

# AUDIT REPORT

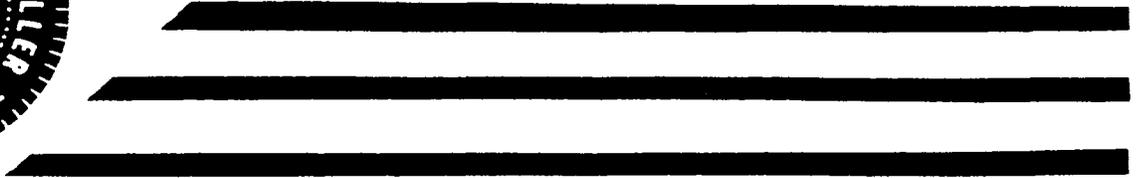
Department of Economic and Community Development

January 2007



STATE OF TENNESSEE  
COMPTROLLER OF THE TREASURY

Department of Audit  
Division of State Audit



**Arthur A. Hayes, Jr., CPA, JD, CFE**  
Director

**Charles K. Bridges, CPA**  
**Kandi B. Thomas, CPA, CFE**  
Assistant Directors

**Ronald E. Anderson, CPA, CFE**  
Audit Manager

**Debby Myers, CISA**  
In-Charge Auditor

**Barbara Ragan, CFE**  
**Benjamin Rogers**  
Staff Auditors

**Amy Brack**  
Editor

Comptroller of the Treasury, Division of State Audit  
1500 James K. Polk Building, Nashville, TN 37243-0264  
(615) 401-7897

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STATE OF TENNESSEE  
**COMPTROLLER OF THE TREASURY**  
State Capitol  
Nashville, Tennessee 37243-0260  
(615) 741-2501

**John G. Morgan**  
Comptroller

January 30, 2007

The Honorable Phil Bredesen, Governor  
and  
Members of the General Assembly  
State Capitol  
Nashville, Tennessee 37243

and  
The Honorable Matthew Kisber, Commissioner  
Department of Economic and Community Development  
11<sup>th</sup> Floor, W.R. Snodgrass Tennessee Tower  
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of Economic and Community Development for the period March 1, 2003, through May 31, 2005.

The review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements resulted in certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report.

Sincerely,

John G. Morgan  
Comptroller of the Treasury

JGM/cj  
05/048



STATE OF TENNESSEE  
COMPTROLLER OF THE TREASURY  
DEPARTMENT OF AUDIT  
DIVISION OF STATE AUDIT

SUITE 1500  
JAMES K. POLK STATE OFFICE BUILDING  
NASHVILLE, TENNESSEE 37243-0264  
PHONE (615) 401-7897  
FAX (615) 532-2765

June 14, 2005

The Honorable John G. Morgan  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Economic and Community Development for the period March 1, 2003, through May 31, 2005.

We conducted our audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we obtain an understanding of internal control significant to the audit objectives and that we design the audit to provide reasonable assurance of the Department of Economic and Community Development's compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Department of Economic and Community Development is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts and grant agreements.

Our audit disclosed certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report. The department's administration has responded to the audit findings; we have included the responses following each finding. We will follow up the audit to examine the application of the procedures instituted because of the audit findings.

We have reported other less significant matters involving the department's internal control and instances of noncompliance to the Department of Economic and Community Development's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA  
Director

AAH/cj

State of Tennessee

# Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit  
**Department of Economic and Community Development**  
January 2007

## AUDIT SCOPE

We have audited the Department of Economic and Community Development for the period March 1, 2003, through May 31, 2005. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements in the areas of the Community Development Block Grant Program; Creative Services; the FastTrack Infrastructure Development Program; the Tennessee Job Skills Program; expenditures; the Financial Integrity Act; Department of Finance and Administration Policy 20, "Recording of Federal Grant Expenditures and Revenues"; and Department of Finance and Administration Policy 22, "Subrecipient Monitoring." The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; and providing support staff to various legislative committees and commissions.

## AUDIT FINDINGS

**The Creative Services Division Did Not Follow Bidding Procedures and Purchasing Guidelines, and Department Management Did Not Successfully Mitigate the Risk of Inappropriate Use of State Funds**

The Creative Services Division of the Department of Economic and Community Development did not follow the Department of General Services Purchasing Division *Agency Purchasing Procedures Manual*

when making purchases between \$400.01 and \$2,000.00. Of the 86 purchases tested, 67 of them were found to have one or more problems associated with them (page 6).

**Tennessee Job Skills Grant Procedures Were Not Followed**

Several companies receiving job skills grant funds were not required by the department to submit a final report as required by *Tennessee Code Annotated* (page 12).

**The Department Should Improve Controls Over Disbursements\***

As noted in the prior audit, the department does not have proper internal controls over disbursements. The results of our sample of 154 disbursement transactions disclosed one or more problems with 62 (40.3%) of the transactions tested. Twenty-three transactions were not properly approved. Twenty-five transactions were not coded to the State of Tennessee Accounting and Reporting System properly. Twelve transactions were not properly supported. Twelve transactions were not paid in a timely manner (page 14).

**The Department Did Not Comply With the Financial Integrity Act**

The Department of Economic and Community Development did not comply with the Financial Integrity Act by preparing and submitting a responsibility letter by June 30, 2003, and June 30, 2004, acknowledging responsibility for maintaining the internal control system of the department. In addition, the Financial Integrity Act Report for December 31, 2003, was not prepared (page 17).

\* This finding is repeated from the prior audit.

