Report of the Vermont State Auditor

March 31, 2008

FISCAL YEAR 2007

Report on Internal Controls Over Financial Reporting and on Compliance with Laws and Regulations

Thomas M. Salmon, CPA
Vermont State Auditor
Rpt. No. 08-6

Mission Statement

The mission of the Auditor's Office is to be a catalyst for good government by promoting reliable and accurate financial reporting as well as promoting economy, efficiency, and effectiveness in state government.

THOMAS M. SALMON, CPA
STATE AUDITOR

STATE OF VERMONT
OFFICE OF THE STATE AUDITOR

Report on Internal Control Over Financial Reporting and On Compliance and Other Matters Based on An Audit of Financial Statements Performed in Accordance With Government Auditing Standards

The Honorable Gaye Symington
Speaker of the House of Representatives

The Honorable Peter D. Shumlin
President Pro Tempore of the Senate

The Honorable James Douglas
Governor

Dear Colleagues,

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Vermont, as of and for the year ended June 30, 2007, which collectively comprise the State of Vermont's basic financial statements, and have issued our report thereon dated January 31, 2008. Our report was modified to include a reference to other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the component units and certain business-type activities, as described in our report on the State of Vermont's basic financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

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Internal Control Over Financial Reporting

In planning and performing the audit, we considered the State of Vermont's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State of Vermont's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below and in appendices I and II, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses or significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the State of Vermont's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote[1] likelihood that a misstatement of the State of Vermont's financial statements that is more than inconsequential[2] will not be prevented or detected by the State's internal control. A material weakness is a significant deficiency, or combination of significant deficiencies, that result in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the State's internal control.

<u>Material Weaknesses (additional information can be found in appendix I)</u>

Control Finding 2007-1: Financial Management and Financial Reporting of the State's Medicaid Section 1115 Demonstration Waiver Agreement (page 1)

Control Finding 2007-2: Estimation of Allowance for Uncollectible Accounts (page 11)

Control Finding 2007-3: Department of Labor's Unemployment Compensation Fund (page 13)

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[1]Statement of Auditing Standards 112 states that the likelihood of an event is "more than remote" when it is at least reasonably possible.

[2]The term "more than inconsequential" describes the magnitude of potential misstatement that could occur. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements.

Significant Deficiencies (additional information can be found in Appendix II)

Control Finding 2007-4: Risk Assessments and Monitoring Processes (page 15)

Control Finding 2007-5: Evaluations of Internal Controls (page 17)

Control Finding 2007-6: Compilation and Review of the Comprehensive Annual Financial Report (page 20)

Control Finding 2007-7: Information Technology Controls (page 24)

Control Finding 2007-8: Accounts Payable Cutoff (page 34)

Control Finding 2007-9: Reconciliations of Subsidiary Systems to VISION (page 35)

Control Finding 2007-10: Department of Education's Administration of Statewide Education Funding (page 36)

Control Finding 2007-11: OVHA Provider Taxes (page 40)

Control Finding 2007-12: Department of Liquor Control Segregation of Duties (page 44)

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of Vermont's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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Appendix III contains a list of State organizations where we performed an evaluation of internal controls. For those material weaknesses and significant deficiencies in which there are recommendations in this report, we provided a draft of this report to the organization to which the recommendations are directed. The recommendations in most of the material weaknesses and significant deficiencies are directed toward the Agency of Administration because it is responsible for ensuring the fiscal integrity of the State and its component departments provide centralized services in areas such as financial management, information technology, and contract management. Other recommendations were directed toward the Agency of Human Services and the Departments of Labor, Education, and Liquor Control. We summarized managements' response to the findings at the end of each applicable section and the comments are reprinted in appendices IV to VIII. We did not audit managements' responses and, accordingly, we express no opinion on them.

In addition to the material weakness and significant deficiencies noted in this report, we found other control deficiencies that do not meet these criteria at a variety of State organizations. These control deficiencies have been, or will shortly be, incorporated into internal control reports addressed to specific State entities and will be available on our web site, www.auditor.vermot.gov.

This report is intended solely for the information and use of the Speaker of the House of Representatives, the President Pro-Tempore of the Senate, the Governor, the Secretary of the Agency of Administration, the Commissioner of the Department of Finance and Management and the head of relevant state agencies, departments or institutions. However, this report is a matter of public record and its distribution is not limited.

Thomas M. Salmon CPA

Thomas M. Salmon, CPA
State Auditor
March 31, 2008

Contents

Report

Tables

Figures

Contents

Abbreviations

AHS	Agency of Human Services
CAFR	Comprehensive Annual Financial Report
CIO	Chief Information Officer
CMS	Centers for Medicare and Medicaid Services
DII	Department of Information and Innovation
DOE	Department of Education
EDS	Electronic Data Systems Corporation
IT	information technology
MCO	managed care organization
NIST	National Institute of Standards and Technology
OVHA	Office of Vermont Health Access
STC	State Technology Council
US-CERT	U.S. Computer Emergency Readiness Team
VHAP	Vermont Health Access Plan
VISION	Vermont Integrated Solution for Information and Organizational Needs

Control Finding 2007-1: Financial Management and Financial Reporting of the State's Medicaid Section 1115 Demonstration Waiver Agreement

The State's Global Commitment to Health section 1115 demonstration waiver[3] (hereafter known as Global Commitment) represents a material change in how Medicaid is funded. Namely, in exchange for greater flexibility to use federal Medicaid funds for other health-related programs, the State took on financial risk by agreeing to a maximum funding amount it could receive during the five years of the waiver period. However, the State has taken actions that have further increased the financial risks associated with this agreement. Specifically, it made certain significant decisions that are not explicitly covered by the terms of the waiver:

(1) to use Global Commitment funding from the federal government to pay for claims with dates of service prior to the start of the waiver period (pre-Global Commitment claims); and

(2) to anticipate that additional federal funding will be forthcoming for claims with dates of service during Global Commitment, but paid subsequent to the end of the waiver term.

In addition, the State's accounting and financial reporting for Global Commitment was influenced by these decisions, which caused it to struggle with deciding on the most appropriate accounting treatment.

Federal Medicaid Funding Significantly Different under Global Commitment

Vermont operates the largest portion[4] of its Medicaid program under the Global Commitment waiver agreement, which is effective for services rendered between October 1, 2005 and September 30, 2010.[5] This waiver

[3]Per the Centers for Medicare and Medicaid Services, section 1115 of the Social Security Act provides the Secretary of Health and Human Services broad authority to authorize experimental, pilot, or demonstration projects likely to assist in promoting the objectives of the Medicaid statute. These projects are referred to as Medicaid 1115 demonstration waivers.

[4]Parts of the Medicaid program, such as expenditures for long-term care and the State Children's Health Insurance Plan, are not covered by the Global Commitment waiver agreement.

[5]The Centers for Medicare and Medicaid Services approved the State's original waiver request in September 2005. This original waiver was subsequently amended in late 2007.

agreement is designed to contain costs; to improve system accountability and quality of care; and, by potentially delivering services to Medicaid beneficiaries for less and reinvesting savings, to allow the State to serve more of its uninsured population. The State believes that it can achieve millions in savings as a result of this waiver agreement.[6]

The Global Commitment waiver fundamentally restructures a significant portion of the state's Medicaid program, particularly with regard to the Centers for Medicare and Medicaid Services' (CMS) commitment to financing Medicaid. According to the waiver terms, Vermont and CMS agreed to a cap that limits Medicaid expenditures to $4.7 billion over the 5-year term of the agreement. Should the state exceed this amount, it would be solely responsible for the excess. In exchange for taking on this risk, the State obtained greater flexibility in how it could use Federal funds. Specifically, the waiver employs a premium-based financing system and allows the State to utilize any excess premiums for various State health care programs and initiatives that might otherwise have been paid for solely with State funds.

To implement the demonstration waiver, the State designated the Office of Vermont Health Access (OVHA) as a managed care organization (MCO). OVHA's parent agency, the Agency of Human Services (AHS) entered into an intergovernmental agreement, considered to be a comprehensive risk contract,[7] with OVHA. Under this agreement, AHS makes monthly capitation payments[8] to OVHA based upon an actuarial certified premium rate and the anticipated number of Medicaid beneficiaries in the month.[9] AHS receives federal Medicaid matching funds for the capitation payments it makes to OVHA. The monthly payment is intended to cover the medical costs and administrative expenses of serving enrolled beneficiaries. If the capitation payment to OVHA is less than the cost of providing services to enrolled

[6]According to *Introduction to Global Commitment* (Joint Fiscal Office and Legislative Council, December 2005) savings from the Global Commitment waiver are expected to be in the $135-$165 million range.

[7]Under a risk contract, the contractor (i.e., MCO) assumes the risk for the cost of covered services and incurs loss if the cost of furnishing services exceeds the payments under the contract. 42 C.F.R. §438.2 (2006).

[8]Capitation payments are payments that a state agency makes periodically on behalf of each recipient enrolled under a contract for the provision of medical services under the state plan, regardless of whether the particular recipient receives services during the period covered by the payment. 42 C.F.R. §438.2 (2006).

[9]*Final Intergovernmental Agreement Between AHS and OVHA for the Administration and Operation of the Global Commitment to Health Waiver* (Sept. 30, 2005), which was subsequently superseded by a June 20, 2007 agreement.

Medicaid beneficiaries during the month, the State may not seek additional reimbursement from CMS. If the capitation payment to OVHA is greater than the cost of providing services to Medicaid beneficiaries, the State may use the excess to fund health care programs and initiatives that meet waiver conditions (called MCO investments).

Under the State's previous 1115 waiver, the Vermont Health Access Plan (VHAP), the State sought reimbursement from CMS for a percentage of all allowable Medicaid claims that the State had paid. In contrast, under Global Commitment, the State receives a payment each month from CMS for the federal share of anticipated costs of serving enrolled Medicaid beneficiaries each month. A good example to illustrate this difference is the issue of whether CMS owes AHS additional money at the end of a fiscal year for Medicaid services that have been rendered by providers, but for which the providers have not been paid. This is commonly referred to as the claims tail.[10] Under VHAP, CMS paid AHS the match rate for these claims as the State made payments to the providers. Thus, CMS owed AHS for the Federal match portion of these claims at the end of a fiscal year. Under Global Commitment, on the other hand, at the end of the fiscal year AHS has already received federal match funding from CMS for the premium[11] that it pays to OVHA. This AHS premium covers all Medicaid services rendered during the period regardless of when OVHA makes payments to providers. Accordingly at the end of a fiscal year, AHS has paid OVHA the premium to cover the cost of Medicaid services and does not owe OVHA any additional money for the claims tail. Correspondingly, CMS does not owe AHS any additional federal match.

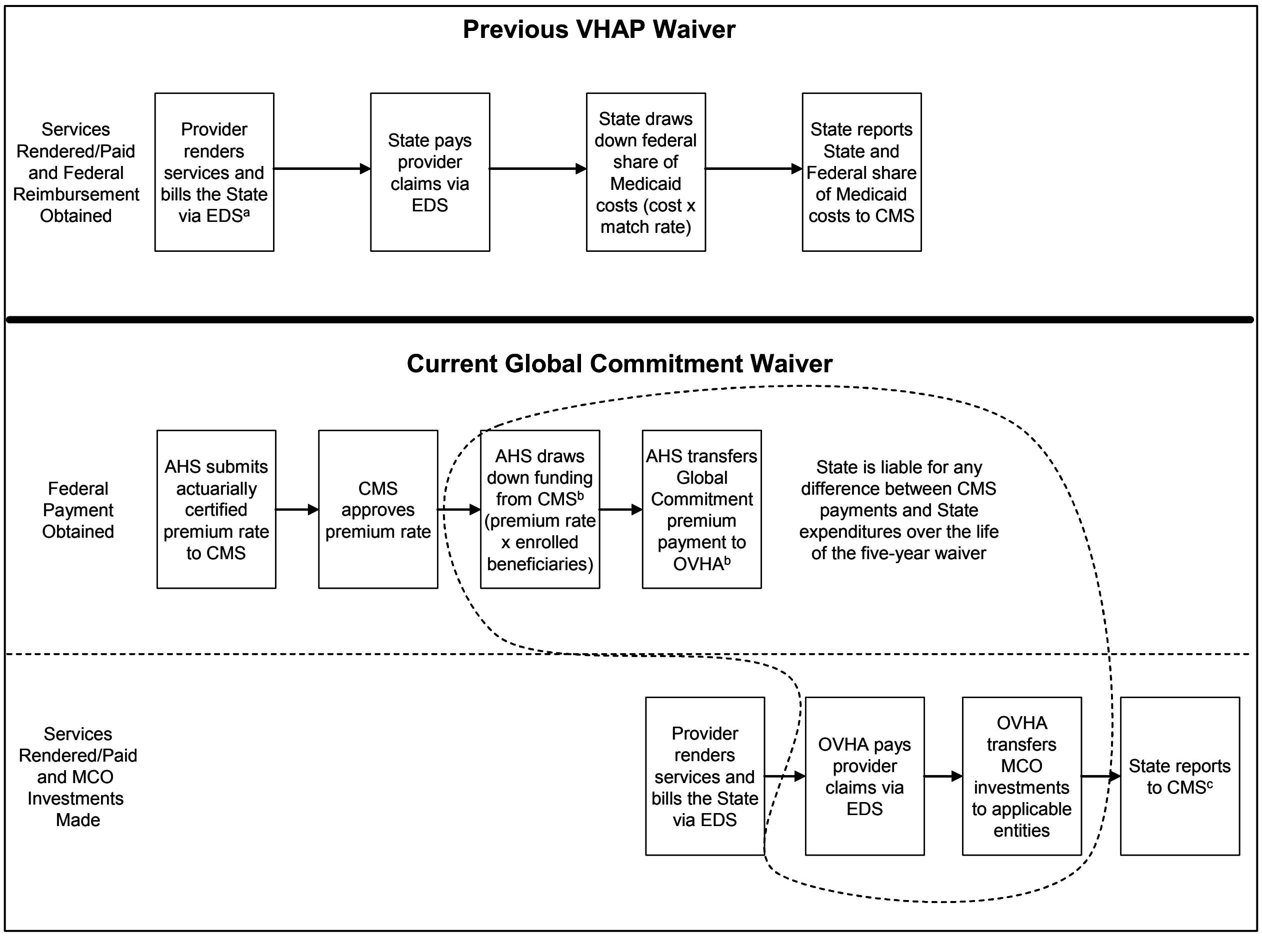
Figure 1 illustrates the different relationship between services rendered/paid and federal reimbursement under the VHAP and Global Commitment waivers. The top part of the figure represents how services were rendered and paid under VHAP while the bottom part illustrates how this works under Global Commitment. Fundamentally, the difference is that under VHAP, payments received from CMS are linked to specific Medicaid claims paid while with Global Commitment the payments from CMS are a percentage of an estimated premium regardless of how much the State pays providers for claims or when these claims are paid.

