Puerto Rico, Guam, and the Virgin Islands) of the Act.

(b) The agency must request information on applicants from the sources listed in paragraph (a)(1) through (a)(5) of this section at the first opportunity provided by these sources following the receipt of the application. If an applicant cannot provide an SSN at application, the agency must request the information at the next available opportunity after receiving the SSN.

(c) The agency must request the information required in paragraph of this section by SSN, using each SSN furnished by the individual or received through verification

(d) Exception: In cases where the individual is institutionalized, the agency needs to obtain and use information from SWICA only during the application period and on a yearly basis, and from unemployment compensation agencies only during the application period….

(e) Exception: Alternate sources.

(1) The Secretary may, upon application from a State agency, permit an agency to request and use income information from a source or sources alternative to those listed in paragraph (a) of this section. The agency must demonstrate to the Secretary that the alternative source(s) is as timely, complete and useful for verifying eligibility and benefit amounts. The Secretary will consult with the Secretary of Agriculture and the Secretary of Labor before determining whether an agency may use an alternate source.
(2) The agency must continue to meet the requirements of this section unless the Secretary has approved the request.

(f) Exception: If …SSA determines the eligibility of an applicant or recipient, the requirements of this section do not apply to that applicant or recipient.

The March 2003 U.S. Office of Management and Budget A-133 Compliance Supplement, Section E(1)(b)(2), page 4-93.778-12 and 4-93.778-13, states the following as it pertains to income verifications for eligibility determination:

> There are specific requirements that must be followed to ensure that individuals meet the financial and categorical requirements for Medicaid. These include that the State or its designee shall:…
>
> (2) Use the income and eligibility verification system (IVES) to verify eligibility using wage information available from such sources as the agencies administering State unemployment compensation laws, Social Security Administration, and the Internal Revenue Service to verify income eligibility and the amount of eligible benefits. With approval from HHS, States may use alternative sources for income information. States may also: (1) target the items of information for each data source that are most likely; to be most productive in identifying and preventing ineligibility and incorrect payments, and a State is not required to use such information to verity the eligibility of all recipients; (2) with reasonable justification, may exclude categories of information when follow-up is not cost effective; and (3) can exclude unemployment compensation information from the Internal Revenue Service or earning information from Social Security Administration (SSA) that duplicates information received from another source.

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states:

> The auditee shall:…
>
> (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs….

03-07 The Department of Social and Health Services, Medical Assistance Administration, has not established sufficient internal controls to ensure compliance with Medicaid provisions regarding licensing and other eligibility criteria for its health care providers.

Background

The Department of Social and Health Services administers the state of Washington Medicaid program (CFDA 93.778), which receives nearly $3 billion in federal funds annually. These funds pay medical providers for health care services to certain low-income clients.

Medical care under Medicaid is offered through certified and/or licensed health care providers. To become eligible to receive reimbursement for services, providers must apply for a provider number as well as meet state licensure requirements. This latter requirement assures the Department of the providers' qualifications to perform the services for which they wish to be paid. In the case of group practices, each individual practitioner must meet the licensure requirements. Evidence of current licensure for all practitioners of the group must be submitted with the application. After an application is approved and processed, the provider is deemed eligible and a provider number is issued and activated within the Medical Management Information System (MMIS). This number, when accompanied by a claim, will allow MMIS to generate an approval so that payment can be made to the provider.

Description of Condition

During our 2001 audit, we found significant weaknesses in the internal controls designed to ensure that providers meet licensing requirements.

Our 2002 audit revealed significant improvements to the internal control structure, but these improvements were only in the preliminary stages of implementation. Some of the enhancements included changes to the Core Provider Agreement; the development of a new provider expiration report; and a massive re-enrollment of all the providers. In terms of re-enrolling providers, those who did not submit an application and meet all necessary licensing criteria by the Department's deadline were to be terminated from eligibility and their provider numbers inactivated.

During our current audit, we reviewed the progress that the Department has made. We reviewed the licensure status of 169 dental practitioners, 106 chiropractors and nine medical practitioners. We found the following exceptions for dental and chiropractic providers:

Condition	Number
Expired license, but still listed as active in Medical Assistance Administration records.	16
Active restrictions on license, but no restrictions noted in Medical Assistance Administration records.	1
Deceased provider, but still listed as active in Medical Assistance Administration records.	3
Suspended license in Department of Health records, but still active in Medical Assistance Administration records.	1
License information erroneously listed in Medical Assistance Administration records.	2
No licensing information in Medical Assistance Administration records, but found in Department of Health records.	35
Previous disciplinary action or restriction on license, no indication that Medical Assistance Administration was aware of the action.	4

In addition, we found:

- Licensees were linked to clinics and practice groups that they have not been affiliated with for up to 11 years.

- The providers that we found to be deceased, but still active in MAA records, had been dead for up to seven years.

- Providers listed as active in Medical Assistance Administration records, but whose licenses had expired nine years before.

Finally, we found inadequate supervisory overview of the initial approval process for providers. Management is relying on staff to accurately follow complex procedures for the many types of providers that they enroll.

Cause of Condition

- The provider enrollment termination deadline initially set for January 2003, which would have terminated the provider numbers for all providers who have not re-enrolled, has not been enforced.

- No controls are in place to detect claims from providers who have a condition or restriction placed on their licenses.

- The Department is generating letters monthly to inform providers of the impending expiration of their licenses and to require them to update their licensure status. However, as of the date of our audit, the Department had never mailed these letters.

- The Department does not have controls in place to detect claims from providers whose licenses have been suspended or revoked by the Department of Health. On a monthly basis the Department of Health sends the Medical Assistance Administration all pertinent licensing information for all practitioners in the state. This data set contains information that would alert the Department of important licensing changes such as suspensions, revocations, practice restrictions and expirations. The Department is not updating its Medical Management Information System with this information.

- The Department stated it lacks sufficient resources to review the work of its staff.

Effect of Condition

- By not enforcing the provider enrollment termination deadline, deceased providers, providers whose affiliations have ended with past practice groups, and providers with inactive licenses cannot be easily removed from the Medical Management Information System.

- Providers whose licenses have expired or been suspended or revoked; providers who are deceased; and individuals who are not actively licensed are active in the Department's records. This condition leaves the Department susceptible to fraud.

- While the Department was able to provide sufficient evidence to give us reasonable assurance that no claims were paid for services performed by the unlicensed providers that reviewed, almost 6 percent of them had provider numbers that were individually payable and active in its Medical Management Information System. This leaves the Department susceptible to fraud as it is possible for these provider numbers to be used to receive payment.

- Twelve percent of the providers that we reviewed have no licensing information listed in Medical Assistance Administration records. Controls that require licensing data such as expiration dates would not function properly.

- It is possible for providers to be paid for procedures that they are no longer licensed to perform.

Recommendations

We recommend the Department:

- Establish and enforce a termination deadline for providers who have not re-enrolled. This would automatically eliminate those providers who are deceased and whose licenses have expired and whose affiliations are no longer valid.

- Update its Medical Management Information System with the monthly licensing data sent by the Department of Health.

- Establish controls that would ensure that claims submitted by providers who have practice restrictions associated with their licenses are not reimbursed for services they are no longer licensed to perform.

- Send the letters of expiration generated by its Medical Management Information System to providers on a monthly basis when no active license is listed on the Department of Health Website.

- Provide the resources needed to enable the Medical Assistance Administration to ensure the initial approval process is conducted as management intends.

Department's Response

The Department of Social and Health Services, Medical Assistance Administration, concurs with this finding. DSHS has or will implement the following to address the weaknesses that were noted in this finding:

- *Established a deadline of December 31, 2003 for the provider re-enrollment project. This deadline will enable MAA to terminate the providers that have not re-enrolled because they have deceased, expired licenses, moved, or sold their practices. This will clean up the provider files.*

- *Establishing a process in the provider enrollment unit that if a provider has limitations on their professional license and the license is still active, we are going to send that information to Quality Management Section to determine how or what type of limitation will be placed on their provider file. DSHS would like to note that the Provider Enrollment does place restrictions on a provider file now upon request, but it will expand the criteria to include license limitations.*

- *MAA currently receives the list of excluded providers from the OIG to terminate the provider numbers monthly. DSHS will be matching the Department of Health (DOH) license database with the provider file database monthly within the next few months. We are also doing a match with another project we are working on in conjunction with the Health Care Authority and Labor and Industries to match license numbers with our license numbers by provider number.*

- *Established a core provider agreement database that holds information about each core provider agreement that is sent in. This will track that status of the Core provider agreement. Also, there will be a report generated once a week that indicates problems with the provider file if claims are not paying correctly.*

MAA will develop a plan to improve monitoring and oversight to ensure procedures for the initial approval process are conducted as management intends.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolve the issues identified in the finding. We also appreciate the cooperation extended to us throughout the audit by Department staff.

Applicable Laws and Regulations

Title 45, Code of Federal Regulations, Section 92.20(a), states:

> A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds.

The March 2003 Circular A-133 Compliance Supplement, page 4-93.778-18, states:

> In order to receive Medicaid payments, providers of medical services furnishing services must be licensed in accordance with Federal, State, and local laws and regulations to participate in the Medicaid program (42 CFR sections 431.107 and 447.10; and section 1902(a)(9) of the Social Security Act) and the providers must make certain disclosures to the State (42 CFR subpart B)

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states:

> The auditee shall:…
>
> > (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs….

03-08 The Department of Social and Health Services, Medical Assistance Administration, has not established sufficient internal controls to ensure that capitation rates for its managed care providers are based on accurate fee-for-service encounter data.

Background

The Department of Social and Health Services administers the state of Washington Medicaid program (CFDA 93.778), which receives nearly $3 billion in federal funds annually. These funds, matched almost entirely by state funding, pay medical providers for health care services for certain low-income people. A state may obtain a waiver of statutory requirements in order to develop a system that more effectively addresses its residents' health care needs. A waiver may involve the use of a program of managed care for some clients or allow the use of program funds to serve specific clients that would be otherwise ineligible. Such programs must meet statutory and regulatory requirements for access to care and quality of services and must be a cost-effective means of providing health care services to the state's Medicaid population. The Healthy Options Program is Washington's managed care waiver and is authorized under sections 1915(b)(1) and (4) of the Social Security Act.

A capitation rate is a uniform per-patient payment that is paid to a managed care provider who treats a Healthy Options client. The provider will receive a consistent monthly payment rate for each client regardless of the number of times a client is seen and regardless of the service that is rendered as long as it is a covered service. Provider billing information and fee-for-service data (or the client diagnostic data and cost-per-visit for clients not enrolled in managed care) are used to determine the managed care capitation rate.

The rate for each managed care plan is determined using all available hospital data, with the exception of pharmaceutical data. It includes demographic, diagnostic, and geographic data, as well as hospital fees. The data is analyzed by an actuary who predicts the cost of care for the next year. From this information, a rate for each Healthy Options managed care plan is determined. In general, those plans that have sicker people will receive higher rates and those plans with healthier people will be given lower rates.

Description of Condition

We reviewed the Department's controls to determine if procedures have been established to ensure that only accurate data is being used to determine the capitated rates for its Healthy Options managed care program. We found the following:

- An outside actuary assumes responsibility for accuracy of the results of the rate computation. However, the fee-for-service data downloaded from the Medical Assistance Administration systems is generally not reviewed by the Department unless the data is rejected by computer system edits. The reliability of this data is crucial as it determines what will be paid to managed care providers.

- Although fraud detection, enforcement, and prevention procedures are being developed and refined, only certain types of provider billings (for example, dentists and pharmacists) are currently being analyzed and pursued.

- Data comparing the fee-for-service costs to the Healthy Options Managed Care costs are not easily or readily obtainable within the Medical Assistance Administration system for analysis. The Department was unable to provide us with this data during our audit.

Cause of Condition

Medical Assistance is reviewing only certain segments of provider fee-for-service billings. Unexamined data that contains undetected errors may be used to determine managed care capitation rates.

Medical Assistance is unable to readily review or compare the cost of the fee-for-service part of Healthy Options to Managed Care Healthy Options.

Effect of Condition

If fee-for-service encounter data is incorrect, it calls into question the accuracy of the managed care rate, resulting in increased premium rates being paid to managed care plans over time, at significant cost to state and federal government. In state fiscal year 2002, the state spent in excess of $481 million for services to managed care enrollees.

The inability to effectively analyze Healthy Options Managed Care as compared to fee-for-service affects the potential identification of cost containment measures and leads to possible inequities between managed care and fee-for-service options for Healthy Options eligible clients.

The Department's lack of monitoring may lead to an increased risk for the submission of incorrect data by providers, causing capitation rates to be greater than they should be.

Recommendations

We recommend the Department:

- Continue to develop its fraud detection, enforcement, and prevention procedures for fee-for-service provider claims expanding to all provider areas.

- Develop formal procedures for referral to the Medicaid Fraud Control Unit or other enforcement action.

- Review the use of data used in setting capitation rates to ensure that rates are not affected by erroneous fee-for-service data.

Department's Response

The Department of Social and Health Services, Medical Assistance Administration, does not concur with this finding.

The auditor misunderstood the rate setting process and that misunderstanding placed too much importance on Fee For Service (FFS) and encounter data in current rate setting. What was presented to the auditor showed the rate setting process in managed care from its inception to present (including 2002).The rate setting process has always been reviewed and approved by

CMS. In 2002 that process was focused on staying under a FFS equivalent, the Upper Payment Limit (UPL), which DSHS accomplished. With the Balanced Budget Act final rules, the focus changed to rates developed from direct costs. We are making that change as part of a CMS approved corrective action. Our rates have been reviewed and approved by CMS through 2005.

Since the final finding and recommendations are focused on Fraud and Abuse, it is important to understand that Fraud and Abuse policies and procedures are in place and compliant with CMS guidelines for managed care and that current and future FFS Fraud and Abuse is irrelevant to current and future managed care rate setting. The only FFS data that has ever entered into rate setting is from 1993.

Auditor's Concluding Remarks

We have a complete understanding of the rate setting process. The capitation rate (a per patient rate the managed care provider will receive) is predicated on the type of treatments given and the types of patients seen. "Up-coding" occurs when a provider bills for a higher level of services than what was actually provided. If up-coding occurs, it will falsely give the impression that the provider is treating sicker people than they really are. The federal government has reported that up-coding is not uncommon and is done so that the capitation rate can be negotiated higher and ostensibly be justified in future years.

The documentation that the Department is providing to the actuary is not reviewed or audited for accuracy. If up-coding occurs, the Department has no controls in place that could detect the erroneous information. As long as this unmonitored fee for service encounter data is given weight as a component of rate setting, there is risk that rates will rise to a level higher than they should be.

The effects of up-coding, when perpetrated by managed care providers, are not readily apparent, as the Medicaid system may not realize the effect of this type of fraud until some time in the future, if ever. Additionally, up-coding by managed care providers may not be subject to prosecution for fraud under the traditional false claims theory. This is because the managed care plan is not receiving money or any other type of constructive gain at the time treatment is given. Additionally, if the Department does not monitor the data, managed care plans may perceive the risk of detection as being relatively low.

With respect to federal oversight in this process, the Center for Medicare and Medicaid Services (CMS) approves of the <u>process</u> by which the rates are set. The rate is determined primarily by the work of the actuary and is based on the information given by the Department. This actuarially computed figure becomes the rate once approved by the legislature.

Applicable Laws and Guidelines

The March 2003 OMB Circular A-133 Compliance Supplement, page 4-93.778-16, states:

- The State plan must provide methods and procedures to safeguard against unnecessary utilization of care and services.

- The State Medicaid agency must establish and use written criteria for evaluating the appropriateness and quality of Medicaid services.

- The agency must have procedures for the ongoing post-payment review, on a sample basis, of the need for and the quality and timeliness of Medicaid services.

Title 42, Code of Federal Regulations, Section 456.3 states the following as it pertains to surveillance and utilization control:

> The Medicaid agency must implement a statewide surveillance and utilization control program that –
>
> (a) Safeguards against unnecessary or inappropriate use of Medicaid services and against excess payments;
>
> (b) Assesses the quality of those services;
>
> (c) Provides for the control of the utilization of all services provided under the plan in accordance with subpart B of this part…

03-09 The Department of Social and Health Services, Aging and Disability Services Administration and Medical Assistance Administration, has not set up an effective system of communication that would ensure that Medicaid payments are not being made to nursing homes that are not in compliance with the federally mandated health and safety standards.

Background

Under the Medicaid program, states can receive federal financial assistance for patients receiving services in nursing homes. To qualify for federal participation, the nursing home must meet certain health and safety standards. The Department's Aging and Disability Services has primary responsibility for conducting health and safety inspections at nursing facilities. Should Aging and Disability Services find that a nursing facility is not meeting federal standards, upon notification from Aging and Disability Services, the U.S. Department of Health and Human Services will send both the facility and Aging and Disability Services a denial of payment notice. This notice prohibits the payment of federal funds for any new Medicaid admissions to the facility until the condition is corrected. The Department's Medical Assistance Administration has primary responsibility for reviewing and paying claims of medical providers. Once notified of a nursing facility's denial-of-payment status, it is also Medical Assistance's responsibility to ensure that payments for services to ineligible clients are not reimbursed.

Description of Condition

During our 2002 audit, we found that neither Aging and Disability Services nor Medical Assistance had a complete record of the nursing homes that were placed in denial-of-payment status. We compared both administrations' records with the list maintained by the federal government and found Aging and Disability Services to have a 14 percent discrepancy rate and Medical Assistance to have a 33 percent discrepancy rate. During that audit, the Department concurred with our results and instituted a corrective action plan through which Medical Assistance would track the denial-of-payment notices directly from the federal government.

To determine whether this internal control improved the accuracy of the Department's records in our current audit, we compared the federal government's denial-of-payment list with the records of Medical Assistance for 36 nursing homes. We found the following:

- Medical Assistance records showed 19 of 36 nursing homes, or 53 percent, that were not matched to the federal government's list.

- Medical Assistance performs no monitoring to ensure that unallowable payments were not paid to nursing homes in facility's denial-of-payment status.

Cause of Condition

The increased discrepancy rate occurred because:

- Medical Assistance is not accurately tracking the denial-of-payment notices issued by the federal government.

- Aging and Disability Services and Medical Assistance do not communicate regarding nursing homes that are not in compliance with health and safety standards. Such communications would alert Medical Assistance of the possible existence of a facility's denial-of-payment notice.

Effect of Condition

Due to inadequate internal controls, there is a risk that the Department paid claims for ineligible patients using federal Medicaid funds.

Recommendations

Medical Assistance should improve its system for tracking the denial-of-payment notices issued by the federal government and monitor the allowability of payments to nursing homes that are in denial-of-payment status. As a preventative measure, we also recommend Aging and Disability Services inform Medical Assistance of the nursing homes that it reports to the federal government as not meeting health and safety standards and therefore likely to be placed in denial-of-payment status.

Department's Response

The Department of Social and Health Services, Aging and Disability Services Administration and Medical Assistance Administration, partially concurs with this finding.

The Department concurs that MAA needs to review current practice to add or strengthen current internal controls that would ensure the following:

- *Method of communication between MAA and CMS is timely and accurate;*

- *Monitor payments to nursing homes that are in DOP status are accurate.*

The Department does not concur that ADSA has a role in the communication between MAA and CMS with regard to the DOPs. CMS has agreed to send a copy of all DOPs to both ADSA and MAA upon issuance, therefore preventing the need for either program to have to track these documents at the agency level.

Auditor's Concluding Remarks

The corrective action plan instituted by the Department in 2002 to correct the deficiencies found in our 2002 audit is not working as management had intended. Rather than improving the condition, we saw a deterioration of controls and an accompanying increase in the risk that nursing homes may be paid with federal funds when they are not in substantial compliance with health and safety standards.

Our Office takes the position that it would be most expedient for the Administration that performs the nursing home survey (ADSA) to communicate with the Administration that pays the nursing homes (MAA) for their services when they have complied with health and safety requirements. Given the current controls, we reaffirm our position of a risk that nursing homes are being improperly reimbursed for services when they are in denial of payment status. Further,

the apparent lack of communication between the two Administrations can threaten program integrity.

Applicable Laws and Regulations

Title 42, Code of Federal Regulations, Section 442.112 (a) states:

> The Medicaid agency may not execute a provider agreement or make Medicaid payments to a facility unless the Secretary or the State survey agency has certified the facility.

Title 42, Code of Federal Regulations, Section 442.119 states:

> The denial of payments for new admissions will continue for 11 months after the month it was imposed unless, before the end of that period, the state finds the facility corrected the deficiency or is making a good faith effort to achieve compliance.

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states:

> The auditee shall:…
>
> > (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs….

03-10 The Department of Social and Health Services, Aging and Disability Services Administration, cannot determine whether nursing home payment rates properly excluded unallowable expenditures related to supplemental Medicaid payments.

Background

Supplemental Medicaid funds (CFDA 93.778) are provided to eligible public hospital districts to preserve access to health care services in rural areas. These supplemental funds are referred to as Proshare. In state fiscal year 2000, the state made Proshare payments totaling approximately $147 million to public hospital district nursing facilities that met the eligibility criteria. This resulted in the state receiving $76.2 million in Federal matching funds. Of the $147 million distributed, the allocation was as follows:

- $127 million was transferred back to the state.
- $10.2 million was shared with three non-profit organizations.
- $9.8 million was retained by 14 public hospital district nursing facilities.

Nursing facilities that provide care for Medicaid patients are reimbursed by the state using a standard daily rate for each patient. The daily rate is based on expenditures of the nursing facility. The $9.8 million in supplemental funds received by the nursing facilities was in addition to the Medicaid payments they received for direct patient care. Because these supplemental Proshare payments are not related to direct patient care, the State Medicaid Plan requires that expenditures from Proshare funds be excluded from the calculation of the daily rate. Except for inflation, nursing home payment rates have not been adjusted since 1999. The daily rate established in 1999 would have taken into account all expenditures of the nursing homes, including those attributable to the supplemental Proshare payments.

Description of Condition

The Department had no documentation that provided reasonable assurance that expenditures attributable to Proshare payments were not used in the calculations that set the nursing homes rates from July 1, 2001 to present. In two of the five cost reports that we reviewed, Proshare revenues were reported by the nursing homes, but expenditures attributable to Proshare were not identified.

Four out of the five analysts that we interviewed reported that they were unaware of Proshare payments and thus did not consider any expenditures related to it in their analyses. However, one analyst did consider these payments and attempted to obtain Proshare expenditure information from a nursing home, but was overridden by management when the nursing home complained to the Department. Consequently, the nursing home made no offset for the expenditures made from Proshare funds.

As an alternative internal control, the Department stated it had other measures built into its rate setting procedures that would have compensated for its decision not to exclude expenditures attributable to Proshare. However, for the nursing homes we reviewed, the Department could not provide evidence that would conclusively support this contention.

Cause of Condition

- In general, Department analysts were unaware of the significance of Medicaid supplemental payments in nursing home rate setting.

- The Department management did not enforce the terms of the supplemental payments as they pertain to nursing home rate setting when it was made aware of the possible existence of such expenditures.

- The Department did not comply with its own audit procedures in requiring adequate documentation to determine whether Proshare funds were used to set the nursing home rate for the 14 hospitals receiving Proshare funds.

Effect of Condition

The Department is at risk that the current nursing home rates are inflated for those facilities that received Proshare funds in 1999. These inflated rates would have been in effect since July 1, 2001 and will continue until the next nursing home rates are set.

Due to a lack of documentation, we could not recalculate an accurate daily nursing home payment rate for the facilities tested and therefore cannot determine potential questioned costs.

Recommendations

We recommend that the Department:

- Follow its own audit procedures and ensure that supporting schedules detailing expenditures attributable to Proshare and other unallowable revenues are present in cost reports and that these expenditures are appropriately offset.

- Consult with the U.S. Department of Health and Human Services to determine if nursing home rates should be recalculated to identify possible unallowable costs charged to Medicaid.

Department's Response

The Department of Social and Health Services, Aging and Disability Services Administration, partially concurs with this finding.

The Department does not concur that there is any reasonable possibility that the 1999 cost year was distorted by improper inclusion of expenses paid for by Proshare money. Total expenditures reported by the PHD nursing facilities do not support the idea that the facilities significantly increased their spending due to receipt of the Proshare money. From 1996 to 1997, the PHD facilities showed an average increase in costs of 7%. From 1997 to 1998, the average change was zero. From 1998 to 1999, the average increase was again 7%. These figures are in line with both general inflation and the spending of non-PHD nursing facilities, which did not participate in Proshare. For example, between 1998 and 1999 – when the PHD facilities reported a 7% increase – all nursing facilities participating in Washington's Medicaid program reported an increase of 8%.

Washington's rate-setting process contains caps on various costs. Moreover, not all costs of a nursing facility are allowed into the calculation of Medicaid rates. When caps and disallowances for the 14 PHD facilities are taken into account, the potential amount of Proshare-funded expenditures that could conceivably have been used in the rate-setting process is decreased from $9.8 million to $3.895 million.

Further, it should be noted that the Proshare money was distributed late in 1999 - on September 30 and November 15. This makes it even less likely that the 1999 cost reports were significantly affected by expenditures covered by Proshare funds – if indeed there were any such expenditures at all.

For the reasons stated above, the department does not support the auditors view that there is a risk that current nursing home rates are in any significant way inflated by inclusion of Proshare-funded expenses in the rate-setting process for PHD nursing facilities. However, the department will continue to investigate the situation and, as the agency in charge of administering Washington's Medicaid program, will take action where appropriate.

The Department does concur that not all analysts in the Nursing Home Rates Section were aware of the existence of the Proshare payments to the PHD nursing facilities. The section manager will inform the analysts of the Proshare program, and of the restriction on the expenditure of Proshare payments, so that this matter will be monitored in the future. Participating facilities will be directed to report their expenditure of Proshare funds, so that it can be confirmed that such expenditures are not included in the Medicaid rate-setting process. The Nursing Home Rates Section will coordinate its efforts with the department's Medical Assistance Administration to ensure that Proshare funds are spent properly, and that this can be confirmed.

Auditor's Concluding Remarks

In its response, the Department stated that the 1999 cost year could not be distorted due to the improper inclusion of expenses attributable to Proshare revenues. The Department could offer no evidence that rate caps, average facility spending, and the time of year that Proshare funds were distributed compensated for its failure to determine whether or not nursing homes excluded expenditures attributable to Proshare for rate setting purposes. That facilities would not use expenditures covered by supplemental payments for rate setting was a condition for receipt of the funds.

Rate adjustments have a significant effect on nursing home operations. In fact, nursing homes will apply for and submit to the rigors of a rate adjustment for an increase of one penny per patient day. This is because even such a small increase can result in substantial reimbursements to the facility over the course of a year. Further, the Department informed us that providing resources for this process is not viewed as a misuse of taxpayer dollars. Therefore, by not accounting for the expenditures related to Proshare revenues, nursing homes that received these funds may be operating under an inflated rate.

The Department's lack of controls for ensuring that Proshare funds are properly disclosed could result in increased federal oversight of the Medicaid program.

Applicable Laws and Regulations

The Medicaid State Plan, Attachment 4.19-D, Part 1, states:

> The supplemental payments made to public hospital districts are subject to ... a contractual commitment by the districts to not allow expenditures covered by the supplemental payments to be included in costs used to set Medicaid nursing facility payment rates.

The terms of the Interlocal Agreement executed by the public hospital districts and the Department states, in part, in Exhibit A, paragraph 1.b:

> The Public Hospital District (Contractor) will: …Not allow expenditures covered by supplemental payments to be used for Medicaid nursing home rate setting.

03-11 The Department of Social and Health Services, Division of Child Care and Early Learning, does not have adequate internal controls over support for payments made to licensed family home providers and assurance that all recovered overpayments are credited to the proper funding source.

Background

The Department of Social and Health Services administers child care programs that pay child care centers and licensed family home child care providers for child care services for eligible families. The Department either pays the providers directly or pays clients directly, with the expectation that the clients will then use the funds for child care services. The Department has assigned responsibility for the Program to the Economic Services Administration, Division of Child Care and Early Learning.

Program payments to vendors and clients are made from both state and federal funds. During fiscal year 2003, total expenditures were as follows:

Funding Source	Working Connections Child Care and Seasonal Child Care
State	$46,936,174
Federal – CFDA 93.575 – Child Care Development Fund-Discretionary	8,216,996
Federal – CFDA 93.575 – Discretionary – Temporary Assistance for Needy Families	102,795,525
Federal – CFDA 93.596 – Child Care Mandatory Fund	38,488,278
Federal – CFDA 93.596 – Child Care Matching Fund	20,721,728
Federal – CFDA 93.558 – Temporary Assistance for Needy Families	75,565,807
Federal – CFDA 93.667 – Social Services Block Grant	1,031,110
Federal Recoveries	20,204
Total Subsidy Payments	**$293,775,822**

Support for Payments

All providers are required to keep daily attendance records. These records determine the number of hours or days of service each child is in care. The daily attendance records are used as payment support for all state and federally subsidized children. These records are to be kept on file for five years and are subject to inspection upon the Department's or the State Auditor's request.

The Division requires child care centers to have the parent or custodian of the child sign the child in and out of care and note the time of arrival and departure. The Division does not require the same information from licensed family home child care providers.

We issued special investigation report No. 6370 on May 28, 2003. In this report, we communicated our concerns regarding the inadequacy of the licensed family home providers' attendance records and recommended the recovery of the overpayments identified at that time.

Overpayments

The Department identifies child care overpayments by reviewing reports of potential overpayments, attendance records, and client files to ensure payments are supported. The Department reports any identified overpayments to its Office of Financial Recovery.

The Department has identified a significant amount of overpayments. The overpayments, estimated at $3.2 million, consisted of approximately 25 percent provider overpayments and 75 percent client overpayments. Overpayments identified in a current fiscal year may not be recovered until a future fiscal year.

Description of Condition

During our recent review, we found the following conditions:

a. Support for payments

The Department continues to allow licensed family home child care providers to use inadequate alternative records as support for payments issued. The alternative records we saw in recent reviews still do not require the parent or custodian to sign the child in and out of care each day and note the time the child arrived and departed. Therefore, this issue has not been resolved.

We asked the Division Policy Director about a standardized attendance form for licensed family home child care providers and a requirement for the parent/custodian to sign children in and out of care. The Director stated the Department has not provided a standardized attendance form for family home child care providers and still does not require parental signatures. He stated many providers use the U.S. Department of Agriculture food program attendance form if they are on the food program. If not, they may make up their own.

b. Overpayments and recoveries:

During fiscal year 2003, the Department did not ensure all funds recovered from client overpayments were returned to the proper funding source. The Department stated that approximately $684,526 was recovered from providers, $611,471 in federal funds and $73,055 in state funds. Approximately $136,000 was recovered from client overpayments. However, the Department has not been able to determine how much of this amount was initially paid with federal and state funds and to which funding source funds should be returned.

Cause of Condition

Support for payments

The Division has not made it a priority to implement policies and procedures that would provide adequate support for payments made to licensed family home providers.

Overpayments and recoveries

The Department has not developed a method of determining to which funding sources client overpayments should be returned.

Effect of Condition

Support for payments

The Department cannot be assured it is paying the licensed family home child care providers only for the hours that children are actually in care. Without a standardized attendance form, licensed family home child care providers are not being held to the same reporting standard as center providers. Alternative records are subject to the interpretation of the reviewer as to whether or not services were provided, since the supporting payment document does not include the same information as the payment report. The information recorded on the attendance record support can vary from one provider to another.

Overpayments and recoveries

The Department may not be returning recoveries of federal funds to the proper funding sources as required by federal regulations.

Recommendation

We recommend the Department:

- Require all licensed family home child care providers use a standard attendance record issued by the Department.

- Require family home child care providers to have the parent or custodian of each child sign the standard attendance record when the child arrives and departs from care, noting the arrival and departure times.

- Ensure that all funds recouped are returned to their proper sources.

Department's Response

The Division of Child Care and Early Learning concurs that there are not adequate internal controls over support for payments made to licensed family home providers. Currently, the Family Child Care Home providers are not required to use a standardized DSHS form to keep attendance. The Department is changing the Family Child Care Home WAC to require parents to sign children in and out of care. The WAC revision is scheduled to be effective August 2004.

The Division of Child Care and Early Learning does not concur with this finding. At the time that a recovery is collected, the Office of Financial Recovery codes the recovery to the original line of coding used for the expenditure. This assures that the recovery is treated as a reduction in expenditure. This was communicated to the State Auditor's Office numerous times throughout the audit, however an understanding was never effectively acknowledged.

Auditor's Concluding Remarks

We appreciate the Division's efforts in revising the Washington Administrative Code to require the parent or custodian of each child to sign children in and out of care.

We are concerned that the Division does not have a system in place to document that recoveries have been credited to the correct funding sources. While the Division may know the total amount of recoveries, it could not demonstrate what portion was state and federal. To do this, the Division stated it would have to trace each recovery back to the original line of coding, a process that would be very time consuming. This demonstrated that the Division does not monitor to ensure, in total, that the recoveries are returned to their proper sources. As a result, the Division can not provide assurance that the federal reimbursement is not overstated. We will review this area in our fiscal year 2004 audit.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, Attachment A, Section C, Basic Guidelines, states in part:

1. Factors affecting allowability of costs. To be allowable under Federal awards, costs must meet the following general criteria:

   j. Be adequately documented.

The same section of the circular states in part:

> 4a. Applicable credits refer to those receipts or reductions of expenditure-type transactions that offset or reduce expense items allocable to Federal awards as direct or indirect costs. Examples of such transactions are:…rebates or allowances, recoveries or indemnities on losses,...charges. To the extent that such credits accruing to or received by the governmental unit relate to allowable costs, they shall be credited to the Federal award either as a cost reduction or cash refund, as appropriate.

03-12 The Department of Social and Health Services, Division of Child Care and Early Learning, does not adequately perform background checks.

Background

The Department of Social and Health Services administers the Child Care program, which pays child care centers and licensed family home child care providers for services on behalf of eligible families. The Department has assigned responsibility for the Program to the Economic Services Administration, Division of Child Care and Early Learning. The Division develops the policies and procedures used to license child care providers. Payments made for the Program are listed in finding 03-11of this report.

Potential providers and any persons 16 years of age or older who will have unsupervised or regular access to the children in care must complete a Background Check Authorization Form. This includes assistants, volunteers and members of the applicant's household. The form is used to check whether the persons have criminal backgrounds that would disqualify them from becoming licensed child care providers, associates, or volunteers. Household members and others with access to the children that have disqualifying criminal backgrounds will also prevent licensing of potential providers.

On the form, the person is required to document current name, date of birth and other names by which they have been known. A Social Security number is optional.

These forms are sent to the Department's Background Check Central Unit. The Unit enters the data provided into the Department database, which draws information from the Washington State Patrol's criminal history database and information provided by the Department.

The Patrol's database only includes Washington arrests; therefore, any search of this database is not nationwide. Individuals can be included in the Patrol's database for several reasons:

- When someone is arrested in Washington State, the arrest cards (including fingerprints) are sent to the Patrol. The Patrol enters this data into the criminal history database. Once final disposition of the case is made, this, too, is entered into the System.

- Fingerprints of all Washington State criminal justice employee applicants are entered into the criminal history database.

- Convicted sex/kidnap offenders are required to register with the sheriff in the county of residence. The requirement to register includes offenders who move into Washington from another state. The county sheriff sends these fingerprints and photographs to be entered by the Patrol into the criminal history database.

- The Patrol also allows individuals meeting certain criteria to provide their own personal identification fingerprint cards to the Patrol for inclusion in the database.

If a person reports residency in the state for <u>more</u> than three years, the background search does not require that fingerprints be taken. The Background Unit conducts the search in the Patrol's criminal history database by using the exact name and exact date of birth as given by the applicant. There are other elements that can match, such as Social Security numbers; however,

the primary search is based on name and date of birth. Matches, if any, produce a Report of Arrest and Prosecution sheet that shows there is a criminal history record for this person. Sometimes this sheet includes a Washington State Department of Corrections number that the Background Unit will research. If the Background Unit finds that the person did not commit a crime in Washington State, yet has a Corrections number, it may indicate that the person has been imprisoned or is under Correction's supervision in this state for a crime committed in another state.

If a person reports residency in Washington State for less than three years, state law gives the Department authority to require a fingerprint-based background check. The Background Unit forwards these fingerprints to the Washington State Patrol. The Patrol performs a statewide search by comparing the fingerprints on the fingerprint card to the fingerprints in the Identification System. The fingerprints are forwarded electronically, by the Patrol, to the Federal Bureau of Investigation (FBI) for a nationwide search. The results of the FBI search are forwarded to the Background Unit electronically by the Patrol and the statewide search results are mailed to the Division. The Patrol and FBI search results are entered into the Department's Background Check Central Unit database as received. The results are mailed to the Division licensors.

We issued special investigation report, No. 6370, on May 28, 2003. In this report, we communicated inadequacies of the background checks performed by the Department.

Description of Condition

The Department continues to conduct inadequate background checks, as follows:

- It does not require licensors to see the individuals in person and at the same time compare their information from the Department Background Check Authorization Form to any piece of original identifying information. The Division's Policy Directive allows potential providers to provide a photocopy of their photo identification issued by a government entity and does not ask for any identifying information from the other individuals who will have unsupervised or regular access to the children in care.

- It does not verify documentation to ensure the persons have accurately stated the length of their state residency.

- It performs no nationwide background checks on persons who report they have lived in the state for more than three years.

Cause of Condition

The Department stated they do not have enough funds to correct the deficiencies in their background checks.

Effect of Condition

The Department could license and pay child care providers who do not meet licensing standards or who have associates or household members who do not meet the standards of adequate background checks. A person could provide any name or date of birth on the Background Check

Authorization Form. In such a case, the background check would be performed on a name and date of birth that may be false or stolen. In our May, 2003 special investigation, we reported an instance in which the Department licensed and paid a provider who was using an assumed name. In addition, an applicant could falsely state residency of more than three years to avoid the fingerprinting process and nationwide search.