**Financial and Compliance Audit**  
**Department of Economic and Community Development**

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**TABLE OF CONTENTS**

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	<u>Page</u>
<b>INTRODUCTION</b>	1
Post-Audit Authority	1
Background	1
<b>AUDIT SCOPE</b>	1
<b>PRIOR AUDIT FINDINGS</b>	3
Resolved Audit Findings	3
Repeated Audit Finding	3
Unresolved Audit Finding	3
<b>OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS</b>	4
Community Development Block Grant Program	4
Creative Services	6
Finding 1 - The Creative Services Division did not follow bidding procedures and purchasing guidelines, and department management did not successfully mitigate the risk of inappropriate use of state funds	6
FastTrack Infrastructure Development Program	11
Tennessee Job Skills Program	12
Finding 2 - Tennessee Job Skills grant procedures were not followed	12
Expenditures	13
Finding 3 - The department should improve controls over disbursements	14
Financial Integrity Act	16
Finding 4 - The department did not comply with the Financial Integrity Act	17

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**TABLE OF CONTENTS (CONT.)**

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	<u>Page</u>
Department of Finance and Administration Policy 20, “Recording of Federal Grant Expenditures and Revenues”	18
Department of Finance and Administration Policy 22, “Subrecipient Monitoring”	19
<b>OBSERVATIONS AND COMMENTS</b>	19
Fraud Considerations	19
Title VI of the Civil Rights Act of 1964	20
<b>APPENDIX</b>	21
Allotment Codes	21

# **Financial and Compliance Audit Department of Economic and Community Development**

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## **INTRODUCTION**

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### **POST-AUDIT AUTHORITY**

This is the report on the financial and compliance audit of the Department of Economic and Community Development. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which requires the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

### **BACKGROUND**

It is the mission of the Department of Economic and Community Development (ECD) to encourage economic growth and maintain a favorable business climate in Tennessee. ECD assists Tennessee communities in preparing and competing for economic development and job creation opportunities. It is also the department’s goal to offer support services for entrepreneurs, existing industries, and new firms, while marketing the state and recruiting new industries domestically and internationally.

An organization chart of the Department of Economic and Community Development is on the following page.

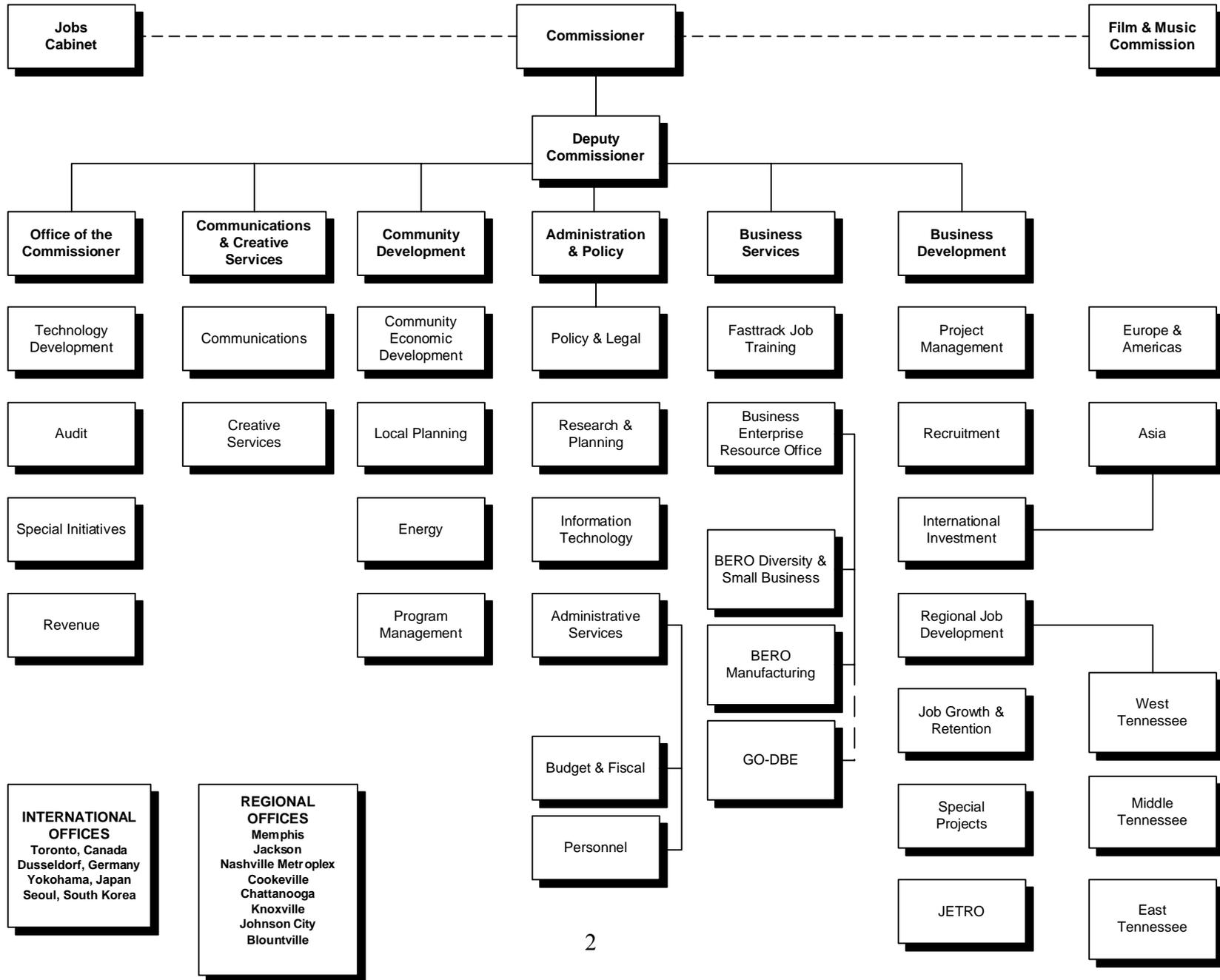
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### **AUDIT SCOPE**