[10]The claims tail is the result of the lag between the date services are rendered and the date payments are made to providers. This lag may be 3 or more months and is significant because at any point in time, including the fiscal year end, it represents the State's liability to providers of medical services.

[11]The premium that AHS pays OVHA includes both a federal and state share.

Appendix I: Material Weaknesses

Figure 1: Comparison of VHAP and Global Commitment Operational Differences



[a]OVHA contracts with Electronic Data Systems Corporation (EDS) Vermont to process Medicaid claims for payment.
[b]These fund transfers occur around the same timeframe.
[c]These reports encompass information on MCO investments, premium payments made to OVHA, and provider claim payments.

Financial Risks Associated with the Implementation of the Global Commitment Waiver

The State has made decisions as to how to implement the Global Commitment waiver that have increased its financial risks. Nonetheless, these risks could be mitigated should the State take expeditious action to reduce its financial exposure.

Appendix I: Material Weaknesses

Undocumented Agreements

AHS and OVHA senior management[12] responsible for negotiating and documenting the terms and conditions of the Global Commitment waiver relied on informal undocumented agreements to handle two significant items. First, AHS and OVHA senior management believe that they have a verbal agreement with a CMS manager in the Boston regional office that the claims tail[13] at the end of the waiver term would be eligible for federal reimbursement under the match rate system. However, according to the documented terms, the State would have already received payment for these claims via the premium payment. The CMS individual with whom the State had this verbal agreement is no longer at CMS and we could not substantiate what, if any, agreements had been reached. The current Associate Regional Administrator in the Boston Regional office noted that he *"understands [the] conversation with the prior person in this job…but I don't have anything within the terms and conditions of the waiver that spells that out. Maybe we need to re-open the waiver, and maybe we need to go back and come to an agreement with the State..."*

The amount of the claims tail is significant. For example, the amount was $62 million and $80 million in fiscal years 2007 and 2006, respectively. In 2010, when the waiver is scheduled to expire, CMS may disagree that it owes the State a match amount for these claims. Without a more definitive written agreement with CMS as to how these claims will be funded, the State may be exposed to substantial monetary risk upon expiration of the waiver term.

AHS and OVHA senior management also believe that they have an agreement with CMS Boston regional office personnel that Medicaid provider claims with dates of services prior to the term of the waiver (pre-Global Commitment claims)[14] could be paid for with Global Commitment money. Since the inception of the waiver on October 1, 2005, OVHA has utilized $75.6 million of Global Commitment funds to pay for pre-Global Commitment claims. We believe that using Global Commitment funds to pay for services provided prior to the inception of the agreement was questionable

[12]Senior management involved in the grant negotiations with CMS included the then Secretary of the Agency of Human Services and the Director of the Office of Vermont Health Access. These negotiations occurred from February 2005 through September 2005.

[13]The claims tail is the result of the lag between the dates services are rendered and the date payments are made to providers. This lag may be 3 or more months and is significant because at any point in time, including the end of the waiver term, it represents the State's liability to providers of medical services.

[14]The dates of service occurred under the VHAP waiver.

because the waiver terms state that "this project is approved for expenditures applicable to services *rendered during* the demonstration period" [emphasis added].[15] Since these pre-waiver costs do not meet this criteria, there is risk to the State that CMS could dispute the use of Global Commitment funds for non-Global Commitment services in the future.

Given the uncertainties associated with relying upon undocumented agreements, we believe that it would have been more prudent for management to negotiate a written agreement that encompassed all material terms and conditions of the waiver. In an analogous situation in which the State is contracting with a vendor or other external entity, the State's policy requires that the written contract represent the entire terms of the arrangement.[16] We believe that situations like the Global Commitment waiver call for similar representations that the written agreement between the parties encompass all material terms and that there are no unwritten arrangements that are being relied upon.

Fund Deficit

In part due to the State's reliance on these undocumented agreements, the Global Commitment Fund reported a $31 million deficit as of the end of fiscal year 2007. In particular, the State has not set the premium at a rate that incorporates the cost of paying for pre-Global Commitment claims with Global Commitment funds. Instead, the premium has been set only to cover the costs of services provided during the waiver period plus spending for various state health care programs. As a result, the premiums received since inception of the waiver have been less than costs incurred during the waiver period. In its fiscal year 2007 financial statements, the State represented that it would address this deficit during the remaining term of the waiver through adjustments to the actuarial rate ranges or that it would include the reimbursement of the pre-Global Commitment claims in future waiver negotiations with CMS.

MCO Investments

Section 40 of the waiver agreement states that any revenue from capitation payments made to OVHA in excess of claims paid on behalf of Medicaid

[15] Original Global Commitment to Health Waiver Terms & Conditions, Section 43.

[16] Paragraph 1 in the standard contract form in the State's Bulletin 3.5, *Contracting Procedures*, states "This contract represents the entire agreement between the parties on the subject matter. All prior agreements, representations, statements, negotiations, and understandings shall have no effect."

eligible recipients may be invested in state health care programs and services as allowed by the waiver agreement. Such "MCO investments" may be used to (1) reduce the rate of the uninsured or underinsured in Vermont, (2) increase the access of quality health care to the uninsured, underinsured, and Medicaid beneficiaries, (3) provide public health approaches to improve the health outcomes and quality of life for the uninsured, underinsured, and Medicaid beneficiaries, and (4) encourage the formation and maintenance of public-private partnerships in health care.

The Single Audit of the Medicaid program questioned the costs of about $38 million in MCO investments. Specifically, the audit found systematic deficiencies in the State's decisions and documentation related to these investments.[17] For example, the audit found instances in which (1) the evidence did not support that the investment was health care related and therefore did not meet the definition of an MCO investment and (2) the organization that received the funds did not maintain any detailed accounting records or other documentation to support how the funds were spent. More specific guidance on documenting the rationale for MCO investments along with the types of records that need to be maintained to show how the funds are being spent could reduce the State's risk that future MCO investments will also be questioned and thereby be put at jeopardy of being disallowed by the Federal government.

Accounting and Financial Reporting Associated with the Waiver

The Global Commitment waiver represented a fundamental change in the State's financial relationship with the Federal government for a large portion of the Medicaid program. Accordingly, it is to be expected that such a substantial change to one of the State's largest program would have a concomitant effect on the State's financial statements. Indeed, the General Assembly established a separate special fund to be the primary source of the State's financing of the Global Commitment waiver.[18] In addition, in fiscal year 2006, the State established a new major governmental fund in its basic financial statements, the Global Commitment Fund,[19] which consists of the

[17] *State of Vermont: Auditors' Report as Required by OMB Circular A-133 and Related Information, Year ended June 30, 2007* (KPMG, March 28, 2008).

[18] 33 V.S.A. §1901d established the State Health Care Resources Fund, into which are deposited revenue from (1) the tobacco products tax and 84.5 percent of the revenue from the cigarette tax, (2) the health care provider assessments, and (3) proceeds from grants, donations, contributions, taxes, and any other sources of revenue as may be provided by statute, rule, or act of the general assembly.

[19] 33 V.S.A. §1901e authorized the establishment of this fund.

actuarially certified premium payments that AHS transfers to OVHA (largely from the State's Federal Fund) for the purpose of providing services under the waiver agreement (payments to Medicaid providers are also made from this fund). Even the State's General Fund is affected by the waiver as transfers from this fund are used as an additional source to fund the State's share of the Global Commitment expenditures.

In the course of the fiscal year 2007 audit, the Department of Finance and Management furnished us with multiple sets of financial statements reflecting different accounting treatments related to the recognition of revenue from the Federal government. The issue that caused these multiple sets of statements revolved around whether the State should book adjusting journal entries to recognize a Federal government receivable for certain Global Commitment claims. Specifically, the State initially booked a $75.6 million adjusting entry to record a receivable for pre-Global Commitment claims paid with Global Commitment funds and later changed this entry to record $62 million receivable for claims that were incurred, but not reported[20] as of June 30, 2007. The issue of whether the federal government owed the State any additional monies other than what is expected to be paid in premiums was a source of disagreement between the State and our office. Ultimately, the State recognized that some ambiguity existed in its interpretation of the waiver agreement and elected not to record an adjusting entry related to this issue.

Disagreements about interpretations and accounting treatments are not unusual and are commonly dealt with as part of the auditing process. However, in this case, the State's different accounting treatments were based on its various interpretations of the same set of facts, namely a waiver agreement that has been in place since 2005. In addition, the State did not have documented rationales for these various interpretations until we requested that they provide such a document to justify their final position. We believe that the accounting and financial reporting treatments for unusual and complex arrangements such as the Global Commitment waiver should be understood and reviewed in detail by the organization in charge of the financial statements. Moreover, it would be preferable that such an analysis occur and be documented before the agreement is signed so that the financial statement implications of such agreements are understood and agreed upon before a final commitment is made.

[20]Incurred, but not reported is an accounting term used to describe the claims tail at the end of a financial reporting period, such as the end of a fiscal year or the end of a demonstration waiver term.

Recommendations

We recommend that the Secretary of the Agency of Administration develop a policy that requires organization heads to certify in writing that the terms and conditions documented in Federal grant arrangements represent the entire agreement between the parties and that there are no unwritten arrangements.

We recommend that the Secretary of the Agency of Human Services and the Secretary of the Agency of Administration pursue a solution with CMS to clarify the terms and conditions of the Global Commitment to Health waiver specifically to address the following:

(1) the allowability of using federal funds received under Global Commitment to pay for pre-Global Commitment claims; and

(2) whether the State may seek reimbursement for claims incurred during the Global Commitment waiver term, but paid subsequent to the expiration of the waiver term.

If the State is not able to reach written agreement with CMS regarding these items, we recommend that the Secretary of the Agency of Administration work with the Secretary of the Agency of Human Services and the General Assembly to establish a mechanism to ensure that at the expiration of the waiver, the Global Commitment Fund has sufficient assets to cover the amount of claims incurred during the Global Commitment waiver term that are expected to be paid to providers subsequent to the expiration of the waiver term. We believe that the State should pursue such a course of action in as expeditious a timeframe as possible.

We recommend that the Secretary of the Agency of Human Services direct OVHA to develop guidance on documenting the rationale for MCO investments along with the types of records that need to be maintained to show how the funds are being spent.

Management's Response and Our Evaluation

On March 27, 2008, the Commissioner of the Department of Finance and Management responded on behalf of the Agency of Administration to a draft of this report (reprinted in appendix IV). In his response, the Commissioner provided examples of the programmatic and financial benefits of the Global Commitment waiver. For example, he cited the waiver agreement as providing federal authority and financial support to continue previous, and implement new, expansions in coverage. In addition, the Commissioner stated that the State vigorously negotiated a waiver that best represented the

State's interests. The Commissioner asserted that all new programs create some financial risks and implementation challenges and stated that it is unrealistic to assume that all risk could be avoided. He noted that the negotiation process has inherent limitations and that Vermont did not have unlimited bargaining power to affect changes to the waiver's terms and conditions. Nevertheless, the Commissioner stated that the Global Commitment waiver is a partnership with the Federal government and expressed confidence that the State would be able to satisfactorily address unresolved issues through open and fair collaboration with CMS.

The focus of our audit was not to evaluate the totality of the benefits and risks associated with the Global Commitment waiver nor to assess the State's negotiating process. Instead, our focus was on evaluating whether the State was managing the waiver in accordance with its written financial terms and conditions and had properly presented the financial results of the Global Commitment Fund. Our internal control finding was that the State made operational decisions based on undocumented agreements, which put it at greater financial risk than if it had operated the waiver in accordance with its written terms. Since the written terms of the waiver itself carry an inherent financial risk to the State (because it includes a cap on expenditures), we do not believe that it was prudent to add to this risk by relying on verbal arrangements that CMS could repudiate or disagree had been made at all.

In terms of our first recommendation to develop a policy that requires organization heads to certify that the terms and conditions documented in Federal grant arrangements represent the entire agreement, the Commissioner agreed in concept with this recommendation. He added that the State strives to clarify terms and conditions in writing whenever possible and in the best interest of the State. However, the Commissioner did not explicitly state that a certification policy would be developed. We believe that such a policy is needed in order to prevent the State from relying on undocumented agreements as was the case in the Global Commitment waiver.

With respect to our recommendation to pursue a solution with CMS to clarify the terms and conditions of the Global Commitment waiver, the Commissioner agreed that the issues that we raised warrant clarification and stated that the State would work with CMS to resolve these issues.

Regarding our last recommendation related to developing guidance related to MCO investments, the Commissioner noted that CMS does not approve or authorize MCO expenditures. Our finding did not address whether MCO investments were approved or authorized. Instead, our concern was that systematic deficiencies in the State's decisions and documentation led to $38 million in questioned costs by an independent auditor, which could result in these costs being disallowed by the Federal government. According to the CMS Director of the Center for Medicaid and State Operations, the permissible uses of federal funds by the State's Medicaid agency and the State's MCO are specified in the terms and conditions of the waiver, monitored by federal officials, and are subject to federal audit.[21] Although the Commissioner commented that AHS and OVHA have been engaged in continuous development and improvement of the identification and management of the MCO investments, the agency did not explicitly address our recommendation. We continue to believe that it would be prudent to develop guidance on documenting the rationale for MCO investments along with the types of records that need to be maintained to show how the funds are spent in order to reduce the likelihood that costs could be disallowed in the future.