Recommendations

We recommend the Department:

- Require licensors to perform a visual confirmation of the person and original photo identification for each person who will have unsupervised or regular access to the children in care. This includes the applicant, assistants, volunteers and members of the applicant's household. The information written on the Background Authorization Form should be compared to other original documentation supporting the identity of the applicant. This review would provide some assurance that the Department is performing a background check on the person completing the form.

- Verify applicants have accurately stated their length of residency in the state.

- Conduct nationwide checks on all applicants.

Department's Response

The State Auditor's Office issued findings that the Department does not require licensors to see the providers in person and validate original identifying information with the Criminal History and Background Authorization Form. The Division of Childcare and Early Learning (DCCEL) acknowledges this is true but does not concur with this finding because in-person validation is not required. We acknowledge that in-person validation might be desirable, but the voluminous turnover of staff in child care facilities would make it impossible to do on an ongoing basis.

The Department does not concur that DCCEL licensors are conducting inadequate background checks. State law does not require nationwide background checks to be performed on persons who report they have lived in the state for more than three years. The Department does not have the ability to verify length of state residency, and the State Auditor's report does not recommend a resolution of this condition. Nationwide background checks on all child care license applicants would be very time consuming and costly. In addition, changing the current background check policy would involve not just DCCEL, but many other state agencies as well.

Auditor's Concluding Remarks

We reaffirm our finding. It is important parents and custodians know there are significant weaknesses in the Department's background check process.

As it stands now, a licensed day care provider, provider associate or household member can have a background check performed on an assumed name and date of birth. As seen in our special investigation, this has already happened. Because the Department does not obtain all information available about the person's identity and possible criminal history, except when it performs a finger-print based background check, it cannot ensure that the person should be allowed access

to children in care. Therefore, these children are at risk of harm and the Department may be liable due to the inadequate checks performed.

Because of the potential liability involved, the Department may wish to consider bringing this issue to the attention of the Legislature and requesting additional funds.

Applicable Laws and Regulations

The Office of Financial Management *State Administrative and Accounting Manual,* Section 85.32.10, states in part:

> …At a minimum, agencies are…to establish and implement the following:
>
> 1. Controls to ensure that all expenditures/expenses and disbursements are for lawful and proper purposes…

Revised Code of Washington 74.15.030 states in part:

> The secretary shall have the power and it shall be the secretary's duty:
>
> > (2) In consultation with the children's services advisory committee, and with the advice and assistance of persons representative of the various type agencies to be licensed, to adopt and publish minimum requirements for licensing applicable to each of the various categories of agencies to be licensed.
>
> The minimum requirements shall be limited to:
>
> > (b) The character, suitability and competence of an agency and other persons associated with an agency directly responsible for the care and treatment of children, expectant mothers or developmentally disabled persons.

Washington Administrative Code 388-155-070 (c) states in part:

> Submit to the department a completed and signed family child care home license application form, including the following attachments:
>
> > (ii) A completed criminal history and background inquiry form for each person sixteen years of age or older who will have unsupervised or regular access to the children in care. This includes you, any other applicants, assistants, volunteers and members of your household…

Budget Restrictions and Fund Shifts

03-13 The Department of Fish and Wildlife spent $5.8 million in federal funds to purchase land without the approval of the Governor and the state Legislature.

Background

In the two-year operating and capital budgets, the Legislature determines how much state agencies are allowed to spend in both state and federal funds, and in some cases, specifies what the money must be spent for. When an agency receives money in excess of its appropriation, it must request permission from the Governor, through the state Office of Financial Management and prior to the expenditure, or request that the Legislature appropriate it in the budget.

For the 2001 through 2003 period, the Legislature approved a capital budget of $54.1 million for the Department. The appropriations within that budget specified what projects were to receive funding, and how much they were to receive.

Description of Condition

During our audit, we found that the Department spent approximately $5.8 million for land purchases that the Governor and/or the Legislature did not approve. Specifically:

- The Department overspent the amount of federal money it had been appropriated by the Legislature to acquire land, and then moved those excess expenditures to appropriations that were not for land purchases.

- Although the Department was aware the appropriation had been overspent, the Department purchased additional land and charged the costs directly to appropriations that were intended for other purposes.

- The Department did not obtain the required expenditure authority from the Governor and/or the Legislature to spend the excess federal funds on these land acquisitions.

Cause of Condition

The Department stated the over-expenditure resulted from a miscommunication between program staff who work with federal agencies to set up federal grants and related land purchases, and the staff responsible for ensuring the Department does not overspend capital budget appropriations.

Effect of Condition

Appropriations provide a crucial means of control over agency spending by the executive and legislative branches of state government. When costs are incurred for purposes not authorized in the budget, the Governor and Legislature are not allowed to exercise their control over spending. This affects the assumptions that budgets, spending plans and other financial decisions are based upon.

Recommendations

We recommend the Department:

- Properly monitor capital budget expenditures to ensure appropriations are not overspent.
- Not spend appropriations for purposes other than those intended by the Legislature.
- Comply with laws and regulations requiring approval of the Governor and/or the Legislature prior to spending unanticipated revenues.

Department's Response

The Department was provided federal authority for the 2001-03 biennium to acquire land using its Partnership Improvements with Customers appropriation. In February 2003, Congress adopted the Federal Fiscal Year 2003 budget containing additional funding for Endangered Species Act related land acquisitions. Additionally, the President expedited the availability of federal funds to states by bypassing federal agencies that historically had processed the grants.

By February 2003, the Department had used up its original $4,000,000 appropriation authority for Partnership Improvements with Customers. The lateness of the adoption of the federal budget, the more immediate availability of greater federal funding for state Fiscal Year 2003 and continued work by Department staff on land acquisition projects were not coordinated. Program staff working with federal agencies to set up federal grants and related land purchases and the staff responsible for ensuring that the Department spent according to the official appropriation schedule did not communicate in a timely manner.

The timing of the discovery of the need for additional federal appropriation authority did not occur in time for submittal of the Governor's 2003 supplemental budget. Thus, it was determined that the Department should submit a request to the 2003 legislature for increased federal appropriation authority in either the 2003 supplemental budget or the 2003-05 Capital Budget. The issue was brought to the attention of the Office of Financial Management and discussions occurred that covered both the 2001-03 and 2003-05 biennial periods.

At the time the Department contacted OFM, Department federal land acquisition expenditures were within its federal authority for Partnership Improvements with Customers. An option was to make a formal request to the Office of Financial Management to use other available federal appropriation authority in the Department's capital budget. Assigning the charges to unused federal authority was seen as a technical adjustment and was not intended to deceive. However, the Department agrees it failed to request official authorization from OFM to use other available federal authority for spending federal funds on land acquisitions. The use of available federal appropriation authority related to Endangered Species Act Compliance and Hatchery Reform Facility Retrofits was not in compliance with state laws and regulations and will not be repeated. Finally, the Department did not exceed its total federal authority nor did the use of available authority in other categories preclude any projects in those other categories from being completed.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolving the issue identified in the finding. We also appreciate the cooperation extended to us throughout the audit by Department staff. We will review the status of this issue during our next audit.

Applicable Laws and Regulations

Revised Code of Washington 43.88.290 states:

> No state officer or employee shall intentionally or negligently: Over-expend or over-encumber any appropriation made by law; fail to properly account for any expenditures by fund, program, or fiscal period; or expend funds contrary to the terms, limits, or conditions of any appropriation made by law.

Revised Code of Washington 43.79.270 (1) states in part:

> Whenever any money, from the federal government, or from other sources, which was not anticipated in the budget approved by the legislature has actually been received and is designated to be spent for a specific purpose, the head of any department … through which such expenditure shall be made is to submit to the governor a statement … setting forth the facts constituting the need for such expenditure and the estimated amount to be expended. A copy … shall be submitted to the joint legislative audit and review committee and also to the standing committees on ways and means of the house and senate if the legislature is in session …

Office of Financial Management (OFM) 2001-03 Operating and Capital Allotment Instructions, Section 3.3 Unanticipated Receipts states in part:

> "The Governor is authorized to grant agencies expenditure authority when unanticipated outside funds are received for a specific purpose. Several conditions apply to the expenditure of these funds:
>
> - Requests for unanticipated receipts must include … source of funding, purpose of grant, and other information used by OFM and legislative analysts.
>
> - No expenditure may occur before OFM approval of the unanticipated receipt request…
>
> - All unanticipated receipt requests are held for ten calendar days before OFM approval to allow an opportunity for legislative comment…
>
> - It is advisable to avoid submitting unanticipated receipts during legislative session, since legislative preference is that this additional spending authority be submitted in supplemental budget requests."

Refunds

03-14 The Department of Health has not established adequate internal controls to ensure that only appropriate refunds are processed.

Background

The Department of Health licenses health-care providers such as doctors, dentists, and nurses. When duplicate payments for licenses are made, refunds are issued.

The Department provides copies of birth certificates, death certificates, and marriage certificates. Partial refunds are issued when the requested certificate cannot be located. Part of the fee is a research fee that is not refunded.

The Department processed approximately $635,000 in refunds during fiscal year 2003.

Description of Condition

Internal controls are inadequate to ensure all refunds are appropriate. We noted:

- Inadequate support for refunds processed. In one section, we found no supporting documentation for 73 percent of the refunds issued. Agency employees said the documentation was discarded after the authorization for payment document was sent to the Department's revenue unit for processing.

- Duties are not adequately segregated. The same employee decides to issue the refund, fills out the refund paperwork and sends the paperwork to be processed.

- Supervisory review of refunds is inadequate. Supporting documentation is rarely reviewed to determine if the refund is accurate and/or appropriate.

Records substantiating transactions are not retained in accordance with state law. Some documentation is not kept at all, and other documentation is only retained for one or two years.

Cause of Condition

Department staff responsible for refunds did not understand the need for further separation of duties and adequate supervisory review. In addition, they were not familiar with the record retention requirements.

Effect of Condition

Inappropriate or inaccurate refunds, including possible fraudulent payments to employees, could be processed and not detected in a timely manner, if at all. We found no evidence of such payments in the licensing unit; however, we were unable to review this area in the vital statistics unit because of missing documentation.

Recommendations

We recommend the Department establish and follow adequate internal controls to ensure that all refund transactions are accurate and appropriate.

We also recommend the Department ensure its licensing and vital statistics units receive adequate training and supervision regarding compliance with state records retention laws.

Department's Response

We concur with the finding by the State Auditor's Office. The Department of Health will modify procedures to ensure that adequate internal controls are in place and followed so that only appropriate refunds are processed.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolving the issues identified in the finding and will review its progress during our next regular audit. We also appreciate the cooperation extended to us throughout the audit by Department staff.

Applicable Laws and Regulations

The State of Washington Office of Financial Management's *State Administrative and Accounting Manual*, Section 20.20.20.b states in part:

> An internal control system should provide *reasonable assurance* that an organization will accomplish its objectives.

Section 20.20.30.a states in part:

> The agency director has the ultimate responsibility for establishing, maintaining, and reviewing the system of internal control in the agency.

Revised Code of Washington 40.14.010 states in part:

> As used in this chapter, the term "public records" shall include any paper,…that have been made by or received by any agency of the state of Washington in connection with the transaction of public business, …
>
> For the purposes of this chapter, public records shall be classified as follows:
>
> (1) Official public records shall include all original vouchers, receipts, and other documents necessary to isolate and prove the validity of every transaction relating to the receipt, use, and disposition of all public property and public income from all sources whatsoever; all agreements and contracts to which the state of Washington or any agency thereof may be a party; all fidelity, surety, and performance bonds; all claims filed against the state of Washington or any agency thereof; all records or documents required by law to be filed with or kept by any agency of the state of Washington; all legislative records as defined in RCW 40.14.100; and all other documents or records determined by the records committee, created in RCW 40.14.050, to be official public records.

RCW 40.14.060, Destruction, disposition of official public records or office files and memoranda -- Record retention schedules.

(1) Any destruction of official public records shall be pursuant to a schedule approved under RCW 40.14.050. Official public records shall not be destroyed unless:

(a) … the records are six or more years old;

Access to Payment Systems

03-15 The Department of Social and Health Services does not have adequate internal controls over the processing of expenditures through the Agency Financial Reporting System.

Background

The Agency Financial Reporting System is the state of Washington's official accounting system. State agencies are required to enter their financial data, including accounts payable, into this System The System has security features that, when used effectively, can aid in reducing the risk of error or fraud in financial transactions.

Designated security administrators in each agency are responsible for determining the level of access granted to individuals within the agency and for removing access when appropriate. Access controls are available within the System to preclude any one person from having total control over a particular type of transaction.

Description of Condition

We reviewed the types of System access the Department has granted to employees with accounts payable functions and found the Department does not take advantage of the System's internal control features that allow for an adequate segregation of duties. Access to the accounts payable function is not secure.

a. We found that 632 Department employees have the capability to enter and approve payment batches, with no management review required. All of these employees could process a fictitious payment without oversight or approval by anyone.

b. Once payment batches are approved and the System is closed in the evening, warrants for payments are prepared. There is a period of time before the System closes in which transactions within batches may be changed by anyone with System input capability.

c. In addition, all 632 employees are capable of processing payments to unauthorized vendors by using certain designated codes. These employees have the ability to generate a warrant to anyone they choose.

d. We noted that 606 of the 632 employees also have the access needed to recall batches for error correction. An employee could recall and change his or her batch as well as recall and change another employee's batch.

e. The Department's System security administrators rely on management in the hundreds of Departmental offices to notify them of requests for access, changes in access, and terminations of access. Currently, this communication is not successful. For the period January 1, 2002 to January 31, 2003, we identified 40 terminated employees who still had access to the accounts payable function. Some of these former employees were working for other state agencies and would thus have an especially easy opportunity to access the Department's accounts payable and prepare transactions.

f. The Department does not require that an independent employee reconcile output data to the data that should have been entered into the System.

Cause of Condition

The Department has not established and followed written policies and procedures that would require an adequate separation of duties and timely access changes in any of its offices with an accounts payable function.

Effect of Condition

These control weaknesses increase to a high degree the risk that error or misappropriation could occur and not be detected by management in a timely manner, if at all.

Recommendations

We recommend the Department develop and follow written policies and procedures for its accounts payable function that would ensure:

- An adequate separation of duties for those involved in making payments in the System.
- Timely changes to and removals from System access when appropriate.

Department's Response

The Department does not concur with the finding that DSHS does not have adequate internal controls over the processing of expenditures through AFRS. The finding is based solely on review and testing of system security access and did not take into account the compensating internal controls the Department has in place. The following are responses to each condition in the finding:

a. The cited condition that 632 employees can enter and approve payment batches without manager review is misleading. The audit report does not provide an evaluation of compensating controls, nor is there consideration for those who have this access for payments versus those who have access for making accounting adjustments. All transactions are required to have review and approval prior to input into the system. This process is based on review of supporting documents and written or documented approval of the input documents. There are also reviews of transaction registers (system output) as well as payment distribution being segregated.

b. For the cited condition that there is a time period when batches can be changed before the system closes, the Department agrees with the technical description of the system process. However, we disagree with the finding condition, the audit report does not include generally accepted compensating controls surrounding transaction register (system output) review. In addition, the condition would still exist for anyone with review/release capabilities or edit/release capabilities. The review of transaction registers (system output) provides the strongest control over reviewing and correcting payment transactions.

c. *The Department does not concur with the condition that via the use of certain codes, employees can generate a warrant to anyone. The audit report does not include other compensating controls to prevent this. As part of efficiency efforts to increase the use of Electronic Funds Transfer (EFT) and Warrant Insertion payments, the Department is working to significantly limit use of the generic vendor number. Compensating controls are provided through separation of payment/warrant distribution from payment generation capabilities and the review of output reports and registers. In addition, headquarters' fiscal staff review the V0D1 usage quarterly, for improper usage. Approved uses for the V0D1 vendor number is posted on the OAS website. Generally, the approved uses of this number are related to one time only payments for efficiency purposes.*

d. *The Department does not concur with the condition that employees can recall and change their batches as well as another employee's, due to other compensating controls in place. Review of transaction registers and distribution of payments is segregated from those with this level of access. No documented testing of these compensating controls has been provided to support the assertion of inadequate control of the payment process.*

e. *The Department concurs with condition that communication has not been successful to timely terminate system access for terminated employees. Steps have been taken to identify those individuals with inappropriate access as well as improve the access documentation processes. Efforts have been initiated to explore alternatives to relying solely on manager communication for access terminations. The Department will be reviewing the possibility of developing an annual self-audit related to accesses. In addition, the Department will be exploring the possibilities of coordinating a notification process with Human Resources for employees who terminate their employment or move to a different job.*

f. *The Department does not concur with the condition that we do not require independent employees to reconcile output data. The historical practice requires an independent employee to reconcile output data for expenditure processing. However, the Department will develop a detailed instruction for broad communication and posting within the Department Financial Business Rules and Processes Manual. This instruction will outline the processes and the importance of access relevance versus risk. The document will include a discussion on the use of additional compensating controls if system controls for segregation are not used.*

Auditor's Concluding Remarks

We evaluated the compensating controls to which the Department refers in its response. We do not believe these compensating controls are adequate to catch an inappropriate payment for several reasons:

a. The Department states that we did not consider the difference between accounting staff who have only access for payments versus those who have access for making accounting adjustments. The system does not have access controls that would allow this type of separation of duties. If an individual has access to input and release a journal voucher for accounting adjustments, that same individual could also create and release a warrant. The only difference between a journal voucher and a warrant is the AFRS transaction code that is used. No restrictions are placed on what transaction code is used by the individual

with AFRS access. During our audit, Accounting Services acknowledged that an individual can input a warrant or Electronic Fund Transfer and at the same time input journal vouchers. We reaffirm our position that the risk of misappropriation of funds is high when employees have the ability to create and release warrants.

The Department states that all transactions are required to have review and approval prior to entry into the system. This is not a compensating control, because Accounting Services has not adopted AFRS system access controls that would prevent an individual from creating and releasing a fraudulent warrant.

b. The Department states there are also reviews of transaction registers (system output) as well as payment distribution. The weakness in this review is that transaction registers do not show the address to which the payment was sent. Also, an individual with this much access could conceal unauthorized transactions in AFRS and on the agency warrant (transaction) registers. This can be done by entering a vendor (real or fictitious) in the vendor field, then placing his or her own name in the second line of the address field. The second line of the address field does not appear on the warrant register. Therefore, a review of the warrant register, even if performed, can not be considered a compensating control. We reaffirm our position on this matter.

c. We appreciate that the Department is working to significantly limit use of the generic designated vendor codes.

d. The Department states that, because it has compensating controls in place, it does not concur with the condition that employees can recall batches and make changes. As noted above, we do not believe Accounting Services has adequate compensating controls in place.

e. We appreciate the Department's plan to ensure terminated employees no longer have access to the accounts payable function.

f. The Department states it does not concur with the condition that it does not reconcile output data. During our audit, we were told that the Office of Accounting Services is so busy during year-end closing it is impossible to monitor output to input. If appropriate AFRS system controls were in place, the risks associated with this condition would be considerably decreased.

Because it is possible for 632 of the 829 employees with System access to make improper payments, the risk is high that such payments could be made and remain undetected. We reaffirm our finding.

Applicable Laws and Regulations

The State of Washington Office of Financial Management's *State Administrative and Accounting Manual*, Section 20.20.20.a states in part:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

Section 20.20.70.a states in part:

> Control activities are the policies and procedures that help ensure management directives are carried out.
>
> **Segregation of duties -** Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions. For example, responsibilities for authorizing transactions, recording them, and handling the related assets should be separated.

03-16 The Department of Community, Trade and Economic Development does not have adequate internal controls over the processing of expenditures through the Agency Financial Reporting System.

Background

The Agency Financial Reporting System is the state of Washington's official accounting system. State agencies are required to enter their financial data, including accounts payable, into this System The System has security features that, when used effectively, can aid in reducing the risk of error or fraud in financial transactions.

Designated security administrators in each agency are responsible for determining the level of access granted to agency employees and for removing access when appropriate. Access controls are available within the System to preclude any one person from having total control over a particular type of transaction.

Description of Condition

We reviewed the System access the Department has granted to employees with accounts payable functions and found the following:

- Twenty-seven Department employees, virtually the entire fiscal office staff as well as various program staff, have the access rights needed to enter and approve payment batches, with no management review required. All of these employees could process a fictitious payment without oversight or approval by anyone.

- Once payment batches are approved and the System is closed in the evening, warrants for payments are prepared. There is a period of time before the System closes in which transactions within batches may be changed by anyone with System data entry capability.

- We noted that the 27 employees also have the access needed to recall batches for error correction. An employee could recall and change his or her batch as well as recall and change another employee's batch.

- In addition, 13 of these employees have access rights that would allow them to process payments to unauthorized vendors by using certain designated codes. These employees could generate a warrant to anyone they choose.

- The Department does not require that an employee independent of the process reconcile output data to the data that should have been entered into the System.

Cause of Condition

The Department has not effectively used the built-in access controls in AFRS and has not developed any written policies and procedures that would require and detail how an adequate separation of duties was to be maintained in the accounts payable function.

Effect of Condition

These control weaknesses increase to a high degree the risk that error or misappropriation could occur and not be detected by management in a timely manner, if at all.

Recommendations

We recommend the Department use the AFRS access controls and develop and follow written policies and procedures for its accounts payable function that would ensure an adequate separation of duties for those involved in making payments in the System.

Department's Response

CTED partially disagrees with the finding. CTED's Accounting Services office has had the same internal controls for the past six years. For several years these controls were audited by the State Auditor's Office and they have concluded that CTED has adequate compensating controls for our AFRS access. CTED's compensating controls include:

- *AFRS batches are not released by the same person who created them in AFRS; and*
- *Payroll staff pick up the warrants from the Office of State Treasurer and reconcile to the previous day's batches. Persons other than who created the batch mail out the warrants.*

After the Auditor's Office notified us of their new opinion, Accounting Services immediately deleted AFRS access for two program staff and changed all Grant Management Analysts access to AFRS to "view only." We will only provide input access to the Grant Management Analysts during peak workloads for fiscal year closings, which requires a significant amount of overtime by the entire Accounting Services office.

The Administrative Services Division will perform a comprehensive review of AFRS access, and make additional changes as needed. Accounting Services will also write policies and procedures documenting agency processes for granting and monitoring access to AFRS.

Auditor's Concluding Remarks

We appreciate the Department's choosing to take advantage of the access controls in AFRS to help ensure an adequate separation of duties in its disbursement activities. We will review the agency's corrective action during our next regular audit.

Applicable Laws and Regulations

The State of Washington Office of Financial Management's *State Administrative and Accounting Manual*, Section 20.20.20.a states in part:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

Section 20.20.70.a states in part:

> Control activities are the policies and procedures that help ensure management directives are carried out.
>
> - **Segregation of duties** - Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions. For example, responsibilities for authorizing transactions, recording them, and handling the related assets should be separated.

03-17 The Small Agency Client Services section of the Office of Financial Management (OFM) has inadequate password controls over financial systems to ensure assets are safeguarded.

Background

State agencies may contract with the Office of Financial Management's Small Agency Client Services for accounting, budgeting and payroll services. Monthly fees charged to the agencies are based on factors such as how much work is done for the agency, the size and complexity of the agency's budget and the number of employees. The Office deposits and/or records approximately $38 million in revenue per year and makes payments of approximately $105 million per year for 38 agencies. Eleven OFM employees perform these services.

Description of Condition

Small Agency Client Services uses a computerized financial system (AFRS) to provide financial services. Our audit found that controls over passwords are inadequate. Each client agency has two assigned log-on identifications and passwords that are shared by the 9 OFM employees. This condition creates the risk that unauthorized transactions could be processed without detection and/or would make it difficult to determine which employee processed a certain transaction.

We understand that the Office recently has taken steps to resolve this condition. We will review this area during our next audit.

Cause of Condition

Although the system is capable of handling multiple log-on identifications and multiple passwords, Office personnel indicated that using this control would be too labor intensive and would require the Office to bill client agencies for costs associated with the additional logon identifications.

Effect of Condition

The practice of sharing log-on identifications and passwords increases the risk of misappropriation and would hinder management's ability to determine who is responsible for any loss.

Recommendations

We recommend that the Office provide all users with a unique log-on identification and password, or establish another means of uniquely identifying each user.

Office's Response

The Office of Financial Management (OFM) does not concur with the finding. The applicable laws and regulations section of the finding states, "Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency." While staff sharing a logon ID and password may by itself be a weakness, the system of internal

controls implemented by OFM's Small Agency Client Services (SACS) unit incorporates many compensating controls to mitigate the weakness:

A. *Client agencies begin the payment process by indicating their approval to pay invoices by signing or initialing each invoice prior to sending them to SACS. Agencies list each invoice and the amount to pay on an Agency Transmittal Form.*

B. *Four staff members in SACS review each payment transaction—two before the transaction is processed, and two after the transaction is entered into the state's computerized financial system (AFRS). Each person indicates their involvement in the process by signing or initialing the document they approved or reviewed.*

   i. *The first person reviews the invoice for compliance with state rules and regulations, and prepares the invoice for processing.*

   ii. *The second person reviews and approves the first person's work, thereby authorizing the transaction to be entered into the state's computerized financial system (AFRS).*

   iii. *The third person reviews the entered transaction online and releases it for payment.*

   iv. *The fourth person reviews the warrant registers generated the next day to ensure that all payments agree with the invoices listed on the Agency Transmittal Form. The warrant registers show the recipient's name and the amount of the payment.*

C. *Support staff sends the warrant registers and the Agency Transmittal Form to the originating agency for review.*

D. *Monthly, SACS sends financial reports to the agencies for which it pays invoices. The reports show the vendor name and the amount of every payment made on their behalf.*

E. *Quarterly, SACS visits agencies to discuss the financial status of each agency. This discussion includes going through the financial reports and explaining the variances between the estimated and actual expenditures. The OFM budget analyst and statewide accounting consultant assigned to the agency usually attend these quarterly meetings.*

In October 2002, SACS strengthened its existing controls by creating additional logon IDs and by separating the enter and release functions in AFRS. This eliminated any one individual from having the ability to generate payments. In November 2002, SACS established additional logon IDs for payroll staff that totally eliminated their ability to process any transactions in AFRS.

We believe the results of the testing by the State Auditor's Office (SAO) support the effectiveness of the system of internal controls implemented by SACS. On March 25, 2003, SAO interviewed three staff within SACS. Prior to the interviews, SAO selected some financial transactions to determine whether the internal controls described were in place and working properly. SAO found no questionable transactions as a result of the inquiries. Also, SAO audits each of the client agencies. There has never been an audit finding for fraud committed by staff in SACS.

OFM is committed to strong internal controls. Section 20.20.20.b of the State Administrative and Accounting Manual (SAAM) states in part, "The concept of reasonable assurance recognizes that the cost of an internal control activity should not exceed the benefit derived

therefrom." While we believe the costs for establishing unique logon IDs and passwords outweighs the benefits, SACS has strengthened the existing system of controls by establishing unique logon IDs for the eight staff that enter and release transactions in AFRS. (The two payroll staff and the manager do not enter or release transactions in AFRS.)

Auditor's Remarks

The State Auditor's Office reviewed the controls that SACS established to compensate for the weakness created by sharing passwords. We do not believe that these controls would prevent or detect a misappropriation since SACS employees are able to circumvent these controls.

Our audit should not be interpreted as support for the effectiveness of the system of internal controls implemented by SACS. As stated in the Office's response, we interviewed three SACS staff. After these interviews, the State Auditor's Office sent a letter to the SACS Product Manager dated May 12, 2003 indicating that we had completed the interviews and concluded that password sharing created an internal control weakness that should be addressed.

In an effort to assist the Office in reaching a solution that would be both reasonable for its staff and also correct the internal control weakness, we consulted with Department of Information Services personnel. They agreed that the sharing of passwords in this environment was not appropriate. As a result, staff from the Office of Financial Management, the Department of Information Services and the State Auditor's Office met in November 2003 and reached a solution.

Although the Office of Financial Management indicated in its response that it did not concur with the finding, each SACS employee now has a unique log-on ID and password.

Applicable Laws and Regulations

The State of Washington Office of Financial Management's *State Administrative and Accounting Manual*, section 20.20.20.a states:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

03-18 The Department of Transportation's controls over access to applications and data files on the mainframe computer are not adequate.

Background

The Department of Transportation manages the security and equipment for all of its mainframe applications. Unlike many state agencies, the Department does not contract for this responsibility with the Department of Information Services. Control issues with security software affect all Department mainframe applications, but the specific effect depends on the function and compensating controls of each application. During the fiscal year 2000, 2001, and 2002 audits, we identified inadequate controls over mainframe security software and communicated those issues to management as we continued to monitor its progress in resolving them. During the fiscal year 2002 audit, we identified inadequate controls over application security for the Department's general accounting system and communicated those issues to management as well.

Description of Condition

During the current audit, we performed a follow-up review of controls over mainframe security software. We found the following weaknesses remain:

- Temporary data, which can be any type of data processed on the mainframe, can be left on a storage device after a job has ended. The default settings on temporary data allow programmers to access the storage device and gain unauthorized access to the data. The Department attempted to correct this by switching the setting to disallow this access. However, this was abandoned because the general accounting system failed to function under this setting due to a weakness in the system.

- Eighteen individuals have access that allows them to bypass security and make unauthorized changes to certain programs without those changes being logged. When these types of programs are run, the changes to data are also not logged.

We also reviewed controls over access to data for one of the applications run on the system. The application selected was the Department's general accounting system, formally named the Transportation Reporting and Accounting Information System (TRAINS). The Department's general accounting system is used to process about $1.6 billion in expenditures a year. During this review we noted the following:

- Security over access to data and programs is not adequate to ensure the reliability of general ledger data. Eight individuals with direct access to data or programs can bypass security to make changes. Access gained in this manner is not logged. Changes to data should be made through user screens, and changes to programs should be made through or with program change control software.

- Security over user IDs and passwords is not adequate to establish accountability for changes made to general ledger data. The file containing user IDs and system passwords is not encrypted. Eight individuals with access to this file can view user IDs and passwords.

- Separation of duties among users of the system is not adequate to ensure changes to general ledger data are appropriate. Individuals with approval authority can make changes to system data, including vendor payment information, and approve their own changes.

Cause of Condition

The Department's general accounting system contains programming issues that allow weaknesses in internal controls. Also, access to mainframe security programs has not been properly reviewed to restrict access to those individuals who require it.

Effect of Condition

The lack of adequate security over access to applications and data files increases the risk of misappropriation and the loss of computer-stored data.

Recommendations

We recommend the Department either make the following changes in security or find other means to achieve the same control:

- Protect temporary data from unauthorized access.

- Only provide temporary access when needed to programs that can change data without the changes being logged.

- Remove individual access that allows changes to be made directly to data files or programs for computer applications.

- Encrypt user ID and password files to prevent users with read access to these files from gaining user IDs and passwords.

- Prevent individuals with approval authority from approving their own changes to system data.

Agency's Response

The Department appreciates the recommendations outlined by the State Auditor's Office. The Department will evaluate each recommendation and implement changes as appropriate relative to cost, benefit, and risk. The Department will report to the Office of Financial Management the Department's information systems risk mitigation plans as required.

Auditor's Concluding Remarks

We appreciate the Department's efforts in addressing this finding and will review its progress toward resolving this issue during our next regular audit.

Applicable Laws and Regulations

The Office of Financial Management's *State Administrative and Accounting Manual*, Section 20.20.20.a states:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

Section 20.20.70.a states:

> Segregation of duties - Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions. For example, responsibilities for authorizing transactions, recording them, and handling the related assets should be separated.

The Information Services Board's *Information Technology Security Standards*, Section E.3 states in part:

> Develop, document, and implement a security program component that is appropriate for the level of sensitivity/confidentiality of the information being processed. The purpose of the data security component of the IT security program is to reduce the risk associated with the compromise or destruction of agency-controlled data. Content should include rules for the storage and dissemination of data shared with other organizations. The data security program component must address the following:
>
> - Agency data security policy statements
> - Access control techniques
> - Data entry processes
> - Processing accuracy
> - Data encryption standards for storage and secure management
> - System access violations

03-19 The Department of Natural Resources does not have adequate control over access to the state's Personnel Payroll System.

Background

The Department of Natural Resources has approximately 1,200 permanent employees located throughout the state. During the fire season, the Department employs approximately 700 additional firefighters and support staff.

The Department processes payroll through the Personnel Payroll System. This system allows agencies access to personnel and payroll functions. The system enables agencies to segregate access to these functions by limiting access to one or the other. Without proper segregation, employees can both put someone on the payroll and pay that individual without approval or oversight by someone else.

Some users of the Personnel Payroll System have access to a Quick Pay screen, through which they may appoint and pay an individual without requiring approval. This is effectively a one-time payment capability designed for payment of temporary staff such as temporary firefighters.

During fiscal year 2003, the Department paid $89.9 million in salaries and benefits. The Department processed approximately 900 transactions using the Quick Pay screen.

Description of Condition

During our current year audit, we followed up on weaknesses in controls over access to the Personnel Payroll System that we communicated to management at the end of our last audit. The following weaknesses remained:

- Twenty-nine employees have rights allowing them access to both personnel and payroll screens in the Personnel Payroll System.

- Thirty-six employees have update access to the Quick Pay screen.

- No appropriate oversight is in place to identify possible errors or misappropriations.

Cause of Condition

During the fire season, the regional offices may not be fully staffed. Without staffing resources, the segregation of duties between personnel and payroll functions may be difficult. The Department did not have adequate personnel and payroll procedures to adequately safeguard resources or to ensure payroll expenditures were made for authorized purposes.

Effect of Condition

Without separation of the personnel and payroll functions, or appropriate oversight, errors or misappropriations could occur and not be detected by management in a timely manner, if at all.

Recommendation

We recommend the Department separate access to both personnel and payroll functions in the system or institute a procedure of oversight to ensure possible errors in processing or unauthorized payroll transactions are detected in a timely manner.

Agency's Response

Resolution/Status: *The Department concurs with this finding and has taken the following corrective action:*

- *Procedure has been implemented for reviewing personnel and payroll transactions of employees with dual access.*

- *Oversight designated to the Region/Division Business Manager to review transactions and reports on a weekly basis for all personnel action request forms and emergency firefighter time report where dual personnel/payroll or quickpay entry has occurred.*

- *Internal auditor will conduct periodic reviews of reports and supporting documentation.*

Auditor's Concluding Remarks

We appreciate the Department's efforts in addressing this finding and will review its work to resolve this issue during our next regular audit.

03-20 The Department of Corrections has not established and followed adequate controls over electronic access to the Trust Accounting System.

Background

State law requires the Department of Corrections to be the custodian of all funds in the possession of a convicted person at the time of incarceration, as well as funds that are sent to the person or are earned by the person while in custody. This money is placed in the Institutional Residents Deposit Account, from which the person's financial obligations and other bills are paid. Since 1999, the Department has been managing these inmate funds of approximately $5.3 million through the Trust Accounting System.

Description of Condition

Our review of the Trust Accounting System's access controls disclosed the following:

- Staff members are allowed to use passwords that have a high risk of being compromised.
- Staff members managing the system database use shared log-ons.
- No intruder lockout has been established to detect unsuccessful sign-on attempts.
- Employees have computer access privileges they do not need to perform their job duties.
- Duties are inadequately segregated. The types of access privileges employees have do not provide for adequate separation of duties between accounting, administrative and warehousing functions.

These conditions were previously disclosed in the 2002 Statewide Accountability Report.

Effect of Condition

These conditions increase the risk that unauthorized access could occur and hinder efforts to assign responsibility for any loss or misuse of inmate funds.

Cause of Condition

Agency management indicated that funding constraints have limited the agency's ability to correct these system weaknesses.

Recommendations

We recommend the Department develop and follow adequate controls over access to the Trust Accounting System.

Department's Response

The conditions reported in the 2002 Statewide Accountability Report are taken seriously and the Department has made considerable progress during the past year on those weaknesses.

Regarding the 2003 conditions:

Passwords - The Trust Accounting System is supplied by a vendor, and as such the Department cannot change the password design. However, the Department has required all employees to "harden" or improve their passwords within the limits of the system. We have informed the vendor of this weakness.

Shared logons - The Department significantly reduced the number of individuals managing the database from six to three. This coming year we will determine if the system will now allow individual logons for this function.

Intruder alert - The system does not include an intruder alert and the Department cannot make that change. We have informed the vendor of this weakness.

Computer access privileges and segregation of duties - The Department concurs and will work to provide greater controls.

Auditor's Concluding Remarks

We appreciate the Department of Corrections' efforts in addressing this finding and will review the agency's progress during our next regular audit.

Applicable Laws and Regulations

The State of Washington Information Technology Standards state in part:

> Hardened passwords should be used whenever technically and operationally feasible. Appropriate user training should be considered regarding the physical protection of hardened passwords that may be more difficult to remember. For those systems for which it would be technically infeasible or which would require modification to meet this requirement… agencies must document what other measures are to be taken to secure user access.

The Office of Financial Management's *State Administrative and Accounting Manual* addresses the principles of internal control as follows:

Section 20.20.20.a:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

Section 20.20.70.a:

> Segregation of duties - Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions. For example, responsibilities for authorizing transactions, recording them, and handling the related assets should be separated.

03-21 The Department of Social and Health Services, Division of Child Support, has not established adequate procedures to limit access to the Financial Management Imaging System only to those who need it.

Background

The Division of Child Support provides services to establish paternity, enforce support obligations, and locate parents who owe child support. The Division is responsible for making child support payments received from non-custodial parents to custodial parents. These transactions are tracked in the Division's Support Enforcement Management System. Money received by the Division is first logged into the Division's Financial Management Imaging System, which receipts over one half billion dollars annually.