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We have audited the Department of Economic and Community Development for the period March 1, 2003, through May 31, 2005. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements in the areas of the Community Development Block Grant Program; Creative Services; the FastTrack Infrastructure Development Program; the Tennessee Job Skills Program; expenditures;

# Economic and Community Development Organization Chart



the Financial Integrity Act; Department of Finance and Administration Policy 20, “Recording of Federal Grant Expenditures and Revenues”; and Department of Finance and Administration (F&A) Policy 22, “Subrecipient Monitoring.” The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state’s Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; and providing support staff to various legislative committees and commissions.

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## **PRIOR AUDIT FINDINGS**

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Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of Economic and Community Development filed its report with the Department of Audit on May 28, 2004. A follow-up of all prior audit findings was conducted as part of the current audit.

### **RESOLVED AUDIT FINDINGS**

The current audit disclosed that the Department of Economic and Community Development has corrected previous audit findings concerning the approval process for Tennessee Industrial Infrastructure Program (TIIP) projects, concealing transactions through a Nashville Area Chamber of Commerce bank account, two sole-source contracts performing the same service simultaneously, and compliance with F&A’s Policy 22, “Subrecipient Monitoring.”

### **REPEATED AUDIT FINDING**

The prior audit report also contained a finding concerning poor internal controls over disbursements. This finding has not been resolved and is repeated in the applicable section of this report.

### **UNRESOLVED AUDIT FINDING**

The prior finding concerning the Tennessee Job Skills Program where the department awarded job skills grant funds to several large companies without obtaining applications as required by state law could not be resolved because no new monies had been granted during the audit period.

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## OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

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### COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM

The Community Development Block Grant (CDBG) Program is authorized under Title I of the Housing and Community Development Act of 1974, as amended by Title 42 of the United States Code, Section 5301. One of the primary objectives of the program is the development of viable communities by providing decent housing, a suitable living environment, and expanded economic opportunities, principally for persons of low and moderate income. CDBG provides eligible cities and counties with annual direct grants that they can use to revitalize neighborhoods, expand affordable housing and economic opportunities, and/or improve community facilities and services, principally to benefit low- and moderate-income persons.

The objectives of our review of the CDBG program were to determine whether

- the department had sufficient controls to ensure the federal program was administered in accordance with the basic laws and regulations governing them,
- the department was in compliance with certain laws and regulations concerning this program,
- federal awards were expended only for allowable activities,
- federal drawdowns were made in compliance with grant rules and regulations,
- the department monitored contractor classifications and wage rates,
- CDBG funds benefited low- and moderate-income persons,
- CDBG funds used for administrative costs were within the limits,
- the department properly recorded program income generated from the use of CDBG funds,
- required reports for federal awards included all activity of the reporting period and were supported by applicable accounting records,
- monitored subrecipient activities provided reasonable assurance that the subrecipient administered federal awards in compliance with federal requirements,
- the state's approval of the request for release of funds and environmental certifications was satisfactory,
- the state was ensuring environmental reviews were performed, and
- loans and repayments were being made in accordance with program requirements.

To accomplish our objectives, we reviewed the most recent Office of Management and Budget Circular A-133 Compliance Supplement and other programs guidelines to become familiar with program objectives, program procedures, and compliance requirements. We interviewed key departmental employees and evaluated departmental controls for adequacy. We selected and tested expenditures and related records to determine if costs were for activities allowed, were considered allowable in accordance with program requirements, and were in compliance with applicable grant rules and regulations. We tested CDBG drawdowns and records to ensure that the drawdowns were made in compliance with applicable grant rules and regulations. We reviewed contractor files to determine whether the department monitored job classification and wage rates. We performed testwork to determine if CDBG funds benefit low- and moderate-income persons. We reviewed financial and related records to determine whether the amount of CDBG funds used for administration costs was within the limits. We tested a sample of deposits to determine if the department properly accounted for program income. We reviewed reports filed with the U.S. Department of Housing and Urban Development (HUD) during the audit period and traced data in the reports to the accounting records to determine if the reports were properly submitted by the department. We performed testwork to determine if subrecipients were being monitored and to determine if the state's approval of the request for release of funds and environmental certifications was satisfactory. We reviewed subrecipient project files to determine if the subrecipients were monitored in compliance with rules and regulations and the monitoring was documented. We tested loans awarded during the audit period and related records to determine if loans were awarded in accordance with program requirements. We tested loan repayments made during the audit period and related records to determine if repayments were made in accordance with program requirements and in compliance with applicable grant rules and regulations.

As a result of our review and testwork, we concluded that

- departmental controls were adequate over the CDBG program,
- the department was in compliance with laws and regulations concerning the CDBG program,
- federal awards were expended for allowable activities,
- federal drawdowns were made in compliance with grant rules and regulations,
- the department properly monitored contractors,
- CDBG funds benefit low- and moderate-income persons,
- CDBG funds used for administration costs were within the limits,
- the department properly recorded program income generated from the use of CDBG funds,
- required reports included all activity of the reporting period and were supported by accounting records,
- monitored subrecipient activities appeared to provide reasonable assurance that the subrecipient administers federal awards in compliance with federal requirements,

- the state's approval of the request for release of funds and environmental certifications was satisfactory,
- environmental reviews were documented, and
- loans and repayments were made in accordance with program requirements.

