State Auditor's Annual Report

Report on Compliance and Internal Control Over Financial Reporting & State of Vermont Management Letter for the Fiscal Year Ended June 30, 2001

Elizabeth M. Ready

Vermont State Auditor

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COVER IMAGE

Sunday in October ***by Regis E. Cummings***
From a series of four original paintings entitled
"Celebrating Montpelier Through the Seasons"

Reprinted with permission of the artist

Cards and prints are available from the artist
24 Colonial Drive, Montpelier, VT 05602
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Artwork is also available at The Country Store and Rivendell Books on Main Street in Montpelier.

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Speaker of the House of Representatives, Walter Freed
President Pro-Tempore of the Senate, Peter Shumlin
Governor Howard Dean, MD

Gentlemen:

The Vermont General Assembly and the Dean Administration have adhered to prudent fiscal policies during the past decade that have resulted in a balanced budget, well-fortified rainy day funds, and the highest state bond rating in New England.

But this legacy could be at risk unless the Legislative and Administrative branches make similar efforts to strengthen the State's internal fiscal management. The attached *Report on Compliance and Internal Control over Financial Reporting* and the State Auditor's annual *Management Letter* highlight a number of weaknesses and conditions in Vermont's system of internal controls that, if left uncorrected, could seriously undermine the State's fiscal environment.

Report on Compliance and Internal Control Overview

Our Office's *Report on Compliance and Internal Control Over Financial Reporting* is related to our audit of the State's General Purpose Financial Statements for the fiscal year ending June 30, 2001. This report, co-signed by KPMG, was previously included as part of the Comprehensive Annual Financial Report (CAFR) issued by the Department of Finance and Management. The Department chose not to include our Report in this year's CAFR.

Our Report found significant deficiencies related to internal controls over financial reporting and operations during fiscal year 2001 at both the Department of Taxes and the Office of the State Treasurer, which we noted as reportable conditions. These reportable conditions, further classified as material weaknesses due to the degree of risk associated with the lack of proper controls, were:

- *The Department of Taxes experienced numerous problems processing, recording and reporting receipts from taxpayers. These problems included: issuing erroneous adjustment letters that included bills or checks for overpayment of taxes; failing to deposit tax payments in a timely manner; and failing to reconcile in a timely fashion the Commissioner's Refund Account.*

The Department of Taxes has taken steps to improve these problems during fiscal year 2002. However, these problems seriously undermined the Department's credibility with respect to its primary role of properly collecting and accounting for taxes in a timely and efficient manner.

- *The Treasurer's Office continued its failure to reconcile the following bank accounts in a timely manner: The Department of Prevention, Assistance, Transition and Health Care (PATH) the Office of Child Support, and Vendor. The Vendor account alone accounts for $1.6 billion in annual disbursements.*

In addition to these material weaknesses, our Office also noted an increase in the amount of prior year expenditures being paid from the subsequent year's budget. As of the end of October 2001, $83 million of bills for goods and services received during fiscal year 2001 were paid for in fiscal year 2002. This number increased from $70 million during the previous fiscal year. The State appears to have sufficient levels of appropriated carry forward to cover the prior year expenditures. However, management of departmental budgets could be adversely affected because there is not always a relationship between the amount of a department's carry forward expenditures and its appropriated spending authority. It is particularly important to note the carry forward of 2001 expenditures to fiscal year 2002, because fiscal year 2002 will be the first year the State plans to institute a full encumbrance accounting system.

Management Letter Overview

The *Management Letter* is a result of our audit of the State's fiscal year 2001 General Purpose Financial Statements and the federally required Single Audit of federal funds for fiscal year 2001. This report is responsive to various duties of the State Auditor outlined in 32 VSA § 163(1) and (7). The purpose of the *Management Letter* and the *Report on Compliance and Internal Control over Financial Reporting* is to indicate specific ways for State managers to improve financial operations, reporting, and the efficient management of the State's resources. We are pleased to present these reports in a timely fashion so that departments can make immediate use of the recommendations.