Description of Condition

We reviewed the list of active access identification codes and found that 37 individuals had System access that they did not need. Two of these individuals were deceased, and some were working for another state agency or had moved to a different job within the Department. In some instances, we were unable to determine their whereabouts. Of the 37 individuals, 14 had been identified during our fiscal year 2002 audit as not needing access.

Cause of Condition

The Division has inadequate procedures to ensure that only appropriate personnel have access to the Imaging System. Field offices are not notifying headquarters of personnel changes so that access may be revoked.

Effect of Condition

Controls over access are necessary to ensure proper use of the computer system. Inappropriate access could lead to unauthorized transactions that may not be detected in a timely manner, if at all. User access should be based upon need and segregation of duties considerations.

Recommendation

We recommend that the Division institute adequate procedures to ensure that only appropriate personnel have access to the Financial Management Imaging System.

Department's Response

The Department concurs with this finding. The Department will implement procedures to deactivate users, in a more timely manner, that are either no longer employed by the Division or no longer have cash processing responsibilities.

Auditor's Concluding Remarks

We appreciate the Department's plan to address this finding and look forward to its actions to resolve these control weaknesses. We will review the Department's progress during our fiscal year 2004 audit.

Applicable Laws and Regulations

The State of Washington Office of Financial Management's *State Administrative and Accounting Manual*, Section 20.20.20.a states in part:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

Section 20.20.70.a states in part:

> Control activities are the policies and procedures that help ensure management directives are carried out.

Contracting and Purchasing

03-22 The Department of Transportation paid nearly $30 million to reimburse the developer of the Tacoma Narrows Bridge Project without gaining adequate assurance that the costs met contract terms and were actually incurred.

Background

In 1993, the Legislature passed a law allowing the Department to enter into public-private partnerships to build transportation projects. The Department contracted with a private company to develop the Tacoma Narrows Bridge project. In 2002, the Legislature changed this law to allow these projects to be financed with public funds, in addition to private funds. This law also required the Department to amend project agreements to be consistent with the use of public financing. The Department renegotiated its contract with the developer and agreed to make two payments: a flat fee and a cost reimbursement. Payments were made in April and August 2002.

During our prior audit of the Department of Transportation, we reviewed the Department's payment of approximately $40 million to the developer. Of that, $10 million was a flat fee paid to the company for acting as the developer of this project. Another $30 million was paid to reimburse the developer for costs to design the project and to set up financing. Prior to making the payment, the Department did not review documentation to determine whether it was reimbursing the developer for costs actually incurred and for items allowed by the agreement.

At the end of our prior audit, we recommended the Department perform a detailed review of the costs it reimbursed, and seek repayment from the company for any costs found to be unallowable under the agreement. In a letter dated January 7, 2003, Department Secretary Doug MacDonald addressed our recommendations with the following comment: "*These issues are very important to us and we had already scheduled an appropriate audit level of review before your office also raised the issue.*"

Description of Condition

During our current audit, we found that the Department had not completed its review of these costs to determine whether all of the $30 million paid to the developer was appropriate. As of the end of our fieldwork, the Department stated that its audit is in progress for $20 million of the $30 million. We have the following concerns about the Department's plans to review the remaining $10 million of these costs. According to Department records, the majority ($7.7 million) of the $10 million comprises fees for legal counsel and financial consulting services. The Department stated it was denied access to documentation regarding how the legal services it reimbursed the developer actually relate to the project. In January 2004, the Department stated that it is having discussions with the developer about gaining access to this additional detailed documentation; however, the Department is not certain at this time whether it will be allowed access to all information needed for a sufficient review of these legal costs. Further, the Department did not obtain sufficient evidence to support the payment for financial consulting services.

The Department made these payments in fiscal years 2002 and 2003 based on a report prepared by a certified public accounting firm and based on discussions it had with the firm, the developer, and the Department's project management team. The firm was hired by the developer to compile total project expenditures. The Department was not a party to the agreement with this

firm, and as such did not specify the items it wanted reviewed. Earlier this year, the Department reviewed the public accounting firm's work, and confirmed that while this work was sufficient for the developer, it did not meet the Department's needs.

The need for additional audit work by the Department demonstrates why we brought this issue to management's attention last year. Prior to making payment, management should have determined whether it required additional evidence to show that the payment request was proper. The Department has since scheduled further audit work of the developer and its sub-consultants. However, the Department has not been able to complete much of the necessary work. Initially, the developer denied the Department access to records required for such a review. The Department was able to start its audit work, and gained access to many of the records and personnel of the developer and its subconsultants.

Under state law, the Department is required to establish internal controls sufficient to ensure that all disbursements are for lawful and proper purposes. This requirement is detailed in the State Administrative and Accounting Manual, Section 85.32.10. State law requires that agencies follow these rules (RCW 43.88.160).

Cause of Condition

Department management stated that it does not believe its actions were inappropriate. Further, the Department stated that the change from a public-private initiative to a public-sponsored project, which involved many sub-consultants, has significantly complicated the review process.

Effect of Condition

The Department is not managing state resources with appropriate care. The Department paid approximately $30 million to the developer before obtaining documentation or other assurances that the payments were proper. By not completing its review of the costs reimbursed, the Department runs the risk that these funds were used for unallowable purposes. If the Department finds unallowable expenditures, it may have to spend additional state resources to collect from the developer.

Recommendations

We recommend that the Department complete a detailed review of the costs it reimbursed, as agreed to at the end of our last audit, to provide adequate assurance that costs for the Tacoma Narrows Bridge project are lawful and for a proper purpose. We again ask that the Department provide our Office with the results of that review as soon as it is complete.

We also recommend that the Department seek repayment from the developer for any costs found to be unallowable according to the agreement.

Agency's Response

The Department appreciates the recommendations outlined by the State Auditor's Office. As agreed at the end of last year's audit, the Department, through its Internal Audit Department (IAD), has dedicated significant resources to the audit/review of payments made to United Infrastructure of Washington (UIW) and will issue its final audit report as soon as possible

Further, if any costs previously reimbursed are found to be unallowable the Department will aggressively seek reimbursement, which is consistent with the Department's standard operating procedures related to vendor payments.

It is the Department's opinion that the extraordinary circumstances related to these payments as well as the Department's efforts in the audit/review of these payments are inadequately explained in this Finding.

The payments made to UIW were the result of the Legislature's decision in 2001 to change the financing structure for the Tacoma Narrows Bridge (TNB) project from a public/private partnership to a publicly financed project. The renegotiated agreement between the Department and UIW included the payment of UIW's previously contracted developer fee plus the reimbursement of all project related expenditures dating back to 1994.

Payments to UIW were made only after appropriate and reasonable steps had been taken to ensure that these payments were in compliance with the original development agreement as well as the renegotiated agreement signed in December of 2001. IAD's recommendation to proceed with payments to UIW was based on its review of the development agreements together with an Attestation Report prepared for UIW by PriceWaterhouseCoopers (PWC), a certified public accounting firm, regarding TNB project expenditures. IAD's review of the Attestation Report was supported by telephone interviews with PWC and UIW senior staff as well as the Department's TNB project management team.

Further, given the significance of the amounts paid and unusual circumstances associated with these payments IAD recommended that additional audit/review work be planned for fiscal 2003. The TNB audit/review was included in the fiscal 2003 audit plan, however, because of the large number of subcontractors leading to logistical challenges together with the extended period of expenditures dating back to 1993, the audit/review is still in progress.

Contrary to the State Auditor's reference to the scope of IAD's audit plan, at completion of IAD's audit/review of the approximate $31 million paid to UIW IAD will have audited/reviewed all significant project expenditures including the majority of the $10 million of legal and financial services expenditures referred to by the State Auditor's Office.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolving this issue. We will follow up on the Department's progress toward resolving this issue during our next regular audit.

Legal Criteria

State Administrative and Accounting Manual Section 85.32.10 states in part:

> It is the responsibility of the agency head, or authorized designee, to certify that all expenditures/ expenses and disbursements are proper and correct. Agencies are responsible for processing payments to authorized vendors, contractors, and others providing goods and services to the agency. Agencies are to establish and implement procedures following generally accepted accounting principles. At a minimum, agencies are also to establish and implement the following:

1. Controls to ensure that all expenditures/expenses and disbursements are for lawful and proper purposes and recorded in a timely manner

   (refer to Chapter 20 of this manual for guidance related to internal control procedures) …

RCW 43.88.160 states in part:

> This section sets forth the major fiscal duties and responsibilities of officers and agencies of the executive branch. The regulations issued by the governor pursuant to this chapter shall provide for a comprehensive, orderly basis for fiscal management and control, including efficient accounting and reporting therefor, for the executive branch of the state government and may include, in addition, such requirements as will generally promote more efficient public management in the state.
>
> (4) In addition, the director of financial management, as agent of the governor, shall:
>
> (a) Develop and maintain a system of internal controls and internal audits comprising methods and procedures to be adopted by each agency that will safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies for accounting and financial controls. The system developed by the director shall include criteria for determining the scope and comprehensiveness of internal controls required by classes of agencies, depending on the level of resources at risk.

03-23 The Department of Labor and Industries did not provide evidence that it complied with state bid laws when purchasing information technology services totaling more than $14 million.

Background

During the audit period, the Department contracted with information technology (IT) specialists for computer services. The work orders and amendments issued under these contracts ranged from $30,000 to $1,150,000. Contractors provide the following types of services:

- System design and support
- Systems analysis
- System conversions
- Employee training

The Department identifies IT vendors from a pool of pre-qualified vendors selected by the Department of General Administration. It is Labor and Industries' responsibility to perform the second level of the selection process. This involves issuing a solicitation document outlining the statement of work, period of performance, deliverables, potential budget and any special terms and conditions. The vendors submit responses directly to Labor and Industries. The Department evaluates the responses based on the criteria in the solicitation document and awards the work order to the successful bidder.

Description of Condition

During our audit, we found that the Department entered into contracts with 14 IT vendors without evidence that it performed all aspects of the second level of the selection process. We found:

- The Department did not retain the files on unsuccessful bidders in accordance with the state records retention schedule. Several files were also missing documentation that the bids were evaluated against the criteria in the solicitation document. Without these documents, we were unable to determine if the Department conducted open and fair competition before awarding the contracts and work orders to vendors. We found 32 work orders totaling $12,471,460 for which the Department could not provide all evidence of competition.

- In five instances, we found that the successful bidder was not the highest scoring vendor according to the evaluation against the predetermined criteria documented in the file. These awards totaled $2,077,060. We could not determine why the Department deviated from the highest scoring vendor since there was no explanation in the file.

Cause of Condition

The Department inadvertently referred to a records retention schedule that did not apply to unsuccessful bid files. This resulted in the files being discarded before the retention expiration

date. The Department did not believe it was necessary to document an explanation for not selecting the highest scoring bidder. Those who selected the vendors believed it was in the Department's authority to select the vendor they felt would do the best job, regardless of bid scores.

Effect of Condition

Since these contracts may not have been competitively bid, all interested vendors may not have had the opportunity to participate in the competition to provide these services. Additionally, the Department cannot be assured that it received the best possible price and quality of services.

Recommendations

We recommend the Department competitively bid its purchased service contracts in compliance with state bid laws and that it retain records in accordance with the state's general records retention schedule.

Department's Response

The Department disagrees with the finding.

The Department recognizes the General Records Retention Schedule No. 06007 requires thirty-six (36) month retention for our bid files. The Department's Unique Records Retention Schedule No. 59341, as approved by the State Records Committee in 1999, grants the Department authority to retain bid files for only twelve (12) months. During the annual review of unique retention schedules, the Department will assess the need to eliminate our unique retention schedule and revert to the general schedule.

In many of our IT contracts, opportunities for contractors were broadened and exceeded minimum requirements required by state bid laws. In the five instances noted in the finding, all prospective bidders were afforded an equal opportunity to contract and, in fact, the file documentation shows the firm with the highest bid did receive a contract. The Department feels the SAO misinterpreted the unique differences in the process from bid to bid. For each IT contract, the bid coordinator – normally the contract manager but can be outsourced for large bids to get the necessary expertise – will complete the bid process from start to finish. For the five instances noted, the bid coordinator was contacted on only 2 of the 5 IT contracts for additional information to clear up questions.

- *In some bid situations, the top scoring bidders from the written proposal received an interview; the top scoring bidders from the interviews were asked to provide a formal presentation; and the final selection was made after the formal presentation. Simply having the high score on the written proposal does not guarantee a contract since there could be up to two additional screening steps remaining depending on the process followed.*

- *In some bid situations, a single individual was evaluated to provide specific programming services. In other bid situations, the Department is looking for a company providing one or more individuals, as needed, with a specific programming expertise to write a specific program within a specific amount of time. While evaluations of*

individual programmers are in the bid folders, it is often the company, not the individual, receiving the contract. The staff a company provides for a project may, and frequently do, change throughout the project depending on the project needs.

- *In some bid situations, prospective contractors have worked at the Department on previous projects making external reference checking unnecessary since the Department already has first-hand knowledge of their work.*

Also, additional questions came up during the audit concerning the interpretation of various phrases in the various retention schedules and their applicability. The Department will work closely with the State Records Committee to clarify the specific intent of the questioned retention schedules.

Auditor's Remarks

We disagree with the Department's selection of the records retention schedule applicable to the situation described in the condition. The schedule the Department believes is applicable states:

> Provides documentation of specifications for purchasing of services and technical assistance required for issuing contracts for health services. [99-11-59341] Retention period is 1 year after purchase is completed.

The schedule the State Auditor's Office believes is applicable states:

> Documentation of the bids submitted to provide goods or services which were not chosen or failed to meet requirements. May include in addition to the unsuccessful bids: list of ranking of unsuccessful bidders; financial information about the bidders; resumes; proposals; pricing sheets, etc. [GS 06007] Retention period is 3 years after the bid award date.

As identified in the condition, the contracts we reviewed relate to information technology services, not to health services. Therefore, we believe that the unsuccessful bidder files for these solicitations should have been retained for three years.

The Department's methods for selecting successful bidders did not agree with the predetermined criteria outlined in its solicitation documents. The Department may select bidders based on a variety of factors, but it must clearly identify the process in its solicitation documents. The highest scoring bidder must be selected based on criteria outlined in the document.

We reaffirm our finding and will review this issue during our next audit.

Applicable Laws and Regulations

Chapter 43.105 of the *Revised Code of Washington* gives the Department of Information Services the authority to develop standards and procedures governing the acquisition and disposition of information technology equipment and services.

The *Information Technology Investment Standards* prepared by the Department of Information Services states, in part:

> The requirements for competitive solicitations are listed in the chart provided in Appendix A. These requirements apply to all forms of competitive solicitations; the estimated acquisition cost is what determines which requirements must be met.

Appendix A of the *Information Technology Investment Standards* requires the solicitation process for IT purchases with an estimated acquisition cost of $100,000 or more to include the following:

- State requirements in writing
- Provide protest procedures
- Provide changes to all bidders in writing
- Bidder responds in writing
- Evaluate all proposals against requirements
- Document evaluation process
- Offer vendor debriefing

Section 40.14.060(1) of the *Revised Code of Washington* states, in part:

> Any destruction of official public records shall be pursuant to a schedule approved under RCW 40.14.050.

The state's *General Records Retention Schedule* requires the unsuccessful bid files to be maintained for **3 years** [Emphasis Added] after the bid award date. Disposition Authority Number GS 06007, entitled "Unsuccessful Bids File" (as of June 2001) includes:

> Documentation of the bids submitted to provide goods or services which were not chosen or failed to meet requirements. May include in addition to the unsuccessful bids: list of ranking of unsuccessful bidders; financial information about the bidders; resumes; proposals; pricing sheets, etc.

The state's *General Records Retention Schedule* requires the unsuccessful bid files to be maintained for **6 years** [Emphasis Added] after the bid award date. Disposition Authority Number GS 06007, entitled "Unsuccessful Bids File" (prior to June 2001) includes:

> Documentation of the bids submitted to provide goods or services which were not chosen or failed to meet requirements. May include in addition to the unsuccessful bids: list of ranking of unsuccessful bidders; financial information about the bidders; resumes; proposals; pricing sheets, etc.

03-24 The Department of Community, Trade and Economic Development did not follow bidding regulations when it solicited bids for the purchase of 25 modular bunkhouses for the Monitor Park Migrant Housing Camp.

Background

During our review of contracts at the Department of Community, Trade and Economic Development, we evaluated on-going Temporary Farmworker Housing projects, due to the complexity of transactions, the number of contract amendments, and the number of entities involved.

In 1998, the Governor declared farm worker housing to be the state's most important housing priority. The following year, the Legislature appropriated $40 million for construction of permanent and temporary community-based housing over the next 10 years. The Department's Housing Trust Fund and other sources also support these projects. During fiscal year 2003, nine farm worker housing projects were at various stages of completion. We judgmentally selected four for in-depth reviews.

One of the four was the Temporary Farm Worker Housing Camp at Monitor Park, near Wenatchee. Among the transactions related to this site was a bid solicitation and award for $443,500 for the purchase of 25 bunkhouses. The Department of General Administration authorized the Department to carry out the procurement process on its own. The successful bidder was an Oregon company.

Description of Condition

Our review of available documents revealed the following conditions:

- Prior to the bidding process, the Department's Farm Worker Housing Coordinator decided to require the use of specific foam and fiberglass wall panels, manufactured by only one vendor. The Coordinator discussed this with the Oregon company and notified the company where the panels could be obtained. We found no documentation showing that any of the other bidders were advised of the location of the panels.

- The Coordinator also notified the Oregon company that the panels had been approved by the Department of Labor and Industries and by the International Conference of Building Officials, which develops and publishes the International Building Code and the Uniform Building Code. We found no documentation that such approval was ever obtained.

- The Oregon company submitted its first bid to the Department several weeks prior to the Department's announcement of an invitation to bid.

- Bidding was open for only four days, providing very little opportunity for most bidders to become familiar with the requirements. The location of the specific required panels was not included in the newspaper announcement of the bid. The Oregon company submitted its second bid, for $17,040 per unit, including the panels, on the third day.

- The Coordinator who informed the Oregon company of the existence, location and approval of the required panels was also the ranking member of the bid evaluation team.

- After the bid opening, the Coordinator realized all other bidders had included delivery charges. The Coordinator called the Oregon company and gave it the opportunity to revise its bid by adding delivery costs at that time. The company added another $700 per unit for delivery.

- We found no documentation establishing that the bid evaluation team considered any factors other than price when awarding the bid. Factors that might have been considered included the ability of the bidder to adequately complete the contract in a timely manner; the experience of the bidder with the new technology; and the financial condition of the bidder.

- When the Department asked the State Procurement Officer at the Department of General Administration if it needed to take any other steps, the Officer reviewed the bids. When he learned of the Oregon company's total low bid of $17,740 per unit, he informed the Department that his analysis identified a significant problem. The Officer noted that two of the three bidders averaging bids of about $17,000 per unit did not meet the specifications, while five of the six that did meet specifications averaged bids of about $30,000 per unit. The Officer was concerned that there was either a flaw in the specifications or bidder misinterpretations of those specifications. In spite of these expressed concerns, the Department awarded the bid to the Oregon company.

- While attempting to meet its deadline, the Oregon company found significant issues with the wall panels and accumulated significant cost overruns. Shortly before the company declared bankruptcy, the Department agreed in writing to hold the company harmless for any liability arising from failure of the panels. Additionally, the panel manufacturer had provided no warranty.

Cause of Condition

Because the Department obtained approval from the Department of General Administration to handle its own procurement only a few days before announcing the bid invitation, it did not have that agency's advice from the start. Following the approval for procurement, the Department Coordinator, who has since left the agency, chose not to follow state laws and General Administration's purchasing regulations, which were still required. The Coordinator also chose not to investigate the concerns of the State Procurement Officer regarding the low bid.

Effect of Condition

The bidding process is in place to protect public resources by ensuring that projects are awarded to the lowest responsible bidder. The process also is designed to ensure that all who are interested in bidding on a project are given an equal opportunity to do so. The circumstances occurring during this bidding and evaluation process do not ensure that these goals were met. The Department originally selected the lowest price but in the process obtained bunkhouses that were constructed by a company that could not meet its original price. In addition, the bunkhouses contain wall panels that may be flawed but have no warranties, leaving the Department liable for any costs due to failure.

Recommendations

We recommend the Department follow applicable statutes and General Administration bidding requirements and advise when performing its own procurements.

Department's Response

The Housing Division has distributed applicable statutes and General Administration bidding requirements to appropriate existing Housing staff. The Division has instructed all staff to always use General Administration procurement services. Former Department staff involved with the cited procurement left state employment on May 31, 2002. The supervisor of the involved staff left state service on April 30, 2003.

Auditor's Concluding Remarks

We appreciate the Department of Community, Trade and Economic Development's efforts in addressing this finding and will review the agency's corrective action during our next regular audit.

Applicable Laws and Regulations

Revised Code of Washington 43.19.190 states in part:

> The director of general administration…shall
>
> > (3) Have authority to delegate to state agencies authorization to purchase…, which authorization shall specify restrictions as to dollar amount or to specific types of material, equipment, services, and supplies. Acceptance of the purchasing authorization by a state agency does not relieve such agency from conformance with other sections of RCW43.19.190 through 43.10.1939, or from policies established by the director.
> >
> > (10) Prepare rules and regulations governing the relationship and procedures between the division of purchasing and state agencies and vendors.
> >
> > (11) Publish procedures and guidelines for compliance by all state agencies…which implement overall state purchasing and material control policies.
> >
> > (12) Advise state agencies…regarding compliance with established purchasing and material control policies under existing statutes.

RCW 43.19.1906 states in part:

> Insofar as practicable, all purchases and sales shall be based on competitive bids, and a formal sealed bid procedure shall be used as standard procedure for all purchases and contracts for purchases…executed by the state purchasing and material control director and under the powers granted by RCW 43.19.190

> through RCW 43.19.1939. This requirement also applies to purchases and contracts for purchases…executed by agencies, under delegated authority granted in accordance with provisions of RCW 43.19.190….

RCW 43.19.1908 states in part:

> …All rules shall be in writing and conform to rules of the division of purchasing.

RCW 43.19.1911 states in part:

> (1) Preservation of the integrity of the competitive bid system dictates that after competitive bids have been opened, award must be made to that <u>responsible</u> (emphasis added) bidder who submitted the lowest responsive bid pursuant to subsection…(9) of this section, unless there is a compelling reason to reject all bids and cancel the solicitation.
>
> (9) In determining "lowest responsible bidder", in addition to price, the following elements shall be given consideration:
>
> (a) The ability, capacity, and skill of the bidder to perform the contract or provide the service required;
> (b) The character, integrity, reputation, judgment, experience, and efficiency of the bidder;
> (c) Whether the bidder can perform the contract within the time specified;
> (f) Such other information as may be secured having a bearing on the decision to award the contract…

Washington Administrative Code 236-48 describes the rules that General Administration has established for procurement. WAC 236-48-012 states in part:

> …Bidders shall be provided sufficient time to prepare and submit their bid, quote, or proposal….

WAC 236-48-013 states in part:

> …Any material information provided a prospective bidder shall be furnished by the purchasing activity to all bidders receiving a copy of the original solicitation.

WAC 236-48-079 states in part:

> Specifications contained in the competitive solicitation will, to the maximum extent feasible, be nonrestrictive so as to provide an equal basis for competition and participation by an optimum number of qualified bidders. The purchasing activity may specify a brand name or equal provided that the intent in doing so is to establish a standard of quality against which other brands will be evaluated….

WAC 236-48-111 states in part:

> …The solicitation form may not be completed, signed, or amended by bidders after official opening time.

03-25 The Department of Community, Trade, and Economic Development Housing Division did not purchase farm worker facilities in compliance with state regulations.

Background

In March of 2001, the Housing Division of the Department of Community, Trade and Economic Development entered into a client service contract with the North Columbia Community Action Council to develop a temporary farm worker housing camp. Under this contract, the Council was responsible for the acquisition of 16 trailer-based facilities, costing between $23,000 and $32,000 each. Although the Council was to maintain and operate the camp, the Department retained ownership of the trailers.

Description of Condition

In contracting with the Council to develop the temporary farm worker housing camp, the Division circumvented state procurement laws and regulations by having the Council purchase the 16 trailers, costing approximately $440,000. Although state agencies are able to do most of their purchasing through authorities granted by the Department of General Administration, that Department has not delegated the authority to purchase trailers.

In addition, the agency also failed to obtain insurance coverage for the trailers as required under the state's risk management regulations.

Cause of Condition

Because of the urgency to provide temporary farm worker housing for the 2001 harvest season, which began in May 2001, Division staff members believed the emergent need required expedited procurement of the trailers. In addition, because the trailers were not obtained directly by the Department, the procurement staff was unaware of the ownership interest in the trailers until June 2003 and failed to record their existence for coverage under the state's insurance policy.

Effect of Condition

The Department cannot provide assurance that the state's resources were used in the most economical manner possible in obtaining the trailers. In addition, the lack of insurance exposed the state to potential legal liability.

Recommendation

We recommend the agency follow state policies and procedures in the purchase and insurance of capital assets.

Department's Response

CTED's Housing Division verified in June 2003 that existing appropriate Housing staff have access to and understand state procurement policies and procedures. These policies and procedures have been added to the appropriate desk manuals.

The Housing Division's contract with North Columbia Community Action Council (NCCAC) required NCCAC to obtain insurance naming CTED as an additional insured. The Division has obtained documentation that NCCAC included these trailers on Policy SCP0413435 with Western Heritage Insurance Company. Additionally, the Department recorded these trailers for the state's insurance coverage on August 15, 2003.

Auditor's Concluding Remarks

We appreciate the Department of Community, Trade and Economic Development's efforts in addressing this finding and will review the agency's corrective action during our next regular audit.

Applicable Laws and Regulations

RCW 43.19.190 states in part:

> The director of general administration, through the state purchasing and material control director, shall:
>
> > (2) Purchase all material, supplies, services, and equipment needed for the support, maintenance, and use of all … administrative and other departments of state government …

RCW 43.19.1906 states in part:

> Insofar as practicable, all purchases and sales shall be based on competitive bids, and a formal sealed bid procedure shall be sued as standard procedure for all purchases ....

General Administration's "General Authorities", as issued under the authority of RCW 43.19.190 (3), Appendix A, states in part:

> The following goods and services *must* be purchased by the Office of State Procurement (OSP) unless delegated by OSP to the individual agency by Specific Authority…
>
> e. Trailers and prefabricated or modular buildings (state commodity codes 2332 and 5410). No authority is delegated for the rental, lease, lease-purchase, or purchase of a trailer or prefabricated or modular building.

The Risk Management section of the Office of Financial Management carries a Master Property Policy for the use of state agencies to insure assets, when appropriate. However, a member of the Office staff explained that each agency must notify it to schedule the specific items to be insured under this policy.

03-26 The State Parks and Recreation Commission did not comply with state bid laws and did not adequately monitor contracts and change orders.

Background

In April 2001, the Commission received a report from the Mason County Department of Health regarding concerns with the adequacy of on-site septic systems at Belfair State Park. The Commission immediately responded to Mason County, committing to work out an acceptable time line for repairing the systems.

In early December 2001, the Commission received a letter from the State Department of Health requiring it to submit a preliminary action plan and compliance schedule by December 21, 2001. On February 7, 2002, the Commission met with the State Department of Health, and agreed to divide the improvements into two phases.

- The first phase covered repairs to the existing collection system, septic tanks, lift stations, and other components.

- The second phase involved construction of one or two new drainfields.

In late March 2002, the Department verbally approved Phase 1. It told the Commission a septic engineer's report would be required prior to construction of the new drainfields.

On April 1, 2002, the Commission's Deputy Director approved a Declaration of Emergency Purchase for repair of the Belfair State Park septic system. It listed the following estimated costs:

- Collection system $100,000 (Phase 1, started April 2002)
- Drainfield reconstruction $ 90,000 (Phase 2, started March 2003)
- Pump station repairs $ 10,000 (by Parks staff)

Description of Condition

Our audit found the Commission did not comply with state bid laws for Phase 2 of the project. Further, the Commission did not prepare a written agreement for either phase of this work, and management did not approve costs beyond the original estimates. Specifically, we found:

- Based on the Declaration of Emergency referenced above, the Commission did not competitively bid either phase of the project. Phase 1 was started immediately after the Declaration and was completed within a few months. Phase 2 was not started until nearly a year after the Declaration of Emergency. Because of this delay, Phase 2 of the project should have been competitively bid instead of taking place through a change order to the original agreement with the contractor.

- No formal, written contract was prepared for either phase of the project. The project engineer used a field order that included a description of the scope of work but did not include the specific terms, such as insurance and bonds, a time schedule for completion of work, terms for payment, how to address changes to the agreement, and performance,

needed to protect both parties. Field orders are used to document purchases but are not meant to replace construction contracts.

- The Emergency Declaration estimated costs of $100,000 for Phase 1. The initial field order for Phase 1 was $68,837. However, the final costs for the collection system were $148,026. The project engineer approved several change orders to the original field order, which violates a Commission policy that requires change orders to be approved by the region manager and the production team manager.

- The Emergency Declaration estimated costs of $90,000 for Phase 2. The project engineer authorized costs of $215,967. A formal contract was not completed for this phase of the project. The project engineer authorized this via another change order to the original field order for Phase 1. This change order also was not prepared and approved in accordance with Commission policy.

Cause of Condition

The project engineer responsible for the project did not comply with internal policies and procedures for contracts and change orders based on the Emergency Declaration.

Effect of Condition

The competitive bid process is intended to prevent misappropriation, collusion or favoritism in the awarding of public contracts and to enable a public entity to obtain the best work at the most reasonable price. Further, when estimated project costs are exceeded without appropriate approval, management is not given the opportunity to make informed decisions about the use of agency resources.

Recommendations

We recommend the agency comply with bidding requirements for public works projects. If management determines that an emergency public works project is necessary and would preclude the agency from accepting bids for the work, we recommend it comply with the terms of state law (RCW 39.04.020,) referred to below.

We further recommend that the agency prepare and approve formal contracts for all construction work.

We also recommend that the agency comply with its internal policies and procedures over contracting and approve change orders as required. The approval of change orders should include a review of the change order description in comparison with the original contract specifications to determine if the additional work is a reasonable extension of the original contract or if a new contract is needed.

Commission's Response

Processes were formerly provided to staff through a number of management directives, power point training presentations, or state laws and statutes. However, these were not available through a single reference source. A coordinated training effort is now in place to assure staff

understanding and compliance with procedures. The agency's Park Development Service Center (formerly Resources & Development Division) now has a comprehensive Contracting Process Manual for use by all staff involved in all forms of contracting and acquisition of purchased services. Employees must sign that they understand and will comply with the manual.

Further, the recent reorganization of the Park Development Service Center has focused management of staff and projects at a regional level rather than the individual level to provide standardization and clear focus on contracting procedures.

Auditor's Concluding Remarks

We appreciate the steps the Commission is taking to resolve this issue. We will review the condition during our next audit.

Applicable Laws and Regulations

RCW 39.04.010 *Definitions* states in part:

> The term public work shall include all work, construction, alteration, repair, or improvement other than ordinary maintenance, executed at the cost of the state or of any municipality, or which is by law a lien or charge on any property therein….
>
> The term contract shall mean a contract in writing for the execution of public work for a fixed or determinable amount duly awarded after advertisement and competitive bid. However, a contract which is awarded from a small works roster need not be advertised.

RCW 39.04.020 *Plans and specifications -- Estimates -- Publication – Emergencies* states in part:

> If the state or such municipality shall determine that it is necessary or advisable that such work shall be executed by any means or method other than by contract or by a small works roster process, and it shall appear by such estimate that the probable cost of executing such work will exceed the sum of twenty-five thousand dollars, then the state or such municipality shall at least fifteen days before beginning work cause such estimate, together with a description of the work, to be published at least once in a legal newspaper of general circulation published in or as near as possible to that part of the county in which such work is to be done. When any emergency shall require the immediate execution of such public work, upon a finding of the existence of such emergency by the authority having power to direct such public work to be done and duly entered of record, publication of description and estimate may be made within seven days after the commencement of the work.

The Commission's internal policy and procedures on contracting states in part:

> They (change orders) are intended to cover emergency and unforeseen changes only, never to materially alter the original contract… Change Orders are also found frequently in projects where the original scoping was inadequate or

inaccurate. It is State Parks' intent that Change Orders should be used exclusively to address small unknowns that arise during the course of a project. They are not intended to add alternatives from the bid openings, and never to enhance or change original detailed scopes.

…The project representative then obtains the region manager's signature on the change order form and has the change order, along with the signed hard copy of a completed R-124, sent to Finance and Contracts for processing…Finance and Contracts will verify funding, and forward the Change Order to the Production Team Manager for final approval.

03-27 The State Parks and Recreation Commission did not adequately monitor contracts with concessionaires and lessees.

Background

State law allows the Parks and Recreation Commission to contract with concessionaires and to enter into leases with certain users of state park lands.

The Commission's Concession Program handles approximately 250 leases and 50 concession contracts. Most land leases are for broadcast towers for radio, television, cellular and other telecommunications. Concession contracts vary. However, many require the concessionaires to pay the Commission a percentage of gross revenues. Total revenues received from land leases and concession contracts have been between $300,000 and $500,000 annually.

Description of Condition

We noted the following concerns during our review of these areas:

- Contracts have not been monitored to ensure they are current and to determine if payments have been received in accordance with the contract terms.

- For those agreements in which a concessionaire is required to pay a percentage of its profits, the Commission does not have a procedure to monitor the reasonableness of amounts received.

- The Commission does not have a process to determine when a concessionaire's books and records should be audited and inspected as stipulated in its Concession Policy.

- The contract files have not been kept current. For at least the last year, documentation has not been filed and data has not been entered into the computer system used for tracking contracts.

The agency is aware of the concerns outlined above and has started reviewing all of the contract files to determine if revenues have been received in accordance with its agreements. Further, agency fiscal management has been in contact with our Office when issues regarding collection of related revenues or compliance with bid rules arise.

Cause of Condition

According to agency management, concession and leases program staff failed to keep up with the workload and to bring this condition to management's attention.

Effect of Condition

The lack of adequate monitoring of these contracts could result in a loss of revenues. In the fall of 2002, the Commission hired an independent accounting firm to determine how much was owed from a concessionaire that had not paid utility and other charges for several months. The

firm found $140,310 of unpaid rent and interest was due from the concessionaire. That concessionaire has since filed bankruptcy, and the Commission is at risk of not collecting these revenues.

Recommendations

We recommend the Commission:

- Establish a monitoring system to ensure that contract requirements are met in a timely manner, and seek recovery of all payments from concession and operating lease contractors who have not made payments in accordance with their agreements.

- For those agreements in which a concessionaire is required to pay a percentage of its profits, the monitoring system should address the reasonableness of amounts received, and when staff should have a concessionaire's books and records reviewed for completeness of revenue reported.

- Update all operating lease and concession contract files to ensure that they are current and complete and update the computer system used to track these contracts with all necessary information.

- Review and update the Concession Policy as deemed appropriate.

- Consider what resources are necessary to bring the Commission into compliance with its contract and lease-related policies and procedures.

Commission's Response

The agency has greatly increased emphasis on business development and in particular its concessions and leases management, through recent reorganization. The Concessions Manager is now blended into the Business Development Service Center and duties now dedicated to strategic work on business development. A second staff person in this service center is now assigned to handle existing agreements, to include watchfulness on reporting and payment deadlines, providing for closer oversight and working problems as they arise. Several employees in the Financial Service Center are now systematically examining the concession and lease files, establishing standardized "face sheets" and linking critical management information to a central report to allow for an overall and immediate view of agreements. Work is now progressing well on temporarily extending lapsed agreements, establishing and seeking collectables, identifying and accounting for uncollectibles, and identifying where and when the agency must pursue new agreements.

The agency will create a means to proof reasonableness of concession percentage amounts received, and as a part of its reporting system, identify when staff should review concessionaire books and records for completeness of revenue reported.

Agency concession policies will be reviewed for adequacy and alignment with the agency's balanced scorecard. The agency will categorize agreements as business opportunities with expectation of significant revenue, or as genuine public service provided with little expectation of revenue to the agency. Agreements will be more focused in a business sense, simplified in

terms of specific conditions and payment calculations and timing, strengthened with regards to "boiler plate" general conditions, and monitored for results.

All these steps will take considerable effort, but tangible results are expected by agency management.

Auditor's Remarks

We commend the agency staff for their commitment to resolving these issues, and urge executive management and the Commission to continue supporting these efforts. We will review the Commission's corrective action during our next audit.

Applicable Laws and Regulations

RCW 79A.05.030 (5) states that the Commission shall:

> (5) Grant concessions or leases in state parks and parkways, upon such rentals, fees, or percentage of income or profits and for such terms, in no event longer than fifty years, and upon such conditions as shall be approved by the commission: PROVIDED, That leases exceeding a twenty-year term shall require a unanimous vote of the commission: PROVIDED FURTHER, That if, during the term of any concession or lease, it is the opinion of the commission that it would be in the best interest of the state, the commission may, with the consent of the concessionaire or lessee, alter and amend the terms and conditions of such concession or lease: PROVIDED FURTHER, That television station leases shall be subject to the provisions of RCW 79A.05.085, only: PROVIDED FURTHER, That the rates of such concessions or leases shall be renegotiated at five-year intervals. No concession shall be granted which will prevent the public from having free access to the scenic attractions of any park or parkway.

The Commission's Concession Policy, dated January 15, 1998, states in part:…

> The concessionaire's books and records will be audited and inspected in order to protect the public interest. The Commission recognizes that only through adequate audits and inspections can data on the financial condition and the results of a concessionaire's operations be determined. Such data is recognized as essential in planning for expansion of facilities and services with concessionaires and carrying out the principle of providing a maximum of services to the public at a minimum of cost.