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## CREATIVE SERVICES

The Creative Services Division, started in 2003, provides graphic services previously provided to the department by external advertising agencies. These services are available to each of the divisions within the department as well as to other state agencies. The objectives of our review were to determine whether internal controls over Creative Services were in place and state purchasing procedures were being followed.

We interviewed key personnel and reviewed documentation to determine if internal controls over the division were proper and if state purchasing guidelines were being followed. We specifically reviewed purchases made by the Creative Services Division from July 1, 2003, to March 31, 2005. Purchases were reviewed for proper bidding procedures and to ensure three competitive bids were obtained. Purchase orders were reviewed for proper content and approval, and to ensure that they were dated prior to the invoice date. Invoices were reviewed for timeliness of payment and to ensure proper approvals were obtained, if applicable, from the publications committee and state print shop; to ensure the amount paid was the same as the bid amount; and to ensure purchase transactions were not artificially divided to make a purchase of more than \$2,000 appear to be less.

Based on our inquiries and review of documentation, we found that internal controls over Creative Services were not adequate. Furthermore, based on our testwork of purchasing transactions, we found the Division of Creative Services was not following proper bidding procedures, purchase requests were not properly prepared and approved, purchase requests were dated after the invoice was received, invoices were not paid timely, proper approvals from the General Services Publications Committee and State Print Shop were not always obtained, invoices appeared to be artificially divided to make a purchase appear to be less than \$2,000, and three competitive bids were not always obtained. These matters are noted in finding 1.

**1. The Creative Services Division did not follow bidding procedures and purchasing guidelines, and department management did not successfully mitigate the risk of inappropriate use of state funds**

### Finding

The Creative Services Division of the Department of Economic and Community Development did not follow the Department of General Services Purchasing Division *Agency Purchasing Procedures Manual* when making purchases between \$400.01 and \$2,000.00. The

manual states, “Procurement requirements shall not be artificially divided so as to appear to be purchases of under \$2,000, therefore constituting a small value delegation. Such practice is referred to as a ‘split invoice’ (TCA Section 12-3-210).” Invoice splitting should not be used to make a purchase of more than \$2,000 appear to be less. Bid specifications should be worded or designed to permit open and competitive bidding, and the agency should obtain at least three competitive bids. Prior to the purchase of printing or reprinting a publication, the department requires an internal form to initiate the purchase, the State Publications Committee must review and approve the request, and the purchase must be authorized to be printed at a non-state-operated facility. However, purchase requests in the Creative Services Division were not prepared and processed properly.

The preface of the *Agency Purchasing Procedures Manual* states,

Employment in a public purchasing entity is a public trust. Employees involved in purchasing or procurement must conduct themselves in such a manner as to ensure the integrity of the competitive bid process and to allow all duly qualified and responsible bidders equal access to the purchasing process. To achieve this end, it is imperative that those involved in purchasing or procurement observe at a minimum the statutes and rules promoting ethical standards.

Evidence of possible purchasing improprieties by the former Director of Creative Services were initially uncovered when the department’s internal auditor obtained information about possible procurement improprieties. She shared this information with us during our field work. This information included intradepartmental communications that revealed that upper management had knowledge that procedures were not being followed in some instances.

As a result of this information, we began our testwork. Management’s efforts to halt the former Director of Creative Services’ violations of purchasing regulations were ineffective in preventing his circumvention of controls. Based on testwork performed, it was discovered that the former Director of Creative Services had routinely split the jobs or reduced the quantity as he suggested in the memo. The former Director of the Creative Services Division also “skewed” purchases in order for the purchase to be less than \$2,000.00. As a result of these activities, the former director was terminated.

We selected 86 printing purchases made by Creative Services between \$400.01 and \$2,000.00 for testing. There were numerous problems with the purchases. Of the 86 purchases tested, 67 of them were found to have one or more problems associated with them. These issues are discussed below.

### **Competitive Procurement Issues Split Purchases**

Twenty purchases tested appear to be artificially divided into smaller amounts. For these 20 purchases, combining orders made to the same vendor on the same date for similar items would have resulted in only nine purchases and invoices. In seven of these nine instances, the

combined dollar amount of the purchases from the same vendor on the same day exceeded \$2,000.00. Purchases over this amount require the bids to go through the General Services Purchasing Division.

### **Misrepresentation of the Nature of Bids**

Of the 86 printing purchases tested, bids were not obtained for another 20 of them. Fifteen of the 20 purchases in which no bids were obtained were from Kinko's. Furthermore, of the purchases where bids were obtained, the three bids for each of 17 purchases were actually from an "alliance of companies" (Advent Trade Show & Exhibit Solutions, Corporate Impressions, and Aurora Exhibit Solutions, Inc.) and each bid was faxed from the same machine at the same time; therefore, the bids were not competitive. We contacted the vendor and confirmed the alliance. The former Director of Creative Services admitted he knew of the alliance and that, in effect, the state was getting just one competitive bid, but continued using the alliance as three separate bids. He felt that one of the alliance members was the only vendor capable of delivering the specific product desired. This vendor got bids from the other two alliance members and faxed them all together. The former director acknowledged that the bids were not open and competitive as required by Section 12-3-502, *Tennessee Code Annotated*. Section 12-3-502 states,

Wherever possible, all specifications for materials, supplies and equipment to be purchased by the state of Tennessee or any of its departments, institutions, or agencies shall be worded or designed so as to permit open and competitive bidding for the supplying of the article or commodities to which they apply; and all proprietary specifications shall be developed in accordance with rules of the department approved by the board of standards.