Control Finding 2007-2: Estimation of Allowance for Uncollectible Accounts

According to the Department of Finance and Management's internal control guidance, departments should devise and implement techniques and procedures to properly account for, record, manage, and collect receivables. Among the practices associated with properly accounting for receivables are realistic estimates of doubtful or uncollectible accounts[22] based on a documented estimation methodology. Five State organizations either did not establish allowances for uncollectible accounts or did not apply an appropriate methodology to estimate the appropriate allowance amount. As a result, in some cases the State's financial statements were materially misstated until audit adjustments were applied. For example, the Department of Taxes underestimated its allowance for uncollectible tax accounts, which resulted in an audit adjustment of approximately $16 million. Although the department had implemented a more robust allowance calculation in fiscal year 2007 than previously, its analysis was not complete. In particular, its calculation did not take into account tax bills for estimated meals and room

[21] 42 CFR §438.6 allows the Federal government to inspect and audit financial records related to MCO agreements.

[22] The portion of the account receivable that is estimated to be not collectible is set aside in a contra-asset account called an "Allowance for Uncollectible Accounts". The actual amount of uncollectible receivable is written off as an expense from allowance for uncollectible accounts to the account called bad debt expense.

and sales and use taxes that are generally realized at amounts lower than originally billed. In another case, the Department of Public Safety did not have an aging schedule[23] for its accounts receivable or calculate an allowance for uncollectible accounts. We estimate that about 10 percent of the department's $2.6 million in receivables are a year or more overdue and should have had an allowance for uncollectible accounts recorded.

Since five organizations did not appropriately estimate an allowance for uncollectible accounts for their receivables, we believe that this is evidence of a systemic problem that would be more efficient to address on a statewide basis. The Department of Finance and Management is the State government's primary resource for proper accounting procedure. Although there is no "one size fits all" methodology for estimating an allowance for uncollectible accounts, this department is in the best position to guide the State's departments in arriving at a methodology that is appropriate for their specific circumstances.

Recommendation

We recommend that the Secretary of the Agency of Administration direct the Department of Finance and Management to require that State organizations with significant accounts or tax receivable balances (e.g., over $1 million) submit a summary of the methodology being used to derive their allowance for uncollectible accounts estimate and should assess the validity of these methodologies.

Management's Response

In his March 27, 2008 response to a draft of this report, the Commissioner of the Department of Finance and Management agreed with this finding and stated that additional policies and procedures would be developed by June 30, 2008. In addition, the department plans to provide guidance to State organizations on compliance and documentation.

[23]This is the process of determining which customers are paying on time, which are not, and how far behind the delinquent customers are from the payment due date. This analysis assists in estimating bad debts and in establishing credit lines.

Control Finding 2007-3: Department of Labor's Unemployment Compensation Fund

The Department of Labor's Unemployment Compensation Fund, which is a enterprise fund in the State's basic financial statements, pays claims for unemployment to eligible recipients and is funded through employer contributions, reimbursements, and federal grants. For fiscal year 2007, this fund had about $70.8 million in operating revenues and $94.4 million in operating expenses.

There were six significant audit adjustments related to this fund in which the net effect was to reduce the decrease in net assets by approximately $3.6 million. These adjustments were related to accounts receivable and the allowance for uncollectible accounts. Control deficiencies led to these adjustments, as follows:

- *Documented reviews*. All significant transactions, journal entry postings, internal financial reports, and account reconciliations should indicate who prepared them and who reviewed them. However, the Department of Labor did not document, or appear to consistently perform, appropriate reviews of journal entries and internal financial information. As a result, there were several areas in which accounts receivable were misstated until audit adjustments were applied. These errors could have been detected if appropriate documented reviews had occurred.

- *Financial Statement Preparation.* There was not a system of internal control in place at the Unemployment Fund to assure that the financial schedules comply with generally accepted accounting principles because there was not a trained accountant with the skills needed to perform this function.

Recommendations

We recommend that the Commissioner of the Department of Labor:

- Require that manager-level review of adjusting journal entries and account reconciliations be conducted. Such manager-level reviews should also be conducted in the case of complex estimates, such as those employed for the allowance for uncollectible accounts.

- Ascertain the most appropriate mechanism to obtain the skill sets needed to prepare financial schedules, which could include contracting for these skills.

Management's Response

On March 24, 2008, the Commissioner of the Department of Labor responded to a draft of this report (reprinted in appendix V). The Commissioner stated that the audit adjustments made in fiscal year 2007 were due to an oversight and inexperienced staff. She noted that the department has taken steps to address these issues. The Commissioner also noted that our recommendation related to having manager-level reviews was appropriate, but difficult to achieve with the Department's current level of financial accounting knowledge and background. To address this limitation in financial skills and experience, the Commissioner reported that the department has taken steps to hire an independent Certified Public Accountant to provide on-site training, guidance, and other activities related to Labor's financial management.

Control Finding 2007-4: Risk Assessments and Monitoring Processes

All entities, regardless of size, structure, nature, or industry, encounter risks at all levels within their organizations. Through a risk assessment process management determines how much risk is to be prudently accepted and strives to maintain risk within these levels. Such a process is important because, according to the State's internal control guidance,[24] managers can use risk assessments to determine the relative potential for loss in programs and functions and to design the most cost-effective and productive internal controls. Most of the State organizations in our review did not have a risk assessment and monitoring process in place.

We have made, or will be making, recommendations under separate cover to individual State organizations that they develop a risk assessment and monitoring process. However, since the preponderance of organizations in our review did not have such a process, it may be cost-effective for the State's internal control group within the Department of Finance and Management to take a leadership role related to providing risk assessment assistance so that individual state entities do not have to duplicate efforts.

An important element in a risk assessment process is the consideration of fraud risk. According to the most recent report by the Association of Certified Fraud Examiners on occupational[25] fraud and abuse, such schemes impose an enormous cost on organizations.[26] The median loss caused by the occupational frauds in this study was $159,000. In addition, a variety of frauds were found, including skimming revenues, submitting fraudulent invoices, or engaging in a business transaction in which there is an undisclosed conflict of interest. According to the Association, tips (particularly from employees) were the most common means by which occupational fraud was detected. The Association believes that this indicates that anonymous reporting mechanisms are a key component of effective anti-fraud programs.

[24] *Internal Control Standards: A Guide for Managers* (Department of Finance and Management).

[25] Occupational fraud was defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets.

[26] *2006 ACFE Report to the Nation on Occupational Fraud & Abuse* (Association of Certified Fraud Examiners, 2006).

Although the State's contract with non-management personnel urges employees to bring inefficiencies or improprieties to the attention of appropriate officials[27] there is no mechanism to support anonymous reporting of such information. The Agency of Administration is responsible for ensuring the fiscal integrity of the State government and for providing centralized support services. This agency currently does not have a mechanism in place, such as an anonymous tip line, that could make such reporting easier.

Recommendations

We recommend that the Secretary of the Agency of Administration direct the Department of Finance and Management to establish a mechanism to provide assistance to State organizations to develop and maintain risk assessment and monitoring processes, including an assessment of fraud risks.

We recommend that the Secretary of the Agency of Administration explore the feasibility of implementing a "whistleblower" or "tip" hotline that employees could use to report possible fraud activities and which the State could use to investigate such reports.

Management's Response and Our Evaluation

In his March 27, 2008 response to a draft of this report, the Commissioner of the Department of Finance and Management focused on the fraud risk element of this control finding and did not address our recommendation related to providing assistance to State organizations to develop and maintain risk assessment and monitoring processes. Less than half of the State organizations in our review had a risk assessment and monitoring process, which is the primary basis for this control finding. Such a process is considered a fundamental part of a strong internal control process. Although we will be making recommendations to individual organizations to establish a risk assessment and monitoring process, since this was a widespread problem we believe that assistance from the Department of Finance and Management would greatly facilitate the execution of these recommendations. Indeed, one agency responding to our recommendation in this area stated that it believes that a statewide template would be the most

[27] Article 65, Agreements between the State Of Vermont and the Vermont State Employees' Association, Inc. (Non-Management Bargaining Unit) states "employees who possess information about inefficiency or impropriety in State government are urged to bring that information to the attention of appropriate officials prior to making public allegations."

efficient approach to establishing a risk management and monitoring program.

With respect to fraud risk, the Department of Finance and Management stated that it believes that it has made good progress in informing departments how to recognize and prevent fraud in the workplace and cited references to a fraud article in one of its Internal Control newsletters and fraud notification language in four best practice documents. In addition, the Commissioner cited our phone number for the confidential reporting of fraud, waste, and abuse as providing the most appropriate mechanism for implementing our recommendation. The Commissioner stated that it is not a prudent use of taxpayer resources to create a second duplicative resource.

We understand the motivation for this viewpoint, but do not consider the use our confidential reporting phone line a viable alternative. First, auditing standards[28] require that we maintain our independence and not perform management functions or be a part of an entity's internal control framework. We believe that this restriction covers being part of a fraud prevention and detection program for State employees. Second, the Secretary of the Agency of Administration, Commissioner of the Department of Finance and Management, and the Director of Statewide Reporting have previously acknowledged that "management has responsibility for the design and implementation of programs and controls to prevent, deter, and detect fraud." Third, we do not believe that the Auditor's confidential reporting line would be a duplicative function since our line has traditionally been used as a mechanism to record citizen concerns and not those of State employees. Lastly, we believe that the Agency of Administration is strategically positioned to take the lead on this issue since it is responsible for ensuring the fiscal integrity of State government.

Control Finding 2007-5: Evaluations of Internal Controls

According to the State's internal control guide, management should establish procedures that monitor the effectiveness of control activities and the use of control overrides.[29] Such monitoring gives management the opportunity to

[28]*Government Auditing Standards*, Chapter 3 (U.S. Government Accountability Office, GAO-07-731G, July 2007). Moreover, Statement of Auditing Standards 99, *Consideration of Fraud in a Financial Statement Audit* (American Institute of Certified Public Accountants) states "it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud."

[29]*Internal Control Standards: A Guide for Managers* (Department of Finance and Management).

identify and correct any control activity deficiencies or problems and to minimize the impact of unfavorable events. Most of the State organizations we reviewed did not have a mechanism in place to evaluate their internal controls.

Two State organizations have implemented an internal control evaluation process—AHS and the Office of the State Treasurer—that demonstrate the benefit of having a focus on internal controls. AHS has established an internal audit group that is responsible for providing reasonable assurance that the agency's funds are used for their intended purposes and to assess related procedures that provide such assurance. One focus of the group has been on establishing better control processes over subgrantees across the agency. The added focus in this critical area helped reduce the number of AHS control weaknesses in the subrecipient grant area between fiscal years 2006 and 2007.[30] In the case of the Treasurer's Office, it has an active internal audit committee that is comprised of staff from its various divisions, which works on internal control improvements.

At the statewide level, the Department of Finance and Management has the responsibility to ensure that state organizations are functioning within the framework of all policies and procedures set forth by the department and the Agency of Administration and to assure that departments are maximizing the information opportunities and the best practices available within the Vermont Integrated Solution for Information and Organizational Needs (VISION) system, the State's principal financial system. To fulfill this role, the department has established an internal control group that has published internal control best practices and has implemented a process whereby state organization's are annually required to fill in an internal control self-assessment questionnaire, which, in some cases, are validated by the internal control group.[31] While the internal control self-assessment questionnaire is a useful tool, such a generic checklist cannot address all of the many varied business activities conducted by the State and does not obviate the need for organization-specific internal control evaluations.

We have made, or will be making, recommendations to the organizations in our review that did not have a process in place to evaluate internal controls other than the self-assessment questionnaire. Since so many organizations did

[30] *State of Vermont: Auditors' Report as Required by OMB Circular A-133 and Related Information, Year ended June 30, 2007* (KPMG, March 28, 2008).

[31] In fiscal year 2007, this group received 58 questionnaires and performed 5 validation reviews.

not have an internal control evaluation process in place, it may be beneficial for the Department of Finance and Management's internal control group to take the lead in helping other departments to implement such a program.

Recommendation

We recommend that the Secretary of the Agency of Administration direct the Department of Finance and Management to convene a statewide task force on evaluating internal controls at the department level to consider the most efficient and effective means by which this can be accomplished.

Management's Response and Our Evaluation

In his response to a draft of this report, the Commissioner of the Department of Finance and Management stated that he did not agree with this finding. The Commissioner cited additional actions that the department has taken in addition to the annual internal control self-assessment questionnaire, such as VISION policy and procedure reviews and the issuance of best practice documents.

We did not mean to convey a concern with the Department of Finance and Management's internal control group. Our primary concern was that the various departments and agencies in our review generally did not have mechanisms in place to evaluate their internal controls other than the self-assessment questionnaire. We agree that in the past couple of years that the Department of Finance and Management has made good strides in providing internal control guidance and assessments. Although these actions are positive, we do not believe that this department can be the sole evaluator of the State's internal controls because of its resource constraints[32] and its necessarily more limited knowledge of a particular entity's business processes. Accordingly, we are making recommendations under separate cover to individual State agencies and departments that they implement an internal control evaluation mechanism. The intent of the recommendation in this report is to have the Department of Finance and Management take a leadership role and lend its internal control evaluation expertise in helping the agencies and departments implement these recommendations. We have added language to this control finding and recommendation to provide additional clarification.

[32]Currently, the internal control group has two staff members.

Control Finding 2007-6: Compilation and Review of the Comprehensive Annual Financial Report

We have reported in previous years, and noted again during our fiscal year 2007 audit, that there are weaknesses in the internal controls related to compiling and analyzing the comprehensive annual financial report (CAFR). These weaknesses relate to both the Statewide Reporting group that is principally responsible for the compilation and analysis of this report and to the agencies and departments that are largely responsible for the transactions that form the underlying basis for the data included in the report.

Statewide Reporting Group

There are five members of the Department of Finance and Management's Statewide Reporting group, which is principally responsible for the activities related to the compilation and analysis activities related to the CAFR. In particular, the Director of Statewide Reporting is actively involved in the day-to-day operations involved in the preparation of the CAFR and other reports. Likewise, much institutional knowledge, strategic oversight, and responsibility for critical day-to-day operations are vested with this Director.