The state of Washington Office of Financial Management *State Administrative and Accounting Manual*, Section 85.54.50.b states in part: …

> Written procedures are to be developed and followed to ensure that past due receivables are followed up promptly and in a manner that is cost-effective for the overall collection program.

03-28 The Department of Social and Health Services, Mental Health Division, did not properly monitor its contract with a non-profit agency whose funds were used for the personal expenses of a staff member.

Background

The Department of Social and Health Services, Mental Health Division, contracted with the National Alliance for the Mentally Ill (Washington), a mental-health consumer group, to provide services to the Division's clients. Funds for this contract in the amount of $165,000 were completely provided by the federal Community Mental Health Block Grant (CFDA # 93.958) during the period July 2001 through December 2002. During that time period, the Alliance also received other funding from private sources.

According to the Statement of Work, the Alliance was to use the Division funds to provide:

- Incentive grants for the growth and development of Affiliate programs and memberships.
- Outreach and educational programs.
- Activities and benefits around the state.

The contract stated the Alliance was to submit oral and written reports to the Division every six months, describing the history, status and expectation of each contracted budget item, as well as steps taken to support the quality, diversity, and geographical requirements of the contract.

During the past year, we received information from a concerned citizen that the Alliance realized in 2002 that funds were missing. In January 2003, the Alliance contracted with a private Certified Public Accounting firm to conduct a special-purpose examination to determine the extent of the loss. The firm found an Alliance staff member had issued and cashed unauthorized checks in the amount of $147,060. This staff member later acknowledged taking Alliance funds for her personal expenses.

Description of Condition

The Division did not adequately monitor contract compliance or determine if the Alliance's activities and expenditures were appropriate under contract terms and conditions. The Division did not require the Alliance to submit supporting documentation for expenditures or semi-annual progress reports before the Division issued payments. In addition, the Division did not document any site visits or other monitoring methods. In some instances, the Division released payments to the Alliance in advance of the time period stated in the contract, possibly resulting in the Alliance receiving the funds before reimbursement was needed.

Cause of Condition

The Department stated the Division did not follow the Department's Administrative Policy 13.11, General Contract Monitoring.

Effect of Condition

The Division paid the Alliance for services without knowing whether they were actually performed. The Division does not know whether Division funds were part, or all, of the misappropriated funds. Because the use of the funds is unknown, we are questioning the entire $165,000.

Recommendations

We recommend the Division:

- Monitor to ensure contractors are complying with contract requirements.
- Ensure it is receiving the services for which it has contracted.

Department's Response

The Department concurs with the finding, the questioned costs and the recommendations. The Mental Health Division has made many improvements to contract monitoring which include: Centralizing parts of field contracting to headquarters, increased staff training and continued risk assessments to measure and implement corrective action steps. The Division will seek reimbursement from the contractor.

Auditor's Concluding Remarks

We appreciate the Department's prompt and thorough response and the cooperation of Division staff provided us during this audit.

Applicable Laws and Regulations

U.S Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states in part:

> The auditee shall…
>
> > (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of it Federal programs…

Subpart A, Section .105 of Circular A-133 further states in part:

> Questioned cost means a cost that is questioned by the auditor because of an audit finding…(2) Where the costs, at the time of the audit, are not supported by adequate documentation…

U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, Attachment C, states in part:

> 1…To be allowable under Federal awards, costs must meet the following general criteria:
>
> a. Be necessary and reasonable for proper and efficient performance and administration of Federal awards.
>
> b. Be authorized or not prohibited under State or local laws or regulations.

The Office of Financial Management *State Administrative and Accounting Manual*, Section 85.32.10, states in part:

> …At a minimum, agencies are…to establish and implement the following:
>
> 1. Controls to ensure that all expenditures/expenses and disbursements are for lawful and proper purposes…

The Department's Administrative Policy 13.11, General Contract Monitoring**,** states its purpose is to provide Department staff with general contract monitoring guidance that can reasonably ensure:

> (1) The department receives goods and services that are paid through the contracting process.
>
> (2) The contractor meets the scope of work and specifications identified in the contract.

03-29 The Department of Social and Health Services, Division of Developmental Disabilities, made inappropriate payments to a for-profit agency with which it has a contract to provide services to its clients.

Background

The Department of Social and Health Services, Division of Developmental Disabilities, contracts with for-profit and non-profit agencies to provide supported living services to some of its clients. Supported living services allow clients to live independently while receiving assistance in performing their daily activities, such as paying bills or preparing meals. The Division reimburses the for-profit and non-profit agencies for expenses associated with these services. Reimbursements are made with state funds and with federal funds from Medicaid (CFDA # 93.778). With some exceptions, clients are expected to pay for their own rent, utilities and food.

During the past year, we received information from a concerned citizen asserting improper accounting activities on the part of one of the agencies providing supported living services. The citizen reported that the agency requested and received Division reimbursement for inappropriate and/or unsupported charges for 2000 and 2001.

Description of Condition

We found the for-profit agency improperly included charges on its 2000 and 2001 cost reports for office rent and utilities, even though the costs cited were actually client rent and utility expenses that already had been reimbursed to the agency by its clients. We also found the agency included costs for staff lodging that were not supported by documentation and costs for ineligible activities such as preparation of a personal income tax return and repairs and maintenance to a landlord's facility. For the two years, the Division overpaid the agency a total of $84,724 because of these improper charges on the cost reports.

Cause of Condition

The Division did not adequately monitor the agency's cost reports to ensure they included only proper charges.

Effect of Condition

The Division paid the agency more than the amount to which it was entitled. We question the $84,724 in improper amounts included on the agency's cost reports. The following chart presents the total payments the Division made to the agency, the amount we are questioning and the state and federal portions of those questioned costs.

	Amount Reimbursed by Division	Amount in Question	State portion of questioned costs	Federal portion of questioned costs
2000	$ 885,954	$13,431	$ 6,470	$ 6,961
2001	977,075	71,293	35,148	36,145
Total	$1,863,029	$84,724	$41,618	$43,106

Recommendations

We recommend the Division:

- Monitor its contracts to ensure payments are proper.
- Pursue recovery of the 2000 and 2001 costs from the applicable agency and determine whether similar costs were improperly reported in succeeding years.
- Ensure costs recovered are returned to the appropriate funding sources.

Department's Response

The Department of Social and Health Services, Division of Developmental Disabilities, concurs with this finding.

The Division has been working with the for-profit agency in determining the actual overpayment amount due and methods of refunding these monies to DSHS for the 2000 and 2001 years. The Division has also reviewed the 2002 cost report in light of the SAO findings and with the cooperation of the for-profit agency management, has made adjustments to reflect actual and allowable costs.

The Division will review and address the items noted under the Cause of Condition section of the finding. Internal controls will be reviewed with regard to the monitoring of the DDD contracts and enhanced where necessary; the questioned costs identified for years 2000 and 2001 will be recovered and returned to the appropriate funding agency.

Auditor's Concluding Remarks

We appreciate the Department's prompt and thorough response and the cooperation of Division staff provided us during this audit.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, Subpart C, Section .300 states in part:

> The auditee shall…
>
> (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs…

Subpart A, Section 105 of Circular A-133 further states in part:

> Questioned cost means a cost that is questioned by the auditor because of an audit finding…(2) Where the costs, at the time of the audit, are not supported by adequate documentation....

U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, Attachment C, states in part:

> 1…To be allowable under Federal awards, costs must meet the following general criteria:
>
> > a. Be necessary and reasonable for proper and efficient performance and administration of Federal awards.
> >
> > c. Be authorized or not prohibited under State or local laws or regulations.

The Office of Financial Management *State Administrative and Accounting Manual*, Section 85.32.10 states in part:

> ...At a minimum, agencies are…to establish and implement the following:
>
> > 1. Controls to ensure that all expenditures/expenses and disbursements are for lawful and proper purposes….

03-30 The Department of Transportation's Washington State Ferries Division is not following state purchasing guidelines when buying from vendors deemed a sole source.

Background

In fiscal year 2003, the Ferries Division purchased approximately $15.7 million in goods and services using the state Department of General Administration's sole source authorization.

By law, state agencies are required to follow the Department's purchasing guidelines when procuring goods and services. These guidelines authorize purchases from a sole source under certain specific conditions. When using the Department's sole source authorization to make a purchase, agencies are exempt from competitive bidding requirements. In order to use the sole source purchase authority, the guidelines require that the agency clearly and convincingly demonstrate that a true sole source situation exists.

Description of Condition

The Division did not comply with the guidelines for sole source purchases. The Division did not adequately document its justification for using sole source purchasing authority, and in some cases purchased goods from a vendor deemed a sole source when those purchases should have been competitively bid. We also found lack of adequate documentation justifying sole source purchases during our fiscal year 2001 audit. We communicated that in a letter to the Secretary of Transportation dated December 14, 2001.

We reviewed 60 sole source purchases from fiscal year 2003 into early fiscal year 2004 amounting to approximately $1.76 million. Fifty-eight out of the 60 sole source purchases reviewed (97 percent) did not have adequate documentation to justify the use of sole source purchasing authority. These 58 represent 89 percent of the dollars reviewed. In addition, we found that 20 of the 60 sole source purchases (33 percent) do not appear to have been from sole source vendors and should have been competitively bid. These 20 represent 11 percent of the dollars reviewed.

For some purchases, we found no written justification to support why the procurement was made as a sole source purchase. For other purchases, the Ferry Division used a letter from the vendor stating that it was the sole source as the justification for buying from that vendor. This is inadequate justification. Further, some of these letters were 10 years to 15 years old.

Cause of Condition

Ferries management stated the extensive use of sole source authority is driven by the unique maritime environment they operate in, as well as the age of their fleet. They also asserted that they have not adequately monitored the use of such authority.

Effect of Condition

When all eligible bidders do not receive a fair and open chance to compete for the Division's business, the agency suffers the risks of not receiving the best value, of supplier protests, and of unfavorable public opinion.

Recommendation

We recommend that the Ferries Division comply with purchasing guidelines for sole source purchases.

Department's Response

The State Auditor's Office has misrepresented this condition by not describing the sampling method and its relationship to the population tested. They report testing sixty transactions, totaling $1.76 million, with an error rate of 97 percent. However, 84 percent of the population was from a single vendor that was excluded from the reported sample. The auditors concurred that purchases from this vendor were appropriately documented, but did not include this result in their report. By not reporting this fact the auditors have overstated the significance of the condition.

Washington State Ferries does concur that monitoring the use of the sole source exception needs improvement, and is taking action to do so. WSF will provide a corrective action plan to the Washington State Office of Financial Management within the allotted thirty-day time frame after the Statewide Accountability Report is issued.

Auditor's Concluding Remarks

We disagree with the Ferries Division statement that the condition has been misrepresented. The Ferries Division has a significant weakness in controls with both the lack of adequate documentation for sole source purchases and for failing to competitively bid purchases where this was required. The error rates cited in the finding are for those items tested. Our testing was not "sampling". Therefore we have not projected error rates to the population.

The Ferries Division response also alludes to a vendor that made up the majority of sole source dollars (but only a small percentage of transactions) and states that this vendor was excluded from the items tested by the auditor. We disagree as this vendor was included in our testing. The Ferries Division response also states that the auditor has concurred that all purchases from this vendor were appropriately documented. We disagree. We do not make that assertion.

We appreciate and support the Ferries Division's actions to monitor purchases from vendors deemed a sole source. We reaffirm our finding and will review any new procedures and their effectiveness in our next audit.

Applicable Laws and Regulations

The Department of General Administration's *General Authorities* prescribe the minimum purchasing requirements that state agencies must meet. Section G.4 Sole Source/Special Market Condition states in part:

> An agency may conduct a purchase of any dollar value for the following goods and services.
>
> > <u>Sole Source or Special Market Conditions</u>: In general, under certain conditions, these may be declared exempt from competitive requirements per RCW 43.19.1906 and can be purchased through the process for sole source or

special market condition (see Part 2 of this document). The purchaser shall adequately document the purchase file relative to non-availability of competition for the specific purchase transaction conducted.

Section P.2 Sole Source and Special Market Conditions states in part:

> Purchases that are clearly and legitimately limited to a single source of supply and purchases involving special facilities, services, or market conditions may be acquired through direct negotiation with documented source selection and price reasonableness. *Declaration of sole source should result from a market search and analysis with all parameters fully documented in the purchase file.*

Loans and Grants

03-31 The Department of Community, Trade, and Economic Development is not adequately administering state housing assistance funds awarded in the form of forgivable loans.

Background

State law (RCW 43.185.010) established the state Housing Assistance Program (HAP) as a continuously renewable resource to assist low- and very-low-income citizens in meeting their basic housing needs. The Department of Community, Trade and Economic Development accounts for all program revenues and expenditures in the Housing Trust Fund.

The Home Investment Partnerships Program (HOME) is another source of housing development funds. These awards originate at the U.S. Department of Housing and Urban Development (CFDA #14.239) and must be matched with 25 percent state funds. While the federal HOME awards are accounted for in a separate fund, the Department accounts for the state HOME matching funds in the Housing Trust Fund. Both the state HAP funds and the state HOME funds are administered with the same guiding principles.

Housing Trust funds are awarded as contracted loans or grants to eligible organizations such as local governments, local housing authorities, and non-profit organizations. The Department later amends some of the loans to reclassify them as forgivable loans, similar to grants. In such cases, covenants are placed on the projects. The principal and interest payments are deferred until the end of the contract terms, which can be as long as 50 years. The loans are then tracked internally and treated not as receivables but as current expenditures in the accounting system, with no expectation of repayment.

A forgivable loan becomes a due and payable receivable to the Department once again only if the contractor defaults on the contract by no longer serving the target population. If covenants are met and there is no default over the life of the contract, forgiveness occurs at the end of the contract term, and no repayment is due from the organization.

At the end of fiscal year 2003, the HAP-funded and state-funded HOME loans totaled $301,049,759 and $55,250,386, respectively. Included in these totals were forgivable loans of between $40 million and $100.6 million for HAP and between $5.5 million and $6.5 million for HOME.

Description, Cause, and Effect of Condition

During our review, we found the Department:

a. Performs no analysis of the level of forgivable loans that may be awarded or minimal rates of return necessary to sustain the Housing Trust Fund as a renewable resource. Without such analysis to determine if there will be sufficient funds to assist those who qualify in the future, the Department may not be complying with the Legislative intent that these funds be a “continuously renewable resource”.

b. Has not established consistent treatment when deciding to reclassify these loans as forgivable. Loan terms are simply amended to forgivable status through a process that

has no specific criteria or required support for making this decision. This situation occurs because the Department considers a contract amendment that converts all or part of the loan amount from a loan to a forgivable loan as a "technical amendment" without financial consequences.

However, the Department does face financial consequences because it now has no expectation of repayment; it has changed a long-term asset (a receivable) into a current-year expenditure. In addition, if all organizations are not afforded the same treatment under the same circumstances, the Department creates the appearance of unfair preference.

c. Does not have a monitoring system in place to ensure that forgivable loan covenants are met during the loan term. Monitoring can include site visits and/or a review of annual reports submitted by those receiving funds. We reviewed the database information for 367 HAP and 32 HOME forgivable loans (as originally identified to us by the Department) with the following results:

	HAP	HOME (State funds)
No site visits indicated	43.6%	25.0%
No site visits for more than 5 years	21.5%	3.1%
Site visits during fiscal year 2003	10.0%	15.6%
No annual reports received for more than 5 years	21.5%	31.3%
Annual reports received during fiscal year 2003	0.0%	0.0%
Neither visit nor report for more than 5 years	18.5%	3.1%

We selected seven HAP and five HOME loans for further documentation review at the program level. For three loans in each program, we did find more recent site visit documentation than that in the contract database; these six site visits all occurred after we began our audit. However, we found no additional documentation that annual reports had been submitted.

The Department stated its current in-house database system is outdated and is not adequate to provide information needed to adequately track and monitor contracts and projects. In addition, the Department has not updated the database to reflect any recent site visits that may have occurred or recent annual reports that may have been received.

The Department also stated the programs within the Fund have grown very rapidly, without sufficient available staff to adequately monitor contracts made with these funds. The focus of the Department has been on ensuring distribution of the funds where need was greatest, based on project priority and other factors. Lesser priority has been given to the continuing viability and monitoring of contract terms and conditions.

Consequently, the Department may not know that a forgivable loan is no longer being used for its intended purpose and certainly will not know 50 years from now after staff has changed many times over and old records have been destroyed.

d. Does not know the correct number or total true value of its forgivable loans. Originally, the Department provided us with a list of 367 HAP forgivable loans with a total of $100,637,459 and 32 Home forgivable loans with a total of $6,453,103. After we had completed our review and compiled the results noted above in condition c, the Department informed us it had given us the wrong list as it also contained grants. Apparently, the database is unable to distinguish between grants and forgivable loans.

   Based on its own evaluation, the Department stated the true value of the HAP loans was approximately $40 million, while the true value of the HOME loans was approximately $5.5 million. We then performed our own evaluation, analyzing in more detail some of the same documents the Department examined. We found many cases in which the Department called a contract a grant on the document face but our assessment of the content showed it appeared to be the same as a forgivable loan. Therefore, we believe the true value of forgivable loans is currently unknown.

Recommendations

We recommend the Department cease its use of forgivable loans. However, if it decides to maintain this practice, we recommend it develop and follow adequate policies and procedures to:

a. Perform statistical analysis determining the rate of return necessary to sustain the revolving Fund and then make loan and grant funding decisions using this analysis.

b. Consider the conversion of ordinary loans to forgivable loans as monetary decisions, with equal notice and opportunity for such treatment given to all eligible organizations in similar situations.

c. Monitor forgivable loans on an on-going basis to determine whether the intended use requirements of the contract agreements continue to be met. Site visits and review of annual reports are particularly reliable monitoring methods in this situation. Adequate monitoring must include adequate records retention for the length of the loan.

d. Continue and improve its assessment of documents to determine the actual number and true value of its forgivable loans. Consider adding coding to the database that will adequately distinguish between forgivable loans and grants.

Department's Response

We disagree with this finding.

a. The Department disagrees with the auditor's interpretation of legislative intent in RCW 43.185 concerning a continuously renewable resource. This finding appears to be based on the assumption that the Housing Trust Fund program should be managed as if it was a profit-generating resource.

The Legislature's intent was for the provision of basic housing needs for low and very low-income citizens and whenever feasible, assistance should be in the form of loans. In keeping with this intent, the Department does the following:

1) *Gives priority to the needs of very low-income citizens as stated in RCW 43.185.010, paragraph 5. Accordingly, the Department gives preference to applications with special needs populations, serving the greatest need, providing housing for persons and families with the lowest incomes, and serving special needs populations which are under statutory mandate to develop community housing based on the criteria in RCW 43.185.070(3)(b), (h), (i), and (j).*

   In many cases, projects for these populations cannot typically sustain additional debt service, and therefore, they have obtained housing assistance program recoverable grants or forgivable loans. The primary interest for the housing programs serving the very-low income is to ensure that the housing is provided, as a first priority, and that the recovery of the full investment is a secondary priority. In some cases, if CTED did not provide this funding as either grants or forgivable loans, then the basic housing needs of the very low-income may not be achieved.

2) *Provides assistance in the form of loans whenever feasible (RCW 43.185.010, paragraph 5) by conducting capacity analysis/project underwriting and structuring financing to assure that projects will be sustainable for the life of the project.*

3) *The contract language stipulates that the funds must be returned if the terms of use are violated. This ensures that the investment funds can be recaptured should the housing project no longer serve low-income populations in future years.*

b. *The Department currently underwrites all housing assistance program contract amendment requests. All amendments are reviewed on a case-by-case basis giving consideration to the needs of the population being served, condition of existing property, financial hardship and continuity of the project. Projects serving special needs populations such as group homes serving persons with developmental disabilities, victims of domestic violence, frail elderly, or chronically mentally ill are very difficult to establish and are therefore given high priority for restructuring if that action will keep the housing available to those populations. Care is given to assure that contracting practices are applied consistently based upon the needs of the population being served.*

c. *Notwithstanding our disagreement with the audit finding, the Department requested and received additional resources to improve the Housing Division's compliance monitoring, including management information. Annual reports have been entered into the data system and are currently under review. Research concerning past monitoring site visits is being conducted and results are being added to the improved data system.*

d. *The discrepancies cited in this section of finding are due to confusion of the terminology used to classify projects held within the portfolio and do not have a material bearing on how fiscal resources are being managed. Additionally, the amounts reported on forgivable loans have no impact on the balance reported on the statewide financial statements. The Department has clarified loan and grant definitions, added coding to its database, and corrected its records to distinguish forgivable loans from recoverable grants.*

Auditor's Concluding Remarks

We have carefully reviewed the Department's response and reaffirm our finding.

a. We did not base our finding on an assumption that the Housing Trust Fund should be managed as if it were a profit generating resource. State law identifies the types of renewable resources: loan repayments, private contributions and other sources. We are concerned that no analysis was performed that considered the effects of eliminating potential renewable resources. If a large portion of the loans is later deemed forgivable, one of the renewable sources of funds is effectively eliminated. This could significantly affect the amount of funding requested from the state Legislature to maintain the program.

   Our original recommendation still stands. However, the Department may wish to obtain clarification from the Legislature regarding its interpretation of "renewable resource" as outlined in the statute.

b. We found no evidence in the Department's records supporting its decisions to reclassify loans as forgivable or documenting that it applied consistent treatment in its decisions.

c. While the contract language may stipulate that the funds must be returned if the terms of use are violated, there is no monitoring protocol or system in place to ensure those terms of use are met.

d. We appreciate the work performed by the Department to clarify loan and grant definitions. We believe the amounts reported as forgivable loans do have a fiscal impact. The Department reports grants and forgivable loans as expenditures and normal loans as assets. This has a distinct financial impact when the agency manages its resources.

Applicable Laws and Regulations

RCW 43.185.010 states in part:

> The Legislature declares that it is in the public interest to establish a continuously renewable resource known as the housing trust fund and housing assistance program to assist low and very low-income citizens in meeting their basic housing needs,…and that whenever feasible, assistance should be in the form of loans.

RCW 43.185.030 states in part:

> The housing trust fund shall include revenue from the sources established by this chapter, appropriations by the legislature, private contributions, repayment of loans, and all other sources.

RCW 43.185.090 states:

> The director shall monitor the activities of recipients of grants and loans under this chapter to determine compliance with the terms and conditions set forth in its application or stated by the department in connection with the grant or loan.

RCW 43.185.120 states:

> The department shall adopt policies to ensure that the state's interest will be protected upon either the sale or change of use of projects financed in whole or in part under RCW 43.185.050. These policies may include, but are not limited to: 1) requiring a share of the appreciation in the project in proportion to the state's contribution to the project; 2) requiring a lump sum repayment of the loan or grant upon the sale or change of use of the project; or 3) requiring a deferred payment of principal or principal and interest on loans after a specified time period.

03-32 The Department of Community, Trade and Economic Development is not complying with state regulations for collection of overdue loan payments in several of its loan programs.

Background

TIMBER and GORGE Programs

The Department receives funds from the federal Department of Agriculture for Cooperative Forestry Assistance (CFDA #10.664), a program that allows some of its funds to be used to make loans and grants. The federal award is based on the state's application plan, which includes a provision for a revolving loan fund. With this type of fund, the expectation is that loan repayments will be used to provide further loans.

The Department's Old Growth Timber Program (TIMBER) uses a portion of these federal funds to provide loans to forest products firms affected by timber harvest reductions; these loans may be for such purposes as machinery, real estate, construction, and inventory. The Department's Columbia River Gorge Program (GORGE) uses another portion of the federal funds to provide loans and equity investments to private businesses to protect and support the area economy; these loans may be for such purposes as downtown revitalization, tourism marketing, and infrastructure improvement. In both programs, the Department may also provide loans to repay entities' prior loans and/or to provide working capital.

To assist higher risk borrowers and to provide gap financing, the Department has taken the second position on many of these loans. In these cases, if an entity declares bankruptcy, the Department will receive repayments only if funds remain after the primary lender is paid. There are no regulations prohibiting this practice.

During Fiscal Year 2003, the Department loaned $3,150,000 for TIMBER projects and $285,870 for GORGE projects. Over the life of the program, the Department has made $9,291,323 in TIMBER loans, with $5,623,534 in current receivables; it has also made $1,359,654 in GORGE loans, with $1,283,668 in current receivables. Since state matching funds are not required, the Department makes all of these loans from the federal awards and program income.

Housing Trust Fund

The Legislature established the Housing Trust Fund in state law to account for the revenue and expenditures necessary to assist low- and very low-income citizens in meeting basic housing needs. Revenue sources may include legislative appropriations, private contributions, repayment of loans, and other sources such as federal funds. The Department awards these funds as contracted loans or grants to eligible organizations such as local governments, local housing authorities, and non-profit organizations. During fiscal year 2003, the Department awarded $19,333,314 from the Trust Fund in loans and grants. Based on Departmental information, it has awarded $356,300,145 in loans and grants over the life of the Fund, with $246,070,554 in current receivables.

Description of Condition

At the time of our audit, we found the Department was not complying with state regulations for the collection of and accounting for delinquent loans. Specifically, it was not:

- Establishing and following written procedures ensuring adequate monitoring and collection of past-due accounts.

- Preparing monthly aging reports for management review.

- Establishing an allowance for uncollectible accounts to recognize potentially delinquent loans to private entities.

We noted that, by the end of the audit period, the Department had drafted policies and procedures for the Housing Trust Fund that may help to ensure compliance in the above three areas. However, these new policies and procedures are applicable only to that Fund and not to the TIMBER and GORGE programs.

Cause of Condition

The Department stated it has program-level portfolio management systems and agency-level accounting systems in place that are not fully integrated. In addition, we were told program personnel have not communicated to fiscal personnel the amount of money likely to be written off from delinquent loans that now appear to be uncollectible.

Effect of Condition

We evaluated the records for eight TIMBER loans and five GORGE loans and found two delinquent loans in each, as follows:

LOAN REPAYMENTS FROM INCEPTION UNTIL MARCH 31, 2003

Old Growth Timber

Loan #	A Loan Amount	B **Receivable balance at** 03/31/03	C Amount paid (A-B)	D Monthly payment	E Estimated payments overdue	Comment
01-796B010	$165,000.00	$165,000.00	$ 0	$ 3,038.73	22	Out of business-delinquent
00-796B009	$327,000.00	$327,000.00	$ 0	$ 3,048.07	16	Moratorium on payments since 11/01-delinquent
Total	$492,000.00	$492,000.00	$ 0			

Columbia River Gorge

96-75196-243	$300,000.00	$294,022.26	$5,977.74	$2,509.32	33	Entity bankrupt-delinquent
01-75100-453	$229,500.00	$229,500.00	$ 0	$2,327.74	20	Entity bankrupt-delinquent
Total	$529,500.00	$523,522.26	$5,977.74			
Grand total	$1,021,500.00	$1,015,522.26	$5,977.74			

During our review of the Housing Trust Fund, we found a similar situation. We reviewed 20 current loans and found two in significant arrears. One loan for $205,030 (principal and interest) was due and payable in August 1997, more than five years before we performed our review. According to the receivable balance, no payments were ever made. The Department began foreclosure proceedings on February 14, 2003, after we started our audit. Another loan, made in 1996 for $406,476, was in "work-out status", with a history of debt restructuring, project completion extensions, and deferred repayment dates. At some point, $250,000 of the loan was made forgivable (See information about forgivable loans in Finding 03-31.) A payment on the loan due in January 2002 was made 420 days late; at the time of our review, a payment of $21,763.60 due in January 2003 was 55 days overdue. According to the receivable balance, no payments were ever made.

Because uncollectible loans from these borrowers have not been recorded, the Department's accounting records may overstate receivables. In addition, Department management had no

opportunity to analyze and evaluate collection procedures and determine if further steps should be taken.

Recommendations

We recommend the Department:

- Establish and follow adequate written procedures ensuring the monitoring and collection of past-due accounts.
- Prepare monthly aging reports for management review.
- Establish an allowance for uncollectible accounts to recognize delinquent loans to private entities.

Department's Response

1. *The Economic Development Division of CTED is taking the following corrective actions to address the conditions noted in the Timber and Gorge Programs:*

   A) *The Economic Development Division of CTED agrees there are insufficient written procedures for monitoring and collection of past due loans in the Forest Products and Columbia Gorge loan programs. However, the Division is monitoring the performance of these loans. As a matter of standard operating procedure the same approved procedures used with other Division loan programs have been followed. The Department has provided extensive documentation showing a range of collection efforts and follow up actions taken regarding the four past due loans identified by the State Auditor's Office, including notices of past due payments, telephone calls, legal correspondence and court intervention. Program-specific procedures for the Forest Products and Gorge loan programs will be drafted by June 30, 2004 for review and approval by the respective loan boards and CTED management.*

   B) *The Economic Development Division agrees upper management in CTED does not currently receive regular aging reports on these loan programs, although at the unit level status is reviewed monthly. However, the respective loan boards for each program receive financial reports and delinquency/aging reports as part of their meeting packets. By mid-April 2004, the Division's new loan portfolio software will provide new aging reports on a monthly basis to the Division's Assistant Director, and quarterly to CTED upper management.*

   C) *CTED agrees more frequent communication between the Business Finance Unit and the Accounting Services Unit regarding loans that are unlikely to fully meet their repayment obligations would be beneficial. By July 30, 2004, the Business Finance Unit will provide the Accounting Services Unit an updated estimation of any loan write-offs that will be necessary due to uncollectible accounts. This will continue on an annual basis and the Business Finance Unit will inform the Accounting Services Unit of any reduction in loan receivables, or loan balances deemed uncollectible when those decisions are made, with agency knowledge and concurrence, by the respective loan boards.*

2. *The Housing Division of CTED is taking the following corrective actions to address the conditions noted in the Housing Trust Fund (HTF) Program:*

   The Department partially disagrees with this finding. In accordance with RCW 85.54.50.b, the Department's Housing Division is cost-effectively managing projects that are delinquent in loan payments. It has initiated collection approaches that are appropriate within the overall goals of the program, which include working with local housing partners and service providers in ways that assure that low-income housing created using HTF investments remains available to the needy populations that it was intended to serve.

   Monthly aging reports are produced, verified and refined. However, the Department will coordinate information between Accounting Services and the Housing Division to ensure necessary information is recorded properly in AFRS in accordance with OFM requirements.

   To improve the Housing Division's internal business practices, the Department requested and received additional resources from the 2003 Legislature to improve its compliance and asset management systems. Improvements to monitoring systems and management information will allow CTED to produce accurate aging reports for the Housing Trust Fund to be reviewed by agency management.

Auditor's Concluding Remarks

We commend the agency's willingness to draft policies and procedures for the collection of overdue loan payments and to take the initiative in obtaining new loan management software. We will review the new procedures and the performance of the new software in our next audit.

Applicable Laws and Regulations

The Office of Financial Management's *State Administrative and Accounting Manual*, Section 85.54.50.a states:

> Agencies with more than $50,000 in past due receivables are to prepare aging reports at least monthly. Aging reports are required to be reviewed by management and such review documented on the report.

Section 85.54.50.b states:

> **Written procedures are to be developed and followed to ensure that past due receivables are followed up promptly and in a manner that is cost-effective for the overall collection program.** These procedures are to provide for the full range of collection procedures to be used as appropriate, including issuance of statements and dunning letters, phone and personal interviews, filing of suits and liens, referral to private collection agencies or letter services, etc. Agencies that do not have special statutory collection authority, or specialized collection operations are encouraged to use collection agencies after receivables become 90 days past due.

Section 85.54.40.b states:

> Amounts due from private entities or individuals on loans that are not due within twelve months, are recorded as debits to the long-term GL Code 1614 “Loans Receivable” and the related amounts estimated to be uncollectible as credits to the GL Code 1644 “Allowance for Uncollectible Loans Receivable.”

Inventory

03-33 The Capital Asset Management System maintained by the Office of Financial Management lacks adequate controls to ensure that assets are properly safeguarded.

Background

The Capital Asset Management System (CAMS) is a computer-based capital asset accounting system that is maintained by the Office of Financial Management (OFM) and used by several state agencies. CAMS is designed to keep track of and provide accountability for equipment and other assets that have an initial cost of $5,000 or more. The system is also used in the preparation of management reports and state financial statements. Approximately 85 state agencies use CAMS to account for $3.5 billion in assets.

OFM is responsible for establishing accounting and reporting requirements for all state agencies. Agencies are required to use CAMS unless they obtain a written waiver from OFM, which allows the agency to maintain fixed asset information on systems other than CAMS.

Description of Condition

During the course of our audit, we reviewed the CAMS system. We noted the following internal control weaknesses:

1. Assets can be deleted from CAMS by users with access to purge. The history of these deletions is not kept in the system. It is not possible for management or the auditor to determine whether items were deleted from the system and subsequently misappropriated.

2. The system does not identify the user who made changes to the system, including corrections, additions and deletions. It is not possible for management or the auditor to determine who made which entries into the system.

3. The system does not require the user to enter an acquisition cost in the total amount field.

4. The system allows the user to enter the date of acquisition as the current date or any past date. Management should ensure the system allows purchases to be posted only within a reasonable amount of time, such as one month, and should establish a process to validate purchases that do not meet that time frame.

5. Users are assigned security access to the system, but the system allows them to have all levels of security up to the level assigned. For example, if an individual is assigned a security level of 10, he or she has the access needed to inquire, browse, request reports and add asset records. Individuals with a security level of 16 have the same access as those with a level 10 access and the access needed to dispose of and delete asset records. This deficiency does not allow agencies to properly separate duties.

Cause of Condition

The Office stated it does not have the funding to correct all of the noted weaknesses within CAMS.

Effect of Condition

These system weaknesses increase the risk that assets could be lost, stolen or misplaced without detection.

Recommendations

We recommend OFM modify the system to resolve the existing weaknesses or consider developing a new system with stronger internal controls.

Office's Response

OFM partially concurs with this finding.

OFM is currently engaged in a feasibility study to determine the proper direction for the Capital Asset Management System (CAMS). The study will assess the system requirements, identify alternative solutions, and provide a recommended course of action. The deficiencies identified in the audit will be incorporated into the requirements for a new system as part of the feasibility study. The results of this study will be used in OFM's portfolio planning process that will determine the systems to be worked on in the 2005-07 Biennium.

In the meantime, OFM has made or is in the process of making changes to the current system that address some of the weaknesses identified in the audit. Listed below is our response to each internal control weakness identified in the audit:

A. *Agencies control who and how many of their employees have purge access in CAMS. While it is true that the history of these deletions is not kept in the system, this information is available on a Daily Activity Report. CAMS automatically generates the Daily Activity Report each day that activity occurs in the system. This report identifies all additions, deletions, and changes to assets made on that date. The report has been modified to show the User ID of the individual that performed each transaction. The distribution of the Daily Activity Report is controlled by each agency and OFM has recommended that it be sent to someone other than the individual with purge access in CAMS. This allows the daily changes to CAMS to be reviewed by an independent authority and provides a paper record of all assets deleted from the system.*

B. *CAMS automatically generates the Daily Activity Report each day that activity occurs in the system. This report identifies all additions, deletions, and changes to assets made on that date. The report has been modified to show the User ID of the individual that performed each transaction. This report provides a paper record of all changes made to assets in CAMS. Agencies are advised that the Daily Activity Report should be retained for three years. OFM is also changing CAMS to provide for the retention of the Daily Activity Report for six years. Agencies will be able to obtain copies of past reports by contacting OFM.*

C. *Input into the acquisition cost field is not required in order to allow flexibility and accommodate the way agencies use the system to track various types of assets. For example, agencies use CAMS to track capital assets, small and attractive assets, and other agency assets. Some agencies record assets at zero dollar amounts because they are not tracked for financial reasons but for physical location reasons. Also, donated assets may be entered into CAMS at zero dollar amounts to show ownership and for tracking purposes. Consequently, capital assets are the only assets for which the acquisition cost is required.*

D. *OFM is in the process of changing CAMS to edit the acquisition date. Once the edit is in place, a valid date will be a date from the year 1850 up to and including the current date. Assets that have not been recorded in CAMS but found during a physical inventory or found during an audit need to be entered into CAMS with the actual acquisition date, which may range from 1850 through the current date.*

E. *It is the agencies' responsibility to assign CAMS access and to establish internal procedures and processes to ensure separation of duties. CAMS automatically generates the Daily Activity Report and should be used by agencies as a control to reduce the risk of an individual performing unauthorized activity in CAMS.*

Auditor's Concluding Remarks

The proposed changes to CAMS, as identified in the response, are not adequate to correct the condition in the finding.

The Daily Activity Report is only helpful to management and our Office on days in which CAMS activity occurs. Therefore, without a report for a certain day, management and our Office cannot determine whether no activity occurred or whether the report was destroyed to conceal a possible misappropriation. Further, agencies are not required to retain the Daily Activity Report according to the general records retention schedule.

The Office's response indicates that CAMS is used by agencies to track capital assets, small and attractive assets, and other agency assets. However, the Office's web site describes CAMS as the system that "provides for the control, accounting, and reporting of agency-fixed assets and capital leases. Information entered into the system is compliant with state asset accounting policies and provides the basis for statewide consolidation of fixed asset information to support preparation of state financial statements." Internal controls in a capital asset management system should address issues unique to capital assets, such as requiring input into the acquisition cost field.

If an agency enters donated assets into CAMS at zero dollar amounts, as OFM suggests in its response, it will be violating section 30.20.10.d of the Office's *State Administrative and Accounting Manual* which requires that donated assets be recorded at the fair market value plus ancillary costs. If the fair market value is not known, the estimated cost is to be used. Therefore, donated assets should be treated as any other asset as either a capital asset, a small and attractive asset or neither.

Our Office does not believe that entering an acquisition date between the year 1850 and the current date is reasonable. As we state in the condition, purchases should be posted to CAMS within a reasonable amount of time, such as one month. If a purchase is not entered after a month has transpired, the system should allow agency management to approve such a transaction.