### **Fabrication of Bid Documentation**

The former director also admitted to one instance of fabricating bid documentation, in that he used bid documentation received for one purchase as the documentation for a different, subsequent purchase. Although he only admitted to one such instance, for 15 of the purchases we tested, five sets of original bids were submitted and then used again for nine subsequent purchases. Not obtaining new bids violates Section 12-3-210, *Tennessee Code Annotated*. Section 12-3-210(b) states,

All purchases authorized and made by departments, institutions, and agencies under the provisions of this section, and the authority granted by the commissioner as therein provided, which exceed one hundred dollars (\$100), or a higher amount if the board of standards unanimously agrees upon the amount, shall, whenever practical, be based upon at least three (3) competitive bids and be made in accordance with the provisions of this part and the purchasing rules and regulations as approved by the board of standards.

Furthermore, 23 purchases had purchase orders dated prior to receiving all three bids, indicating the three competitive bids were not obtained prior to making the purchase.

### **Other Procurement and Payment Issues**

- Purchase requests were not prepared for 5 of 86 purchases tested.
- Seven purchase requests were not approved by either the Director or the Assistant Commissioner.
- Ten purchases had freight charged on the invoice but not on the purchase request or bid.
- Twenty-two purchase requests were dated after the date the vendor prepared the invoice, indicating the purchase was made without preparing a purchase request.

Three purchases from a local printer had purchase requests originally prepared for a different printing company that submitted a higher bid. However, after the winning bidder added an amount for extra copies and other additional charges, the final invoice amount was 1.8% greater than the bid amount from the printer whose bid came in second. The difference in the winning bidder's bid amount and final invoice amount was an increase of 4.5%.

Section 16.12.1 of the *Agency Purchasing Procedures Manual* states that, prior to the purchase of printing or reprinting a publication, the Publications Committee must review and approve the request, and the purchase must be authorized to be printed at a non-state-operated facility. One of the purchases tested did not have the required approvals from the Publications Committee and the Department of General Services Records Management Division.

For 17 purchases tested, the invoice was not paid in a timely manner. Section 19.1 of the *Agency Purchasing Procedures Manual* states that, upon receipt of claims, the agency is to verify actual receipt of goods or services and prepare a voucher. Section 19.4 requires that if no date for payment is agreed upon in the contract, payment will be made within 45 days after receipt of the invoice. All the invoices have payment terms of either "Net 30" or "Due upon receipt." These invoices were paid more than 45 days after the invoice was stamped received by the department's Budget and Fiscal Office. Furthermore, for 14 purchases tested, the department's Budget and Fiscal Office did not date-stamp the invoice.

The failure to adhere to state purchasing policies and procedures increases the risk of inappropriate use of state funds and erodes the integrity of the competitive bid process. Furthermore, the lack of upper management's monitoring of the former director's activities after it was known that procedures had been violated in some instances allowed his improper purchasing activities to continue for an extended period of time without detection.

## **Recommendation**

Management should ensure that competitive bids are obtained as required by the Department of General Services purchasing guidelines. Bids should be obtained from different, independent, and competitive companies. Management should ensure that all bids are received before a purchase order is prepared. Properly completed purchase orders should be approved in advance of all applicable purchases. Management must also ensure that purchases are not divided in an attempt to “split invoices” and circumvent purchasing requirements. Management should ensure that proper approvals are obtained from the Publications Committee and the Department of General Services Records Management Division when applicable. Invoices should be paid in a timely manner. Upper management with approval authority should be more knowledgeable of state purchasing procedures in order to better identify any discrepancies and implement appropriate internal controls. Management should ensure that risks such as these noted in this finding are adequately identified and assessed in their documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

## **Management’s Comment**

We concur. However, we would like to emphasize that, while purchasing improprieties were noted within the Creative Services Division in 2003 and 2004, these improprieties were the result of a specific employee’s actions and are not and should not be considered indicative of the environment at the department as a whole. These improprieties were discovered during an investigation performed by the department’s Internal Audit Division, revealing many irregularities and the indication of potential abuse and intentional circumvention of approved purchasing policies and procedures by a specific employee. Upon conclusion of that investigation, the department took swift and effective steps to remedy the situation, immediately terminating the employee involved.

In addition, the department has also taken several additional steps to further mitigate the risk of inappropriate purchasing practices. Department staff have been provided with extensive training on purchasing policies and procedures. These include a number of meetings with and presentations by Department of General Services’ Purchasing Division staff to ensure a clear, concise, and accurate understanding of purchasing requirements, rules and guidelines.

After consultation with the Department of General Services, the Creative Services Division has taken steps to identify those purchases of a repetitive nature and develop and implement departmental contracts for the procurement of those items. Since August 2004, nine such contracts have been put in place. In addition, fiscal staff reviews all purchase requests, along with the supporting documentation, to verify that the appropriate purchasing procedures were followed, with any weaknesses or concerns immediately flagged and reported.

The department has placed a strong emphasis on and is engaged in identifying problems, weaknesses, and areas of concern, taking steps to address those issues. These include actively putting in place internal controls and procedures, creating an internal audit function, increasing fiscal staff, and communicating the clear expectation to all department staff that employees are expected to comply with and adhere to established internal controls, guidelines, and policies and procedures. The gravity with which the department undertook the investigation of Creative Services and the swift action that followed is only one indication of department management's determination and commitment to resolving longstanding compliance and internal control issues in the department.

However, it is important to note that while internal controls are designed to provide reasonable assurance regarding the safeguarding of assets against loss from unauthorized use or disposition, the reliability of financial records, and maintaining accountability for assets, they do not provide absolute assurance. Although a number of steps have been taken by the department to prevent, deter, and detect instances of fraud, waste, and abuse, they may still occur notwithstanding the presence of programs and controls designed to reduce the risk of such occurrences.