Our concerns with this condition is that with such a heavy reliance on this single individual to perform key functions, if she were unavailable, the operations of this group and the financial reporting of the State as a whole could be adversely effected. Other staff members may be able to provide some additional coverage with respect to daily departmental operations in the short-term absence of the Director, but the department needs to ensure an appropriate distribution of financial review and analysis and critical areas of knowledge such that the absence of this individual would not create undue risk. As we recommended in our 2006 internal control report,[33] the department recently hired a new Assistant Director of Statewide Reporting, which, in time, should help alleviate this condition. Nevertheless, at this point, the breadth of the responsibilities placed on the Director of Statewide Reporting and the centricity of her role in compiling, preparing, analyzing and reviewing the year-end financial statements continues to be a risk that can threaten the achievement of the department's objectives.

[33] *Fiscal Year 2006: Report on Internal Control Over Financial Reporting and on Compliance with Laws and Regulations* (Vermont State Auditor's Office, Report No. 07-07, February 16, 2007).

Appendix II: Significant Deficiencies

Agency and Department Accounting

Vermont has a decentralized financial and reporting process that largely relies on the State government's agencies, departments, offices, and other entities to initiate the vast majority of financial transactions. In such an environment, timely and reliable financial reporting is largely dependent upon appropriate oversight and guidance provided to individuals performing the accounting and financial management function at the decentralized locations.

During our fiscal year 2007 audit, we found significant errors in the governmental funds financial statements. Specifically, prior to a series of audit adjustments, (1) expenditures were understated by approximately $5 million, (2) revenues were overstated by $13 million, (3) allowances for uncollectible accounts were understated by about $17 million. There were also a myriad of other errors that, although they did not result in audit adjustments because they did not meet materiality thresholds, were errors nonetheless. These various errors were largely due to the (1) incorrect application of period end cut-off procedures that ensure that transactions are classified in the correct fiscal year, (2) misclassification of certain transactions as revenue, and (3) lack of understanding of how to analyze receivables to take into consideration an allowance for uncollectible accounts. In addition, these errors were spread across multiple agencies and departments. These types of errors indicate a lack of widespread understanding of accrual-based accounting concepts. We reported similar findings last year. Also similar to last year, we remain concerned that the Statewide Reporting group's financial reporting analyses, including their analyses of year-to-year fluctuations in account balances, did not detect such significant errors.

Last year we made a series of recommendations to address these same types of issues. However, the Department of Finance and Management has not fully implemented these recommendations. Because we continued to find material errors directly related to a lack of understanding of relevant accounting and financial reporting concepts and since the commitment to hiring and developing competent and knowledgeable personnel is a critical component to a strong control environment, we believe that these recommendations remain applicable.

Recommendations

We are reiterating our recommendation from last year that the Secretary of the Agency of Administration direct the Department of Finance and Management to:

- Produce an accounting policies and procedures manual to be made available to agency personnel as a reference guide for accounting transactions and financial reporting.
- Review the annual financial statement compilation process to determine whether additional oversight controls over the agencies' financial accounting could be designed to allow the division to operate more efficiently.
- Work in conjunction with the Department of Human Resources to propose and oversee specific accounting and financial reporting training for business managers and accountants key to the financial reporting process.
- Work in conjunction with the Department of Human Resources to review the accounting and financial knowledge, skills and abilities listed in applicable job specifications for accounting and financial positions to determine whether the State is recruiting employees with sufficient and relevant experience.

Management Response and Our Evaluation

The Commissioner of the Department of Finance and Management's March 27, 2008 response to a draft of this report did not always explicitly address our recommendations. The comments discussed various points, as follows:

- The Commissioner disagreed with our comment regarding the reliance on the Director of Statewide Reporting for day-to-day operations related to the preparation of the CAFR and other reports. In particular, he pointed to the hiring of a new Assistant Director of Statewide Reporting. We acknowledge in our report that, in time, the new Assistant Director should reduce the State's reliance on the Director of Statewide Reporting. However, in the compilation of the fiscal year 2007 CAFR, the Director was responsible for the vast majority of the review activities with the Assistant Director being responsible for less than 5 percent of these tasks. The Commissioner also mentioned that the Statewide Reporting group uses a database to track assignments and review signoffs of the major components of the CAFR. After validating the use of this database in the fiscal year 2007 CAFR compilation, we deleted the comment in the draft report related to concerns over the documentation of supervisory reviews.

- The Commissioner of the Department of Finance and Management agreed that a comprehensive accounting policies and procedures manual would be a useful tool, but added that the department is not sufficiently staffed to add the development of such a manual to its already heavy workload. We understand that the Department of Finance and Management has a heavy workload. However, an accounting policy and procedures manual could help to reduce this workload in the future as agencies and departments better understand financial requirements and have a manual to reference, rather than call the department to seek guidance. In addition, the department could consider temporarily augmenting its resources for this task through the use of accounting staff at other State organizations or through a personnel services contract to help with its development.

- Regarding accounting and financial reporting training, the Commissioner provided examples of training opportunities that his department has been involved in creating. For example, he cited the creation of an accounting course that the department had developed in the past year in collaboration with the Summit Center for State Employee Development. Additionally, the Commissioner reported that his department and the Summit Center have worked with the State's Business Improvement Group to build on the accounting coursework and to connect it to the VISION system. The Commissioner also discussed the VISION training that has been offered. These various training opportunities are improvements from what has been offered in the recent past. However, we note that this training, in large part, addressed budgeting/appropriations, procurement, and VISION system training, not accrual accounting concepts. In addition, the training generally occurred subsequent to the end of fiscal year 2007. Moreover, we were told that the curriculum for the next accounting course at the Summit Center was being reworked. Since our concerns related to the many accounting errors, some material to the financial statements, that we continued to find during the fiscal year 2007 audit that indicated that some financial staff did not sufficiently understand accrual accounting concepts, it is unclear whether these training opportunities will address this problem. However, we will consider removing this recommendation next year if we do not find the same level of errors during the fiscal year 2008 audit period.

- The Commissioner reported that a formal review and reclassification of all financial positions in the State was recently completed. According to the Commissioner, the Department of Human Resources' Classification division is currently assigning each financial position into "like-skilled" categories, such as professional accountants and accounting clerical staff. Once completed, it is planned that these categories will carry minimum hiring standards for academic and/or experience levels when recruiting. We expect that this will address our last recommendation in this control finding when completed.

Control Finding 2007-7: Information Technology Controls

Significant deficiencies were found in the State's design of general controls[34] in selected information technology (IT) environments. In particular, there were control deficiencies in the five environments that we reviewed for the fiscal year 2007 financial statement audit. In addition, while the State's approach to improving its IT security posture as a whole is moving in the right direction, progress has not been made at a rate commensurate with the internal and external risks being faced. Moreover, additional resources will likely need to be dedicated to IT security for the State's initiatives in this area to be fully implemented in a timely manner. Effective IT controls are essential to provide reasonable assurance that the State's financial information and financial assets are adequately safeguarded from inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction. Moreover, ineffective IT controls can impair the accuracy, completeness, and timeliness of information used by management and increase the potential for undetected material misstatements in the State's financial statements.

The State relies extensively on computer systems to process, account for, and report on its financial activities. In particular, the State's financial statements are derived from its principal financial system, VISION, although a substantial amount of the State's financial activities originate in other systems. The systems in which financial data are originated are operated by a wide variety of agencies and departments. For example, in fiscal year 2007 the (1) Department of Taxes' systems accounted for approximately $680 million in income tax revenue, (2) Office of the State Treasurer's retirement system was used to disburse about $154 million in retirement benefits to retired State and municipal employees and teachers, and (3) Department of Labor systems were used to pay almost $81 million to unemployment insurance claimants.

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[34] General controls are the structure, policies, and procedures that apply to an entity's overall computer operations. They create the environment in which application systems and controls operate.

Appendix II: Significant Deficiencies

During the fiscal year 2007 financial statement audit, general controls were reviewed for five IT environments, the (1) Agency of Administration's VISION and Human Capital Management system environments, (2) Agency of Human Services' Bright Futures Information System and Social Services Management Information System environments, and (3) Office of the State Treasurer's Vermont Retirement System. Specifically, we considered whether there were weaknesses in the design of the following control areas: (1) access to programs and data, (2) application and system software changes, and (3) computer operations. Table 1 summarizes the control objectives that were reviewed in each of these areas as well as how many of the five environments had weaknesses in one or more of the controls reviewed under each objective.[35] The following are examples of some of the weaknesses found:

- Organizations should ensure that information and information systems are protected during and after personnel actions, such as transfers and terminations. In addition, the State's password policy requires that when user access is no longer a business requirement that such access be disabled. Not all of the State IT environments reviewed had a policy or procedure in place to conduct regularly scheduled reviews of user access to identify and remove unauthorized or inappropriate access. The absence of periodic reviews of system or application access increases the risk that unauthorized individuals may retain inappropriate access to key system, application, and data assets.

- Controls over changes to application and system software help to ensure that only authorized programs and authorized modifications are implemented. Such controls include authorization of changes, testing, and migration into the production environment. Without such controls, there is a risk that processing irregularities could be inadvertently or deliberately introduced. All but one of the IT environments in our review had one or more control weaknesses in this area, such as a lack of change control policies and procedures, lack of signoffs that changes have been approved and tested, and application developers that were allowed access to the production environment.

[35]Because of the potentially sensitive nature of these findings, confidential appendices in applicable agency or department-specific internal control reports have been, or will be, issued to each of the organizations in our review. These appendices also contain recommendations to fix the control deficiencies found.

- Losing the capability to process, retrieve, and protect information maintained electronically can significantly affect an entity's ability to accomplish its mission. Accordingly, a process should be in place to regularly back up data files, application programs, systems, software, database software and copies of other information or supplies that may be needed to maintain operations. The IT environments we reviewed had some, but not all, expected controls in this area. For example, although each of the organizations had backup procedures in place, restoration tests of off-site data backups were not regularly performed. Without periodic and regular testing, assurance cannot be placed on the reliability of backup media to recover key systems, applications, and data assets in the event of an emergency.

Table 1: Results of General Control Review for Five State IT Environments Reviewed in Fiscal Year 2007

Control Objective Description	Number of IT environments[a] with one or more exceptions
ACCESS TO PROGRAMS AND DATA: Access controls should provide reasonable assurance that computer resources are protected against unauthorized modification, disclosure, loss, or impairment.	
Information security is managed to promote consistent implementation of security practices, and that users are aware of the entity's position with regard to information security, as it pertains to financial reporting applications and data (2 controls).	2
Physical access to IT computing resources, particularly those used to process and report on financial activity, is restricted by the implementation of appropriate identification, authentication and authorization procedures that reduce the risk of unauthorized and/or inappropriate access (5 controls).	2
Logical access to IT computing resources, particularly those used to process and report on financial activity, is restricted by the implementation of appropriate identification, authentication and authorization procedures that reduce the risk of unauthorized and/or inappropriate access (9 controls).	5
Procedures have been established that ensure user accounts are added, modified and deleted in a timely manner and which reduce the risk of unauthorized access and/or inappropriate use of the entity's financial applications and data (3 controls).	3
Controls are in place to monitor the management and maintenance of access rights to the entity's financial applications and data (2 controls).	5
Appropriate segregation of duties within key financial applications and system processes have been identified and have been put into operation (2 controls).	3
Security violations including unauthorized access attempts to an entity's financial systems and applications are monitored and reported (2 controls).	2

Appendix II: Significant Deficiencies

Control Objective Description	Number of IT environments[a] with one or more exceptions
PROGRAM CHANGES: A disciplined process for testing and approving modified programs prior to their implementation is essential to make sure programs operate as intended and that no unauthorized changes are introduced.	
Changes to the entity's financial applications have been authorized by an appropriate level of management prior to development and migration into production (2 controls).	3
System software and configuration changes to the computer systems that run the entity's financial application have been authorized by an appropriate level of management (1 control).	3
Changes to the entity's financial applications have been tested, validated, and the results approved prior to being moved into production (3 controls).	3
Operating system software and configuration changes that affect the entity's financial computer systems have been tested, validated, and the results approved prior to being moved into production (4 controls).	3
The ability to migrate financial application changes into production is restricted to authorized staff (2 controls).	4
The ability to migrate system software and configuration changes that affect the entity's financial computer systems is restricted to authorized staff (1 control).	4
Emergency changes made to an entity's financial applications, systems and infrastructure configurations are appropriately managed and approved (3 controls).	3
Financial application documentation is maintained in a timely fashion and access to the documentation restricted to authorized staff (2 controls).	2
COMPUTER OPERATIONS: Controls in this area address a wide variety of issues, such as controls over job processing, backup and recovery procedures, and problem management procedures.	
The entity's financial application job runs including batch jobs, interface runs and system backups are accurate, complete, and timely (4 controls).	2
Backup and recovery procedures have been implemented that permit databases, transactions feeds and application programs that are necessary for the entity's financial reporting to be recovered (5 controls).	3
Periodic testing of financial system and data file restoration process is conducted and that the quality of backup media used to store the entity's financial applications and data is monitored (2 controls).	5
Back up media for systems and applications used by the entity's financial applications is safeguarded, and only authorized staff have access to the backup media (2 controls).	1
The entity's financial application hardware, software, and media inventory is tracked and kept current (2 controls).	5
Operations documentation is maintained and access restricted to authorized staff (1 control).	1
Incidents, problems and errors arising from the entity's financial applications are analyzed and underlying causes resolved (2 controls).	1

[a]The FY 2007 IT environments reviewed were the (1) Agency of Administration's VISION and Human Capital Management system environments, (2) Agency of Human Services' Bright Futures Information System and Social Services Management Information System environments, and (3) Office of the State Treasurer's Vermont Retirement System.

We also followed up on whether our recommendations related to the five IT environments[36] that were reviewed in 2006 had been implemented. In general, good progress was made although it varied greatly by organization. The Agency of Transportation, Department of Taxes, and Department of Information and Innovation had implemented at least two thirds of the recommendations. For example, in Spring 2007, the Agency of Transportation implemented a change management policy and procedures for its State Transportation Accounting and Reporting System that included a variety of controls. In addition, the Department of Information and Innovation implemented several actions to improve the physical security over its data center. On the other hand, the Department of Labor had only implemented one recommendation although most of the others were in the process of being implemented. Even with the progress that these organizations showed, important recommendations, including those related to access controls, software change controls, and computer operations remained outstanding. For example, in some cases, strong password syntax protocols were still not established or enforced at the system or application level.