We agree with the Office's response that it is the agencies' responsibility to assign CAMS access. However, the system doesn't allow agency management to assign access that results in segregation of duties.

We appreciate the Office's recognition of these weaknesses and its willingness to pursue a feasibility study.

We reaffirm our finding and will review the changes to the system in our next audit.

Applicable Laws and Regulations

Section 43.88.160 (1) of the *Revised Code of Washington* states, in part, that the Office of Financial Management:

> …shall devise and supervise a modern and complete accounting system for each agency to the end that all revenues, expenditures, receipts, disbursements, resources, and obligations of the state shall be properly and systematically accounted for. … Any agency maintaining its own accounting and reporting system shall comply with the updated accounting procedures manual and the rules of the director adopted under this chapter. An agency may receive a waiver from complying with this requirement if the waiver is approved by the director.

Section 30.40.30 of the *State Administrative and Accounting Manual* states, in part:

> Agencies are to use the Capital Asset Management System (CAMS) operated by the OFM Accounting Division for all assets that meet the state's capitalization policy. Agencies may use an alternate in-house system provided written approval of OFM Accounting Division is obtained prior to initiating acquisition or development of the system.

Section 30.20.10.d of the *State Administrative and Accounting Manual* states, in part:

> Donated Assets – Use the fair market value at the time of acquisition plus all appropriate ancillary costs. If the fair market value is not practicably determinable due to lack of sufficient records, use the estimated cost.

03-34 The Department of Labor and Industries removed equipment that cost more than $133,000 from its inventory system without evidence that it had done a reasonable search for the missing items. The Department did not report these losses and additional equipment losses of $128,000 to the State Auditor's Office as required by state law.

Background

The Department of Labor and Industries' inventory system indicates it has approximately $21 million of equipment in inventory. When an asset is missing, state regulations require the Department to perform and document a reasonable search before removing it from the inventory system. State law also requires the Department to notify the State Auditor's Office when an asset is lost or misappropriated.

Description of Condition

During the course of our audit, we became aware that the Department had removed missing equipment from its inventory system. We reviewed inventory records and found that 72 items, including laptop computers, digital cameras and camcorders, which cost more than $133,000, were removed from the inventory system. No search had been performed and documented.

In order to determine the extent of this condition, we reviewed records from prior periods and noted the same issue. We could not determine the dollar value of the missing equipment since the Department destroyed inventory records prior to January 2001 before their scheduled destruction date.

Using the documentation available, we were able to determine that at least $261,000 in equipment losses were not reported to the State Auditor's Office as required by state law.

Cause of Condition

The Department stated it believes reasonable searches were performed even though no evidence of these searches could be found.

The Department's officials state they did not immediately report the losses to the State Auditor's Office because they were unaware of the reporting requirements.

Effect of Condition

Removing equipment from the inventory system without performing a reasonable search decreases the likelihood of recovering the missing equipment. It also causes the Department to spend money for replacement equipment. Further, it does not encourage agency employees to be accountable for equipment.

Failure to comply with state law that requires the Department to notify the State Auditor's Office of losses prevents the Auditor from fulfilling its responsibility to promote accountability. If the losses had been initially reported in the year 2001, recommendations from the State Auditor's Office could have minimized subsequent equipment losses.

Recommendations

We recommend the Department conduct and document reasonable searches for missing equipment prior to removing it from inventory records. We also recommend Department officials promptly report all losses of public funds or assets to the State Auditor's Office as required by law.

Department's Response

We concur with this finding.

In response to the State Auditor's Office's concerns, the agency has developed a process and form document that will be used to document the steps taken to locate a missing asset. This form requires the signature of the Division Executive along with an explanation of the search activities undertaken to locate the asset.

The agency is now reporting asset losses when notified. We will continue to work with the State Auditor's Office as we continue to refine this process.

Our former system required that each property officer conduct a search for the missing assets before authorizing the removal of the asset record. The Department believes adequate searches were conducted prior to authority given to remove assets from the Department asset records. The new system will document that such searches have occurred.

Beginning in October 2003, the agency is tracking all its assets — tangible and software — with a system that uses two new programs, WiseTrack and TS Census. WiseTrack is an asset management program; TS Census tracks computer software and hardware and updates this data to WiseTrack where it is managed as an asset record.

WiseTrack improves the overall efficiency and strengthens the internal controls of L&I's asset management process. WiseTrack identifies the property officer associated with asset transfers by the user the transfer is made to. Property officers involved with a transfer are notified by e-mail messages (called "Asset Alerts") about the asset change.

Auditor's Remarks

We appreciate the Department's efforts to resolve the issues identified in the finding and will review its progress during our next regular audit.

Applicable Laws and Regulations

The *State Administrative and Accounting Manual*, section 30.40.80 states in part:

> When suspected or known losses of inventoriable assets occur, agencies should conduct a search for the missing property. The search should include transfers to other divisions or agencies, storage, scrapping, conversion to another asset, etc. If the missing property is not found:
>
> > Have the individual deemed to be primarily responsible for the asset, as well as that individual's supervisor, complete and sign a Property Disposal Request

(Form S.F. 267-A or equivalent). Include on the Request a description of events surrounding the disappearance of the property, who was notified of the loss, and steps taken to locate the property.

Section 43.09.185 of the *Revised Code of Washington* states:

> State agencies and local governments shall immediately report to the state auditor's office known or suspected loss of public funds or assets or other illegal activity.

Section 40.14.060(1) of the *Revised Code of Washington* states, in part:

> Any destruction of official public records shall be pursuant to a schedule approved under RCW 40.14.050.

03-35 The Department of Veterans Affairs does not have sufficient internal controls over its pharmaceutical inventory to prevent or detect misappropriation or loss.

Background

The Washington Veterans Home in Retsil is a 262-bed facility operated by the Department of Veterans Affairs. The Home is a certified Medicaid facility providing skilled nursing care, assisted-living and domiciliary care to qualified veterans.

The Home's pharmacy and its services are an essential part of residential treatment programs. The pharmacy receives deliveries of all pharmaceuticals for the Home and distributes them daily to six nursing stations housed within four buildings on its campus. The Home's pharmacy is also responsible for supplying pharmaceuticals to the Department's Veterans Home in Spokane.

The pharmacy is open Monday through Friday. The pharmacy fills an average of 200 prescriptions per day. When the pharmacy is closed, Retsil nursing staff can obtain needed pharmaceuticals from emergency kits located at each nursing station.

Description of the Condition

We reviewed the Home's internal controls over pharmaceutical inventory including purchasing, receiving, storage and distribution. We found the following significant weaknesses:

Inventory

- The pharmacy does not have an inventory system capable of tracking or monitoring the quantity of non-controlled substances in stock. Non-controlled substances are those that do not tend to cause physical or psychological dependency.

- Although a physical inventory is conducted at fiscal year end, this procedure is performed only for the purpose of valuing the inventory. The Home has no methods or procedures for determining if drug losses occurred.

Accountability

- The Department contracts out for the destruction of unusable drugs. These drugs are recorded in a destruction log as they are returned to the pharmacy throughout the year. The drugs are then stored at the pharmacy until they are sent off-site for destruction once or twice a year. However, the pharmacy performs no final count and does not reconcile drugs sent off for destruction to the log.

- Duties of ordering and receiving controlled and non-controlled drugs are not separated. It is possible for the same employee to order, receive, stock and distribute any of the drugs in inventory.

- No one reviews the documentation used to record returns from the wards to the pharmacy. Such a review would ensure drugs were not diverted during transport to the pharmacy.

Security

On the day of our review, we found:

- The cabinet containing the drugs designated for destruction was not locked.

- Access to the pharmacy was not adequately restricted. We observed the pharmacy door unlocked, opened and unattended, permitting access to all areas of the pharmacy.

- The cabinet containing Schedule II and Schedule III controlled substances (narcotics) was not locked. No employees were present to provide oversight of the cabinet prior to auditors entering the area.

Cause of Condition

Management did not believe it was necessary to provide an inventory system capable of determining specific quantities of pharmaceuticals. In addition, management indicated there was insufficient staff and time to provide adequate controls, and that, in the absence of other controls, integrity of the staff is a sufficient compensating control.

Effect of Condition

The Home's current internal control structure lends itself to misappropriation or loss of narcotics during their transport. Additionally, due to insufficient monitoring, lack of segregation of duties, and poor inventory practices, the risk of loss or misappropriation of drugs is high. Losses may not be detected in a timely manner, if at all.

Recommendations

We recommend that the Department of Veteran's Affairs:

- Institute an inventory system that ensures accountability for non-controlled substances and detects losses.

- Perform a final count of unusable drugs to be sent for destruction and reconcile those counts to those on the return log.

- Establish adequate separation of duties in the ordering and receiving of drugs. At least two people should be involved in the receiving process, which should include a reconciliation to the original order.

- Establish procedures and perform routine reviews of the return documentation for controlled and non-controlled substances returned to the pharmacy from the wards.

- Restrict access to the pharmacy and secure cabinets containing Schedule II and III controlled substances when not using them.

Department's Response

- ***Institute an inventory system that ensures accountability for non-controlled substances and detects losses.***

  We will offset the risk of loss through management monitoring to include at least quarterly, random product checks comparing purchase totals, dispensed totals and residual in stock. Any variance will be thoroughly investigated and corrective actions implemented by the Pharmacy Manager. Findings will be regularly reviewed with facility Administration. Additionally, we will develop policy and procedures that document how we will ensure the appropriate counts and verification. Also, we will evaluate the application of technological solutions, such as automated dispensing systems as a resource efficient method for perpetual inventory control in the new facility. Additionally, we will establish random/periodic management monitoring for compliance. We anticipate implementation by mid-April.

- ***Perform a final count of unusable drugs to be sent for destruction and reconcile those counts to those on the return log.***

  We will ensure that when a drug comes back from the unit to the Pharmacy for destruction, it is returned with a form ("Medication Destroyed", WVH 337). This form will include the name of the medication, the strength, quantity, the date discontinued and a signature block for the nurse and pharmacist to sign, verifying that the document correctly reflects what is returned to the Pharmacy. One copy of the signed form will be given to the nurse for Nursing files and one copy will remain with the drug until it is destroyed. A summary record (Pharmacy form "Controlled Substance Destruction Log") will be completed as the drug is put in the holding cabinet. The pharmacy technician will prepare the drugs to be sent for destruction and sign as verification of the information. This will be reviewed and signed by a pharmacist prior to sending the drugs for destruction. Additionally, we will institute documentation verifying that the firm doing the destruction signs for and validates the type and amount of drugs being destroyed.

- ***Establish adequate separation of duties in the ordering and receiving of drugs. At least two people should be involved in the receiving process, which should include reconciliation to the original order.***

  Having received this feedback in mid-November, the Pharmacy Manager immediately realigned responsibilities. The Pharmacy Assistant now orders pharmaceuticals and the Pharmacy Technicians receive and account for the products, creating a clear separation of duties.

  Also in mid-November, the pharmacy implemented the practice of making a copy of the pharmaceutical order, which is stapled to the invoice upon receipt. The order and the invoice are compared to ensure they match.

- ***Establish procedures and perform routine reviews of the return documentation for controlled and non-controlled substances returned to the pharmacy from the wards.***

  As noted in the second response above, the use of the "Medication Destroyed" form, which is co-signed by the nurse returning the drugs and the pharmacist receiving the drugs, will

verify that the document correctly reflects what is being returned to the Pharmacy and provides a double check. This has been formalized in updated existing Pharmacy procedures 240.702-VH-RX DISPOSAL OF NON-CONTROLLED MEDICATION and 240.701-VH-RX DISPOSAL OF CONTROLLED MEDICATION.

- ***Restrict access to the pharmacy and secure cabinets containing Schedule II and III controlled substances when not using them.***

  We are in the final stages of installing a monitored alarm system for the Pharmacy. Additionally, the main door to the Pharmacy has a magnetic lock release, meaning it is self-closing. The door is equipped with both a key and a numeric push-button lock, both under the control of the pharmacists. The cabinet for the controlled substances has a lock put in place to keep secure when not in use and the Pharmacy Manager has instructed staff on the change in security. Management will perform random/periodic checks to ensure proper security procedures are maintained.

Auditor's Concluding Remarks

We thank the Department for its planned corrective action. We believe the additional controls noted below are also necessary to resolve the weaknesses noted in our finding. We will follow up on the Department's corrective action during our next audit.

Unusable drugs

The Department's controls should include performing a physical count of the drugs at the time they are sent for destruction and reconciling that count to the summary record. Any discrepancies between the record and the physical count should be investigated.

Drugs returned to the pharmacy

The Department's controls should include a periodic comparison of the record showing the quantity returned to the pharmacy with the recorded reductions in the inventory record.

Applicable Laws and Regulations

The State of Washington Office of Financial Management's *State Administrative and Accounting Manual* addresses basic principles of internal controls as follows:

Section 35.10.10 states:

> The purpose of an inventory system is: 1) to provide control and accountability over inventories.

Section 35.10.25 states the agency responsibilities include the following:

> Developing and implementing policies and procedures to safeguard, control, and account for inventories.
> Planning, conducting, and reconciling the physical inventory with inventory records.

Section 20.20.70.d states:

> Physical controls - Equipment, inventories, securities, cash, and other assets should be secured physically, and periodically counted and compared with amounts shown on control records.
>
> Segregation of duties - Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions.

Section 20.20.20.d states:

> Each agency is to adopt methods to assess risk and review control activities.

Section 20.20.60.d states:

> Management systems and internal activities need to be monitored to assess the quality of their performance over time. Assessment is accomplished through ongoing monitoring activities, separate evaluation, or a combination of the two.

Code of Federal Regulations, Title 21, Section 1301.72 (b)(3)(ii) states:

> (b) Schedules III, IV and V. Raw material, bulk materials awaiting further processing, and finished products which are controlled substances listed in Schedules III, IV, and V, and GHB when it is manufactured or distributed in accordance with an exemption under section 505(i) of the FFDCA, shall be stored in the following secure storage areas:
>
> (1) A building used for storage of Schedules III through V controlled substances with perimeter security which limits access during working hours and provides security after working hours and meets the following specifications:
>
> (ii) Is equipped with self-closing, self-locking doors constructed of substantial material commensurate with the type of building construction, provided, however, a door which is kept closed and locked at all times when not in use and when in use is kept under direct observation of a responsible employee or agent of the registrant is permitted in lieu of a self-closing, self-locking door.

Code of Federal Regulations, Title 21, Section 1301.75 b (8) (d) states:

> Accessibility to storage areas. The controlled substances storage areas shall be accessible only to an absolute minimum number of specifically authorized employees. When it is necessary for employee maintenance personnel, non employee maintenance personnel, business guests, visitors to be present in or pass through controlled substances storage areas, the registrant shall provide for adequate observation of the area by an employee specifically authorized in writing.

03-36 The Washington Horse Racing Commission lacks adequate controls to safeguard equipment and other assets that are small and susceptible to misappropriation.

Background

Commission assets that cost $5,000 or more and assets that are considered small and susceptible to misappropriation, such as laptop computers, are to be maintained on inventory records. These records are designed to keep track of and provide accountability over equipment and other assets.

Description of Condition

During our audit, we found that 209 of the Commission's 211 assets were not listed on the inventory report. During the Commission's planned physical inventory, the Commission compiled a list based on the items it could locate. Our audit did not include procedures to verify that the Commission located all of the assets. In addition, we found:

- Eleven assets were identified as being surplused on the inventory records, but the Surplus Property Division of the Department of General Administration had no record of receiving these items. The cost of the 11 assets was $24,255.

- The cost of each item was not included in the inventory report for 67 percent of the items. The total cost for those items with listed costs was $226,703. Therefore, the estimated cost of the entire inventory is $686,979 ($226,703 divided by 33 percent).

- For the assets with a cost listed in the inventory report, 31 percent had even dollar amounts, such as $500 or $1,000. Since unit costs, tax and shipping don't usually result in round figures, we believe these costs may have been based on estimates rather than actual costs.

- Assets assigned to 12 consecutive tag numbers could not be located, nor were we able to determine whether they had been misplaced, voided or whether the asset had been misappropriated.

- The inventory report did not have the minimum asset information. For example, tag numbers were missing for 20 percent of the assets and more than 50 percent of the assets did not have a serial number.

- Duplicate tag numbers were used for two different assets in nine instances.

- The financial statement records reflect the Commission's total inventory cost of $139,113. This is 394 percent less than our estimate of $686,979. Therefore, we conclude that physical inventories have not been reconciled with financial records. Small Agency Client Services (SACS) at the Office of Financial Management did not perform the inventory reconciliation as required by an interagency agreement wit the Commission.

- The Commission did not perform a physical inventory within the last two years.

- The Commission does not have adequate instructions for its employees regarding physical inventory.

Cause of Condition

Former Commission management did not monitor fixed asset activity to ensure the inventory was maintained in accordance with state regulations.

Effect of Condition

Where accountability is lacking over equipment and small and attractive assets, the risk is greatly increased that they will be misappropriated without detection in a timely manner, if at all.

Recommendations

We recommend that the Commission strengthen controls over assets and update inventory records to comply with state regulations.

Commission's Response

The Washington Horse Racing Commission (WHRC) has historically used both the state inventory system (CAMS) and its own inventory database for tracking assets. The recent audit identified the system and procedures used by the WHRC were not sufficient to meet state requirements for safeguarding assets.

The WHRC recognizes and understands its duty to maintain accountability over equipment and other assets and will implement the necessary steps to ensure compliance with the recommendations contained in the audit finding by June 30, 2004. The WHRC appreciates the State Auditor's Office efforts to identify these issues and to assist the agency in meeting its compliance obligations.

Auditor's Remarks

We appreciate the Commission's willingness to address these issues. We will follow up on the Commission's progress during our next audit.

Applicable Laws and Regulations

Section 30.10.10 of the *State Administrative and Accounting Manual* states, in part:

> The purpose of a capital asset inventory system is: 1) to provide control and accountability over capital assets…

Section 30.20.20 of the *State Administrative and Accounting Manual* states, in part:

> The state's capitalization policy is as follows:…capital assets with a unit cost (including ancillary costs) of $5,000 or greater…

Section 30.40.10 of the *State Administrative and Accounting Manual* states, in part:

> The following assets are inventoriable assets and must be carried on the property records of an agency: All assets meeting the state's capitalization policy…, assets with a unit cost...less than $5,000 identified as small and attractive assets.

Section 30.30.50 of the *State Administrative and Accounting Manual* states, in part:

> Agencies are to ensure that adequate controls for safeguarding unissued, mutilated, and voided capital asset inventory tags are established.

Section 30.40.20 of the *State Administrative and Accounting Manual* states, in part:

> …absent a risk assessment and development of written policies for identifying and controlling small and attractive assets, agencies must include, at a minimum, the [certain] assets with a unit cost of $300 or more as small and attractive.

Section 30.40.30 of the *State Administrative and Accounting Manual* states, in part:

> Agency capital asset inventory systems should contain, at a minimum, the following data elements: acquisition date, cost, order number, serial number…

Section 30.45.40 of the *State Administrative and Accounting Manual* states, in part:

> After the physical inventory count is completed, the agency inventory officer is to conduct the reconciliation process. When all differences have been identified and explained, the inventory is considered reconciled.

Section 30.45.10 of the *State Administrative and Accounting Manual* states, in part:

> Agencies may conduct their capital assets inventory on a revolving basis if the following conditions are met: Every item is subject to a physical count or verification at least once every other fiscal year.

03-37 The Washington State Historical Society has not completed an inventory of historical artifacts.

Description of Condition

Since 1991, we have reported that the Washington State Historical Society does not maintain a complete inventory list of historical artifacts. The collection is documented in varying degrees of detail and accuracy through card catalogs, donor lists and other historical records. The Society is making progress in recording the artifacts into a single comprehensive system. As a result, the Society anticipates this condition to be corrected in the near future.

Cause of Condition

The Society indicated that it does not have the funding to hire additional staff to complete the inventory process more quickly.

Effect of Condition

Weak controls put historical artifacts, held in trust by the Society, at risk. Artifacts could be misappropriated or misplaced. The current system is inadequate to identify the missing items.

Recommendation

We recommend the Society complete cataloging its inventory of historical artifacts as soon as possible to comply with state regulations and to satisfy its mission of preserving history through artifacts.

Society's Response

As even the State Auditor has noted, the agency has made strides to address this finding. Inventory of the Society's historical artifacts continues at a brisk pace of about 1,000 per month. By the end of the calendar year of 2003, staff reached the milestone of 76% of the artifact collection (numbering 50,000 items) being inventoried. If work continues at this current pace, it is estimated that we can reach 88% by June 2004.

Auditor's Concluding Remarks

We appreciate the Society's efforts in addressing this finding and will review its progress toward resolving this issue during our next regular audit.

Applicable Laws and Regulations

Section 27.34.070 (1) of the *Revised Code of Washington* requires the Society to catalog historical artifacts:

> Each state historical society is designated a trustee for the state whose powers and duties include but are not limited to the following: (a) To collect, catalog, preserve, and interpret objects, manuscripts, sites photographs, and other materials illustrative of the cultural, artistic, and natural history of this state.

The Office of Financial Management's *State Administrative and Accounting Manual*, section 30.40.10 states in part:

> Collections under the control of a state historical society as defined by RCW 27.34.020 are required by RCW 27.34.070 to be cataloged.

Safeguarding of Other Assets

03-38 More than $5.8 million in employer industrial insurance premium payments recorded as being received by the Department of Labor and Industries between July 2002 and December 2002 were not reflected as being deposited in the industrial insurance accounts. The Department was unable to account for this difference.

Background

The Department collects industrial insurance premiums totaling more than $1 billion per year from more than 166,000 businesses in Washington in accordance with the state industrial insurance law. Premium assessments and the related payments are posted to employer accounts as they are received.

Description of Condition

During our audit, we noted weaknesses in how employer premiums were receipted. We noted the same weaknesses in our 2002 Statewide Accountability Report when a difference of $4.7 million could not be resolved.

We attempted to reconcile premiums posted to employer accounts to amounts deposited in the bank. We found that the employer account system reflected payments of $5.8 million more than what was recorded as deposited recorded in the industrial insurance financial accounts. Neither our staff nor Department personnel were able to determine what caused the difference. Possible explanations are that money came in and was not deposited or that the transaction was recorded as a payment received, when it was an adjustment to an account. Minor timing issues and misclassification of payments received may have contributed to this variance. Total payments received for the six-month period were $542,630,733 per the employer account system and $536,794,568 per bank deposit records.

We reviewed the internal controls over cash receipts and found:

- The Department does not perform a daily reconciliation between cash deposited and the records of the day's transactions. Cashiers balance amounts to be deposited to the payments recorded in employer accounts daily, using a report produced by the employer accounts system. However, the total amounts to be deposited are hand-written on the report by the cashiers. Without documentation from the financial reporting system that transactions have been entered, this procedure does not provide assurance that amounts deposited balance with employer account records. The Department stated that it recently established a daily reconciliation between cash deposited in the bank and payments recorded in the employer accounts system. We will review this during our next audit.

- The employer accounts report used by cashiers performing the daily balancing procedure includes a page identifying the items that were backdated. However, no report is generated if no backdated transactions occur on a specific day. Therefore, a cashier could receive and later destroy the report, concealing the backdated transaction from a supervisor. The Department stated that it has recently established a new procedure in which reports of backdated transactions are received via e-mail sent to the employee

responsible for reviewing the daily balancing reports. We will verify during the next audit period that this new procedure is adequate to resolve the weakness noted above.

- Duties are not segregated in the cashier's office. Cashiers handle cash, post payments to employer accounts and adjust employer accounts. Although the lead cashier monitors the activity of the cashiers, the lead cashier's transactions are not monitored daily.

Cause of Condition

The employer accounts system was not designed to fully support reconciliation to the financial system.

Effect of Condition

Without adequate internal controls over cash receipting, the Department cannot ensure that all payments received are deposited. This increases the risk that errors or misappropriation could occur and not be detected by management in a timely manner, if at all.

Recommendations

We recommend the Department:

- Reconcile payments posted to independent systems, including the employer accounts system, to amounts deposited.

- Establish and follow internal controls designed to safeguard cash receipts either by modifying the employer accounts system or by using other compensating controls.

- Determine what accounts for the $5.8 million discrepancy.

Department's Response

The Department is very confident all monies received were reconciled and deposited to the appropriate accounts.

We concur with this finding. The agency has already corrected the receipting conditions cited in this finding beginning in September 2003. The corrective action itemized below was provided to the State Auditor's Office during the audit period:

- *Accounting Services has implemented a daily EASE/AFRS reconciliation process. This reconciliation uses the Cashier Daily Balancing Control Report (RP15065A) produced by EASE and updated by the Cashier's Office for the day's activity. All EASE cash receipts (cash, check, EFT, IAP, journal vouchers) reported daily on the RP15065A report are reconciled at the AFRS document level by Accounting Services. Reconciliation documentation is maintained in Accounting Services. This reconciliation process verifies EASE receipt activity with the "financial reporting system" (AFRS), as required in the condition.*

- *Current day and prior date receipts activity reported on the employer accounts report used by the cashiers for the daily balancing is emailed daily to the Cashier's Office, Accounting Services, Employer Services staff and the Financial Services program manager, which removes the opportunity for the Cashier to conceal or destroy backdated transaction reporting. Backdated EASE postings are shown as a separate day's activity on the emailed report.*

- *All EASE activity is reconciled to AFRS on a daily basis. In addition, CashRec activity is reported to the Financial Services program manager on a bi-weekly basis. The CashRec information is reviewed by the program manager using cashier records. In addition, per recommendation of the State Auditor's Office, Cashier staff approves each other's end of day totals.*

The Employer Account system originally produced a set of monthly reports for reconciliation. The State Auditor performed a comparison of the EASE monthly reports for the six-month period to receipts posted in AFRS to arrive at the $5.8 million variance. In response to last year's finding, the agency did a review of the six-month period of data using the monthly EASE reconciliation reports. Based on this review, the agency determined the monthly reconciliation reports should not be used as they made the process inefficient and ineffective. The agency instead developed and implemented the daily reconciliation process described in this response. This daily process was presented to the State Auditor's Office and was modified based on input from the Auditor.

The agency is required to balance all cash activity – including receipts – with the State Treasurer's Office on an ongoing basis. Since a contracted third party deposits the majority of the premium revenue, and because L&I stays current with the balancing of the State Treasurer's Office, the risk of funds not being deposited is lessened. In addition, the State Auditor did testing of premium receipts during the audit period and found no receipts that were not properly accounted for. The agency's daily reconciliation is much more thorough and effective than the monthly reconciliation process resulting in a more efficient and complete reconciliation process than could be achieved using the monthly EASE reports. Additionally, with the institution of the daily reconciliation process, the incomplete separation of duties has been mitigated due to the increased and more detailed review now being conducted.

The Department was not able to uncover any discrepancies after extensive and exhaustive testing using our daily reconciliation process. The Department feels very confident all monies received were reconciled and deposited to the appropriate accounts. Hence, due to the resource intensive nature of attempting to reconcile previous periods, the Department will maintain daily reconciliation from this point forward.

Auditor's Remarks

The daily reconciliation between the deposit and the State Treasurer's system does not affect the condition noted in this finding. This reconciliation provides assurance that the amount that the Cashier sent to be deposited was the same as the amount received by the bank. The reconciliation noted by the Department would not detect a misappropriation that occurred prior to the preparation of the deposit by the Cashier's Office, which is the focus of this condition. During our review of the daily reconciliation process, we were not satisfied that it would prevent or detect a misappropriation. Our Office did perform some limited review of cash receipt

transactions covering a two-week period to gain an understanding of whether the daily reconciliation process was working as designed.

Duties are not segregated. Cashiers handle cash, post payments to employer accounts and adjust employer accounts. We will review the increased management review process to determine whether this mitigates for the lack of segregation of duties in the Cashier's Office.

We appreciate the Department's efforts to correct the weakness caused by the system's ability to backdate transactions. However, this will only be an effective compensating control if management uses the report to verify that the backdated cash receipt was deposited. We will review this during our next audit.

We look forward to working with the Department during the next audit period to resolve these issues.

Applicable Laws and Regulations

Section 85.50.40.a of the Office of Financial Management's *State Administrative and Accounting Manual* states in part:

> Daily, cash is to be counted and reconciled with the appropriate records reflecting the day's transactions. All differences are to be investigated to ascertain the reason for the discrepancy.

Section 85.20.10.c, states that:

> On a daily basis, collections are to be counted and reconciled with cash receipt records and local account deposit slips. Any differences between the deposits and records of receipts are to be investigated and resolved.

Section 20.20.30.a, states in part:

> The agency director has the ultimate responsibility for establishing, maintaining, and reviewing the system of internal control in the agency.

Section 85.54.60.c, states that:

> Any adjustment increasing or decreasing the amount of receivables carried on the books of an agency is to be supported by a revised billing document, a credit memorandum, or other appropriate documentation. Written procedures are to be developed and followed to ensure that only authorized adjustments are recorded.

03-39 The Department of Labor and Industries does not have adequate internal controls over cash receipts and disbursements in its Self Insurance section.

Description of Condition

Cash Receipts

The Self Insurance section of the Department collected more than $156 million during the audit period from self-insured employers, including payments of quarterly assessments, initial funding of pension obligations and reimbursements of pension benefits. Of the total collected, $114 million was sent directly to the bank by employers and the bank made the deposits to the Department's account. The remaining $42 million was received at the Department's Tumwater headquarters building.

We reviewed internal controls over cash receipts and accounts receivable and found the following:

- Mail initially opened in the mail room is not immediately recorded on a log when opened to provide accountability over the money received.

- The spreadsheet used to bill employers and record payments received does not have adequate controls to prevent unauthorized use. It also does not provide an adequate audit trail since it does not record who created each transaction. In addition, data that is modified or deleted is not retrievable.

- Duties are not segregated among those who bill customers, handle cash receipts, maintain customer accounts in the spreadsheet and have access to employer accounts in the Department's main database.

The Self Insurance section has made improvements to its internal controls since the last audit period. It has made arrangements with the bank to receive more of its customer payments directly.

Disbursements

During the audit period, the Self Insurance section paid over $9.9 million in workers' compensation benefit refunds for cost-of-living increases to employers. We reviewed internal controls over these payments and found the following:

- An excessive amount of employees have the computer access necessary to generate a payment.

- Employees who monitor payment registers also have the access necessary to generate payments. These duties should be separated.

- Some payment registers do not show evidence that they had been reviewed by someone independent of the payment duties.

- The section does not have a system to monitor for duplicate payments.

- Checks are kept in an unsecured location allowing unauthorized access.

Cause of Condition

Although we reported the internal control weaknesses in cash receipts during the last audit period, Department personnel stated that they do not have the resources needed to develop a cash receipting system for the Self Insurance section.

The Department was not aware of the internal control weaknesses in the area of Self Insurance disbursements.

Effect of Condition

Inadequate internal controls increase the risk of loss of public funds. In addition, these conditions impair the Department's ability to prevent or detect errors and irregularities in a timely manner, if at all.

Recommendations

We recommend the Department improve internal controls over its Self Insurance cash receipting and disbursement processes.

Department's Response

Cash Receipts

When the State Auditor's Office identified the cash handling issue during the previous audit cycle, the Department took immediate action to mitigate the risks. The Department changed its processes such that all Self Insured Employers (SIEs) were required to remit their quarterly assessments, initial funding of pension obligations and reimbursements of pension benefits to a bank lockbox for direct depositing to the Department's account. The Department has continued to educate employers about the new process. A number of SIEs still have not changed their processes. They will be receiving personal notification from the Department if monies are incorrectly sent to the Department directly.

The Department agrees with the finding and has either taken the following additional action or is pursing other mitigation options as detailed below.

As more and more SIEs start sending their monies to the bank lockbox, the central office mailroom issue will cease to exist. Our Internal Audit and Facilities staffs are exploring possible alternative solutions to mitigate this issue. Given the potentially increased workload to resolve this issue, a solution will need to be reached such that workload issues are minimized.

In this interim period, the Department has instituted password protection to the spreadsheets used to bill employers and record received payments. Separate password controls are now in place. Individuals who have control of the quarterly report and lock box and cash receipts spreadsheets are different so segregation of duties has been achieved. Additionally, the

Department will investigate the feasibility of having an automated accounts receivable system designed and implemented for the Self Insurance section. Another enhancement the Department is seeking is to allow SIEs to electronically file quarterly reports and make payments electronically eliminating any possibility of compromise depending on resource availability. Additional staff has been added to allow full segregation of duties.

Disbursements

The Department has segregated duties. The individual who is the warrant register auditor no longer has access to generate a payment and vice versa. Access to allow the generation of a payment has been restricted to two individuals. Neither are involved with monitoring the warrant register. This same segregation of duties has also taken place for the special warrant registers as well. The Department feels this segregation of duties and restricted access will mitigate any potential for loss in the Self Insurance section.

Our current database is being reviewed on a periodic basis to provide an early alert when a payment to an individual has been made for a particular quarter to avoid any future duplicate payments.

We have modified our internal procedures so we now ensure staff maintains positive control of the printed warrants until turned over to the mail courier for further processing.

Auditor's Remarks

We appreciate the Department's commitment to resolving this issue. We will review the condition during our next audit.

Applicable Laws and Regulations

Section 20.20.20.a of the *State Administrative and Accounting Manual* states, in part:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

03-40 The Department of Labor and Industries does not perform a periodic reconciliation between its unique disbursement systems and the financial system.

Background

The Department has three large unique computer systems used to disburse workers' compensation benefits that operate independently of each other and independent of other state financial systems. They are:

Medical Information Payment System (MIPS)
Benefit Payment System (BPS)
Pension Payment System (PPS)

Description of Condition

We compared six months of activity between the Department's overall financial system and two of the systems identified above and found the following differences:

	Financial System	Unique System	Difference
PPS	$ 205,329,314	$ 207,927,726	$ 2,598,411
BPS	$ 260,888,522	$ 267,010,340	$ 6,121,818

We were unable to perform a comparison between MIPS and the financial system because no MIPS report was available.

The Department has several other unique systems not mentioned in this finding that also are not reconciled to the financial system.

Cause of Condition

The Department stated it does not have enough staff to perform the reconciliations in a consistent and timely manner. We do not know what caused these differences.

Effect of Condition

When the Department does not perform reconciliations between its unique systems and the financial system, it does not have assurance that the amounts reported in any of the systems are accurate and free of errors or irregularities. Maintaining accurate information in its financial system is important to legislators, Department staff and others in policy-making and budget-setting positions.

Recommendations

We recommend that the Department perform periodic reconciliations between its unique systems and the financial system and make appropriate adjustments to the system(s) if discrepancies are detected.

Department's Response

The Department concurs with this finding. The systems identified in the finding were not originally designed to support periodic reconciliation to AFRS for payment transactions. The agency will seek options available to improve the reconciliation for systematic payments within our resource allowances.

Auditor's Remarks

We appreciate the Department's commitment to resolving this issue and will review its progress during the next audit.

Applicable Laws and Regulations

Section 20.20.20.a of the *State Administrative and Accounting Manual* states, in part:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

03-41 The Department of Transportation's Washington State Ferries Division does not have adequate controls over ticket sales and revenue collection.

Background

We have reported inadequate controls over revenue collection at the Washington State Ferries Division in reports dating back to 1986. The Washington State Ferries Division uses point-of-sale and automated revenue control systems to track money collected at ferry terminals. Approximately $113 million was collected in 2003. Independent contractors at terminals in the San Juan Islands and in British Columbia collected an additional $2.7 million. While the Ferries Division has worked to strengthen internal controls over recorded sales, additional controls are needed to ensure all sales are recorded. Neither our Office nor the Ferries Division can estimate how much is lost due to unrecorded sales.

During the past year, a Ferries Division investigation concluded that a seller had misappropriated funds from unrecorded sales on several occasions. Division staff learned of this when a customer reported having received an unusual looking, hand-written receipt. Staff determined that this transaction was not recorded in the official receipt records, nor was this money in the seller's deposit for the day. Their investigation also included video surveillance of the seller in question for a five-day period. Their documentation of this video surveillance showed that the seller had misappropriated approximately $300 in unrecorded receipts for those five days. The Ferries Division has approximately 190 full and part-time sellers. This incident further demonstrates the need for strong controls.

Description of Condition

Our audit revealed that controls over revenue collections at ferry terminals do not provide reasonable assurance that public funds are safeguarded. Improved controls are needed due to the large amount of money collected and the large volume of transactions processed by individual sellers. Currently, the Ferries Division must rely on seller entries into the system to determine how much has been collected.

Controls in place to detect unrecorded sales include the electronic display of amounts due and signs at each booth notifying customers of the telephone number to call if they do not receive a correctly printed receipt. However, these controls are inadequate to ensure that all money collected is recorded in the system.

Specifically:

- No system is in place to ensure that all sales are recorded. Money from unrecorded sales could be lost or misappropriated, without detection by management in a timely manner, if at all. The Ferries Division does not independently collect vehicle and passenger counts for comparison to revenue collected by individual sellers or in total. Inadequate compensating controls are in place to provide the necessary protection for public funds.

- Frequent-user ferry coupons collected by sellers in booths and ticket takers in the terminal traffic lanes are not adequately controlled. Historically, coupons represent about 45 percent of the total vehicle and passenger transactions. Unless requested, customers do not receive a receipt when they pay with a frequent-user coupon. In addition, the

Ferries Division performs only limited reconciliation of coupons collected to what is entered in the point-of-sale system. This increases the risk that a coupon could be used more than once or that a cash sale could be entered incorrectly as a coupon collection in order to misappropriate cash without detection.

In addition to these control issues, Ferries Division management did not report the misappropriation to our Office, as required by state law.

Cause of Condition

Ferries Division management stated that it does not believe it is cost-effective to put in place additional controls using the current point-of-sale system.

Effect of Condition

The Ferries Division's inadequate internal controls increase the risk that the loss or misappropriation of public money may not be detected in a timely manner, if at all, and in fact, allowed a misappropriation to occur. Further, when management does not report to us known or suspected losses of funds, it hampers our ability to conduct our audit.