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## **FASTTRACK INFRASTRUCTURE DEVELOPMENT PROGRAM**

The FastTrack Infrastructure Development Program (FADIP) provides funds to local governments for infrastructure improvements. The program is governed by Public Chapter 842, Section 32. Funds may not be used for "speculative" projects but are restricted to situations where there is a commitment by certain private-sector businesses to locate or expand in the state and to create or retain jobs for Tennesseans. The objectives of our review of this area were to determine whether

- administrative controls were adequate;
- grants awarded were in compliance with laws, regulations, and program requirements; and
- grant payments were made in accordance with grant rules and regulations.

To accomplish our objectives, we interviewed key personnel, reviewed appropriate laws, evaluated administrative controls, and reviewed program objectives and procedures. We selected a nonstatistical sample of grants awarded during the audit period. We tested the grants to ensure compliance with laws, regulations, and program requirements. We selected a nonstatistical sample of grant payments to determine if they were made in accordance with grant rules and regulations.

As a result of our review and testwork, we concluded that the department's administrative controls were adequate, grants were awarded in compliance with laws, regulations, and program requirements, and grant payments were made in accordance with grant rules and regulations.

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## TENNESSEE JOB SKILLS PROGRAM

The Tennessee Job Skills Program is a workforce development incentive program to enhance employment opportunities and to meet the needs of existing and new industries in the state. The program gives priority to the creation and retention of high-wage jobs and focuses on employers in industries that promote high-skill, high-wage jobs in high-technology areas, emerging occupations, or skilled manufacturing jobs.

The objectives of our review of this area were to determine whether

- administrative controls were adequate;
- grants awarded complied with laws, regulations, and program requirements; and
- grant payments were made in accordance with grant rules and regulations.

To accomplish our objectives, we interviewed key personnel, reviewed appropriate laws, evaluated administrative controls, and reviewed program objectives and procedures. We discovered that no new monies had been granted during our audit period. Therefore, we could not determine if the prior finding had been resolved. However, we did note that several companies receiving Job Skills funds were not required by the department to submit a final report. This problem is noted in finding 2.

### **2. Tennessee Job Skills grant procedures were not followed**

#### **Finding**

Several companies receiving Job Skills grant funds were not required by the responsible department staff to submit a final report. Controls were not in place to detect these failures. *Tennessee Code Annotated*, Section 50-7-451(e), states that:

Each employer who receives a Tennessee job skills grant pursuant to the provisions of this section shall file a final report with the department of economic and community development at the conclusion of the Tennessee job skills grant period which contains the following information:

- (1) The number of participants in the project who are employed at the conclusion of the project;
- (2) The number of participants in the project who are not employed at the end of the project;
- (3) The starting wage of each participant employed; and
- (4) Any other information required by the department of economic and community development.

Based on testwork performed, 13 of 17 grant contract files reviewed (76%) did not have a final report. The total amount of these 13 contracts was \$865,805.69. The purpose of the final report is to show that the companies receiving funding fulfilled contract obligations.

### **Recommendation**

The Department of Economic and Community Development should ensure that all procedures outlined in Section 50-7-451, *Tennessee Code Annotated*, are followed for the Tennessee Job Skills Program in order to comply with the law.

### **Management's Comment**

We concur. However, although all final reports were not received, the department extensively monitors the administration of all Tennessee Job Skills grants throughout the life of each grant to ensure that grant funds are reimbursed appropriately and to assess whether grant recipients are achieving program goals.

Data on the number of trainees, the number of jobs created and/or upgraded, and the related Title VI information, has been and is collected, tracked, summarized, and analyzed by program staff on a regular basis. This information is required from all Tennessee Job Skills grant recipients, as a condition for reimbursement, and is to be submitted with each reimbursement request. As a result, while final reports were not received from the identified Tennessee Job Skills grant recipients, the lack of those reports did not diminish the department's ability to monitor the administration of the grant program or to evaluate the resulting job creation and upgrades.

Final reports are requested from each grant recipient. However, during the period identified, due to staff turnover and the resulting transition period, the department did not perform adequate follow-up to ensure the receipt of all final reports. Beginning this fiscal year, the department has included, as a requirement within each Tennessee Job Skills grant contract, the submission of a final report meeting the requirements of *Tennessee Code Annotated*.

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## **EXPENDITURES**

Our objectives in reviewing expenditures were to determine if

- the department's controls over processing and payment were adequate; and
- expenditures were adequately supported, properly approved, properly classified in the accounting records, and paid in a timely manner.

We interviewed key personnel to gain an understanding of the department's controls over expenditures. We selected certain expenditures to determine if they were properly supported, approved, complete, timely, and properly classified.

Based on our interviews, reviews of supporting documentation, and testwork, we determined that controls over expenditures were not adequate. We reviewed selected expenditures and discovered problems with approval, classification, support, and timely payment. The problems are discussed in finding 3.

### **3. The department should improve controls over disbursements**

#### **Finding**

As noted in the prior audit, the department did not have proper internal controls over disbursements. Management concurred with the prior finding, stating, "There were no department-wide internal controls in place prior to January 18, 2003. Since that time, the department has taken a number of steps to better monitor and account for purchases, expenditures, and all travel claims." However, when we selected 154 disbursement transactions for testing, the results of the testwork disclosed one or more problems with 62 of 154 (40.3%) transactions tested. Transactions were tested for proper approvals for payment, adequate support, proper coding in the accounting records, and prompt payment.