The appropriate design of IT controls is not just an academic exercise. Weaknesses in such controls can be exploited with serious consequences and the U.S. government has seen increases in such exploitation attempts. For example, in 2006 federal agencies reported a record 5,146 incidents to the U.S. Computer Emergency Readiness Team (US-CERT), as compared to 3,569 such incidents in 2005. During this period, US-CERT also recorded a dramatic rise in incidents in which either physical loss or theft or system compromise resulted in the loss of personally identifiable data. Moreover, a recent report by the U.S. Secret Service and CERT has also shown that the exploitation of poorly designed controls is not limited to the Federal government or to external offenders.[37] This report found that government sector[38] insiders (including those at the State level) have the potential to pose a substantial threat by virtue of their knowledge of, and access to, employer

[36]The five environments reviewed in 2006 were those associated with the (1) Department of Innovation and Information's GOVNet wide-area-network and data center operations, (2) Department of Taxes' Vermont Integrated Revenue Collection System, Revenue and Receipt Accounting System, and Customer Information Control System, (3) Agency of Transportation's State Transportation Accounting and Reporting System, (4) Department of Labor's Vermont Automated Benefit System and Contribution Tax System, and (5) Agency of Human Services' ACCESS system.

[37]*Insider Threat Study: Illicit Cyber Activity in the Government Sector* (U.S. Secret Service and the Carnegie Mellon University, Software Engineering Institute's CERT Program, January 2008).

[38]The government sector was defined as federal, state, and local government agencies, and private agencies contracted to serve as arms of the government or other private franchised organizations that provide services on behalf of the government.

systems and/or databases. Among the findings in this report were that, of the insiders that perpetrated illicit cyber activity, (1) 58 percent worked in administrative and support positions as data entry clerks, typists, customer service representatives, and bookkeepers, (2) 26 percent worked in positions that required technical skills, and (3) 90 percent were current employees with authorized access to the organizations' systems and networks at the time of the initial damage. In addition, the weaknesses in business and operational practices that were exploited were some of the same types of problems that were found in our review, such as deficiencies in access controls and software development processes. In about 40 percent of the fraud cases, such insider exploits resulted in over $50,000 in damage. Moreover, insiders successfully altered, inserted, or deleted information or data files in 86 percent of the incidents.

Vermont State Government's IT environment is largely decentralized, with the agencies and departments generally responsible for their own IT activities, including the establishment of system security. However, as we reported last year, Vermont's Chief Information Officer (CIO), who is also the Commissioner of the Department of Information and Innovation (DII), has appointed a System Security Director and formed an enterprise Security Policy Development Team to identify and quantify risk, draft policy, and manage the policy development process. In addition, the State Technology Council (STC), plays a significant role in IT security. In 2004 the Secretary of the Agency of Administration reorganized the State government's information technology management in recognition that DII did not have the resources to lead change by itself. He established the STC, chaired by the CIO, and comprised of the IT managers of the larger agencies (the group subsequently expanded its membership to other State organizations) to add resources and strategic alliances among state agencies. Among its other duties, the STC was charged with creating standard IT policies for State government.

Since our last report the CIO, in conjunction with the Security Director and Development Team as well as the STC, have taken various actions related to IT security, as follows:

- completed a contractor-led assessment of the State's interactive online/web applications that resulted in recommendations to improve controls;

- issued, in conjunction with the Department of Human Resources, a revised policy prescribing rules of conduct and procedures for State employees when using or accessing state government owned or provided computers or electronic communication devices/systems;

- promulgated a data encryption policy and standard for laptop and tablet computers; and

- worked with an external security contractor to improve network security.

These groups have also begun two significant initiatives. First, in the August-October timeframe, the STC adopted a risk assessment framework promulgated by the U.S. National Institute of Standards and Technology (NIST).[39] The NIST framework provides instructions on selecting and specifying security controls for information systems. It contains a set of security controls that satisfy the depth and breadth of security requirements levied on information systems and provides the fundamental concepts associated with security controls selection and specification. The use of the NIST framework is a commendable, and ambitious, goal. As part of this effort, a set of risk assessment tools has been drafted that are expected to be rolled out to the agencies shortly. Second, an IT Security Program Guideline was drafted, but not yet finalized. This guideline will be applicable to all agencies that operate, manage, or use IT to support the State's business functions. The draft guideline contains best practices in 10 core security components, which are strongly recommended, but not mandatory. According to the CIO, he anticipates that this draft will be finalized by the end of March and that departments will be expected to launch the program, including an implementation plan to fix deficiencies, by September 2008. Both of these initiatives are likely to require a considerable amount of time and resources before they are fully implemented.

There are other critical security activities that were announced over a year ago, but which have not yet been implemented. The following are examples of initiatives announced in February 2007 and their current status.

- The CIO stated that agencies would be asked to inventory all systems, identify the type of data (e.g., confidential or public), and apply a risk rating to the system. Further, all systems with confidential data were to be required to submit a security plan and each system will be audited based on need and risk. **Status:** According to the CIO, each agency was

[39] *Recommended Security Controls for Federal Information Systems* (U.S. Department of Commerce/National Institute of Standards and Technology, Special Publication 800-53, last revised in December 2007).

required to complete a risk assessment, but agencies were not required to respond that the assessment was completed nor were security plans for systems with confidential data requested to be submitted to the CIO.

- Mandatory employee security awareness training was to be deployed in February/March 2007. **Status:** This training program has not yet been launched. According to the CIO, training materials are expected to be issued shortly.

- Agency compliance audits will be required each year for servers and applications. **Status:** This is not currently a State policy, but the CIO plans to roll out a security program and begin an annual maturity ranking for agencies. However, the specifics of how this will be performed has not yet been determined.

In addition, as we reported last year, one factor that contributes to the State's IT general control weaknesses is that existing statewide security policies are outdated and not comprehensive. Policies are an important part of any security procedure because they document what controls should be in place and how they can be implemented. Although a process has been established to develop IT security policies, there is no list of policies that is expected to be developed nor expected issuance dates. For example, a consistent area of weaknesses that we have found in the last two years of general control reviews is a lack of formal change control policies and procedures for application and system software. Without proper controls over this area there is a risk that security features could be inadvertently or deliberately omitted or turned off or that processing irregularities or malicious code could be introduced. Nevertheless, there are no statewide policies in this area. In mid-March the CIO reported that he plans to contract with a consultant to assist in policy development and anticipates issuing a change management policy later in the year. We have previously recommended that the CIO direct the Security Policy Development Team to develop a plan that details the tasks, resources, and milestones for the development of IT security policies and how compliance with the policies will be achieved. This recommendation has not been implemented.

Moreover, although having specific policies and procedures in place is an important factor in helping agencies to secure their information systems and to protect personally identifiable information, proper implementation of these policies and procedures remains crucial. At this time, the State does not have a mechanism in place to determine whether those policies and procedures that exist have been implemented. For example, a data encryption policy and standard for laptop and tablet computers was issued in April 2007 that was effective June 1, 2007. The CIO stated that to his knowledge all agencies have implemented encryption on laptops with sensitive data, but no validation has yet occurred. In another case, the CIO's office contracted for an assessment of the State's interactive online/web applications, which resulted in recommendations to various agencies. Although the CIO told us that he believed that all of these recommendations had been implemented, as of March 6, 2008, he did not have confirmation from the applicable organizations.[40]

Although we believe that the State is moving in the right direction with respect to improving IT security, we believe that a more aggressive and systematic approach is warranted. Given the confidential and sensitive data that are housed in State systems and the criticality of some of these systems to the State's operation, the State is moving too slowly to implement fundamental security practices. For example, the planned risk assessments are just a starting point. These assessments could identify serious deficiencies that would require additional time to fix or to develop controls to mitigate the deficiencies if, for example, sufficient resources are not available to make corrections. In the meantime, these weaknesses can result in unintentional consequences or intentional exploitation. There is also no overall plan of action that lays out at an enterprise (i.e., State) level what is going to be done, when, and using what resources. A detailed action plan is necessary to ensure that all of the various State organizations involved in IT security have a blueprint that shows the State's security priorities, the timing of major initiatives, and the role that each entity is expected to play.

The resource issue could be particularly problematic. For example, the CIO's office has one part-time official devoted to IT security. The CIO estimated that, in total, his office devotes two full-time-equivalents to IT security, but the other staff are primarily used on technical security related to the mainframe and network that DII manages for the State. With this resource level, we are skeptical that the CIO's office will be able to both help develop policies and evaluate their implementation as well as take on a myriad of other IT security initiatives. To date there has been no assessment of the IT security skills that are needed to fulfill the State's various IT security

[40]After our discussion with the CIO, he requested that agencies and departments provide an update as to whether the encryption policy and the recommendations associated with the assessment of the State's interactive online/web applications had been implemented. In mid-March, the CIO reported that the encryption policy had been implemented in all but one department and that all serious deficiencies had been addressed related to the assessment of interactive online/web applications.

initiatives and, to the extent they are not available, how any gaps can be filled (e.g., through hiring, training, or use of contractors).

Recommendations

We recommend that Secretary of the Agency of Administration:

- Direct the CIO to develop a plan of action for improving the State's IT security posture. This enterprise-level plan should include tasks, milestones, and resources for implementing the NIST framework, IT Security Program Guideline, and other major IT security initiatives. In addition, this plan should be published and regularly updated on the CIO's web site to provide visibility to this critical issue.

- Direct the CIO to establish a target list of IT security policies to be developed and publish a plan that details the tasks, resources, and milestones for the development of these policies.

- Require that, for current and future IT security policies, State organizations (1) certify that they are in compliance with the policies, (2) provide corrective action plans for achieving compliance, or (3) request an exemption from all or part of the applicable policy. Corrective action plans should be tracked until completion.

- Direct the CIO to develop a process to evaluate agencies' and departments' progress in implementing the State's IT security initiatives and to fix identified deficiencies. This evaluation process should include specific performance measures (e.g., a report card or stop light model) that can be used to summarize and publicize agencies' and departments' progress over time.

- Direct the CIO, in conjunction with the STC, to analyze the skills and resource needs of the State government for IT security and, if applicable, develop a plan for achieving the necessary skills and resources.

Management's Response and Our Evaluation

The Commissioner of the Department of Finance and Management's comments on a draft of this report (who responded at the request of the Secretary of the Agency of Administration) reiterated some of the initiatives discussed in the finding and provided a high-level plan that addressed, for example, establishing agency/department security programs and statewide policies. In addition, he reported that a security strategic plan is expected to be developed by the end of calendar year 2008.

Although the Commissioner did not address our specific recommendations, the proposed security strategic plan could provide a mechanism for their implementation. In particular, consistent with our recommendations, we believe that it is critical that this plan or other mechanism(s) provide (1) a blueprint for how the IT security goals of the state will be achieved (e.g., tasks, milestones, and resources), (2) a process to evaluate agencies' and departments' current IT security conditions and progress towards improvement, and (3) an analysis of the State's current IT security skills and resources versus those that are needed to meet the State's goals.

Control Finding 2007-8: Accounts Payable Cutoff

As part of its year-end closing procedures, the Department of Finance and Management required departments to add a "PY" prefix to the invoice number recorded in the State's principal accounting system (VISION) for all vouchers and journals entered in fiscal year 2008 that pertained to goods and services received or performed in the prior fiscal year.[41] The proper coding in VISION of prior year payables through the use of the "PY" designation allows the State's Division of Financial Operations to extract relevant data from the system to record accounts payable in the correct fiscal year in the State's financial statements.

About half of the State organizations in our review had one or more errors in their use of the "PY" designation in VISION. In particular, four entities had error rates greater than 10 percent. For example, out of 186 invoices with an accounting date of July 1, 2007 or later reviewed at AHS, 21 were not recorded in VISION properly (11 percent). As a result, an audit adjustment of almost $4.5 million was made to increase accounts payable and related expenses in fiscal year 2007.

Recommendation

We have made, or will be making, recommendations to the applicable State entities under separate cover. No further recommendations are being made.

[41] *FY 2007 Year End Closing Instructions* (Department of Finance and Management, May 1, 2007).

Management's Response

The Agency of Administration had no comments on this control finding.

Control Finding 2007-9: Reconciliations of Subsidiary Systems to VISION

A reconciliation process, whether manual or automated, is a necessary and valuable part of a sound financial management system. Some State organizations record detailed transactions in their internal systems and summary-level data in VISION. The Department of Finance and Management has directed that all State departments that maintain an accounting system outside of VISION reconcile the activity in their systems to VISION as of the end of the fiscal year.[42]

Three departments did not reconcile the financial data in their subsidiary financial systems to VISION. For example, the Department of Fish and Wildlife did not reconcile the system that it uses to record detailed revenue transactions from angler and hunter licenses purchased from agents to VISION. Such deficiencies could have been found as part of the State's self assessment process for internal controls, which is administered by the Department of Finance and Management. However, the questionnaire that is used in this process does not explicitly address reconciliations of subsidiary systems to VISION.

Recommendation

We recommend that the Secretary of the Agency of Administration direct the Department of Finance and Management to include in the State's internal control self assessment checklist, questions pertaining to whether reconciliations between VISION and subsidiary financial systems are being performed.

Management's Response

In his March 27, 2008 response to a draft of this report, the Commissioner of the Department of Finance and Management reiterated the department's requirement that entities that maintain accounting systems reconcile these systems to VISION. In addition, the Commissioner stated that the our

[42] *FY 2007 Year End Closing Instructions* (Department of Finance and Management, May 1, 2007).