Recommendations

We recommend that the Ferries Division develop and follow additional controls to provide reasonable assurance that public funds are adequately safeguarded.

We also recommend that the Ferries Division report to us any known or suspected losses of public assets, as required by state law.

Agency's Response

Washington State Ferries (WSF) does not concur with this finding. Management has balanced considerations of cost, benefit, and risk, and believes the current system of internal controls is adequate given the existing point-of-sale receipting system. The fact that no significant employee theft losses have been discovered in the eighteen years the auditors have reported this condition underscores this assessment. WSF has made improvements to internal control every year, including the recent addition of a Ferries Division internal audit function. WSF is in the process of replacing the current point-of-sale system with an electronic fare system, scheduled for implementation in 2006. In the interim, WSF will continue to examine new ways to cost effectively mitigate system weaknesses.

WSF will provide our corrective action plan to the Washington State Office of Financial Management within the allotted thirty-day time frame after the Statewide Accountability Report is issued.

Auditor's Concluding Remarks

As first reported in 1986, our concern with the Ferries Division revenue collection system is that it does not adequately prevent nor would it adequately detect unrecorded sales that could then be misappropriated. The inability of the system to adequately detect unrecorded sales severely hampers the ability to discover misappropriation. Therefore, we disagree with the statement of

Ferries Division management that the lack of discovery of a significant employee misappropriation in the last 18 years supports an assessment that additional controls are not needed. Further, if a misappropriation were discovered, the system would be inadequate to determine its magnitude.

We reaffirm our finding and will review any new procedures and their effectiveness during our next audit.

Applicable Laws and Regulations

RCW 43.09.185 states:

> State agencies and local governments shall immediately report to the state auditor's office known or suspected loss of public funds or assets or other illegal activity.

03-42 The Department of Transportation's Washington State Ferries Division made travel payments to employees in excess of contract amounts and lacked adequate controls over travel payments.

Background

The Department's Ferries Division pays employees time and mileage to travel to work under circumstances negotiated in union contracts. We audited travel payments for licensed employees governed by a contract between the Ferries Division and the National Marine Engineers Beneficial Association (MEBA), the union representing some Ferries Division workers.

Payments for travel time and mileage are processed through the payroll system. Employees record hours spent traveling and related mileage on their time sheets. During fiscal year 2003, 190 licensed employees were paid approximately $1.3 million under the MEBA contract for travel time outside the normal workday and for mileage.

We reviewed pay for travel time and miles for 17 Ferries Division employees who were among those who received a significant amount of travel pay. We reviewed a total of 45 months for those employees.

Description of Condition

We found that some employees were overpaid for travel when they claimed the wrong starting point for trips. We also found that the Ferries Division paid others for travel in excess of written contract limits, at management's direction. Both situations are described below.

- Three of the 17 employees reviewed were overpaid $67,110 because they claimed the wrong starting point for trips when calculating hours and miles traveled. For some travel, employees are to be paid for time and miles starting from the terminal closest to the employee's residence. This is referred to as the employee home terminal by the Ferries Division. We found that three employees had designated on their timesheets a home terminal that was not the terminal closest to their residence. For 11 months of timesheets we audited for these three employees, we found a total overpayment of $7,912. Additionally, during our fiscal year 2002 audit, we reviewed timesheets for one of these three employees for July 1998 through March 2002 and found an additional $59,198 of overpayments due to the wrong home terminal designation.

- We also found that for the crews of one vessel, the Ferries Division paid for travel in excess of written contract limits. For ferries serving the San Juan Islands, the MEBA contract authorizes payment of one round trip per week from the employee's home terminal to the vessel's normal relieving terminal. However, for those who work on the ferry vessel that has the San Juan inter-island route, the Ferries Division has been allowing three and a half hours of travel pay for daily round trips between Friday Harbor and Anacortes. The Ferries Division has designated Anacortes as the normal relieving terminal for this vessel. Crew changes normally occur at Friday Harbor for this vessel. Employees assigned to any other ferry vessel are not compensated daily for travel to and from the destination where crew changes normally occur. Management has not clearly explained how the contract authorizes these payments.

For the 17 employees included in our review of timesheets, three were receiving daily Friday Harbor/Anacortes travel pay. For the 11 months of pay orders we examined for these three employees, $7,656 was paid for this daily travel. Additionally, during our fiscal year 2002 audit, we looked at timesheets from August 2000 through April 2002 for an employee not included in this year's audit and found $22,739 of travel payments for the daily Friday Harbor/Anacortes travel.

We also identified the following weaknesses in controls over travel pay:

- The Ferries Division has not documented, in writing, its interpretations of the union contract or other practices it considers binding relating to travel pay. Therefore, we found a lack of clear and consistent guidance to aid employees in submitting and approving travel claims.

- Employees record their home terminal on their time sheets. The home terminal designations are not verified consistently to ensure they are accurate.

- Time sheets do not provide enough detail of travel being claimed. Employees complete one time sheet for a two-week period. The time sheets contain one space for trip origination and one for destination, and a remarks section for any other detail. The form does not allow for or require information by trip. When multiple trip originations and destinations are on the same time sheet, determining what point-to-point travel is being claimed can be difficult.

Cause of Condition

- Overpayments of travel based on incorrect employee home terminal designations are caused by employees designating the wrong home terminal on their time sheets and inadequate management review to detect errors.

- Ferries Division management stated payments for daily travel in the San Juan Islands were intentionally made.

- Ferries Division management stated that it will not document its travel-related compensation practices without the union's participation because this could be an improper unilateral action, even when the practices continue.

- Ferries Division management also stated that it believes the current time sheet form requires sufficient travel detail.

Effect of Condition

Employees are being paid in excess of contract limits for travel. Further, the Ferries Division is more likely to apply travel rules inconsistently as long as those rules are not all in writing.

Recommendations

We recommend that the Ferries Division:

- Enforce contract provisions to avoid excess payments that create a risk that the Ferries Division could become obligated to continue the payments.

- Include in the contract, or document in writing, existing binding compensation practices related to travel pay.

- Improve controls to ensure that the determinations of employee home terminals are correct. This should include maintaining a list of employee home terminals, verified for accuracy, and available to staff that approve travel-related claims.

- Require sufficient information that clearly identifies the point-to-point travel being claimed.

- Consult with legal counsel about whether to require employees to repay the excess travel payments.

Agency's Response

Washington State Ferries (WSF) does not concur with the condition noted regarding payments to employees in excess of ***written*** *contract terms. Ferries management believes the auditors are inappropriately questioning the well-established principles of past practice as a basis of rules governing matters not included in the written contract and the right of the agency to interpret and apply those principles in determining rights and benefits under the contract. Further, the auditor appears to be inappropriately questioning whether WSF negotiated well. WSF also disagrees with the recommendation that this and other unwritten, yet binding compensation practices be summarized in writing, as this could constitute an improper unilateral action.*

WSF partially concurs with the internal control conditions noted. WSF has begun a review of all employees' home terminal designations, and plans to perform such a review periodically. With respect to the level of detail available on timesheets WSF believes the current timesheet does not need to be revised. Although the auditor's sample identified timesheets for which the initial detail was inadequate, in all cases they were satisfied the employee was properly compensated.
WSDOT will provide our corrective action plan to the Washington State Office of Financial Management within the allotted thirty-day time frame after the Statewide Accountability Report is issued.

Auditor's Concluding Remarks

We reaffirm our finding and will review any new procedures and their effectiveness in our next audit. In addition, we would like to make clear that we weren't satisfied as to whether the employee was properly compensated, for every timesheet tested for which the detail was inadequate.

Applicable Laws and Regulations

National Marine Engineers Beneficial Association (MEBA) contract for 1997 to 1999 and 1999 to 2001 (still in effect).

Section 12(a) states:

> When travel pay is authorized under any rule of this Agreement, it shall be paid at the straight-time rate of pay for the appropriate travel time indicated in Schedule A, attached hereto. If the employee furnishes transportation under such circumstances, he/she shall be reimbursed for the appropriate number of miles only for travel actually performed as indicated in Schedule A, attached hereto. The mileage rate for such time shall be that allowed by the State Office of Program Planning and Fiscal Management for use of private automobiles.

Section 12(e) states:

> Payment will be made for travel and mileage actually performed from the terminal closest to the employee's residence to the temporary relieving terminal or from the normal relieving terminal to the temporary relieving terminal, whichever is less.

Section 12(d) states:

> Regular employees permanently assigned to the San Juan Islands – Anacortes – Sidney B.C. routes or the Port Townsend – Keystone route will be paid the mileage and travel time indicated in Schedule A for one round trip per week when working, from the terminal nearest the employees residence.

03-43 The Liquor Control Board does not have adequate internal controls over revenue collected in its state liquor stores.

Background

The agency collected approximately $383 million from sales at its liquor stores during fiscal year 2003.

During our audits of fiscal years 2000 and 2001, we found several areas in which money collected at liquor stores was not adequately safeguarded from misappropriation. One significant weakness in controls over bank deposits remained at the end of our last audit, and we communicated this to management. During this year's audit, we confirmed that this weakness continues.

Description of Condition

Bank deposits prepared by the store managers are not independently monitored to ensure the deposit reconciles with the transactions recorded in the store's point-of sale computer system, either in total or by mode of payment (i.e. cash and check). Store personnel do not perform this comparison after the deposit has been made, leaving the person who makes that deposit with too much control over these funds.

Further, more than one person has access to the bank deposit before it is made.

The lack of controls described above creates a risk that:

- Money could be taken from the deposit. If it is detected by staff in the finance division, management may not be able to determine who is responsible.

- Checks could first be misappropriated and not recorded in the store's point-of-sale computer system, then later substituted for cash in the deposit. If this occurs, finance staff would not detect the loss because the total amount deposited would match the total entered into the point-of-sale computer system. Our audit experience in other state agencies proves that misappropriations can and do occur when management does not compare the check and cash composition of receipts to bank deposits.

Cause of Condition

The Board does not require its stores to reconcile transactions from its point-of-sale computer system to the bank deposit, after the deposit is made with the bank. Reconciliations at the store occur beforehand. Further, more than one person at the store has access to the deposit before it is made.

Effect of Condition

Inadequate internal controls increase the risk that public funds will be misappropriated or lost and impair the agency's ability to prevent or detect errors and irregularities in a timely manner, if at all.

At Liquor Store Number 2 in Seattle, the agency lost $650 from three deposits in late 2002 and early 2003. While this was detected by agency finance staff, it was only because the deposits were less than what was reported as receipted, and was not the result of substituting checks for cash as described above.

Recommendations

We again recommend that the agency establish and follow procedures for each store to properly reconcile receipt records to bank deposits, in total and by mode of payment (i.e. cash and check), to adequately protect public funds.

We further recommend that each store's deposit be kept in the custody of one person at a time, and when custody is transferred, staff count the funds and document the transfer.

Agency Response

The annual audit also resulted in a finding regarding internal controls over bank deposits made by state liquor stores. Specifically, there were two concerns identified: 1) reconciliation of the deposit is not made by the store to assure total deposit amount or mode of payment, and 2) more than one person has access to the bank deposit before it is made.

Although immediate reconciliation of the deposit is not performed at the stores, reconciliation of total deposit amounts is done by Financial staff at Headquarters. However, system limitations currently prevent reconciliation of mode of payment by Financial Staff. This ability is one of the improvements our new POS system will address in phase 2 of its implementation. In the meantime, a process improvement team including members of Finance, Retail, Internal Audit and representatives of our labor partners will explore options for addressing the finding, given limited staffing levels in the stores.

The LCB is taking these issues very seriously and will make every effort to further increase the protection of state resources. Again, the Board Members and staff of the Liquor Control Board appreciate the work done by the State Auditor's Office and look forward to the continued cooperation for the benefit of the state.

Auditor's Concluding Remarks

We appreciate the agency's efforts in addressing this finding and will review its progress toward resolving this issue during our next regular audit.

03-44 The Department of Social and Health Services, Office of Accounting Services, does not have adequate internal controls over the Foster Care Trust Fund.

Background

The Department of Social and Health Services, Office of Accounting Services, is the custodian for the Foster Care Trust Fund, which holds funds belonging to children placed in foster care by the Department. The Office's Trust Fund Unit maintains these funds in a bank account. The Unit is responsible for receiving these funds, ensuring that they are properly deposited, withdrawing them for the benefit of the children, maintaining accurate records for each child, and reconciling bank statements. Most Unit activities involve withdrawals, made when expenditures on behalf of a child are authorized. The balance in the bank account usually totals about $3 million.

Description of Condition

We found the following weaknesses in internal control:

- Duties are not properly segregated, as the Unit supervisor has complete access to the Trust Fund. The supervisor is able to prepare a bank withdrawal slip, sign it as the authorizer, and receive the amount from the bank. The supervisor also is able to authorize a deposit, prepare a deposit slip, and then take the deposit slip to the bank. In addition, the supervisor prepares the monthly bank reconciliation. These activities are not independently reviewed by management.

- All three employees in the Unit, including the supervisor, have complete access to the state's automated payment system and can enter transactions, approve those transactions, and correct errors. (See related finding 03-15.) In addition, the warrant register, which could be independently reviewed to determine if proper payment was made, is returned to the individual who entered the transaction data.

- As of September 2003, the Unit was three months behind in completing bank reconciliations.

Cause of Condition

The Office has not made it a priority to develop and follow policies and procedures that would provide adequate segregation of duties for the supervisor, management review of the supervisor's activities, adequate controls over access to the payment system, and timely bank reconciliations.

Effect of Condition

These weaknesses in internal control increase the risk that the children's funds could be misappropriated or lost and impair the Department's ability to prevent or detect errors and irregularities in a timely manner, if at all.

Recommendations

We recommend the Office develop and follow policies and procedures to provide for adequate segregation of the supervisor's duties, management review of the supervisor's activities, adequate controls over access to the payment system, and timely bank reconciliations.

Department's Response

The Department partially concurs with this finding. However, it is important to note the audit review was concurrent with the final testing, conversion and implementation of the new Children's Trust Fund accounting and reporting system. During the conversion we could not follow some of our normal processes.

The Trust Fund Supervisor does currently have signature authority on the US Bank accounts. However, it is the policy and practice of the office to require two signatures for all account withdrawals. This policy is strictly adhered.

There is also separation of duties for bank deposits. The Trust Fund employees prepare A19s through the Children's Trust Fund system to deposit funds with the bank. The A19 is payable to the bank and includes the bank account number. The OAS Cash Unit employees provide the input processing for AFRS.

The bank reconciliation is normally completed upon receipt of the bank statements. However, as a result of the conversion to the new Children's Trust Fund system and the subsequent problems with reports, the bank reconciliations were completed by the Trust Fund Supervisor and system programmer. Under normal conditions, bank reconciliations would be completed by employees assigned to a unit independent of the Children's Trust Fund system and the bank statements would be mailed directly to this employee from the bank. As was explained to the SAO auditor, this was a temporary situation that occurred for a few months and non-trust fund employees will resume the monthly reconciliations, consistent with past practices.

The department partially concurs there is a need for increased segregation of duties and will ensure controls are in place for bank withdrawals and deposits, bank reconciliations, and AFRS access and warrant register review.

Auditor's Concluding Remarks

Except for the preparation of bank reconciliations, we disagree that the conversion to the new accounting and reporting system contributed to the weaknesses we identified.

Accounting Services states its policy requires two signatures for bank withdrawals. However, the bank only requires one signature. If an individual wanted to withdrawal funds for inappropriate reasons, he/she could do so.

Accounting Services states that there is separation of duties for bank deposits. We disagree. Under the current procedures, a deposit to the bank follows a disbursement from the Office of State Treasurer. This disbursement is made through the use of the Agency Financial Reporting System. At the time of our audit, the Trust Fund Supervisor had the ability to create and release a warrant through that system. Because of this lack of segregation of duties, inappropriate payments could be made from trust funds.

We appreciate that Accounting Services understands the need for increased segregation of duties. We will review this area again in our fiscal year 2004 audit.

Applicable Laws and Regulations

The State of Washington Office of Financial Management's *State Administrative and Accounting Manual*, Section 20.20.20.a states in part:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

Section 20.20.70.a states in part:

> Control activities are the policies and procedures that help ensure management directives are carried out.
>
> **Segregation of duties -** Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions. For example, responsibilities for authorizing transactions, recording them, and handling the related assets should be separated.

03-45 The Washington State Commission on African-American Affairs does not have adequate internal controls over its disbursements, which resulted in a loss of at least $5,857.

Background

The Commission employs two individuals, an Executive Director and an Executive Assistant. The current Director was appointed in January 2004. The Commission contracts with the Office of Financial Management's Small Agency Client Services (SACS) to provide accounting, budgeting, and payroll services.

Description of Condition

During our audit, we determined that the Commission incurred losses totaling at least $5,857 between January 2001 and December 2002.

- Neither our Office nor Commission personnel could determine whether long-distance telephone calls with a cost of at least $3,115 were business-related. Of this amount, calls with a cost of $515 were made using a long-distance code of a former employee. The remaining $2,600 was paid by the Commission for more than 4,700 long-distance calls. We were unable to determine who made the calls since the caller did not use the state long-distance system, which requires an access code. During our last audit, we brought this issue to the attention of Commission management and recommended that all calls be placed through the state's phone system.

- The Commission purchased items in 2002 totaling at least $2,022 that could not be located during our audit. Items included moving boxes, a surge protector, a hand truck, computer speakers, a dry-erase board, luggage and other miscellaneous supplies.

- Tuition of $720 was paid by the Commission to reimburse a former employee for the spring 2001 quarter, but the Commission did not verify whether the class was successfully completed, as required by state regulations. The former employer resigned in November 2002. We contacted the College that offered the course and found the employee had not completed it.

The reported conditions occurred under the former Executive Director, who resigned on July 31, 2003.

Cause of Condition

The losses occurred and remained undetected by the Commission due to the lack of internal controls. Although SACS provides accounting services, Commission employees were able to perform the purchasing, receiving and approval functions without adequate oversight.

During the prior audit, we identified a misappropriation of at least $545 committed by a different former employee. At that time, we recommended that the Commission improve internal controls.

Effect of Condition

Without adequate internal controls, the risk is increased that assets could be misappropriated and not be detected in a timely manner, if at all.

Recommendations

We again recommend the Commission strengthen its internal controls over disbursements, assets and phone usage to guard against misappropriation and to ensure compliance with state regulations.

We also recommend the Commission seek reimbursement from the former employee for the cost of college tuition for the class that was not successfully completed.

Commission's Response

The Commission has addressed concerns identified in the Schedule of Audit Findings as follows:

Item 1 – Telephone Charges – As discussed with the Auditor's Office, new controls have been instituted and the Commission telephone system has been modified to block untraceable long-distance telephone calls. The Commission telephone system no longer allows chargeable long distance calls to be placed without an authorized long-distance code. All long-distance calls charged to the Commission must be placed through the state's phone system.

Item 2 – Supplies and Purchased Items – The Commission shares office and storage space with four other small state agencies. Given these limitations, reasonable controls over purchased items and supplies have been or will be instituted, including (a) separately identifiable storage space for non-shared consumable supplies, (b) a policy that all Commission purchases must be approved by the executive director prior to payment or reimbursement; (c) clear, visible, inventory labeling of Commission valuables that are likely to be misappropriated or mistakenly removed by others, and (d) construction of a reception area at the office entryway, if feasible, to create a barrier limiting access of non-agency personnel to storage areas of the Commission's purchased items and supplies.

Item 3 – Tuition Reimbursement – The executive director has reviewed WAC 356-39-100 and has, consistent with section 356-39-100, instituted a policy that tuition reimbursement for Commission employees will require (a) written approval by the executive director prior to commencement of the qualified course, and (b) written documentation of satisfactory course completion prior to tuition reimbursement being paid by the Commission, unless good cause is shown for prepaying an employee's tuition or registration fees. If the Commission prepays tuition or fees, satisfactory completion of the course by the employee within a reasonable time period remains required.

Additionally, a letter from the Commission is being forwarded to the former employee seeking clarification of the terms of the spring 2001 tuition reimbursement and requesting, if appropriate, reimbursement of the tuition paid by the Commission.

Conclusion - The executive director is reviewing, refining and updating all Commission internal policies. Consistent adherence to these policies, in addition to the actions outlined above, will

provide reasonable assurance that misappropriation will be minimized and will ensure compliance with state regulations.

Auditor's Concluding Remarks

We appreciate the Commission's commitment to resolve the issue identified in the finding.

Applicable Laws and Regulations

Section 20.20.20.a of the *State Administrative and Accounting Manual* states, in part:

> Each agency director is responsible for establishing and maintaining an effective system of internal control throughout the agency.

The *Washington Administrative Code*, section 356-39-100 states:

> Agencies may approve for full or partial tuition reimbursement a qualified course conducted by an educational institution, vocational school, or a professional training organization….
>
> > (2) Agencies shall reimburse eligible employees who have satisfactorily completed a course which was previously approved for tuition reimbursement. Agencies may prepay employee's tuition or registration fees.

03-46 The Washington State Historical Society has not established adequate internal controls over its local bank account and investments.

Background

The Society has a bank account that is used to pay operating expenses. Revenue from membership contributions, donations, customer sales, investment interest and other miscellaneous receipts are deposited into the account. During the audit period, $1.6 million was deposited into the account and $1.7 million was paid from the account. The Society also has investment accounts totaling $1.6 million at the end of the fiscal year.

Description of Condition

During our audit, we determined that the Society has not established adequate segregation of duties between writing checks, signing checks and performing the monthly bank reconciliation. In addition, the duties of making investment withdrawals, posting investment interest to the accounting system and preparing investment reports are not segregated. The reports are used by management to assess investment performance and make future investment and financial decisions.

Cause of Condition

The Society's small staff size makes it difficult to segregate key duties.

Effect of Condition

The lack of internal control increases the risk that money in the bank and investment accounts could be misappropriated and not be detected in a timely manner, if at all.

Recommendation

We recommend that the Society establish and follow policies and procedures that require adequate segregation of duties.

Society's Response

As segregation of duties regarding the local checking account is impractical, the internal control committee will perform periodic reviews of the monthly bank reconciliation. The Society will segregate duties so that all investment transactions will be initiated by the fiscal officer, approved by the director and verified against the original bank statement by the Administrative Officer.

Auditor's Concluding Remarks

We appreciate the Society's efforts in addressing this finding and will review its progress toward resolving this issue during our next regular audit.

Applicable Laws and Regulations

Section 85.32.10 of the Office of Financial Management's *State Administrative and Accounting Manual* addresses internal controls for disbursements:

> It is the responsibility of the agency head, or authorized designee, to certify that all expenditures/ expenses and disbursements are proper and correct. Agencies are responsible for processing payments to authorized vendors, contractors, and others providing goods and services to the agency. Agencies are to establish and implement procedures following generally accepted accounting principles. At a minimum, agencies are also to establish and implement the following: …Controls to ensure that all expenditures/expenses and disbursements are for lawful and proper purposes . . . .

Section 85.38.90 states:

> Agencies with local accounts are to develop and implement written procedures for controlling local checks. Procedures should provide for adequate internal control . . . .

03-47 The Washington State Historical Society has not established adequate internal controls over cash receipts.

Description of Condition

During our review of the Society's cash receipts, which total about $745,000 annually, we noted the following internal control weaknesses:

State History Museum, Tacoma:

The Museum does not have an adequate attendance monitoring system to determine if all cash received is deposited.

The pre-numbered tickets being used do not indicate the price of the ticket purchased and, therefore, the number of tickets sold during the day does not allow management to set an expectation for how much cash should be received daily. In addition, pre-numbered tickets were issued to non-paying customers, such as Museum members who do not pay for individual admissions.

The Museum's fiscal officer performs conflicting duties. The fiscal officer is the back-up cashier, has unrestricted access to the safe, records the deposit on the log and reconciles the bank-validated deposit slip to the deposit log.

The Museum has the following mail processing internal control weaknesses:

Mail was not secured prior to being opened and recorded by two individuals to protect against the loss of money received by the Museum.

The Museum did not have adequate internal controls in place to safeguard parking receipts and parking change funds. The Museum receives about $128,000 annually in parking receipts.

Collection procedures for parking receipts are not consistently enforced. The two individuals responsible for daily collections do not consistently initial the transmittal form that provides the Museum's management documented evidence that two individuals were present to collect and count the receipts.

Fiscal employees perform back-up duty to collect parking machine receipts and also perform their regular duties of counting, recording, transferring and reconciling the parking change funds.

The change fund log used to document transfers of change funds between the safe in the fiscal office and the safe in the security guard office was not consistently signed by the fiscal employee and security guard staff to verify the transfer of funds.

State Capitol Museum, Olympia:

The Museum receives about $17,000 in admission fees annually. We found the receipting process has the following control weaknesses:

The Museum has no process to monitor the completeness of revenue at the point of sale.

Cash register tapes are not independently reconciled to deposit slips to ensure receipts are deposited and intact.

One employee counts the admission receipts, makes the initial recording into the cash receipt log, prepares the deposit, takes the deposit to the bank and records admission revenue into the accounting system.

We noted other cash receipt control weaknesses as follows:

Rental agreement forms are not pre-numbered. As a result, management is unable to independently verify that all rental revenue is deposited.

The employee who is responsible for rental agreements also receives the payments.

The Museum has no mail opening procedures and mail is not secured prior to being opened.
An initial list of payments received in the mail is not kept.

The donation box revenue is collected by one employee who also records the revenue in the cash log, prepares the deposit, delivers the deposit to the bank and records the revenue in the Society's accounting system.

Cause of Condition

The Society has attempted to establish a pre-numbered ticket system that would allow management to determine if all admission receipts were recorded and deposited. However, management states employees were not trained on how to use the new system. Management also indicated that the new procedures were not adequately enforced. As a result, the new system never functioned as an effective monitoring tool.

The internal control weaknesses related to segregation of duties, mail opening procedures and procedures for collecting parking receipts were caused by a lack of emphasis on good internal controls.

Effect of Condition

Internal control weaknesses result in decreased accountability over cash receipts and an increased risk that cash could be misappropriated and not be detected in a timely manner, if at all.

As a result of inadequate internal controls, a misappropriation of at least $856 occurred at the State History Museum. The Society detected the misappropriation and promptly reported it to our Office. The employee responsible for the loss subsequently resigned from his position. The case is currently under investigation by our Office to determine whether additional amounts were misappropriated.

Recommendation

We recommend that the Society strengthen internal controls over cash receipts.

Society's Response

We concur with this finding. The agency relied on volunteers to collect tickets in addition to their regular duties of staffing an information desk, but the duties were incompatible because the volunteer workforce viewed their role as education and visitor information and not a regulatory one.

To address the above operating difficulty and the concomitant reductions in fiscal staff due to state budget constraints, the Society implemented an automated ticketing system that accounts for paying and nonpaying admissions. Oversight of the ticketing function was moved from visitor services/public relations to the fiscal office for better management accountability and systems support.

Mail procedures have been implemented at the History Museum to meet audit requirements. As segregation of duties is impractical within the existing framework of the Society, it will implement an internal control committee to perform periodic internal audits of a number of functions.

Relative to the State Capital Museum, the Society will make procedural changes that attempts to address the facility rental accountability deficiencies, secure the mail delivery, and log cash receipts by mail. The donation box will be collected by two people. As segregation of duties is impractical given the size of the staff, the internal control committee will perform periodic internal audits of a number of functions.

Auditor's Concluding Remarks

We appreciate the Society's efforts in addressing this finding and will review its progress toward resolving this issue during our next regular audit.

Applicable Laws and Regulations

The Office of Financial Management's *State Administrative and Accounting Manual* addresses cash handling:

Section 85.50.40.a states, in part:

> Daily, cash is to be counted and reconciled with the appropriate records reflecting the day's transactions. All differences are to be investigated to ascertain the reason for the discrepancy …Section 85.20.10.c states:

Section 85.20.10.c states:

> On a daily basis, collections are to be counted and reconciled with cash receipt records and local account deposit slips. Any differences between the deposits and records of receipts are to be investigated and resolved.

Section 85.54.60 states, in part:

> Transactions affecting receivables are to be supported by documents indicating all pertinent information relating to the transactions. Detailed postings of documents are to be recorded and maintained in the subsidiary ledgers for all outstanding receivables. Detailed postings are to be summarized and entered in the general ledger control account …

Section 85.54.60.a states, in part:

> Sequentially numbered billing documents (invoices) are to be used.

Other State Legal Compliance

03-48 The Department of Health did not comply with state law regarding yearly surveys of hospitals.

Background

State law requires the Department of Health to make, or cause to be made, a yearly on-site inspection of all hospitals in the state to determine compliance with laws, standards, rules and regulations. To avoid duplication, the law allows some survey exceptions when certain other professional organizations have performed recent, comparable surveys and reported the results to the Department, followed by hospital requests for exclusion from state surveys.

In addition to other sources of revenue, hospitals statewide received more than $253 million in state and federal Medicaid funds from July 2002 through December 2002 in payments for services received by clients.

Description of Condition

The Department is not complying with this requirement for yearly hospital surveys. We obtained the dates for Departmental hospital surveys conducted during calendar years 2000 through 2002 and the survey schedule for 2003, along with a list of hospitals requesting waivers because of surveys by other groups. We evaluated survey frequencies for 109 hospitals for 2002 and 2003 and found the following:

- The Department did not survey 39 of the 109 hospitals during 2002 and was not planning to survey them in 2003. The frequency of surveys from 2000 through 2003 at these hospitals ranged from 25 months to 37 months. Two other hospitals were not surveyed in 2002 but were on the 2003 schedule. None of these hospitals had received approved surveys by other professional organizations. State and federal Medicaid funds together reimbursed these hospitals at least $64,303,990 from July through December 2002.

- Other accredited organizations performed surveys at 22 of the 109 hospitals; however, the hospitals did not request exclusions from state surveys, as required, nor did they receive state surveys. State and federal Medicaid funds together reimbursed these hospitals at least $92,407,624 from July through December 2002.

Cause of Condition

The Department stated it lacks sufficient staff to survey all hospitals on an annual basis.

Effect of Condition

The state is making significant payments to hospitals for services to Medicaid clients with no assurance that the services provided are meeting state health standards and regulatory requirements.

Recommendations

We recommend the Department comply with the state law regarding annual hospital inspections. Alternatively, we recommend the Department request, at the next opportunity, either an appropriate change in the legislation or increased funding to ensure it can meet current requirements.

Department's Response

We concur with the finding by the State Auditor's Office. The department will look carefully at whether the public's interest would be adequately served if we requested a legislative change in how often we were required to survey hospitals. Alternatively, we will attempt to secure additional funding in order to remain in compliance with current requirements.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolving the issues identified in the finding and will review its progress during our next regular audit. We also appreciate the cooperation extended to us throughout the audit by Department staff.

Applicable Laws and Regulations

RCW 70.41.120 states in part:

> The department shall make or cause to be made at least yearly an inspection of all hospitals….The department may make an examination of all phases of the hospital operation necessary to determine compliance with the law and the standards, rules and regulations….

RCW 70.41.122 states in part:

> …a hospital accredited by the joint commission on the accreditation of health care organizations or the American osteopathic association is not subject to the annual inspection provided for in RCW 70.41.120 **if**:
>
> 1) The department determines that the applicable survey standards of the…commission…or the…association are substantially equivalent to its own;
>
> 2) It has been inspected by the…commission…or the…association within the previous twelve months; and
>
> 3) The department receives directly from the…commission…, the…association, or the hospital itself copies of the survey reports…demonstrating that the hospital meets applicable standards.

Washington Administrative Code 246-320-025 states:

On-site licensing survey. The purpose of this section is to provide annual on-site survey requirements in accordance with chapter 70.41 RCW.

(1) The department will:

(a) Conduct at least one on-site licensing survey each calendar year to determine compliance with the provisions in chapter 70.41 RCW and this chapter;
(b) Notify the hospital in writing of state survey findings;
(c) Contact the hospital to discuss the findings of an on-site licensing or joint commission on accreditation of healthcare organizations (JCAHO) survey when appropriate; and
(d) Not conduct the annual on-site licensing survey when requested by a hospital accredited by JCAHO in accordance with subsections (2) and (3) of this section.

(2) A hospital accredited by the JCAHO may request exclusion from an annual on-site licensing survey during the year of the JCAHO survey. To request exclusion, a hospital must submit to the department:

(a) A written request asking to be excluded from the annual on-site licensing survey during the calendar year in which the hospital will be surveyed by the JCAHO;
(b) The written request at least thirty days prior to the beginning of the calendar year for which the exclusion from an annual on-site licensing survey will be made;
(c) Verification of current JCAHO accreditation; and
(d) A copy of the decisions and findings of the JCAHO survey within thirty days of receipt of the final JCAHO survey report.

(3) The department will grant an exclusion from the annual on-site licensing survey when:

(a) The hospital:

(i) Meets the requirements in subsection (2) of this section; and
(ii) Verifies current JCAHO accreditation;

(b) The department determines the JCAHO survey standards used at the time of the JCAHO survey exceed or are substantially equivalent to chapter 70.41 RCW and this chapter.

(4) A hospital excluded from an annual on-site licensing survey in accordance with this section:

(a) Is not subject to an annual on-site licensing survey during the calendar year the hospital is surveyed by the JCAHO and for twelve months after the date of the JCAHO survey; and
(b) Must notify the department in writing of any changes in JCAHO accreditation status within ten days of receipt of the accreditation report from the JCAHO.

03-49 The State Printer does not bill agencies on an actual cost basis as required by state law.

Background

The State Printer provides printing, binding and other services and supplies to state departments, commissions, institutions, boards and officers. During fiscal year 2003, it billed these customers more than $34 million. Of that amount, $15 million was for work performed by outside vendors for the Printer; the balance of $19 million was for services or supplies provided directly by the State Printer. State law requires the Printer to bill for actual costs. The Printer's billing system contains detailed itemizations of the estimated costs as well as the actual costs of production.

Description of Condition

During our audit, we randomly selected 11 billing invoices for services provided directly by the Printer to a variety of state and local agencies. We found that 10 of these 11 billing invoices were based on estimates, rather than actual costs, even though the billing system could be programmed to bill for the latter. Actual costs for seven of these 10 were less than the estimated costs billed, while actual costs for the other three were more than the estimated costs. The Printer did not provide documentation demonstrating that these over- and under-charges evened out on an agency-by-agency basis.

Cause of Condition

The Printer has chosen to program its billing system to charge customers estimated costs instead of actual costs. It believes that, on an overall basis, over- and under-charges even out.

Effect of Condition

Agencies cannot determine if they are being charged the correct price for the printing services they receive. They may be overcharged in some cases and undercharged in others.

Recommendations

We recommend the Printer program its billing system to generate billing invoices that charge customers actual costs incurred.

Department's Response

Thank you for the opportunity to respond to the draft audit finding that focused on a number of activities during fiscal years 2002-2003. Although we do not concur with the results of the audit, we appreciate the fact that the State Auditor has acknowledged our efforts of safeguarding public assets under our control and maintaining the highest level of integrity and accountability.

The Department of Printing will provide our corrective action plan to the Washington State Office of Financial Management within the allotted 30-day time frame after your organization issues the final Statewide Accountability Report for FY03.

We value the contributions and assistance of your office.

Auditor's Concluding Remarks

We appreciate the Printer's efforts in addressing this finding and will review its progress during our next regular audit.

Applicable Laws ands Regulations

RCW 43.78.080 states in part:

> Printing specifications. All printing, ruling, binding, and other work done or supplies furnished by the state printing plant for the various state departments, commissions, institutions, boards, and officers shall be paid for on an actual cost basis as determined from a standard cost finding system to be maintained by the state printing plant.

03-50 The Department of Labor and Industries did not allocate indirect costs equitably among its programs and funds.

Description of Condition

The Department has at least five divisions, the Director's Office, Human Resources, Administrative Services, Regional Administration and Legal Services, that provide central administration services. As we also reported last year, our review of the budget process at the Department found no reasonable process in place to allocate these indirect costs to each fund and program.

The Department charges 99 percent of its central administrative costs to the Workers' Compensation accounts. We estimated an indirect cost allocation and determined that the following accounts were not paying their full share by the following amounts:

General Fund	$ 783,408
Public Safety and Education Account	383,478
Electrical License Account	1,889,103
Farm Labor Revolving Account	1,963
Worker and Community Right to Know	96,928
Plumbing Certificate Account	71,632
Pressure Systems Safety Account	185,877
	$3,412,389

These amounts are being charged in excess to:

Workers' Compensation Accounts	
Accident Account	$1,199,008
Medical Aid Account	2,213,381
	$3,412,389

The Department did develop an indirect cost allocation methodology, but has not begun to use it yet.

Cause of Condition

Department officials indicated that revenue is not available to pay indirect costs in some programs without reducing direct services to customers, especially those that are funded by fees to the public since Initiative 601 limits fee increases. Officials also stated that state budget cuts have resulted in a decrease of general fund money, making it difficult to cover indirect costs.

Effect of Condition

When the Department does not use a reasonable indirect cost allocation plan, certain funds are supporting other funds, while others are not paying their share of these expenditures.

Recommendations

We again recommend that the Department request additional money from the Legislature to cover indirect costs and/or seek legislative approval to raise fees, where necessary, in excess of the fiscal growth factor so that it will be able to allocate its indirect costs equitably among its funds and programs. We also recommend that the Department reimburse indirect costs to the funds that paid more than their share.

Department's Response

As the State Auditor's Office noted, the Department has developed an indirect cost allocation methodology since last year's finding. The Department hired an outside consulting firm with experience developing indirect cost allocation models in April 2003 to help develop a methodology grounded by an indirect cost allocation policy. An assessment was completed within Administrative Services to evaluate allocation alternatives for each cost center and a blended model was developed based on that assessment. The Department then met with key stakeholders including the State Auditor's Office and the Office of Financial Management beginning in October 2003 to brief them on the results of the cost allocation review.