Twenty-three of the 62 transactions were not properly approved. Of the 23 unapproved transactions, two approvals were obtained after payment was made. Fifteen of these 23 transactions were credit card statements for airline travel. The charges were not approved or matched to the travel authorizations. Twenty-five of the 62 transactions were not coded properly. The majority of the 25 transactions not properly coded to the State of Tennessee Accounting and Reporting System (STARS) were erroneously charged to travel. Twelve of the 62 transactions were not properly supported. Six of the 12 unsupported transactions did not have invoices supporting payment. These payments were supported by internal memos requesting payment to the vendors for an authorized event. Support for the other transactions did not have enough detailed information on the invoice to specifically identify the nature of the payment. However, our review did not indicate that these transactions were fraudulent in nature. Also, 12 of the 62 transactions were not paid in a timely manner. Section 12-4-703, *Tennessee Code Annotated*, states,

An agency which acquires property or services . . . shall pay . . . if no date or other provision for payment is specified by contract, within forty-five (45) days after receipt of the invoice covering the delivered items or services.

Invoices not paid timely were paid between 2 and 55 days late. Paying invoices late could cost the state in vendor discounts. By paying in a timelier manner according to the Prompt Payment Act, the agency will give vendors access to their funds when payment is due.

As stated in the prior audit, effective internal controls are essential to account for government resources and to ensure that payments are appropriate. Management has the responsibility to institute and maintain control procedures that will ensure all transactions are properly authorized, processed, supported, and paid timely. When controls are weak, there is a high degree of risk that payments may be made for unallowable or unreasonable goods and services.

### **Recommendation**

The Commissioner should ensure that internal controls are developed and enforced over disbursements to ensure they are properly approved, supported, accounted for, and paid in a timely manner. Unapproved or unsupported invoices should not be paid. The department should verify airline charges to travel authorizations. Out-of-state travel authorizations and detailed invoices should be obtained and compared with the statements prior to payment. In addition, disbursements should be charged to the proper expenditure classification in the state accounting system. Invoices should be paid in a timely manner.

### **Management's Comment**

We concur. As noted in the previous financial audit of ECD in 2003, the department has had a long history of circumventing internal controls and bypassing state policies and procedures. Under the current administration, the department has placed an emphasis on, and is engaged in, identifying problems, weaknesses, and areas of concern, and is taking steps to address those issues. These steps include actively putting in place internal controls and procedures, creating an internal audit function, increasing fiscal staff, and communicating the clear expectation to all department staff that employees are expected to comply with and adhere to established internal controls, guidelines, state law, policies, and procedures. The increased emphasis on accountability represents a new day in the principles and operations of the department.

Since July 2004, the department's fiscal division has identified, implemented, and strengthened a number of internal controls and processes, allowing the department to further improve the accuracy, accountability, and timeliness of its processes, to provide reasonable assurance regarding the integrity and reliability of financial data and records, to safeguard assets against loss, to maintain accountability for assets, and to provide in-depth analyses of the department's resources. Some of the steps taken by the department include:

- Creation of an electronic database of all accounting transactions, updated on a regular basis, improving the department's ability to analyze expenditure payments and revenue collections, and detect and correct errors in coding;
- Regular reconciliations of accounting transactions to STARS accounting reports to ensure the accuracy of expenditure and revenue data and daily monitoring of the STARS error report to review and correct any errors in processing payments;

- Revision of the process for receiving and depositing checks, including development of an electronic log to document receipt and deposit dates, improved security measures, increased separation of duties in handling and depositing checks, and reconciliation of log entries, certificates of deposit, and STARS reports to ensure accuracy;
- Implementation of procedures and additional reviews for all TOPS purchases to ensure that the appropriate purchasing processes were followed;
- Utilization of grant accounting files in STARS to ensure that all expenditures and revenue transactions relating to federal grant funds are appropriately recorded and accurate drawdown of federal funds and federal reporting occurs;
- Development of an electronic log and procedures to improve the processing of invoices to ensure that appropriate approvals are obtained, payments are made timely, and all eligible discounts are obtained;
- Reconciliation of credit card statements to travel authorizations and F&A billings to ensure appropriate and authorized airline charges;
- Implementation of an electronic travel claim form to improve the accuracy and timeliness of processing staff travel claims;
- Implementation of a purchase approval process department-wide; and
- Addition and training of back-up staff to improve timeliness and internal control reviews.

In addition, the creation of the internal audit function within the department has provided the department with an additional tool to review the reliability and integrity of the financial and operational information, improve the effectiveness and efficiency of operations, safeguarding of assets, compliance with applicable laws and regulations, and the prevention, detection, and deterrence of fraud, waste, and abuse. The internal audit function has already played a vital role in identifying and addressing internal control weaknesses in the department. Internal Audit continues to work closely with the Fiscal Division to identify, prioritize, and correct deficiencies.

The department has also met with other state divisions to improve compliance with state policies and procedures and ensure that reports required by other state agencies, including those dealing with risk insurance, records management, financial integrity, and motor vehicles are analyzed and completed appropriately, accurately, and timely. These include Statewide Accounting, Policy Development, and the Office of Contracts Review, within the Department of Finance and Administration, and Central Printing and Records Management within the Department of General Services.

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## **FINANCIAL INTEGRITY ACT**

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to submit a letter acknowledging responsibility for maintaining the internal control system of the

agency to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30 each year. In addition, the head of each executive agency is required to conduct an evaluation of the agency's internal accounting and administrative control and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

Our objectives were to determine whether

- the department's June 30, 2004, and June 30, 2003, responsibility letters and December 31, 2003, internal accounting and administrative control report were filed in compliance with Section 9-18-104, *Tennessee Code Annotated*;
- documentation to support the department's evaluation of its internal accounting and administrative control was properly maintained;
- procedures used in compiling information for the internal accounting and administrative control report were in accordance with the guidelines prescribed under Section 9-18-103, *Tennessee Code Annotated*; and
- corrective actions had been implemented for weaknesses identified in the report.