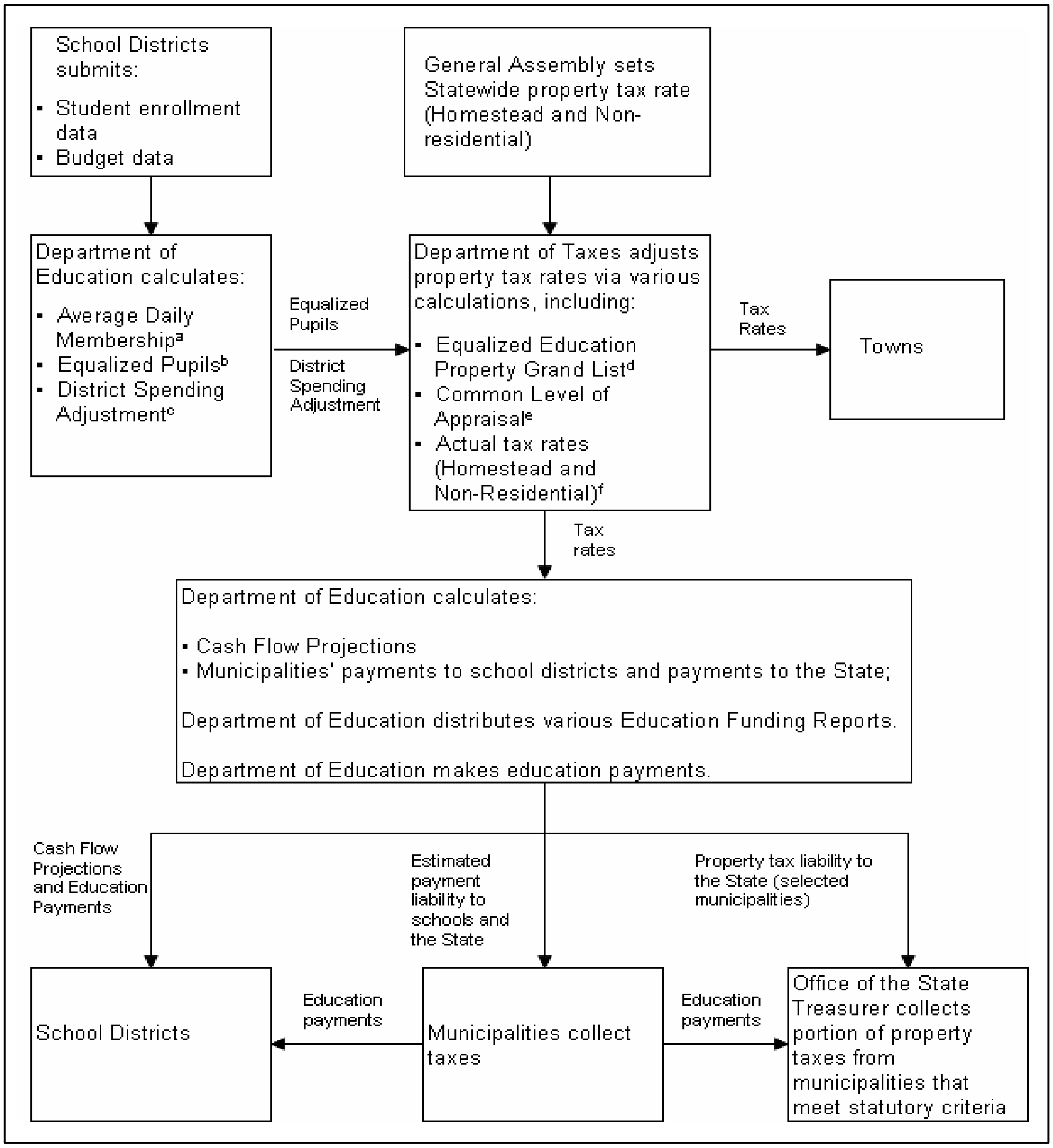
recommendation would be implemented as part of the Spring 2008 internal control self-assessment questionnaire.

Control Finding 2007-10: Department of Education's Administration of Statewide Education Funding

Several revenue sources support the State's expenditures that fund public education. The statewide property tax is the most significant of these revenues, totaling $879 million in FY 2007. While multiple State departments and all of the municipalities play a role in the statewide education funding system, the Department of Education (DOE) has a central role in administering statewide education funding. DOE calculates the allocation of the statewide property taxes to various school districts and the amounts towns owe to the State as statewide property taxes. In addition, DOE is responsible for disbursing the amounts collected from municipalities to school districts. Finally, calculations performed by DOE impact the development of property tax rates by the Department of Taxes. All of DOE's calculations are performed utilizing Excel spreadsheets. Figure 2 illustrates the processes and state/municipal entities involved in the statewide property tax administration.

Appendix II: Significant Deficiencies

Figure 2: Simplified Illustration of the Statewide Property Tax Calculation, Collection and Distribution Process



[a]The Average Daily Membership (ADM) is a count of resident and state-placed students who receive an elementary or secondary education at public expense, performed in accordance with 16 V.S.A. §4001.
[b]Per 16 V.S.A. §4001, Equalized Pupils means the long-term weighted ADM multiplied by the ratio of the statewide long-term ADM to the statewide long-term weighted ADM.
[c]The District Spending Adjustment is the ratio of the district's education spending plus excess spending per equalized pupil for a year to the base education payment for the school year.
[d]The Equalized Education Property Grand List means one percent of the aggregate fair market value of all nonresidential and homestead property adjusted in accordance with 32 V.S.A. §5401.
[e]The Common Level of Appraisal is the ratio of the aggregate value of local education property grand list to the aggregate value of the Equalized Education Property Tax Grand List.
[f]The actual tax rate is calculated for each municipality by dividing the statewide residential and non-residential tax rates by the municipality's most recent common level of appraisal.

Many of the activities we reviewed at DOE had adequately designed controls. However, control exceptions were also identified, including incomplete controls over key spreadsheets and lack of segregation of duties.

Spreadsheet Controls

According to a PricewaterhouseCoopers LLP whitepaper on spreadsheet controls, strong operational controls over key spreadsheets are essential for any organization to prevent and deter errors.[43] Such controls include, but are not limited to process documentation, access controls, logic checks of unique formulas, and management oversight. Numerous field studies conducted on spreadsheets used in organizations have demonstrated that spreadsheets contain a high rate of error.[44] According to Raymond N. Panko, Ph.D., a KPMG study showed that 91 percent of spreadsheets examined had errors serious enough to affect decisions.

DOE utilized multiple spreadsheets to calculate inputs to the property tax rate calculated by the Department of Taxes and to determine education payments to school districts and established some controls over their key spreadsheets. These controls included maintenance of a naming convention to ensure version control and the use of analytical procedures as a detective control to find errors in the spreadsheet. However, DOE did not employ other controls that are important to ensure the integrity of the spreadsheets.

First, the Department of Education did not have formal written policies and procedures descriptively supporting the various spreadsheets formula design and calculation processes. According to the State internal control guidance, proper documentation is critical for establishing consistent and accurate application of the Department's transactions. It is a key training tool that helps to ensure adequate and consistent understanding of the key inputs, formulas and outputs, which, among other things, would allow less experienced employees to have unambiguous guidance to the process design and its implementation. Written documentation is also critical to ensure that formulas in the spreadsheet are updated in accordance with the applicable statutory provisions and makes errors or omissions less likely.

[43] *The Use of Spreadsheets: Considerations for Section 404 of the Sarbanes-Oxley Act* (PricewaterhouseCoopers, LLP, July 2004).

[44] *Controlling Spreadsheets,* Raymond R. Panko, Ph.D., ISACA, Information Systems Control Journal, Volume 1, 2007.

Second, DOE did not implement a process to require someone other than the user/developer of the spreadsheets to inspect the logic of formulas within the spreadsheets and to document the results of this review. Third, there was no documented review that demonstrated that changes to the statewide property tax calculations were tested and approved, independent of the developer of the changes. The lack of a documented independent review of logic in the spreadsheet formulas and changes to the spreadsheet increases the risk of errors in which inappropriate formulas are created and improper results generated.

Segregation of Duties and Review and Approval Process

While the School Finance division had assigned certain responsibilities related to the various calculations to a financial analyst, we found that it was primarily the School Finance Manager who was responsible for key aspects of the process. He designed the calculation spreadsheets, created formulas, changed and updated the spreadsheets, authorized school payments and prepared the supporting schedules for recording revenue and expenditures in VISION. As previously discussed, the Department of Education did not have a formal documented management review and approval process of calculations of the statewide education funding and education payments to schools.

According to the State's internal control guide, segregation of duties is the division of key functions and responsibilities among different people to reduce the risks of errors. Different personnel should perform the functions of initiation, authorization and record keeping. No one individual should control or perform all key aspects of a transaction or event.

The Department of Education was not following this guide and a single staff member performed all key aspects of the education funding transactions.

Recommendations

We recommend that the Commissioner of Education:

- Establish spreadsheet controls over calculations of the general education funding and payments, including (1) formal documentation of the process, (2) formula logic tests, and (3) review and approval controls.

- Segregate fundamental functions of initiation, authorization and recordkeeping within the School Finance Group and establish processes for the management review, approval and sign off on the key transactions.

Management's Response and our Evaluation

On March 28, 2008, the Department of Education's Chief Financial Officer provided comments on a draft of this report (see appendix VI for a reprint of these comments). In general, DOE's comments addressed the actions that it planned to take in response to our findings. The following summarizes DOE's comments and our evaluation.

In his response to a draft of this report, the DOE Chief Financial Officer noted that the Department's School Finance Group had worked very closely with the business managers of the supervisory unions; thus ensuring the transparency and accuracy of the DOE calculations. In addition, according to the Chief Financial Officer, the developer of the spreadsheets reviewed and manually recalculated the formula results for 12 to 15 districts during fiscal year 2007. However, this control is limited because the developer was reviewing his own work. The Chief Financial Officer also noted that he spot checked many of the spreadsheet functions.

Notwithstanding such activities, the Department of Education agreed to implement additional spreadsheet controls. Specifically, DOE stated that it plans to (1) create a notebook documenting data origin, data checks, and file names and (2) maintain a log sheet to document file updates that will be used to document the spreadsheet review. Moreover, in December 2006, DOE hired a Financial and Systems Analyst who has been given the primary responsibility of maintaining the spreadsheets in fiscal year 2008. During fiscal year 2008, the School Finance Manager has been performing oversight and review of the spreadsheets.

Control Finding 2007-11: OVHA Provider Taxes

The State collects assessments from health care providers that help fund the State's Medicaid program. Specifically, as required by statute, the State annually assesses a tax on any hospital, nursing home, intermediate care facility for the mentally retarded, home health agency, or retail pharmacy operating in the State.[45] OVHA is responsible for the administration of these

[45] 33 V.S.A. §1950 to §1958.

provider taxes, including (1) calculating the annual tax assessment, (2) collecting the taxes, and (3) recording the amounts received in VISION.

There were a variety of control deficiencies related to the provider tax area, as follows:

- *Use of spreadsheets.* OVHA maintains a series of spreadsheets to track provider tax receipts and assessments. These spreadsheets are overly complex and are not an effective tool for tracking outstanding provider tax accounts receivable balances. For example, we could not easily identify how much was due from the providers and had difficulty reconciling the total fiscal year receipts to the general ledger. Because of the limitations of these spreadsheets, it may be prudent for OVHA to consider a more robust system alternative, such as a subsidiary accounts receivable system, to track provider tax receivables.

- *Review of provider tax assessments.* OVHA's Program Integrity Manager reviewed the spreadsheet used to calculate the provider taxes. However, this review was limited to checking spreadsheet formulas and links for accuracy and did not validate that (1) the statutory rates reflected the applicable statutes and (2) the spreadsheet accurately reflected the underlying support.

- *Segregation of duties*. Segregation of duties is the division of key duties and responsibilities among different people to reduce the risk of error or fraud. No one individual should control or perform all key aspects of a transaction or event. In April 2007 a single accountant became responsible for handling, depositing, and recording provider tax receipts because of a vacancy. This same accountant was already responsible for maintaining and reconciling the provider taxes to the general ledger and her added responsibilities created a lack of segregation. Although OVHA has attempted to address this issue through a request to the Department of Human Resources, its request has not been approved. Nevertheless, a single individual should not have both custodial and record-keeping responsibilities because, for example, asset misappropriation is by far the most common form of occupational fraud, particularly as it relates to cash (defined as including currency, checks, and money orders) according to the Association of Certified Fraud Examiners.[46]

[46] *2006 ACFE Report to the Nation on Occupational Fraud & Abuse* (Association of Certified Fraud Examiners, 2006).

- *Controls over processing and documenting of cash receipts.* Strong internal controls call for organizations to establish physical controls to secure and safeguard assets that are vulnerable to risk of loss or vulnerable to abuse, such as cash.[47] However, OVHA did not immediately endorse provider tax checks received, which increased their vulnerability to possible misuse. Another control over cash—daily reconciliations of checks received to total checks deposited—was also not performed. The lack of daily reconciliations increases the risk that mistakes or misuse would not be detected in a timely manner.

- *Reviews and reconciliation of provider taxes to the general ledger.* A reconciliation process, whether manual or automated, is a necessary and valuable part of a sound financial management system. In addition, the Department of Finance and Management has directed that all State departments that maintain an accounting system outside of VISION reconcile the activity in their systems to VISION as of the end of the fiscal year.[48] OVHA has not been reconciling the total approved provider tax assessments in its spreadsheets to the total related revenue reported in VISION. In addition, at the end of fiscal year 2007, OVHA did not reconcile the provider tax receipts recorded in its spreadsheets to VISION. Moreover, although daily reconciliations were being performed of provider tax receipts, there were no supervisory reviews of these reconciliations. We were subsequently not able to agree the total cash receipts in OVHA's spreadsheets to the total amount in VISION for fiscal year 2007.

- *Supporting documentation.* The provider tax assessments are calculated using provider tax basis information provided by the Department of Banking, Insurance, Securities, and Health Care Administration, such as the net patient service revenue for hospitals derived from audited financial statements. In fiscal year 2007, this information was gathered and entered into a provider tax assessment calculation spreadsheet by OVHA's then Director of Reimbursement, but was not retained. Because the Department of Banking, Insurance, Securities, and Health Care Administration updates this information periodically, there were non-material differences between OVHA's spreadsheet and data that we were able to obtain from

[47] *Standards for Internal Control in the Federal Government* (U.S. Government Accountability Office, GAO/AIMD-00-21.3.1, November 1999).