While it appears the Department has not implemented the new methodology, the Department cannot act alone; we must first receive Legislative approval to redistribute the funds based on the new allocation methodology. We have taken the first opportunity available by submitting an FY 2004 supplemental budget request. This request has been included in the Governor's supplemental request and we are currently awaiting action from the Legislature.

The Department is concerned about the implications of any retrospective application of this finding. A transfer of revenue of $7,000,000 from the Electrical Fund, $1,000,000 from the Pressure Systems Safety Account, and $200,000 from the Asbestos Account to the General Fund was enacted by the Legislature during the 2003 legislative session further creating the potential for a devastating impact to services if the retrospective finding is applied. The Department included a request to restore the revenue transfer back to its original funds from the General Fund in the Department's FY 2004 supplemental budget request. However, this request was not included in the Governor's supplemental request. Hence, the Department will not apply any retrospective application of previous indirect cost allocation inequities due to current insufficient funding.

In addition, according to the State of Washington Status of Audit Resolution December 2003, the Legislature provided proviso language in response to the Department of Natural Resources 2003-05 budget request for retroactive application indicating it was neither practical nor desirable. This was acceptable to the State Auditor's Office to resolve the prior biennia issue. We will pursue this option with the Legislature as well.

The Department will continue to work with the State Auditor's Office, Legislature, and affected stakeholders on the cost allocation issue.

Auditor's Remarks

We appreciate the Department's efforts in addressing this finding and will review its progress toward resolving this issue during the next regular audit.

Applicable Laws and Regulations

The Revised Code of Washington (RCW) 43.09.210 prohibits one fund from supporting another. It states in part:

> …no department, public improvement, undertaking, institution, or public service industry shall benefit in any financial manner whatever by an appropriation or fund made for the support of another.
>
> The Attorney General's Office has determined that this law applies to state agencies as well as local governments. The State Supreme Court upheld this interpretation in 1983 (State v. Grays Harbor County, 98 Wn.2d 606 (1983).

03-51 The Department of Labor and Industries destroyed inventory records prior to the approved destruction date.

Background

State law requires governmental entities to promote and support the orderly and efficient management of their records. Records retention and disposition schedules are vital to every records management program. The purpose of these schedules is to ensure that records are retained for as long as they are needed for administrative, fiscal, legal and historical/research purposes. Minimum records retention periods are determined by careful study and analysis of records by the agencies' appointed records officer to determine their potential value for these purposes.

Description of Condition

During the course of our audit, we discovered that all Property Disposal Requests completed prior to January 1, 2001 detailing lost or stolen equipment subsequently removed from the inventory system had been destroyed. Additionally, we noted that all Monthly Activity Reports from the inventory system had been destroyed. According to the state records retention schedule, these documents must be maintained for a minimum of six years.

Cause of Condition

Department officials misinterpreted the records retention schedule related to the Property Disposal Requests. They initially thought the documents were subject to a shorter retention period. The Department was not aware that Monthly Activity Reports had to be retained.

Effect of Condition

Destroying inventory records in advance of the approved destruction date creates the potential for the misappropriation of public assets.

Without copies of the Property Disposal Requests, it is more difficult to determine the circumstances surrounding the disappearance of the equipment. It is also more difficult to review any steps taken to locate the items, which are required to be documented.

The Department’s inventory system allows some users to permanently remove items from its records. This system automatically generates Monthly Activity Reports, which detail any changes made to records. Keeping copies of these reports allows agency management and others to determine which items have been removed.

Recommendations

We recommend the Department comply with approved records retention schedules.

Department’s Response

We concur with this finding. An incorrect records retention schedule was used resulting in premature destruction of the records by the records center. This condition was corrected when brought to the agency’s attention during the audit.

Auditor's Remarks

We appreciate the Department's efforts in addressing this finding. We will review the condition during our next audit.

Applicable Laws and Regulations

Section 40.14.060 of the *Revised Code of Washington* states:

(1) Any destruction of official public records shall be pursuant to a schedule approved under RCW 40.14.050. Official public records shall not be destroyed unless:

(a) Except as provided under RCW 40.14.070(2)(b), the records are six or more years old;
(b) The department of origin of the records has made a satisfactory showing to the state records committee that the retention of the records for a minimum of six years is both unnecessary and uneconomical, particularly if lesser federal retention periods for records generated by the state under federal programs have been established; or
(c) The originals of official public records less than six years old have been copied or reproduced by any photographic or other process approved by the state archivist which accurately reproduces or forms a durable medium for so reproducing the original.

(2) Any lesser term of retention than six years must have the additional approval of the director of financial management, the state auditor and the attorney general, except when records have federal retention guidelines the state records committee may adjust the retention period accordingly. An automatic reduction of retention periods from seven to six years for official public records on record retention schedules existing on June 10, 1982, shall not be made, but the same shall be reviewed individually by the state records committee for approval or disapproval of the change to a retention period of six years.

Recommendations for the destruction or disposition of office files and memoranda shall be submitted to the records committee upon approved forms prepared by the records officer of the agency concerned and the archivist. The committee shall determine the period of time that any office file or memorandum shall be preserved and may authorize the division of archives and records management to arrange for its destruction or disposition.

Federal Compliance

03-52 The Department of Social and Health Services, Medical Assistance Administration, has not established sufficient internal controls to ensure financial reports submitted to the federal government comply with Medicaid provisions.

Background

The Department of Social and Health Services administers the state of Washington Medicaid program (CFDA 93.778), which receives nearly $3 billion annually. These funds are used to pay medical providers for health care services for certain low-income people. The Department is required to report its expenditures for medical assistance and administrative costs to the federal government on a quarterly basis. In turn, the federal government reimburses the Department for its expenditures based on the information submitted on its reports. The report is referred to as the CMS-64.

Description of Condition

We reviewed the Department's procedures for preparing its quarterly reports and reviewed certain types of information to determine if it was accurately reported. We found the following reportable internal control weaknesses and reporting errors:

1. The Department is not reporting disbursements for alien emergency medical services.

   Between July 2002 and December 2002, the Department completed 438,921 transactions for a total of $41,748,835 in services for 9,717 undocumented aliens. Line 27 of the CMS-64, Emergency Services Undocumented Aliens, is to be used to report the allowable emergency expenditures for which the Department is seeking reimbursement from the federal government. However, the Department does not use this line. Instead, it combines payments for both emergency and non-emergency services and reports this amount on a different line.

Cause of Condition

The Department has no coding in its accounting records to differentiate emergency services from non-emergency services for undocumented aliens. As such, services are included as one accounting category.

Effect of Condition

Payments for ineligible services to undocumented aliens are reported by the Department as allowable expenditures. As a result, the Department is receiving federal Medicaid funds to which it is not entitled. Because emergency and non-emergency payments are commingled in the accounting records, the Department cannot determine the total amount of over-payments it has received.

Recommendation

We recommend the Department develop account coding that would differentiate emergency from non-emergency services for undocumented aliens and report the proper allowable amount on the correct line of the CMS-64.

2. The Department is underreporting disbursements in some categories.

   We reviewed the line designated as Other Care Services for the Medical Assistance Administration on the CMS-64 for the fourth quarter of federal fiscal year 2002. Included in the total amount reported on this line was $4,267,195 labeled as "suspense". The Department informed us the suspense account is used as a repository for all payments for which the Medical Management Information System (MMIS) does not recognize the coding. Such coding can occur in many situations, including the addition of new service codes or the addition of new clients. The System views these as errors and places the payment records in suspense rather than in the correct payment categories. The Department performs no adjusting entries to place these suspense transactions in the proper category of medical assistance payments.

Cause of Condition

Given staff shortages, the Department considers updating the System to be of lower priority than other responsibilities. However, it informed us that it has recently initiated steps to correct some of these problems.

Effect of Condition

Erroneous reports do not provide the grantor with complete information regarding how the Department has used its federal funding.

Recommendation

We recommend the Department establish procedures, including System updating and adjusting entries, to help ensure amounts initially reported on the Suspense line are properly moved to the appropriate payment category on the CMS-64.

3. The Department does not have sufficient internal controls over preparation of the CMS-64.

   The Department does not reconcile the CMS-64 to its financial reporting system or to its cost allocation system. Additionally, we found the Department provides for no monitoring over the preparation of the claims before they are submitted. As such, the accuracy of the claims is not ensured. While the Department does have a representative from the federal government review reports and some transactions related to the claims, this review is a high level analytical review of disbursements. The federal representative does not certify or attest to the accuracy of the claim, which is the responsibility of the Department.

Cause of Condition

Reconciliations were performed in the past, but this control has stopped due to staff turnover and a lack of training and monitoring.

Effect of Condition

The lack of reconciliation and monitoring increases the risk that the Department's claims for reimbursement are inaccurate.

Recommendations

We recommend that the Department:

- Institute training protocols and monitoring procedures that would ensure accuracy in the preparation of the CMS-64.

- Perform reconciliations between the CMS-64 and the financial reporting and cost allocation systems prior to submission of each claim.

4. Payments for Disproportionate Share Hospitals were not accurately reported on the CMS-64 for the fourth quarter of federal fiscal year 2001.

   Due to changes to MMIS that took effect on July 1, 2001, an error caused the System to miscode payments for Disproportionate Share Hospitals. The problem was not discovered until the CMS-64 had already been submitted to the federal government for the quarter ending September 30, 2001. In March 2002, while preparing its next quarterly report, the Department found the error, identified the cause, and began to correct the problem. The Medical Assistance Administration was aware of the problem, but did not notify the Department's Office of Accounting Services until May 2002. Proper adjustment and disclosure of the error were not made until October 2002 because Accounting Services could not obtain all of the information it needed from Medical Assistance.

Cause of Condition

The Department stated that coding errors and a lack of communication between the Department's Office of Accounting Services and Medical Assistance Administration were responsible for the errors.

Effect of Condition

The lack of communication caused Office of Accounting Services to submit a report that was understated for Disproportionate Share Hospital payments by $4,700,549. This error was corrected one year later in the report submitted for the quarter ending September 30, 2002.

Recommendations

We recommend that the Department:

- Establish timely and consistent communications between Medical Assistance Administration and the Office of Accounting Services.

- Ensure that the coding in the Medical Management Information System is accurate.

Department's Response

The Department partially concurs with this finding. Each element of the finding will be addressed separately:

1. *Alien Emergency Medical Services – The Department does not concur with the element of the finding. MAA completed its review of the claims and has concluded that the clients on this list were eligible for the AEM services. With the decision from Gutierrez v. DSHS, Yakima Superior No. 032017662 (2003) and MAA policy, follow-up medical service to an emergency medical condition is claimable and coverable under the AEM program. Furthermore, it's impossible to determine, based on the procedure codes alone, whether the medical service provided was necessary to continue treatment of an emergency medical condition or to prevent the condition from imminently deteriorating to an emergency. In addition, many of the claims we reviewed were for pregnant women for which the AEM program pays for both labor and delivery. It is important to note that any non-emergent prenatal care provided to these women was charged to state only funds*

2. *Underreporting of Disbursements – The Department partially concurs with this element of the finding. The Department is not underreporting expenditures in aggregate, but because of a current situation in the MMIS system, there are expenditures included on Line 29, "Other Care Services" that should be reported elsewhere. All reported expenditures are for eligible Title XIX clients. There are certain instances where MMIS may not recognize the service code of a disbursement. These disbursements are assigned a code that currently has a misleading title of "Suspense". These are not suspense items. They are legitimate Title XIX disbursements and are reported on the CMS 64. This situation was identified by MAA prior to the audit and we are actively working on a solution.*

3. *Preparation of the CMS-64 – The Department does not concur with this element of the finding. The entire claim preparation is in itself a reconciliation of Title XIX expenditures. The CMS 64 claim system is a database that was created specifically to prepare the CMS 64 claim. On a monthly basis we reconcile the data that is imported to the claim system to ensure it matches the expenditures recorded in AFRS for the month. This allows us to begin the quarterly claim preparation with the exact expenditures that were recorded in AFRS for the quarter. During the preparation of the claim there are many steps taken that would legitimately cause the claimed amount to differ from the actual expenditures for the quarter. We created a document that summarizes the reconciliation differences. Although we did not use this summary document for several*

claim quarters it does not improve or take away from the reconciliation of expenditures claimed on the CMS 64 to AFRS.

Additionally, the Department does not agree with the statement that DSHS "…provides for no monitoring over the preparation of the claims…". CMS has a full time fiscal auditor assigned to the State of Washington who is on-site at DSHS for several weeks during the preparation of the claim. The CMS auditor reviews cost categories and expenditure detail during the preparation of the claim, requesting justification and explanation for specific expenditures. The auditor approves the claim submission prior to DSHS certifying the claim.

4. *DSH Payments – The Department concurs with this element of the finding. There is now better coordination between staffs in the Office of Accounting Services and Medical Assistance Administration. Additionally, the Medical Assistance Administration staffs have implemented better tracking and monitoring mechanisms for these payments.*

Auditor's Concluding Remarks

Condition 1: The Department is not reporting disbursements for alien emergency medical services.

The Department should develop controls that would make it possible to determine whether the medical service provided was for emergency or non-emergency conditions. It is this condition that is causing the commingling of unallowable services with allowable services on the federal reporting form. During our audit, the Department provided no evidence that the non-emergency services rendered were originally related to an emergent condition. Further, federal statutes have no provisions for federal financial participation for routine or follow-up services related to emergency conditions.

Some of the clients that we reviewed were maternity clients. However, the medical procedures to which we took exception were for services completely unrelated to the labor and delivery process. Examples of some of the unallowable services include routine dental exams, dental fillings, contact lenses, massages and breast pumps.

Our audit revealed that non-emergency prenatal care was paid for with federal funds and not state funds as the Department asserts. We ascertained this by tracing the services rendered from the provider's claim to the federal report (CMS-64) on which the Department lists the services eligible for federal funding.

Condition 2: The Department is underreporting disbursements in some categories.

Our primary concern in this area is not the allowability of the charges, but whether or not the services are being properly reported on the correct lines of the CMS-64. This will ensure that the federal government receives the most accurate information from which it can make decisions about the program. The Department is performing no adjusting entries that would make the report accurate.

Condition 3: The Department does not have sufficient internal controls over preparation of the CMS-64.

The internal controls that the Department employed over the preparation of the CMS-64 during our audit period appeared significantly weaker than we have seen in past years. During our fieldwork, staff indicated no reconciliations were being performed. The errors and other reportable conditions that we have found in the CMS-64 during our audit substantiate our position that Departmental monitoring could be improved.

Applicable Laws and Regulations

The state of Washington's Office of Financial Management's *State Administrative and Accounting Manual* Section 50.30.45.2, describes the reporting responsibilities of state agencies that administer or expend federal awards:

> Identity, account for, and report all expenditures of federal awards in accordance with laws, regulations, contract and grant agreements, and requirements included in this and other sections of the OFM *State Administrative and Accounting Manual***.**

Title 45, Code of Federal Regulations, Section 92.20(a), states:

> A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds.

Title 42, Code of Federal Regulations, Section 430.30(c) states:

> Expenditure reports. (1) The State must submit Form CMS-64 (Quarterly Medicaid Statement of Expenditures for the Medical Assistance Program) to the central office (with a copy to the regional office) not later than 30 days after the end of each quarter. (2) This report is the State's accounting of actual recorded expenditures. The disposition of Federal funds may not be reported on the basis of estimates.

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states:

> The auditee shall:…
>
> > (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs….

03-53 The Washington Interagency Committee for Outdoor Recreation should improve its internal controls over federal reporting.

Background

The Pacific Coast Salmon Recovery-Pacific Salmon Treaty program (CFDA 11.438) is a cooperative program funded by the U.S. Department of Commerce. This program assists states in salmon restoration and in fulfilling responsibilities under the Pacific Salmon Treaty. Activities performed with funds from this grant program include salmon habitat restoration, salmon research, recovery planning and salmon enhancement. The Washington Interagency Committee for Outdoor Recreation reported total grant expenditures of $17.6 million for fiscal year 2003.

Description of Condition.

As part of its responsibilities, the Committee is required to submit federal financial reports (referred to as the SF-269) to the Department of Commerce semi-annually. These reports provide information to the federal grantor about the amounts obligated and spent by the Committee and identify the amount of matching funds contributed by the Committee and its subrecipients. The Committee did not have adequate internal controls over the preparation of these reports and did not submit them in a timely manner. Currently, one individual prepares, signs, and submits the federal reports without supervisory review.

The Committee is required to use the accrual method of accounting and submit its SF-269 report every six months. We reviewed the SF-269 reports submitted in June 2003 for the six-month periods ending September 30, 2002 and March 31, 2003. We found that the federal expenditures reported on the September 30, 2002 report were understated by approximately $1.8 million and federal expenditures reported on the March 31, 2003 report were overstated by approximately $2 million. Further, both reports were not submitted in a timely manner.

Cause of Condition

Until recently, the Committee was not aware of the requirements for submission of the SF-269 report. Further, the reports were not reviewed by a second person to ensure they were accurate.

Effect of Condition

The financial reports did not reflect actual activities in accordance with the accrual basis of accounting and were not submitted in a timely manner. Without accurate and timely reporting, the federal grantor is unable to assess program operations and make decisions about future funding.

Recommendation

We recommend the Committee:

- Improve internal controls over federal reporting, including supervisory review for accuracy and timeliness.

- Submit federal reports in accordance with grant requirements.

- Use the accrual basis method when preparing the financial status report and reconcile amounts back to its accounting system.

Committee's Response

Thank you for the opportunity to respond to the Pacific Coast Salmon Recovery audit. IAC recognizes the importance of administering the funds appropriately. This audit pointed out two technical areas the agency could improve on, and we agree. You noted two reports due to the Department of Commerce were submitted late. All reports since then have been submitted timely. IAC is committed to submitting reports timely and in accordance with grant requirements. In reporting accruals, this office had followed a different interpretation of the rules. This was a technical issue involving the actual period that we reported the expenditure compared to when we actually released the payment. IAC will report all future accruals by the method identified by the auditors. We note all federal reimbursements were submitted and reimbursed appropriately in any event. IAC would like to thank the auditors that worked on this audit. They provided valuable guidance and recommendations.

Auditor's Concluding Remarks

We appreciate the Committee's commitment to resolve the issue identified in the finding. We also appreciate the cooperation extended to us throughout the audit by Committee staff.

Applicable Laws and Regulations

Title 15, Code of Federal Regulations, Section 24.20 states, in part:

(a) A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and accounting procedures of the State, as well as its subgrantees and cost-type contractors, must be sufficient to –

(1) Permit preparation of reports required by this part and the statutes authorizing the grant, and
(2) Permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

Title 15, Code of Federal Regulations, Section 24.41 states, in part:

2) Accounting basis. Each grantee will report program outlays and program income on a cash or accrual basis as prescribed by the awarding agency.

4) Due date. When reports are required on a quarterly or semiannual basis, they will be due 30 days after the reporting period.

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states:

> The auditee shall:…
>
> > (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal

03-54 The Department of Social and Health Services, Medical Assistance Administration, is not complying with subrecipient monitoring requirements for the Medicaid Program.

Background

State agencies often distribute federal funds to other organizations that provide services needed to accomplish federal program objectives. These organizations are known as subrecipients, while the state agencies are called pass-through agencies. To help ensure that funds are spent appropriately, the federal government requires pass-through agencies to monitor the activities of subrecipients to provide reasonable assurance that they are complying with federal requirements. Monitoring may take various forms such as reviewing reports submitted by subrecipients and performing on-site reviews of subrecipient financial and program records and operations. Monitoring also includes providing subrecipients with program information, such as the award name and Catalog of Federal Domestic Assistance number, the name of the awarding federal agency, and federal requirements for the program. For subrecipients spending $300,000 or more in federal awards during a fiscal year, pass-through agencies must ensure the performance of appropriate audits, respond to subrecipient audit findings, and ensure appropriate and timely corrective action.

Description of Condition

During our audit of the Medicaid program (CFDA 93.778), we evaluated the Department's system of monitoring local health jurisdictions that participate in the Medicaid Administrative Match program. The activities performed by the local health jurisdictions include providing information about the Medicaid program to clients, helping potential Medicaid-eligible clients through the application process, and enhancing the ability of Medicaid-eligible clients to access Medicaid services. Those local health jurisdictions that perform these activities are reimbursed for 50 percent of their costs with federal Medicaid funds.

Thirty-two county health departments and 13 Indian nations participate in this program. Our review found that approximately 44 percent of the local health jurisdictions have never been monitored by the Department. These jurisdictions received $1,612,393 in federal Medicaid funds in state fiscal year 2002. This accounts for approximately 15 percent of the program's funding for that year. Further, these jurisdictions have been receiving funds from the Medicaid Administrative Match program since at least December of 1997.

Cause of Condition

The Department was aware the local health jurisdictions were subrecipients, but stated it had only one employee to monitor both the local health jurisdictions and school districts that participate in the program. Between the two, 245 entities must be monitored.

Effect of Condition

Without proper monitoring, the Department cannot ensure that subrecipients are complying with federal requirements and that subrecipient claims for reimbursement are calculated correctly and adequately supported.

Recommendations

We recommend the Department devote the resources necessary to ensure compliance with subrecipient monitoring requirements.

Department's Response

The Department of Social and Health Services, Medical Assistance Administration, partially concurs with this finding.

The Department agrees that only 44% of the entities contracted with had on-site visits. However, monitoring can and does take various forms, as stated above. Some of the methods employed by DSHS included:

- *Reviewing reports submitted by subrecipients. This includes the review of the monthly billings received by DSHS that have supporting documentation attached and through the program/progress reports that provide DSHS with the status of the program along with current measurements.*

- *Providing subrecipients with program information in the contract. Such items provided include the award name and Catalog of Federal Domestic Assistance number, the name of the awarding federal agency, and federal requirements for the program.*

- *Providing assistance through phone, written correspondence, and email on contract requirements, new program requirements or discussing with them issues with regard to current day to day activities.*

- *Review of the entities annual audit report. If findings are noted, following up with the entity with regard to their corrective action plan taken.*

It is through these methods that MAA has been monitoring all of their subrecipients.

Auditor's Concluding Remarks

In its response, the Department identified its methods of monitoring. We have no objection to these methods. Our primary concern is the lack of procedures that ensure subrecipient claims for reimbursement are calculated correctly and adequately supported. The Department receives monthly billings from the subrecipients. However, these billings are simply representations made by the subrecipients. They are not accompanied by supporting documentation. Additionally, the Department could not provide us with monitoring reports for those sites it stated it had reviewed subrecipient billings.

The Department does not ensure that each local health jurisdiction spending $300,000 or more in federal awards annually receives a Circular A-133 audit as required. If an audit was performed, the Department will review the report. However, if an audit was not performed, the Department makes no effort to ensure compliance with Circular A-133.

Applicable Laws and Regulations

U.S. Office of Management and Budgets Circular A-133, *Audits of States, Local Governments, and Non-profit Organizations,* Section 400(d) states, in part:

> A pass-through entity shall perform the following...
>
> 1. Identify Federal awards made by informing each subrecipient of CFDA title and number, award name and number, award year….and name of Federal agency…
>
> 2. Advise subrecipients of requirements imposed on them by Federal laws, regulations, and the provisions of contract or grant agreements as well as any supplemental requirements imposed by the pass-through entity.
>
> 3. Monitor the activities of subrecipients as necessary to ensure that Federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
>
> 4. Ensure that subrecipients expending $300,000 or more in; Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.
>
> 5. Issue a management decision on audit findings within sic months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.
>
> 6. Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.

03-55 The Department of Health does not adequately monitor its subrecipients for the Breast and Cervical Cancer program.

Background

The Department of Health administers the federal Breast and Cervical Cancer Early Detection Program (CFDA 93.919) in Washington State. The program is designed to provide uninsured and underinsured women with breast and cervical cancer screenings and related services. Over 9,000 women are enrolled and screened annually.

The Department provides technical assistance and federal financial assistance to eight subrecipients, known as prime contractors, who administer the program in regions throughout the state. In turn, the prime contractors work with clinics, private physicians, hospitals, local health departments, laboratories, and radiology facilities that provide services to eligible clients. The group of eight prime contractors includes five local health departments, one hospital and two private, for-profit organizations.

Description of Condition

In fiscal year 2003, the Department reported grant expenditures of $5,071,956. About half of this amount is awarded to the eight prime contractors to carry out administrative responsibilities and to pay the providers for services rendered. During our audit, we reviewed the Department's system for monitoring the activities of its subrecipients and the method of paying subrecipient claims. The monthly claims include program administration costs and provider billings. We found that the prime contractors do not submit supporting documentation of their costs with reimbursement claims. We also reviewed the Department's procedures for reviewing financial documentation when it performs on-site visits of the eight contractors, which would provide a compensating control, but found that it does not review that information.

However, we did note that while the internal controls over the monitoring of contractor financial information need improvement, the Department provides a substantial amount of technical assistance to the contractors. The Department also has established procedures for the contractors to ensure that only eligible clients are served and that provider billings are allowable.

Cause of Condition

The Department was aware of the need to review financial information of its subrecipients, but lacked the staff to meet this responsibility.

Effect of Condition

Given the lack of documentation to support reimbursement claims and a lack of fiscal monitoring, the Department cannot ensure that its subrecipients have spent grant funds for allowable purposes.

Recommendations

We recommend the Department review the financial documentation that supports subrecipient reimbursement claims as part of its on-site monitoring program. Alternatively, the Department

could require all subrecipients to submit supporting documentation with their reimbursement claims.

Department's Response

We concur with the finding by the State Auditor's Office. All community-based subrecipients submit electronic documentation for clinical costs monthly. All local health jurisdiction subrecipients submit electronic documentation for clinical costs monthly. Both community-based and local health jurisdictions will have financial documentation reviewed on site periodically, in conjunction with other department programs, and through a program review/quality assurance process that is under development.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolve the issue identified in the finding. We also appreciate the cooperation extended to us throughout the audit by Department staff.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Section .400(d), states in part:

> **Pass-through entity responsibilities**. A pass-through entity shall perform the following for the Federal awards it makes: …
>
> Monitor the activities of subrecipients as necessary to ensure that Federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved….

03-56 The Department of Community, Trade and Economic Development did not comply with federal requirements for time and effort reporting and suspension and debarment in the Home program.

Background

The Department of Community, Trade and Economic Development administers the federal Home Investment Partnership Program (CFDA 14.239), also referred to as the HOME program. The objectives of the program are to expand the supply of decent and affordable housing, particularly to low- and very-low-income residents; to strengthen the abilities of state and local governments to develop strategies to provide an adequate supply of affordable housing; to provide financial and technical assistance to states; and to strengthen partnerships among governments involved with providing and administering affordable housing. The Department reported total HOME expenditures of $12,514,445 for fiscal year 2003.

Description of Condition

During our audit, we found the following internal control weaknesses and instances of noncompliance:

a. Payroll time and effort reporting

For payroll costs charged directly to federal awards, federal regulations require employees to document the time and effort spent on each federal activity monthly. These monthly records must reflect the actual distribution of the employee's activities. However, if an employee works on only one federal activity, semi-annual certifications signed by the employee or a supervisor meet federal requirements.

During our review of payroll charges, we noted that the Department did not require two salaried employees who worked solely on the HOME Partnership grant to prepare semi-annual certifications. In addition, we found approximately 19 employees who worked on multiple activities were keeping monthly time and effort records based on budgeted amounts, rather than actual amounts. For employees who worked on multiple activities, the total salaries and benefits charged to the federal award for state fiscal year 2003 are estimated to be $287,376.

b. Suspension and debarment

Recipients of federal assistance are required to obtain a certification from all subrecipients and potential contractors that would receive in excess of $100,000 in compensation that states they have not been suspended or debarred from participating in federal programs. When reviewing the Department's internal controls over contracting, we found that it did review the federal list of suspended and debarred parties before awarding contracts, but was not obtaining suspension and debarment certifications for its construction-related contracts as required. For fiscal year 2003, the Department spent approximately $3,268,272 for construction projects that were subject to the suspension and debarment requirement.

Cause of Condition

The Department was unaware of the federal requirements regarding time and effort reporting. For suspension and debarment, the Department relied on standard contract language prepared by another state agency that did not contain the required certification.

Effect of Condition

Time and effort reporting

Without proper time and effort records, we are unable to substantiate the accuracy of the payroll costs charged to this program. As a result, we are questioning $287,376 charged to the grant.

Suspension and debarment

If the Department does not obtain suspension and debarment certifications, it may be liable for amounts paid to subrecipients and vendors who have been suspended or debarred from receiving federal funds.

Recommendation

We recommend the Department:

- Maintain time and effort records that comply with federal regulations and consult with the federal grantor to determine whether questioned costs should be repaid.

- Obtain suspension and debarment certifications for all current contractors and update all contract language to incorporate this certificate.

Department's Response

CTED is taking the following corrective actions to address the conditions noted in the HOME program finding on Suspension and Debarment and Time and Effort requirements:

A.1. On December 9, 2003, the Administrative Services Division communicated the Suspension and Debarment requirements to all CTED employees. All program managers are required to review their current practices to determine if they are in compliance with the Suspension and Debarment requirements and when necessary to correct any non-compliance issues.

A.2 The Housing Division, HOME program, will require suspension and debarment certifications for all of its construction-related contractors. The Housing Division will:

- *Require all future subrecipients and contractors receiving awards for HOME funds for construction projects to sign and submit the U.S Department of Housing and Urban Development (HUD) form 2992, Certification Regarding Debarment and Suspension before contracts are executed. This was made effective as of January 2004.*

- *Obtain a completed HUD form 2992 certification from all of the current 2003 subrecipients and contractors using HOME funds for construction projects. This will be completed by April 30, 2004.*

- *Update the HFU contract - General Terms and Conditions, Section 7.01 Certification Regarding Debarment, Suspension, or Ineligibility to include the requirement for subrecipients and contractors to sign and submit HUD form 2992. This will be completed by January 31, 2004.*

B.1 For compliance with the time and effort requirement for staff that work solely on one federal program, CTED will revise the timesheet template to include a time and effort certification statement. All supervisors, or their designee, will be required to review the timesheets and sign the certification semi-monthly.

B.2 For compliance with the time and effort requirements for staff who work in multiple programs, the Housing Division staff who charge their time to HOME and other programs will conduct quarterly time studies to verify the timesheet charges made to HOME. This process will be effective February 2004.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolve the issues identified in the finding. We also appreciate the cooperation extended to us throughout the audit by Department staff.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, Attachment B, Section 11(h), states in part:

1) Charges to Federal awards for salaries and wages, whether treated as direct or indirect costs, will be based on payrolls documented in accordance with generally accepted practice of the governmental unit and approved by a responsible official(s) of the governmental unit.

2) No further documentation is required for the salaries and wages of employees who work in a single indirect cost activity.

3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee.

4) Where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation which meets the standards in subsection (5) unless a statistical sampling system (see subsection (6)) or other substitute system has

been approved by the cognizant Federal agency. Such documentary support will be required where employees work on:

a) More than one Federal award,
b) A Federal award and a non-Federal award,
c) An indirect cost activity and a direct cost activity,
d) Two or more indirect activities which are allocated using different allocation bases, or
e) An unallowable activity and a direct or indirect cost activity.

5) Personnel activity reports or equivalent documentation must meet the following standards:

a) They must reflect an after-the-fact distribution of the actual activity or each employee,
b) They must account for the total activity for which each employee is compensated,
c) They must be prepared at least monthly and must coincide with one or more pay periods, and
d) They must be signed by the employee.
e) Budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards but may be used for interim accounting purposes, provided that:

i. The governmental unit's system for establishing the estimates produces reasonable approximations of the activity actually performed;
ii. At least quarterly, comparisons of actual costs to budgeted distributions based on the monthly activity reports are made. Costs charged to Federal awards to reflect adjustments made as a result of the activity actually performed may be recorded annually if the quarterly comparisons show the differences between budgeted and actual costs are less than ten percent; and
iii. The budget estimates or other distribution percentages are revised at least quarterly, if necessary, to reflect changed circumstances.

Title 24, Code of Federal Regulations, Section 24.510(b) states:

Certification by participants in lower tier covered transactions. (1) Each participant shall require participants in lower tier covered transactions to include the certification in appendix B [*not included in this finding*] to this part for it and its principals in any proposal submitted in connection with such lower tier covered transactions.

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states:

> The auditee shall:…
>
> > (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs….

03-57 The Department of Community, Trade and Economic Development did not comply with federal requirements for time and effort reporting in the LIHEAP program.

Background

The Department of Community, Trade and Economic Development administers the Low Income Home Energy Assistance Program (CFDA 93.568), also referred to as LIHEAP. The program assists eligible households in meeting the costs of heating and cooling of homes. The program seeks to improve energy self-sufficiency of low-income individuals and to reduce health and other risks arising from energy needs.

The program targets low-income households with the highest home energy costs or needs in relation to income, and taking family size into account. Other targets are low-income households with members who are vulnerable such as the elderly, disabled, and young children. The Department reported total program expenditures of $36,754,449 for fiscal year 2003.

Description of Condition

For payroll costs charged directly to federal awards, federal regulations require employees to document the time and effort spent on each federal activity monthly. These monthly records must reflect the actual distribution of the employee's activities. However, if an employee works on only one federal activity, semi-annual certifications signed by the employee or a supervisor meet federal requirements.

During our review of payroll charges, we noted that the Department did not require three salaried employees who worked solely on the LIHEAP grant to prepare semi-annual certifications. In addition, we found approximately nine employees who worked on multiple activities were charging their time based on budgeted amounts, rather than actual amounts. For employees who worked on multiple activities, the total salaries and benefits charged to the federal award in fiscal year 2003 are estimated to be $174,679.

Cause of Condition

The Department was unaware of the federal requirements regarding time and effort reporting.

Effect of Condition

Without proper time and effort records, we are unable to substantiate the accuracy of payroll costs charged to this program. As a result, we are questioning $174,679 charged to the grant. For the salaried employees who did not prepare a semi-annual certification, we were able to obtain alternative evidence that supported time and effort charged to the grant.

Recommendation

We recommend the Department maintain time and effort records that comply with federal regulations and consult with the federal grantor to determine whether questioned costs should be repaid.

Department's Response

CTED is taking the following corrective actions to address the conditions noted in the LIHEAP Program finding on Time and Effort requirements:

For compliance with the time and effort requirement for staff that work solely on one federal program, CTED will revise the timesheet template to include a time and effort certification statement. All supervisors, or their designees, will be required to review the timesheets and sign the certification semi-monthly.

For compliance with the time and effort requirements for staff who work in multiple programs, the Community Services Division staff who charge their time to LIHEAP and other programs will conduct quarterly time studies to verify the timesheet charges made to LIHEAP. This process became effective January 2004.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolve the issues identified in the finding. We also appreciate the cooperation extended to us throughout the audit by Department staff.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, Attachment B, Section 11(h), states in part:

1) Charges to Federal awards for salaries and wages, whether treated as direct or indirect costs, will be based on payrolls documented in accordance with generally accepted practice of the governmental unit and approved by a responsible official(s) of the governmental unit.

2) No further documentation is required for the salaries and wages of employees who work in a single indirect cost activity.

3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee.

4) Where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation which meets the standards in subsection (5) unless a statistical sampling system (see subsection (6)) or other substitute system has been approved by the cognizant Federal agency. Such documentary support will be required where employees work on:

    a. More than one Federal award,
    b. A Federal award and a non-Federal award,
    c. An indirect cost activity and a direct cost activity,

d. Two or more indirect activities which are allocated using different allocation bases, or
e. An unallowable activity and a direct or indirect cost activity.

5) Personnel activity reports or equivalent documentation must meet the following standards:

a. They must reflect an after-the-fact distribution of the actual activity or each employee,
b. They must account for the total activity for which each employee is compensated,
c. They must be prepared at least monthly and must coincide with one or more pay periods, and
d. They must be signed by the employee.
e. Budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards but may be used for interim accounting purposes, provided that:

i. The governmental unit's system for establishing the estimates produces reasonable approximations of the activity actually performed;
ii. At least quarterly, comparisons of actual costs to budgeted distributions based on the monthly activity reports are made. Costs charged to Federal awards to reflect adjustments made as a result of the activity actually performed may be recorded annually if the quarterly comparisons show the differences between budgeted and actual costs are less than ten percent; and
iii. The budget estimates or other distribution percentages are revised at least quarterly, if necessary, to reflect changed circumstances.

NOTE: Federal regulations exempt certain grant programs, including LIHEAP, from the cost principles of OMB Circular A-87, provided the state adopts procedures consistent with Circular A-87. The state of Washington has not adopted its own principles in lieu of Circular A-87. Further, the exemption does not include the principle of allocability, which requires costs to be allocated to federal awards in relation to the benefits received.

U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* Subpart C, Section .300 states:

The auditee shall:…

(b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs….

03-58 The Employment Security Department did not comply with federal requirements for payroll time and effort reporting for the Unemployment Insurance program.

Background

The Employment Security Department administers the Unemployment Insurance Program (CFDA 17.225), which is partially funded by the U.S. Department of Labor. The program's objectives are to provide unemployment compensation to unemployed workers for periods of involuntary unemployment and to help stabilize the economy by maintaining the spending power of workers while they are between jobs. The Department reported total program expenditures of $2,420,855,385 for fiscal year 2003. Of this amount, $1,586,931,830 represents state and/or employer contributions and $833,923,555 represents federal grant funds.

Description of Condition

For payroll costs charged directly to federal awards, federal regulations require employees to document the time and effort spent on each federal activity monthly. These monthly records must reflect the actual distribution of the employee's activities. However, if an employee works on only one federal activity, semi-annual certifications signed by the employee or a supervisor meet federal requirements.