We interviewed key employees responsible for compiling information for the internal accounting and administrative control report to gain an understanding of the department's procedures. We also reviewed the June 30, 2003, responsibility letter to determine whether it had been properly submitted to the Comptroller of the Treasury and the Department of Finance and Administration.

We determined that the June 30, 2004, Financial Integrity Act responsibility letter and the internal accounting and administrative control report due December 31, 2003, were not prepared. Also, the June 30, 2003, responsibility letter was not submitted on time in compliance with *Tennessee Code Annotated*. These matters are discussed in finding 4.

#### **4. The department did not comply with the Financial Integrity Act**

##### **Finding**

The Department of Economic and Community Development did not comply with the Financial Integrity Act by preparing and submitting a responsibility letter by June 30, 2003, and June 30, 2004, acknowledging responsibility for maintaining the internal control system of the department. In addition, the Financial Integrity Act Report for December 31, 2003, was not prepared.

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to submit a letter to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30 each year acknowledging responsibility for maintaining the internal control system of the agency. In addition, the head of each executive agency is required to conduct an

evaluation of the agency's internal accounting and administrative control and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

Based on discussion and review, the responsibility letter due on June 30, 2003, was received by the Comptroller's Office on March 29, 2004. The responsibility letter due on June 30, 2004, was never prepared and the financial integrity report due on December 31, 2003, was never prepared.

### **Recommendation**

The Commissioner of the Department of Economic and Community Development should ensure that the required letters are submitted to the Commissioner of Finance and Administration and the Comptroller of the Treasury by the submission deadlines. The Commissioner should also ensure that the Financial Integrity Act Report is prepared and transmitted to the Commissioner of Finance and Administration and the Comptroller of the Treasury by the due date.

### **Management's Comment**

We concur. Upon awareness of this lack of compliance, the department's fiscal staff took immediate steps, meeting with Department of Finance and Administration staff to understand the requirements of the Financial Integrity Act and ensure that future letters and reports submitted by the department were appropriate, addressed a meaningful and relevant evaluation of the department's internal controls, and complied with deadlines. The department submitted its Financial Integrity Act responsibility letter for June 30, 2005 and June 30, 2006 on time.

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### **DEPARTMENT OF FINANCE AND ADMINISTRATION POLICY 20, *RECORDING OF FEDERAL GRANT EXPENDITURES AND REVENUES***

Department of Finance and Administration Policy 20 requires that state departments whose financial records are maintained on the State of Tennessee Accounting and Reporting System (STARS) fully utilize the STARS grant module to record the receipt and expenditure of all federal funds. Our objectives were to determine whether

- appropriate grant information was entered into the STARS Grant Control Table upon notification of the grant award, and related revenue and expenditure transactions were coded with the proper grant codes,
- the department made draw downs at least weekly using the applicable STARS reports, and
- the department utilized the appropriate STARS reports as bases for preparing the Schedules of Expenditures of Federal Awards and reports submitted to the federal government.

We interviewed key personnel to gain an understanding of the department's procedures and controls concerning Policy 20. Based on our interviews, reviews, and test work, the department was in compliance with the Department of Finance and Administration Policy 20. The department had fully utilized the STARS Grant Module to record the receipt and expenditure of all federal funds and made draw downs in a timely manner. The department also used the appropriate STARS reports as the basis for preparing the Schedule of Expenditures of Federal Awards and reports submitted to the federal government.

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**DEPARTMENT OF FINANCE AND ADMINISTRATION POLICY 22,  
SUBRECIPIENT MONITORING**

Department of Finance and Administration Policy 22, "Subrecipient Monitoring," establishes guidelines for uniform monitoring of subrecipients that receive state and/or federal funds from state agencies. Our objectives were to determine whether

- the department submitted the required monitoring plans and monitoring reports to the Department of Finance and Administration in a timely manner,
- the department identified its subrecipients and included them in the monitoring plans, and
- the department assessed the risk of each subrecipient in accordance with the guidelines established by the Department of Finance and Administration.

We interviewed key personnel to gain an understanding of the department's procedures and controls concerning Policy 22. We reviewed the annual monitoring plan and the Department of Finance and Administration approval of the plan.

As a result of our review, we determined that the department had submitted monitoring plans and reports to the Department of Finance and Administration in a timely manner, the department had identified its subrecipients and included them in the monitoring plan, and the department had assessed the risk of each subrecipient in accordance with the guidelines established by the Department of Finance and Administration.

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**OBSERVATIONS AND COMMENTS**

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**FRAUD CONSIDERATIONS**

Statement on Auditing Standards No. 99 promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates

the obvious premise that management, and not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

## **TITLE VI OF THE CIVIL RIGHTS ACT OF 1964**

Section 4-21-901, *Tennessee Code Annotated*, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by June 30 each year. The Department of Economic and Community Development filed its compliance reports and implementation plans on June 28, 2002; July 1, 2003; and June 30, 2004.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds. The Tennessee Title VI Compliance Commission is responsible for monitoring and enforcement of Title VI.

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## APPENDIX

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### ALLOTMENT CODES

330.01	Administrative Services
330.02	Business Development
330.05	Business Services
330.04	Regional Grants Management
330.06	FastTrack Infrastructure Development Program
330.07	Community Development
330.08	Energy Division
330.09	FastTrack Job Training Assistance Program
330.13	Tennessee Jobs Skills Program