[48] *FY 2007 Year End Closing Instructions* (Department of Finance and Management, May 1, 2007).

this department. Accordingly, we were unable to completely substantiate the provider tax basis data used by OVHA in its provider tax calculation.

Recommendations

We recommend the Secretary of the Agency of Human Services direct the Office of Vermont Health Access to:

- Implement an account receivables subsidiary system and establish a process to bill and collect provider taxes.
- Perform a detailed review of the provider tax assessment which also includes a validation of (1) statutory rates to the applicable statutes and (2) tax provider basis to the underlying support. In addition, a crosscheck should be performed of the provider tax letters to the provider tax assessment spreadsheet prior to the provider tax assessment letters being signed by the Director and mailed.
- Establish segregation of duties over the handling and recording of cash receipts.
- Establish procedures to ensure that (1) the total approved provider taxes assessments and cash receipts maintained in OVHA spreadsheets are reconciled to VISION and (2) a review of these reconciliations be performed periodically.
- Develop a segregated process whereby (1) all checks are immediately restrictively endorsed and logged, and (2) the authenticated deposit slips are compared to the cash receipts log to ensure that all checks are accounted for.
- Retain and file all underlying provider tax basis information to substantiate the providers' tax base used in the provider tax assessment calculation worksheet.

Management's Response

On March 25, 2008, the Secretary of the Agency of Human Services provided comments on a draft of this report (reprinted in appendix VII). The Secretary's response discussed the actions that the agency is taking, or plans to take, in response to this control finding. For example,

- OVHA plans to use an existing accounts receivable subsystem managed by its Medicaid fiscal agent (EDS) to establish and maintain provider tax receivables.
- OVHA is in the process of implementing processes to ensure proper segregation of duties over the handling and recording of cash receipts and developing a policies and procedures manual.
- OVHA plans to implement a process to reconcile provider taxes to the general ledger (VISION).
- OVHA is developing written procedures to address the computation and review of provider taxes as well as what supporting documentation needs to be retained.

Control Finding 2007-12: Department of Liquor Control Segregation of Duties

The Department of Liquor Control manages the Liquor Control Fund, an enterprise fund in the State's basic financial statements. This fund consists of (1) all receipts from the sale of spirits and other items by the department, (2) fees paid to the department, (3) all other amounts received by the department, and (4) all amounts that are from time-to-time appropriated to the department. For fiscal year 2007, this fund had about $44 million in operating revenues and $43 million in operating expenses.

Assigned duties should be structured, wherever possible, to segregate record keeping, authorization, and custody of assets in order to reduce the risk of error or fraud. The design of the Department of Liquor Control's internal controls did not always meet this standard. In particular, for the Special Purchase Allowance program,[49] the purchasing group manages the program, prepares the source documentation for billing, receives cash receipts, and posts the receipts to the vendor accounts receivable balance. Generally, the financial group of an organization would perform the latter two responsibilities in order to maintain a segregation of responsibilities. In fiscal year 2007, there were about $1.7 million in receipts related to this program.

[49]The Special Purchase Allowance is a sales program offered by beverage vendors to the Department of Liquor Control. Purchase discounts are available based upon the volume of product purchased, and sold by the department. The department pays its vendors full price for the product and "bills" vendors for the discounts, based upon sales volume.

Appendix II: Significant Deficiencies

Recommendation

We recommend that the Commissioner of the Department of Liquor Control review the responsibilities associated with the Special Purchase Allowance program and segregate these responsibilities among different organizational elements or implement other compensating controls.

Management's Response

On March 24, 2008, the Commissioner of the Department of Liquor Control provided comments on a draft of this report (reprinted in appendix VIII). The Commissioner responded that he was having staff from various divisions within the department seek an automated solution to the segregation of duties issue discussed in this report. He estimated that such a solution would be completed by the end of 2008.

Appendix III: List of State Organizations in Scope

The following are the State organizations at which we performed an evaluation of internal controls.

Agency of Administration
Department of Buildings and General Services
Department of Finance and Management
Department of Human Resources
Department of Taxes

Agency of Human Services
Central Office
Department of Disabilities, Aging and Independent Living
Department for Children and Families
Department of Corrections
Department of Health
Office of Vermont Health Access

Agency of Natural Resources
Central Office
Department of Environmental Conservation
Department of Fish and Wildlife
Department of Forests, Parks and Recreation

Agency of Transportation

Department of Banking, Insurance, Securities, and Health Care Administration
Insurance Division
Securities Division

Department of Education

Department of Labor

Department of Liquor Control

Department of Public Safety

Judiciary

Office of the State Treasurer

Appendix IV: Response from the Agency of Administration

VERMONT

State of Vermont
Department of Finance & Management
109 State Street, Pavilion Building
Montpelier, VT 05620-0401

[phone] 802-828-2376
[fax] 802-828-2428

Agency of Administration

MEMORANDUM

TO: Thomas M. Salmon, Vermont State Auditor of Accounts
CC: Michael K. Smith, Susan Zeller, Nancy Collins, Brad Ferland, Tanya Morehouse
FROM: Jim Reardon, Commissioner
RE: Administration's Responses
DATE: March 27, 2008

Secretary Smith has asked me to respond to your letter dated March 14, 2008. We thank you for the opportunity to respond prior to the release of your report entitled *Fiscal Year 2007; Report on Internal Controls Over Financial Reporting and on Compliance with Laws and Regulations*. We have reviewed the control findings and our Agency responses are detailed below. Please let me know you require additional information or if I can be of further assistance.

Appendix I: Material Weakness

Control Finding 2007-1: Financial Management and Financial Reporting of the State's Medicaid Section 1115 Demonstration Waiver Agreement

Management Response:

The Administration has reviewed the Auditor's finding with regard to the Global Commitment to Health Section 1115 Demonstration Waiver (Global Commitment, or Demonstration). The finding acknowledges that the Demonstration "…fundamentally restructures a significant portion of the state's Medicaid program, particularly with regard to the Centers for Medicare and Medicaid Services' (CMS) commitment to financing Medicaid." The Auditor's finding also identifies financial risks associated with the Demonstration and offers an opinion that some or all of these risks could have been mitigated or eliminated through clarification of language in the Demonstration's Special Terms and Conditions.

The Global Commitment Demonstration is the centerpiece for Health Care Reform in Vermont and has enabled the State to lead the nation in covering uninsured individuals and reforming public funding of health care. All new programs, particularly those as innovative and ground-breaking as Global Commitment, create some financial risks and implementation challenges.

Given Vermont's role as a leader in health reform, it is unrealistic to assume that all risks could be avoided. We therefore believe and fairness dictates that the program's benefits be weighed against its risks. These benefits include federal authority and financial support to:

- Implement Green Mountain Care expansions (including Catamount, Catamount Employer Sponsored Insurance, and VHAP Employer Sponsored Insurance).
- Continue previous coverage expansions (including VHAP and the Pharmacy only coverage programs).
- Invest in prevention and alternative delivery systems
- Sustain Vermont's Medicaid program and health care system

The enormous benefits of the Demonstration are clearly evident and significantly outweigh the additional risks borne by the State as a result of the Demonstration. For example, the Kaiser Commission on Medicaid and the Uninsured report dated April 2006 recognized significant programmatic and financial benefit to the State of Vermont.

The Auditor indicates that some of the financial risks could have been mitigated by inclusion of additional, clarifying language in the Special Terms and Conditions. The Auditor has determined that, "The State has made decisions as to how to implement Global Commitment that have increased its financial risks."

We do not disagree that the State incurs financial risks under the Demonstration. The Administration and the Vermont Legislature identified risks associated with the program and concluded that the agreement, in its totality, represented the best interests of the State of Vermont. We acknowledge that few, if any, agreements can mitigate all risks.

The State of Vermont vigorously negotiated a set of Special Terms and Conditions for the Global Commitment Demonstration that best represented the State's interests and provided the State with flexibility to develop a sustainable program to serve its neediest residents. However, the negotiation process has inherent limitations and Vermont did not have unlimited bargaining power to effect changes to the Special Terms and Conditions.

We believe that the Global Commitment Demonstration truly is a federal-state partnership and elements of the Demonstration design could serve as a model for program reform nationally. We therefore believe that CMS, like Vermont, is dedicated to ensuring that the program is successful. While the Special Terms and Conditions as drafted leave some issues unresolved, we conclude that through open and fair collaboration with CMS, we can satisfactorily resolve these issues.

Because of the unique and innovative nature of Global Commitment, implementation of the program presented (and continues to present) a number of challenges for the State of Vermont. No other State operates an internal Managed Care Organization (MCO) to meet the requirements of the State's Medicaid program. Both CMS and the State of Vermont have had to develop procedures to support this unique situation within the confines of their respective regulatory and legislative frameworks.

We agree in concept with the Auditor's first recommendation and strive to clarify terms and conditions, in writing, whenever possible and in the best interests of the State. Given this is a new demonstration project, the State of Vermont and the federal government frequently find themselves working through issues prior to establishing written policies and procedures. To these cases, the State frequently finds itself in a position where it is unable to secure clarification in writing; in these cases, the benefits and risks need to be weighed to determine whether to accept the terms as presented or reject the arrangement in its entirety. In the case of the Global Commitment Demonstration, we believe the program's benefits far outweigh its associated risks.

The Auditor's second recommendation relates to seeking clarification from CMS with regard to the use of Global Commitment funds for services rendered prior to the effective date of the waiver and the use of Global Commitment funds for services incurred prior to the end of the Demonstration but paid after termination of the Demonstration. The State agrees that these issues warrant clarification and will work with CMS to resolve these issues.

Excess MCO revenue, post capitation payment, is used, as identified in our waiver terms and conditions to support health care programs in Vermont. This is truly a unique piece of our agreement with the federal government that helps define the "public" MCO concept. Specifically, in a traditional MCO arrangement, savings achieved by the MCO support the company profit margin. In our public MCO model savings are used to advance Vermont's goals of promoting access to quality health care services and supporting innovative healthcare reform efforts. CMS does not approve or authorize those expenditures; they are authorized through the legislative budget process and represent the State's investment in the well being of all of our citizens. AHS and the MCO have been engaged in continuous development and improvement of the identification and management of these as well as other new innovative aspects of the Global Commitment waiver.

Control Finding 2007-2: Estimation of Allowance for Uncollectible Accounts

Management Response:

We agree with the finding and will establish additional policies and procedures to be issued and in place by 6/30/08. We will also provide guidance to departments on compliance and documentation.

Appendix IV: Response from the Agency of Administration

Appendix II: Significant Deficiencies

Control Finding 2007-4: Risk Assessment and Monitoring Processes

Management Response:

A. We believe that there has already been good progress in informing departments how to recognize and prevent "fraud" in the workplace, including:

- The headline on the December 2006 Internal Control Newsletter and the lead article was on "Occupational Fraud" (distributed and available on F&M website).
- The VT State Auditor's Office maintains a confidential line at 1-877-290-1400 to report suspected financial fraud, abuse, or corruption in State Government (which is prominently listed on the SAO's website).
- The following bullet is included in the Best Practice documents (distributed and available on F&M website) for "Cash Receipts", "Petty Cash", "Accounts Receivable", and "Fixed Assets":

  Upon suspicion of fraud or theft, immediately notify the appropriate personnel (i.e. management, State Auditor's Office, law enforcement).
- F&M will add a specific link to the SAO's Confidential Line on F&M's website re-design (in process).
- F&M is considering modifications to the 2008 Self-Assessment; one modification being considered is the addition of a "fraud" question(s):

  e.g. "Does the department inform employees that the SAO maintains a confidential line for reporting suspected fraud, abuse, or corruption in State Government?"

B. As the VT State Auditor's Office has already provided State employees and the general public with a "whistleblower" or "tip" hotline, we believe it is not a prudent use of taxpayer resources to create a second duplicative resource. We will work with the Department of Human Resources on a method to periodically publicize the ability to report fraud to VT State Auditor's Office and consider the possibility of adding additional web links to the auditor's website.

C. Although the SAO finding focuses on fraud risk, departments face other risks that could threaten the accomplishment of objectives such as sudden and significant changes in operating conditions. To help mitigate these risks, departmental "Continuity of Operation Plans" (BGS Policy 0024: Continuity of Government) are a risk assessment and management tool already in place to provide for the continuity of mission critical functions and services in the event of an emergency. A link to the BGS policy follows:

BGS Policy 0024: Continuity of Government

Control Finding 2007-5: Evaluation of Internal Controls

Management Response:

We do not agree in whole with this finding. Finance & Management does more than "the first step" of the annual internal control self assessment questionnaire (survey). The survey results are used to determine which areas of weakness will be addressed with "Best Practice" releases. Follow up transaction and VISION policy and procedure compliance reviews are conducted when the survey and/or VISION Help Desk questions indicate a particular department is deficient in a particular area.

The Self Assessment survey strategy was to first develop a "baseline" for comparison purposes. Now that we have completed the 3rd survey, we are satisfied that the sufficient data has been collected to result in a usable baseline. In the next self assessment survey due for release later in the spring of 2008, we will begin to expand the survey by adding new areas of internal control evaluation, resulting in the expansion of our Best Practice publication.

Control Finding 2007-6: Compilation and Review of the Comprehensive Annual Financial Report

Management Response:

A. While over reliance on the Director of Statewide Reporting was the case in the past; we disagree with the current comments. Not only was a fully competent Assistant Director hired, an experience government CPA who is rapidly coming up to speed, but the staff is now very well trained. In fact, for the preparation of the 2007 Financial Statements, the Director provided primarily oversight, review and approval of staff work. It was the staff that performed almost all of the necessary analysis, reconciliation and adjusting entries this past year. The Statewide Reporting group has used a Microsoft Access database to track assignments and reviewer sign-off of the major components of the CAFR for the past four years.

B. In the last year The Summit: Center for State Employee Development, under the Department of Human Resources, Division of Workforce Development & Wellness, worked collaboratively with the Department of Finance and Management (F&M) to create an accounting course offered through the center (by F&M staff), for state employees (targeting those who work in the area of finance).