The findings from our audit of the State's fiscal year 2001 General Purpose Financial Statements, a financially-related review of the internal controls over cash at the Courts, and the annual federal Single Audit suggest areas where improvements should occur and where current efforts should continue. Some of the findings and areas that need improvement include:

- *Lack of internal controls in regard to the reconciliation of cash accounts within the Treasurer's Office and the Tax Department has escalated since our finding of this deficiency in prior years' Management Letter Comments. Failure of the VISION automated reconciliation process to function properly has only compounded these problems. As of the date of this letter, the Treasurer's Office has not reconciled its accounts for nine months since June 30, 2001, and has hired an outside accounting firm to complete its reconciliations.*

- *The Treasurer's Office is responsible for maintaining proper internal controls over the State retirement system investments. However, the Treasurer relies almost entirely on consultants to execute transactions, evaluate performance and perform reconciliations. There is no documentation to show whether the Treasurer's Office has reviewed these processes.*

- *Many Departments point to VISION, the State's new financial management information system, as the tool they will use to correct the issues we raised in our comments. Conversion to VISION, on July 1, 2001 has not been without problems, including extended processing times and the inability to generate timely and useful reports and bank reconciliations. The Department of Finance and Management must continue efforts to train personnel and to implement efficient and effective internal controls that will take full advantage of VISION's capabilities.*

• *The financial statements produced by the State and all of its component units for the year ending June 30, 2002 must be in compliance with the new financial reporting requirements contained in Government Accounting Standards Board (GASB) Statement No. 34. These new reporting standards change the manner in which the financial statements are presented. The Department of Finance and Management will need to invest adequate time, resources, and staff to ensure the State and its component units are fully prepared to implement GASB No. 34 in a timely manner.*

Information Technology (IT) as a Tool for Improving Controls

A number of the reportable conditions and comments that are outlined in the *Report on Compliance and Internal Control Over Financial Reporting* and the *Management Letter* would benefit from improvements in the oversight and management of the IT systems that support fundamental and essential operations of State government. The problems experienced by the Tax Department in processing tax receipts, lack of timely reconciliations in the Treasurer's Office, and challenges that the State will face in complying with GASB Statement No. 34, all relate to IT systems and the internal controls surrounding these systems.

During this past year my Office has issued several special reports focusing on different components of the State's information technology systems. Each of these reports includes recommendations, which if implemented, would lead to improved systems and efficiencies. These reports are available on my Office's website at www.state.vt.us/sao and include:

– A review of the Department of Finance and Management's Implementation of Project VISION;
– Securing the Enterprise, A High Level Assessment of Vermont's Information Technology and Data Recovery Policies; and,
– Wiring Vermont's Future, Stronger Oversight & Project Management Needed to Develop and Protect Vermont's Information Technology Investments.

Governing For Results

Performance budgeting is a top priority of our Office. Agency of Administration Secretary Kathleen Hoyt has taken the lead in directing the State's effort to adopt performance based-budgeting. During 2001 Secretary Hoyt convened two day-long sessions for department managers and budget directors to learn how to develop and implement measurable outcomes that answer, "who is better off because of the work we do or because of the services we provide?" The fiscal year 2003 budget includes performance measures for at least one program of every department of state government. The goal is to expand this effort to eventually include performance measures for all programs of every department of state government. The Legislature will need to be a strong partner with the Administration in order for this new initiative to be successful.

I wish to thank the Commissioner of Finance and Management and his staff, the Deputy Treasurer, the Office of the Court Administrator, and the staff of the State Auditor's Office for their collective efforts in completing this year's audit. Our Office will follow up on department progress in implementing these recommendations by September 30, with the hope of seeing substantial improvements as the year unfolds.

I am hopeful that with the implementation of VISION the State will soon be able to prepare the CAFR by December 31st as outlined in 32 V.S.A. § 182(a)(8). In 1998 the Legislature extended this date to March 31st until such time as the Commissioner of Finance and Management could utilize data generated by VISION to prepare the financial reports. Returning to the December 31st deadline for completing the CAFR will improve the usefulness of the report as well as the effectiveness of the state's financial operations.

Fiscal year 2002 will be a fiscal proving ground for Vermont in many ways. The State faces budget and revenue challenges. It is in the first year of full Generally Accepted Accounting Principles (GAAP) accounting with new accounting and tax software systems in place. The State and its component units must comply fully with GASB Statements 34 and 35. Vermont continues to experience challenges in the successful development and implementation of information technology systems that are fully integrated across State government. Finally the State is preparing for significant changes in top executive positions.

Vermont cannot afford to drift along in the current of these changes. The State must recommit itself to an environment of strong management and internal controls. The reportable conditions and material weaknesses described above must be fully addressed; new information technology systems must be fully delivered and implemented; and, new required accounting standards must be fully adopted if Vermont is to maintain its strong fiscal standing.

Sincerely,

Elizabeth M. Ready

Elizabeth M. Ready
State Auditor

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