During our review of payroll charges, we found six employees whose daily time distributions for multiple activities were charged directly to the federal programs using same percentage every pay period, rather than reflecting the actual time worked. Using a budget or estimate of time worked is permissible, provided the grantee keeps monthly records that demonstrate the employee's actual effort and reconciles these records with the budgeted amounts quarterly. The total salaries and benefits charged to the Unemployment Insurance federal award in fiscal year 2003 for the six employees noted above was $58,600.

This condition was also reported in the State of Washington Single Audit report in fiscal years 2000 through 2002. However, it should be noted that the Department has made significant improvements in its internal controls to inform its employees of federal time and effort requirements and to monitor compliance.

Cause of Condition

In prior audits, the Department has found it difficult to efficiently allocate time for certain staff positions because employees in these positions work on or support a great number of programs or projects. As noted above, the Department is taking steps to remedy the condition and to develop a reporting system that tracks actual effort for these positions.

Effect of Condition

Without proper time and effort records, we are unable to substantiate the accuracy of the payroll costs charged to this program. As a result, we are questioning $58,600 charged to the federal program.

Recommendations

We recommend the Department reimburse the appropriate federal programs for any costs the grantor determines to be unallowable. We also recommend the Department ensure employees accurately report their time. We further recommend the Department consult with the grantor to determine a reasonable and acceptable way to account for payroll costs charged to federal funds.

Department's Response

Salary costs for six employees within two divisions were questioned by the State Auditor's Office due to the appearance of repetitive time charging. We are providing explanatory information for the finding related to the time reporting practices, resulting questioned costs and corrective action taken for each employee as follows:

WorkSource Operations Division:

WorkSource Specialist 2, Lynnwood

At the time of the audit this employee charged his time consistent with the appropriate codes for the work performed, however, it appears he reported his daily activities in a manner that may not reflect actual activities performed. However, a substantial portion of this employee's job duties consist of providing services within the Unemployment Insurance program, including the following:

- *He is a designee within this WorkSource office to provide direct Unemployment Insurance (UI) services to clients, answers UI questions within his scope of assignment and redirects UI customers to the Telecenter.*

- *Copies and mails Unemployment Insurance related Commissioner Approved Training/Training Benefit application packets and non-monetary responses to the appropriate UI Adjudication Center.*

- *Explains UI job search requirements and provides direction in accessing information about the Unemployment Insurance program via the Internet and the TeleCenter. Manually tracks direct UI services he provides in the WorkSource Center by keeping a daily log of these activities.*

Administrative Assistant 4, West Region

This employee works as part of the West region office team that administers, provides oversight and management support to local area operations for program implementation including those funded by the Unemployment Insurance program. The work performed by this employee directly relates to programs to which her time was charged. The following is a summary of the duties performed by this employee:

- *Provides management assistance to the West Region Director, who oversees the program operations of five local areas and two District Tax Offices. Organizes, plans, prioritizes and coordinates workflow and office staff activities with regional management staff, area administrators, and other divisions within the agency.*

- *Monitors, tracks and reviews funds management of contractors working with agency partners, to ensure expenditures are within program budget.*

- *Serves as West Region office property manager, coordinates regional office operations, arranges for maintenance contracts and facility repairs, to include the tracking of state vehicles assigned to the region office. Analyzes need for new office equipment, such as phone system, copy machines, etc.*

- *Coordinates, tracks, and reviews all Commissioner and Governor's Office assignments for West Region assuring compliance with agency policy and procedures. Participates as a member of West Region Leadership Team, other various agency work groups, committees and task forces in problem solving on regional and agency related issues providing technical assistance.*

Due to the administrative nature of this position, it has been difficult to accurately charge the various programs that are supported by the work performed by this employee. The agency has attempted to charge benefiting programs, including Unemployment Insurance, equitably for these services.

Office Assistant Senior, West Region

This employee works as part of the West Region office team. Her duties are to provide administrative support to the West Region office operations. The work performed in her job duties includes the project and function codes her time is being charged to.

This employee serves as back up and support to the Administrative Assistant and assumes administrative support lead responsibility during her absence. Her responsibilities/duties involve working with time sheets, inventory, supplies, assignment management, requisitions and invoice payment and document preparation and distribution for regional programs.

As with the Administrative Assistant position noted above, the agency has attempted to charge benefiting programs, including Unemployment Insurance, equitably for these services.

WorkSource Specialist 3, Mount Vernon

This employee provides employment and reemployment services to all Mount Vernon WorkSource customers with an emphasis on Unemployment Insurance claimants. Her work responsibilities/duties involve providing labor market and job search information in group and one-on-one settings. She is also responsible for insuring that services provided are recorded in the labor exchange and Unemployment Insurance data collection systems, and refers potentially eligible individuals to training. Her job duties are directly related to the programs to which her time is charged.

WorkSource Specialist 4, Lakewood

The time charges by this employee are based on his actual hours worked. He is the only permanent WorkSource Specialist 4 (WSS4) lead worker in Pierce County. As such, he serves as the back-up for the UI Job Search Review function and serves as the office's liaison for UI

services. He also consults with staff in the resolution of the more complex cases of monetary and non-monetary eligibility for the unemployment insurance program.

His other responsibilities include scheduling staff, assisting in the resource room, covering the front desk. As a result of the various jobs performed, the employee charges to multiple programs. The agency believes the funding sources used to account for this employee's time were the appropriate ones.

The above employees from the Lynnwood, West Region, Lakewood and Mt Vernon offices have been made aware that time charged on a daily basis is to be distributed by project codes that represent the various programs on which they work, and should reflect actual time spent on that activity. They will fill out their time sheets and charge their time according to duties performed each day.

Information Technology Services Division:

Information Technology Services Specialist – Bremerton WorkSource

A portion of this employee's job duties is to provide information technology services to agency employees, including several providing Unemployment Insurance services, within the Bremerton WorkSource office. In order to charge this employee's time to benefiting programs a portion of his time was allocated to the Unemployment Insurance program. The allocation was based upon the percentage of employees in the WorkSource office charging to the UI program. Staffing in the office is relatively constant and the programs charged by staff do not fluctuate significantly. However, to ensure that time is allocated appropriately, effective July 1, 2003 that portion of the employee's time used to support WorkSource staff, including those charging to the UI program, will be charged to an overhead allocation code which is reevaluated on a monthly basis.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolve the issues identified in the finding. We also appreciate the cooperation extended to us throughout the audit by Department staff.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, Attachment B, Section 11(h), states:

(1) Charges to Federal awards for salaries and wages, whether treated as direct or indirect costs, will be based on payrolls documented in accordance with generally accepted practice of the governmental unit and approved by a responsible official(s) of the governmental unit.

(2) No further documentation is required for the salaries and wages of employees who work in a single indirect cost activity.

(3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at

least semi-annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee.

(4) Where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation which meets the standards in subsection (5) unless a statistical sampling system (see subsection (6)) or other substitute system has been approved by the cognizant Federal agency. Such documentary support will be required where employees work on:

a) More than one Federal award,
b) A Federal award and a non-Federal award,
c) An indirect cost activity and a direct cost activity,
d) Two or more indirect activities which are allocated using different allocation bases, or
e) An unallowable activity and a direct or indirect cost activity.

(5) Personnel activity reports or equivalent documentation must meet the following standards:

a) They must reflect an after-the-fact distribution of the actual activity of each employee,
b) They must account for the total activity for which each employee is compensated,
c) They must be prepared at least monthly and must coincide with one or more pay periods, and
d) They must be signed by the employee.
e) Budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards but may be used for interim accounting purposes, provided that:

(i) The governmental unit's system for establishing the estimates produces reasonable approximations of the activity actually performed;
(ii) At least quarterly, comparisons of actual costs to budgeted distributions based on the monthly activity reports are made. Costs charged to Federal awards to reflect adjustments made as a result of the activity actually performed may be recorded annually if the quarterly comparisons show the differences between budgeted and actual costs are less than ten percent; and
(iii) The budget estimates or other distribution percentages are revised at least quarterly, if necessary, to reflect changed circumstances.

03-59 The Employment Security Department did not comply with federal requirements for payroll time and effort reporting for the Workforce Investment Act program.

Background

The Department expended $70,492,608 from the Workforce Investment Act program (CFDA 17.255) in state fiscal year 2001. The issue described in this finding relates to costs charged to the program in state fiscal year 2001. We performed additional tests of compliance in the 2001 audit period to meet the requirements of OMB Circular A-133 as recommended by the U.S. Department of Labor as part of its quality control review process. Because we issued our single audit report for fiscal year 2001 prior to completion of this work, we are reporting this finding in our fiscal year 2003 report as recommended by the U.S. Department of Labor and the U.S. Department of Health and Human Services, which serves as the federal cognizant agency for the state. We have audited the Workforce Investment Act cluster (CFDA 17.258, 17.259, and 17.260) as part of our fiscal year 2002 and 2003 single audits, and the issue described in this finding has been resolved in 2003.

Description of Condition

For payroll costs charged directly to federal awards, federal regulations require employees to document the time and effort spent on each federal activity monthly. These monthly records must reflect the actual distribution of the employee's activities. However, if an employee works on only one federal activity, semi-annual certifications signed by the employee or a supervisor meet federal requirements.

During our review of fiscal year 2001 payroll charges, we found two employees whose daily time distributions for multiple activities were charged directly to the federal programs using same percentage every pay period, rather than reflecting the actual time worked. Using a budget or estimate of time worked is permissible, provided the grantee keeps monthly records that demonstrate the employee's actual effort and reconciles these records with the budgeted amounts quarterly. The total salaries and benefits charged to the Workforce Investment Act award in fiscal year 2001 for the two employees noted above was $27,517.

It should be noted that the Department has made significant improvement in its internal controls to inform its employees of federal time and effort requirements and to monitor compliance. We consider this issue resolved for 2003.

Cause of Condition

The Department has found it difficult to efficiently allocate time for certain staff positions because employees in these positions work on or support a great number of programs or projects. As noted above, the Department is taking steps to remedy the condition and to develop a reporting system that tracks actual effort for these positions.

Effect of Condition

Without proper time and effort records, we are unable to substantiate the accuracy of the payroll costs charged to this program. As a result, we are questioning $27,517 charged to the Workforce Investment Act program for fiscal year 2001.

Recommendations

We recommend the Department consult with the U.S. Department of Labor to determine if the questioned costs identified above should be returned to the Workforce Investment Act program.

Department's Response

We appreciate the State Auditor's Office recognition of our efforts to improve agency time reporting. As noted, the state fiscal year 2003 audit report did not have a time reporting finding for the WIA program, and stated that ESD has made significant improvement in its internal controls to inform employees of the requirements. The auditors stated the issue raised in this finding for fiscal year 2001 is considered resolved for the WIA program in fiscal year 2003.

The following additional information is material to this fiscal year 2001 audit issue. Both staff members whose salaries have been questioned, stated in writing their WIA time charges for the fiscal year in question were reasonably correct, and noted their considerable work efforts for specific WIA products. WIA was an important cost objective for both individuals. Both stated they understood their time charges resulted in tangible WIA work products and their charges to WIA funds were reasonably accurate. Both stated that they charged time only to grants on which they worked as follows:

1. *The Administrative Secretary/Program Assistant was the lead support staff and supervised administrative staff performing work that included Workforce Investment Act activities. This employee's work was directed to a number of federal grants, with a considerable amount of her time spent on Workforce Investment Act (WIA) activities.*

   This staff member supported the WIA program in her work throughout fiscal year 2001. Some examples of her WIA work efforts included: creating and organizing the Division monthly report to senior management and meeting agendas, letters to inquiring citizens, and Worker Adjustment and Retraining Notifications (WARN). She also formatted and organized additional correspondence and charts related to the Workforce Investment Act programs. Copies of related work as well as the employee's written statement are available if needed.

2. *The Administrative Secretary was also a staff member whose work included WIA administrative functions. The Workforce Investment Act charges can be supported by documentation of her work. Evidence of her work included: WARN notices, review of staff time sheets and travel vouchers, organizing symposiums and WIA files, requesting WIA strategic plans from each of the twelve local entities, and participation in the contracting process for WIA activities and review of submitted documentation. To the best of her knowledge, she stated her salary costs charged to WIA were in support of the WIA program. A copy of the employee's statement and related work is available if needed.*

These two individuals were the main support staff for WIA as well as other smaller Department of Labor employment and training programs for the agency's Employment and Training Division. The state administrative headquarters of the WIA program includes many staff with administrative, program and oversight responsibilities. We believe these costs are allowable because they were both reasonable and necessary, and directed to the WIA program. The work of these individuals resulted in significant contributions to the WIA program for this period.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolve the issues identified in the finding. We also appreciate the cooperation extended to us throughout the audit by Department staff.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments,* Attachment B, Section 11(h), states:

(1) Charges to Federal awards for salaries and wages, whether treated as direct or indirect costs, will be based on payrolls documented in accordance with generally accepted practice of the governmental unit and approved by a responsible official(s) of the governmental unit.
(2) No further documentation is required for the salaries and wages of employees who work in a single indirect cost activity.
(3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee.
(4) Where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation which meets the standards in subsection (5) unless a statistical sampling system (see subsection (6)) or other substitute system has been approved by the cognizant Federal agency. Such documentary support will be required where employees work on:

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b) A Federal award and a non-Federal award,
c) An indirect cost activity and a direct cost activity,
d) Two or more indirect activities which are allocated using different allocation bases, or
e) An unallowable activity and a direct or indirect cost activity.

(5) Personnel activity reports or equivalent documentation must meet the following standards:

(a) They must reflect an after-the-fact distribution of the actual activity of each employee,
(b) They must account for the total activity for which each employee is compensated,
(c) They must be prepared at least monthly and must coincide with one or more pay periods, and
(d) They must be signed by the employee.
(e) Budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards but may be used for interim accounting purposes, provided that:

i The governmental unit's system for establishing the estimates produces reasonable approximations of the activity actually performed;

ii At least quarterly, comparisons of actual costs to budgeted distributions based on the monthly activity reports are made. Costs charged to Federal awards to reflect adjustments made as a result of the activity actually performed may be recorded annually if the quarterly comparisons show the differences between budgeted and actual costs are less than ten percent; and

iii The budget estimates or other distribution percentages are revised at least quarterly, if necessary, to reflect changed circumstances.

03-60 The Department of Social and Health Services did not comply with federal time and effort reporting requirements for its Rehabilitation Services grant.

Background

The Department of Social and Health Services administers the Rehabilitation Services-Basic program (CFDA 84.126) in the state. The objective of this program is to provide vocational rehabilitation services for individuals with disabilities so that such they may prepare for and engage in gainful employment. The Department reported total federal program expenditures of $48,921,833 for fiscal year 2003.

Description of Condition

For payroll costs charged directly to federal awards, federal regulations require employees to document the time and effort spent on each federal activity monthly. These monthly records must reflect the actual distribution of the employee's activities. However, if an employee works on only one federal activity, semi-annual certifications signed by the employee or a supervisor meet federal requirements.

During our review of payroll charges, we noted that the Department charged $17,542,438 in salaries and benefits to the grant for employees working directly in the program statewide in fiscal year 2003. This is about 35 percent of the total grant outlays. Over 300 employees worked full time on vocational rehabilitation duties, however, we found that the Department did not require these employees to certify their time and effort spent working on the grant program as required by federal regulations.

Cause of Condition

The Department was not aware of the federal requirements over time and effort reporting for employees who work 100 percent on a grant program.

Effect of Condition

Without time and effort certifications, the federal grantor cannot be assured that wages charged to its program are accurate and valid. However, in considering the nature of the job duties and responsibilities of each field office, we feel the risk is low that the 300 employees were performing duties other than vocational rehabilitation and therefore will not question the costs.

Recommendation

We recommend the Department require employees who work 100 percent on a single federal program to certify, in writing, their time spent working on the program on a semi-annual basis. It is also acceptable for an employee's supervisor to sign the semi-annual certification on behalf of the employee, provided the supervisor has first hand knowledge of the work performed by the employee.

Department Response

The Department concurs with the finding and will implement semi-annual certifications. We disagree with the statement that "…the federal grantor cannot be assured that wages charged to its program are accurate and valid". These employees are not only assigned to work on a single federal activity, there is only one federal activity to charge them to. The risk is low, if any, that the 300 employees were performing duties other than vocational rehabilitation.

Auditor's Concluding Remarks

We appreciate the Department's commitment to resolve the issue identified in the finding. We also appreciate the cooperation extended to us throughout the audit by Department staff.

Applicable Laws and Regulations

U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, Attachment B, Section 11(h), states in part:

(1) Charges to Federal awards for salaries and wages, whether treated as direct or indirect costs, will be based on payrolls documented in accordance with generally accepted practice of the governmental unit and approved by a responsible official(s) of the governmental unit.

(2) No further documentation is required for the salaries and wages of employees who work in a single indirect cost activity.

(3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee.

Follow-Up to Previous Statewide Audit Areas

During our last audit period, we examined six areas on a statewide basis. Following is a discussion of the results of those audits, the overall recommendations we made at that time, and the current status of those recommendations.

Claims and Benefits

Our fiscal year 2001 and 2002 audit work found the state lacks a centralized process to determine whether individuals are eligible for benefits or whether they are receiving benefits through some programs that would make them ineligible for others. The audit also found that individuals are not always required to provide information, such as personal identification numbers, that would assist in determining eligibility. As a result of the fiscal year 2002 audit, we made nine recommendations to the agencies covering areas such as:

- Establishing adequate internal controls, including appropriate training, segregation of duties, monitoring, and preparation and retention of supporting documents.

- Data sharing between agencies to help determine client eligibility, including income requirements.

- Obtaining valid Social Security numbers when required for benefits.

- Making timely and accurate benefit payments and attempting recovery of unallowable payments.

In our fiscal year 2002 audit, we recommended to the Legislature that it consider developing a centralized process to determine if individuals are eligible to receive benefits and to cross match income data to other state agency benefit payment systems. This could include creating a single identification number for each individual receiving benefits that can be cross-matched to state records and to data files of the Internal Revenue Service and border states.

For our audit of fiscal year 2003, we again included claims and benefits as a statewide area. As can be seen in the details of our findings, our concerns have been reaffirmed by the issues we identified this year. We have restated our suggestions in the section Recommendations to the Legislature.

Billings and Accounts Receivable

Last year, we reported that most agencies were managing these areas properly and according to state guidelines. We noted a few areas that could be improved, including inadequate policies and procedures for collecting and writing off past due accounts, charging interest when required, and monitoring the accounts. We made a few recommendations related to those issues. Because of the generally positive results, we did not include this as a statewide area during the fiscal year 2003 audit. However, we did review the issues when we assessed high risk at a particular agency. We are reporting no findings in this area this year.

Contracting

Last year, we found in general that state agencies were operating in compliance with the laws and regulations governing contracting. We noted some weaknesses in contract monitoring, the purchase of services, and compliance with bid laws. Again, because of the generally positive results, we did not include this as a statewide area during the fiscal year 2003 audit. However, we did review the issues when we assessed high risk at a particular agency. As can be seen in our findings, the weaknesses we noted last year are continuing issues.

Restricted Funds and Indirect Cost Allocations

Last year, we found that the direct costs charged to restricted funds were legal and appropriate but that there were a few weaknesses in how indirect costs were allocated to them. We noted some failures to provide fair allocation methods and some uses of estimates different from actual figures. We made recommendations related to these weaknesses but did not include this as a statewide area during the fiscal year 2003 audit. However, we did review the issues when we assessed high risk at a particular agency.

State Grants

We reported last year that the state has little or no criteria regarding steps agencies must take to ensure grants composed only of state funds are awarded, administered, and spent properly. As a result, we found a wide disparity in the way agencies treat these grants and several weaknesses related to monitoring. We also noted that agencies sometimes have difficulty distinguishing state grant expenditures from non-grant expenditures and that the state does not have an adequate definition of what constitutes a state grant.

We recommended that the state define and describe state grants, develop criteria to help ensure adequate procedures when agencies award and monitor these grants, and establish account coding that will allow agencies to identify and report on the use of state grant funds.

We did not include this as a statewide area during the fiscal year 2003 audit because no criteria have yet been provided. We reaffirm last year's recommendations and have included a further discussion of this issue in the section Recommendations to the Legislature.

Schedules of Prior Year Findings

Fiscal Year 2001

Finding Number	Finding Caption	Status
2001		
01-06	The Washington State Historical Society has not established adequate internal controls over cash receipting.	Repeat finding for 2003.
01-07	The Washington State Historical has not completed an inventory of historical artifacts.	Repeat finding for 2003.
01-08	The Washington Horse Racing Commission did not collect satellite fees totaling $954,600 from its licensees during calendar years 1999, 2000 and 2001.	Resolved
01-09	The Washington Horse Racing Commission held a meeting that did not comply with the Open Public Meeting Act.	Resolved

Fiscal Year 2002

Finding Number	Finding Caption	Status
2002		
02-01	The State of Washington overpaid claimants and service providers by approximately $1.2 million due to poor internal controls and a lack of data sharing between agencies to determine whether individuals are eligible for benefits. Additionally, we questioned the validity of payments to claimants and service providers of approximately $1.9 million.	Summary level only. Resolution of individual findings listed below
02-01A	The Department of Social and Health Services, Medical Assistance Administration, has not established sufficient internal controls to ensure compliance with Medicaid provisions.	Corrective Action in progress. Repeat finding for 2003.
02-01B	The Department of Labor and Industries paid at least $725,774 in workers compensation benefits to claimants and survivors who were no longer eligible for the benefits. Additionally, the Department does not verify dependents claimed when calculating time loss benefits.	Partially resolved. Reported as a Management Letter for 2003.
02-01C	The Department of Social and Health Services, Economic Services Administration does not perform adequate or timely reviews to ensure the allowability of child care payments made to clients and vendors from federal and state funds.	Corrective action in progress. Repeat finding for 2003.
02-01D	The Department of Social and Health Services, Economic Services Administration, is not in compliance with eligibility requirements for the Temporary Assistance to Needy Families Program.	Corrective action in progress. Repeat finding for 2003.
02-01-E	The Employment Security Department is not complying with client eligibility requirements for the Unemployment Insurance Program.	Resolved.
02-01F	The Washington State Health Care Authority has not established sufficient internal controls to ensure compliance with Basic Health Plan requirements.	Resolved
02-01G	The Washington State Health Care Authority has not established sufficient internal controls to ensure that all of those who are receiving health insurance coverage are eligible to do so.	Resolved
02-02	The Department of Community, Trade and Economic Development is not in compliance with state accounting and financial reporting requirements for accounts receivable.	Partially resolved. Remaining unresolved issue included in 2003 finding.
02-03	More than $4.7 million in employer industrial insurance premium payments recorded as being received by the Department of Labor and Industries between July 2001 and December 2001 were not reflected as being deposited in the industrial insurance financial accounts. The Department was unable to account for this difference.	Unresolved. Repeat finding for 2003.

02-06	The Department of Labor and Industries did not comply with state bid laws when purchasing medical services totaling more than $1.5 million.	Partially resolved. Reported as a Management Letter for 2003.
02-07	Some restricted funds administered by the Department of Natural Resources were charged more than their share of overhead costs.	Resolved
02-08	The Department of Labor and Industries did not allocate indirect costs equitably among its programs and funds.	Unresolved. Repeat finding for 2003.
02-09	The Department of Licensing's controls are not adequate to ensure information processed within the Unisys System is secure.	Unresolved. Management Letter issued
02-10	The Department of Corrections had not established and followed adequate controls over electronic access to the Trust Accounting System.	Unresolved. Repeat finding for 2003.
02-11	The Department of Social and Health Services, Division of Vocational Rehabilitation does not have adequate internal controls over the processing of expenditures for client services.	Resolved.
02-12	The Small Agency Client Services section of the Office of Financial Management (OFM) had inadequate password controls over financial systems to ensure assets are safeguarded.	Unresolved. Repeat finding for 2003.
02-13	The Department of Transportation's Washington State Ferries Division does not have adequate controls over ticket sales and revenue collection.	Unresolved. Repeat finding for 2003
02-15	The Department of Transportation's Washington State Ferries Division lacks adequate internal controls over travel payments.	Unresolved. Repeat finding for 2003
02-16	The Department of Social and Health Services, Division of Child Support did not have adequate supporting documentation for printing and payroll costs.	Partially resolved. The Division has improved its processes for verifying services received prior to paying the State Printer. Remaining concerns are discussed in a Management Letter for 2003.
02-18	The Department of Health should improve monitoring of subrecipients and ensure compliance of vendors for the HIV Care Formula Grants program.	Resolved.
02-19	The Department of Transportation's Washington State Ferries Division lacks adequate internal controls over ferry vessel equipment and items that are small and susceptible to misappropriation.	Partially resolved. Management Letter issued

02-20	The Department of Social and Health Services, Mental Health Division does not have sufficient internal controls over drugs in Western State Hospital pharmacies to prevent and/or detect misappropriation or loss.	Almost completely resolved. Remaining items needing additional controls are discussed in a Management Letter.
02-21	The Employment Security Department did not comply with regulations for allocating payroll costs for four Department of Labor federal programs.	Corrective action in progress. Repeat finding in 2003.
02-22	The Department of Community, Trade and Economic Development did not prepare and submit required financial reports for the Low Income Home Energy Assistance program.	Resolved.
02-23	The State of Washington Military Department did not comply with federal requirements for time and effort reporting, prevailing wages and suspension and debarment.	Resolved.
02-24	The Department of Social and Health Services, Economic Services Administration, did not comply with federal cost principles for charging terminal leave payments.	Resolved.

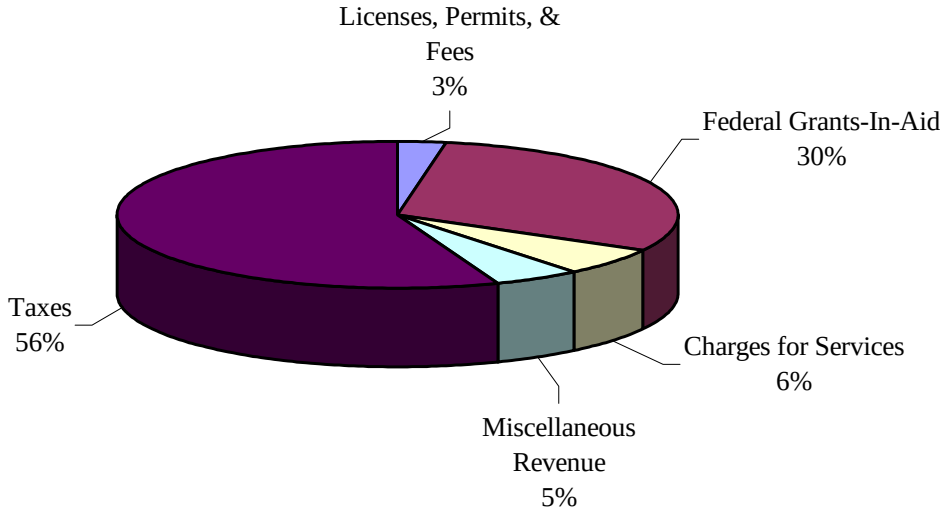
State of Washington Statistical Information

The State Auditor's Office uses statistical information in planning our audits of the state of Washington. The analysis may include a review of revenues for unusual or unexpected fluctuations or to identify a new revenue source. Analytical procedures also may include a review of expenditures to identify unusual or significant increases in program expenditures or to determine if payments to vendors, providers or contractors could be questionable.

The following provides summary information on the revenues, federal dollars received and expenditures the state incurs as well as on audit costs in relation to total expenditures.

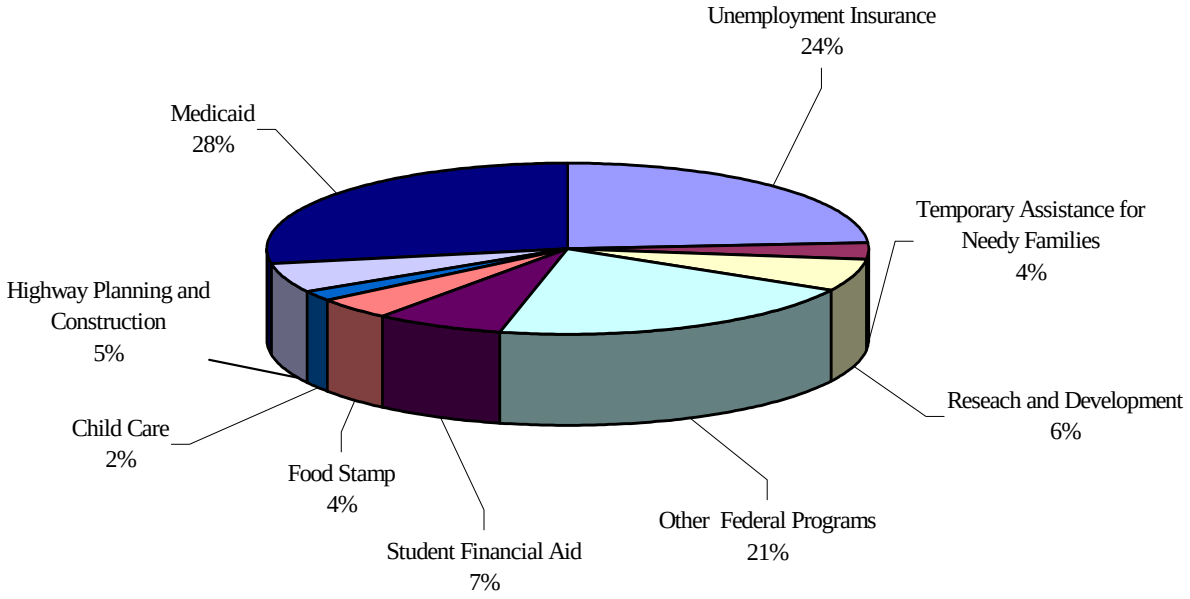
Revenues – The state of Washington's revenues for all government funds (the largest group of funds the state has established) totaled $23 billion for fiscal year 2003. As shown below, those revenues included taxes, charges for services and federal grants. Most of this revenue is generated by taxes. The main tax sources are retail sales tax, business and occupation taxes, property taxes and motor fuel taxes. Our approach is to focus on those revenues subject to risk of fraud or noncompliance with state law. We review the internal controls and processes to ensure that the money collected is deposited.

State of Washington
Revenues
For the Fiscal Year Ended June 30, 2003



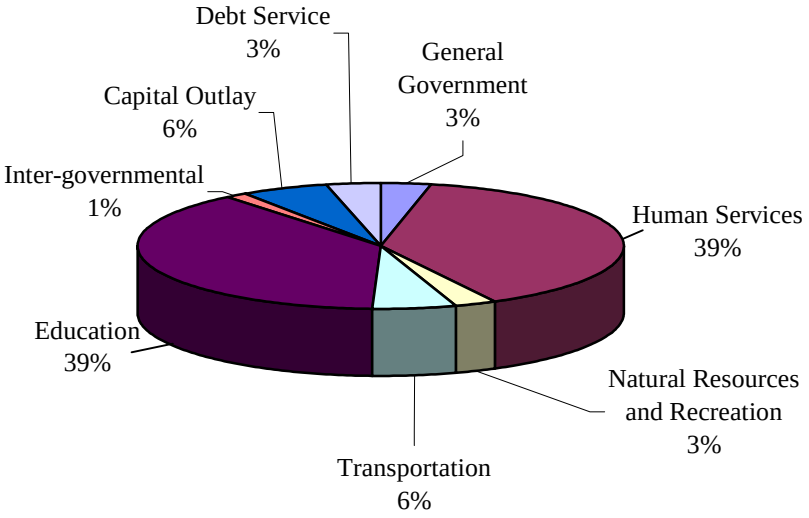
Federal Funding – The state of Washington received $10.1 billion in federal money in fiscal year 2003, with $2.8 billion of it going to the Medicaid program to provide health care for the state's low-income residents. The state is required to match the Medicaid program with state funds. Other major federal programs include student financial aid, highway planning and construction, and unemployment insurance. We audit these funds under special requirements of the federal government and the results are reported in our State of Washington Single Audit Report.

State of Washington
Federal Funding
For the Fiscal Year Ended June 30, 2003



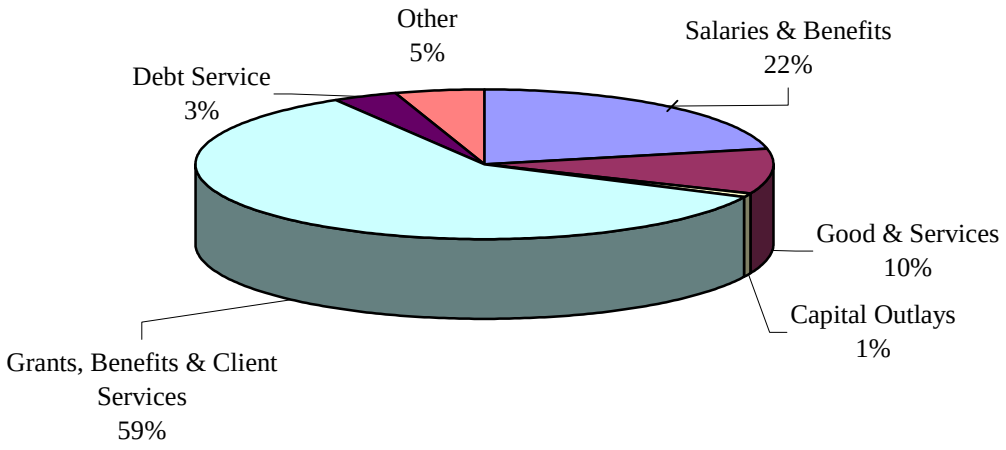
Expenditures – For the fiscal year, expenditures for the state of Washington totaled $24.5 billion for all governmental fund types. Bond issues and transfers from non-governmental funds compensated for the difference between this amount and revenues. Thirty-nine percent of expenditures was spent on both human services and education and the remaining 22 percent in other areas.

State of Washington
Expenditures
For the Fiscal Year Ended June 30, 2003



<u>Expenditures by Object</u> – Of total expenditures in the fiscal year ended June 30, 2003, fifty-nine percent was for grants, benefits, and client services, including K-12 basic education grants. Twenty-two percent was for salaries and benefits and ten percent for goods and services. The remaining nine percent was spent on other miscellaneous expenses.

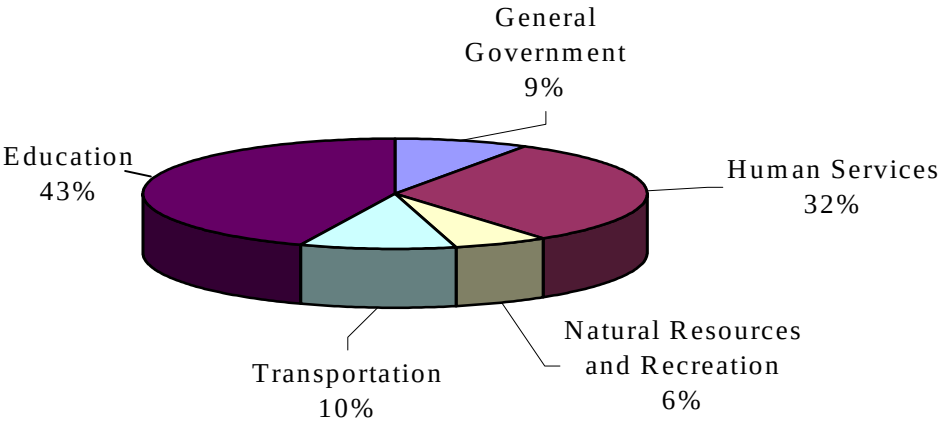
State of Washington
Expenditures by Object
For the Fiscal Year Ended June 30, 2003



State Employees – OFM measures the number of state employees in full time equivalent (FTE) staff years; (one person working 40 hours a week for a full year is counted as one FTE staff year). Two people working half time also count as one FTE. Although the state provides funding for compensation of local school teachers, this support is in the form of payments to the school districts. Therefore, OFM does not consider kindergarten through grade 12 teachers in statewide FTE statistics.

Our analysis indicates that 75 percent of the state's 104,254 FTEs are in higher education and human services. The remaining 25 percent are in general government, natural resources and recreation, and transportation.

State of Washington
FTE's
For the Fiscal Year Ended June 30, 2003



Audit Costs – Over the past five years, our audit costs have increased $130,935, while state expenditures have increased $7.8 billion. The audit cost as a percentage of expenditures continues to decrease. The State Auditor's Office continues to find more efficient ways to audit.

	1998	2003	Change	Change in $
Number of state audits completed	125	81	-44	
Total state expenditures subject to audit	$25,991,432,000	$33,747,387,008	30%	$7,775,955,008
Total state audit costs	$5,900,756	$6,031,691	2%	$130,935
Audit costs as a percentage of expenditures	0.023%	0.018%	-0.005%	

Agencies Audited for Fiscal Year 2003

Columbia River Gorge Commission

Department of Agriculture

Department of Community, Trade and Economic Development

Department of Corrections

Department of Ecology

Department of Employment Security

Department of Financial Institutions

Department of Fish and Wildlife

Department of General Administration

Department of Health

Department of Labor and Industries

Department of Licensing

Department of Natural Resources

Department of Printing

Department of Retirement Systems

Department of Revenue

Department of Services for the Blind

Department of Social and Health Services

Department of Transportation

Department of Veterans Affairs

Freight Mobility Strategic Investment Board

Governor's Office of Indian Affairs

Health Care Authority

Horse Racing Commission

Interagency Committee for Outdoor Recreation

Liquor Control Board

Marine Employees Commission

Office of Financial Management

Office of the Attorney General

Office of the Governor

Office of the Insurance Commissioner

Office of the State Treasurer

Office of the Superintendent of Public Instruction

State Investment Board

State Law Library

State Parks and Recreation Commission

State of Washington Commission on Asian Pacific American Affairs

Utilities and Transportation Commission

Washington State Commission on African-American Affairs

Washington State Commission on Hispanic Affairs

Washington State Gambling Commission

Washington State Historical Society

Washington State Lottery

Washington State Patrol

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