Staff from The Summit, F&M and the Business Improvement Group (BIG) has been meeting to build on the accounting coursework already offered and connect it to the VISION System, for a more applied approach to increase student understanding and retention. We will explore other areas of opportunity in particular as connected to requested information and training discovered through the Business Basics Pilot Course (a course created and offered for business office managers and staff, to ensure knowledge and consistent practice enterprise-wide). This was also a joint venture between The Summit, F& M and the BIG.

Additionally, the Summit web page (where state employees go to look for training opportunities) now contains a link to the VISION Training page of the Department of Finance and Management, and collaboration on plans to meet future training need continues.

The Finance & Management Change Management Director position, which was vacant, is now filled and will facilitate an evaluation of the training plan and execution. Finance & Management continues to provide VISION training courses and a wealth of on-line documentation, manuals, policies and procedures. During the most recent technical upgrade, Finance & Management selected and trained numerous departmental "Training Coordinators". These Coordinators provide in-house departmental VISION expertise. The Coordinators, the VISION Help Desk staff and Financial Operations staff are available for daily VISION and accounting questions. The VISION website is regularly updated so that manuals and other reference material are current.

The list of training classes offered is dynamic in that additional classes are added to accommodate sessions that are oversubscribed. The number of seats trained since January 2007 is 186. Business unit specific trainings are on-going. Examples include sessions for users who are migrating a function from a third party platform to VISION and sessions for decentralized, casual users. 24 seats have been trained in less than six months. Spring workshops are offered in preparation of year end. Workshops are an opportunity for users to bring specific issues to the Help Desk or Financial Operations for one-on-one resolution. Examples include assisting with asset management after physical inventory and facilitating the preparation of purchase order and requisitions for purchase order rollover.

C. While we agree that a Statewide comprehensive accounting policies and procedures manual would be a useful tool, the Department of Finance & Management is not sufficiently staffed at this time to add the development of such a manual on top of an already heavy workload, especially in light of the PeopleSoft Enterprise Expansion Project due to begin development in August 2008.

However, the Finance & Management website provides many components of such a manual, as it contains a wealth of information, instructions, VISION Procedures, training materials, F&M Policies, Accounting Period Closing Instructions, Internal Control Best Practice issues and newsletters, with new documentation added regularly. Finally, as stated previously, the Training Coordinators, the VISION Help Desk staff and Financial Operations staff are available for daily VISION and accounting questions.

D. A team of position reviewers (including the Director of Financial Operations) under the authority of the Department of Human Resources, Director of Classification, Compensation & HRIS (Classification) recently completed a formal review and reclassification of all financial positions in the State. This process assures that an incumbent's position is appropriately graded for the actual work being performed by that incumbent.

The final phase, which is currently in process, is for the Classification division to assign each financial position into like-skilled categories, such as professional accountants, non-professional accountants and accounting clerical staff, etc. These categories will carry minimum hiring standards for academic and/or experience levels when recruiting.

Control Finding 2007-7: Information Technology Controls

Management Response:

We appreciate the Auditor's commitment to improving the practices in state government, specifically related to information technology. As the report points out, we have made progress, we are on the right path, but we must accelerate the pace of progress in this area.

For the findings related to access controls, change management and operations, we intend to issue statewide policies clarifying exactly what the expectations are for agencies and departments. We plan to work with a consultant to update policies in these specific areas and formally issue those policies by August 1st, 2008. We also intend to completely update any policies by the end of 2008.

The report also mentioned the Encryption Policy for laptop computers issued in 2007. Encrypting all of the state laptops with sensitive data was a significant project that is over 90% complete at this time. 100% compliance should be achieved by July 1st, 2008. In 2007, web site penetration testing revealed some deficiencies and all of those issues have been corrected. We plan to launch the Employee Awareness Training by April 1st and should have that process completed by July 1st, 2008. The Agency and Department level security programs will be fully launched by September 1st, 2008.

We intend to develop a Security Strategic Plan as a supplement to the annual Information Technology Strategic Plan beginning with the next report which will be completed by the end of this calendar year.

While I am confident that our citizens' information is secure and well protected, there is always room for improvement. We look forward to working with the Auditor and all state entities to increase our Security Posture to the highest levels.

State of Vermont
2008 Information Security Action Plan
Actions Steps

Step 1 Establish Agency/Department Level Security Programs
- *-Assign Security Leads (6/1/08)*
- *-Complete Agency level security program launch (by 9/1/08)*
- *-Begin conducting Risk Assessments with new format (start by 6/1/08)*
- *-Develop Compliance Plan and Implement Remediation (as required)*
- *-Issue Agency Security Program Maturity Rating (by 12/1/08)*

Step 2 Policies
- *-Contracted with consultant to assist in policy development (4/1/08)*
- *-Data Classification (5/1/08)*
- *-Change Management (6/1/08)*
- *-Back Up and Restoration (7/1/08)*
- *-Access Controls (8/1/08)*

-Update all existing policies, if necessary (12/1/08)
Step 3 Re-establish CSIRT (5/1/08)
Step 4 Employee Training and Awareness (launch by 4/1/08)
-IT staff and all employees
Step 5 Enterprise Architecture Program (launched by 6/1/08)
-Enterprise security standards for future application development
Step 6 Data Centers and Server Consolidation (Underway)
-Consolidate the state's servers into 2-3 data centers

Control Finding 2007-9: Reconciliation of Subsidiary Systems to VISION

Management Response:

We agree that subsidiary system reconciliation to VISION is absolutely necessary. This is why we include such a directive in our annual closing instructions:

> ***"FY 2007 Reconciliation of Accounting Systems Maintained Outside Of VISION to VISION***
> *All departments who maintain an accounting system outside of VISION must reconcile the activity in their system to the VISION system as of June 30, 2007. Full documentation of this reconciliation must be kept on hand and available for audit by the Department of Finance and Management and the Office of the Auditor of Accounts. The reconciliation and documentation must be completed by August 10, 2007, and all adjusting journal entries for reconciling items must be posted with a July, 2007 accounting date and a PY in the journal class field on the journal header."*

The Finance & Management, Internal Controls unit will add a specific question(s) relating to the regular reconciliation of subsidiary systems to VISION to the annual *Internal Control Self-Assessment Survey*, as recommended. The next survey is slated for the spring of 2008.

Appendix V: Response from the Department of Labor

VERMONT

State of Vermont
Department of Labor
5 Green Mountain Drive
P.O. Box 488
Montpelier, VT 05601-0488
www.labor.vermont.gov

[phone] 802-828-4000
[fax] 802-828-4022

March 24, 2008

Thomas M. Salmon, CPA
State Auditor
132 State Street
Montpelier, VT 05633-5101

Dear State Auditor Salmon:

I have reviewed your letter dated March 17, 2008, and first want to thank you and your staff for working closely with Valerie Rickert, our Unemployment Insurance and Wages Division Director. We appreciate your office's input and guidance on the issues encountered during the audit conducted last fall.

While the adjustments totaled $3.6 million, nearly $2 million of this amount was attributable to our Trust Fund Accountant using a report that had been used for several years to document amounts due from overpaid unemployment insurance benefits. This oversight was detected by our staff while the audit was being conducted and corrected accordingly. Safeguards have been put in place to prevent this mistake from occurring again. Other necessary adjustments are attributable in part to two thirds of the staff working with the trust fund having less than a year's experience and in many ways still heavily involved in the training process. Steps have been taken to document who has prepared and reviewed pertinent entries.

All that said, we have taken steps to hire an independent CPA, who will provide on-site training, review and validate our newly installed accounting software, and complete a pre-trial balance sheet. We also will be seeking guidance and suggestions from the CPA on the most effective and efficient way to validate entries.

The recommendation that a manager-level review adjusting journal entries and account reconciliations is appropriate, but difficult to achieve in substance with current levels of knowledge and background in financial accounting. This lack of knowledge will be offset by the assistance of the independent CPA and review by the department's business manager. Management is already reviewing the allowance for uncollectible accounts.

It is hoped this response adequately addresses the material weaknesses found in the FY 07 Unemployment Trust Fund audit. Should you have further questions, please contact Valerie Rickert.

Sincerely,

Pat McPaul

Patricia Moulton Powden
Commissioner

PMP:lc

Appendix VI: Response from the Department of Education

State of Vermont
Vermont Department of Education
120 State Street
Montpelier, VT 05620-2501

March 28, 2008

Thomas M. Salmon, CPA
Vermont State Auditor
132 State Street
Montpelier, VT 05633-5101

Re.: Response to Audit Findings

Dear Tom:

We have reviewed the draft audit report and note there is one finding of a significant deficiency regarding spreadsheet controls for our public education funding system. We have carefully reviewed our processes since reading the report and offer the attached response including corrective actions.

I want to commend your staff for their professional manner and expertise. This process has been informative and instructive and will help us improve our systems. Please let me know if you need additional information.

Sincerely,

Bill Talbott

Bill Talbott, CFO

VERMONT

Response to Significant Deficiency Finding Regarding Spreadsheet Controls
Vermont Department of Education
March 28, 2008

The School Finance section of DOE works very closely with the business managers of the supervisory unions. A significant portion of that work involves educating the business managers as to how the funding formula works. The School Finance section also provides them with spreadsheets that assist them when working with school boards to determine the impact of proposed budgets. The business managers therefore know what they should be receiving from the towns (education property taxes) and the State Education Fund (*i.e.*, the State Treasury). One of the goals of this education process is to make the calculations as transparent as possible, to as many people as possible.

The same holds true with the town treasurers who receive sheets detailing the flow of cash between the towns, the school district, and the State Education Fund.

Cash flow sheets for every school district and subsequent notifications of payments to or from the Education Fund are sent to the business managers. The business managers in turn review those data and calculations, ensuring that the figures are correct and are as expected. DOE could require electronic confirmation from business managers, stating that they have seen and reviewed the data and resolved any questions they may have.

1. "First, the Department did not have formal written policies and procedures descriptively supporting the various spreadsheets formula design and calculation processes." *page 13, paragraph 2*
    a. Create a notebook containing documentation of data origin, data checks, and file names into which data are inserted. Each file will have its own page with a brief, explanatory paragraph stating the purpose.
    b. A log sheet will be created that will be a check-off page with date and initials of person updating files.
2. "Written documentation is also critical to ensure that formulas in the spreadsheet are updated in accordance with applicable statutory provisions . . ." *page 13, paragraph 2*
    a. Reference to statutory citations for new formulas modifying the funding formula have always been inserted in the top sections of each affected column of the spreadsheet when those changes have a significant impact to a number of districts or are new and impact all districts.
    b. Significant statutory changes will be duly noted in the log sheet of the impacted file.
3. "Second, DOE did not implement a process to require someone other that the user/developer of the spreadsheets to inspect the logic of the formulas within the spreadsheets and to document the results of this review." *page 13, paragraph 3*
    a. When a spreadsheet had been modified due to statutory changes, each new formula was checked and recalculated on paper via calculator. Only then was the formula incorporated into the final spreadsheet.

1

b. Each spreadsheet was reviewed and tested cell by cell for differing categories of districts. Multiple districts in each category were tested and reviewed (generally for a total of 12 to 15 districts). Each formula in each cell for any given district was reviewed and recalculated by hand throughout the spreadsheet.
c. There was a vacancy in the Financial and Systems Analyst position for most of FY2006 through the first half of FY2007. The spreadsheet determining the FY2007 calculations that were audited was done in June of 2006 and modified as budgets that had previously failed were approved. A Financial and Systems Analyst was hired in mid to late December of 2006, midway through the fiscal year. At that point, the spreadsheets had been completed, cash flows had gone out, and two of three payments from the Education Fund had been made as well as one of the two billings having been sent to towns. The Chief Financial Officer had occasionally been consulted during that time period an he spot checked many of the spreadsheet functions.
d. In FY2008, the Financial and Systems Analyst has primarily responsible for maintaining the spreadsheet for the FY2008 payments, with oversight and review from the School Finance Manager.
e. Review documentation will be included in the log sheet as described above in 1b.

4. "Third, there was no documented review that demonstrated that changes to the statewide property tax calculations were tested and approved, independent of the developer of the changes." *page 13, paragraph 3*
   a. All formulas have been worked through by hand in the past. New formulas are worked through and carefully scrutinized to ensure the results are as expected. They are then incorporated into the spreadsheet.
   b. The log sheet will refer to relevant statutory language that explains the changes to the formulas.
   c. The reviewer's initials and date will be entered.

Segregation of Duties and Review Approval Process

5. "Different personnel should perform the functions of initiation, authorization and record keeping. No one individual should control or perform all key aspects of a transaction or event." *page 14, paragraph 1*
   a. As noted above in number 3, there was a vacancy in the Financial and Systems Analyst position for the first half of FY2007. A Financial and Systems Analyst was hired in mid to late December of 2006, midway through the fiscal year. Currently, the School Finance Manager and the Financial and Systems Analyst review one another's work for logic and accuracy. There are no other staff available to provide additional review.
   b. In FY2008, the Financial and Systems Analyst has primarily been responsible for maintaining the spreadsheet, with oversight and review from the School Finance Manager.

2

Appendix VII: Response from the Agency of Human Services

State of Vermont
Agency of Human Services
Office of the Secretary
103 South Main Street
Waterbury, VT 05671-0204
www.ahs.state.vt.us

[phone] 802-241-2220
[fax] 802-241-2979

Cynthia D. LaWare, Secretary

March 25, 2008

Thomas M. Salmon, CPA
Vermont State Auditor
132 State Street
Montpelier, VT 05633-5101

Subject: Management response to Report on Internal Controls over Financial Reporting and on Compliance with Laws and Regulations Finding 2007-11

Dear ~~Auditor~~ Tom Salmon,

Attached please find the Agency response to the above-referenced finding.

Sincerely

Cynthia D. LaWare

Cynthia D. LaWare, Secretary
Agency of Human Services

Attachment

cc: J. Westervelt

VERMONT

Appendix VII: Response from the Agency of Human Services

Control Finding 2007-11: OVHA Provider Taxes

Appendix III: Management's Response

Use of spreadsheets: EDS, the contracted organization with OVHA to handle all MMIS (Medicaid Management Information System) transactions, has an existing accounts receivable subsidiary system that tracks receivables collected by EDS on behalf of OVHA. Effective March 18, 2008, OVHA employees will be trained on the EDS system which will allow for receivables to be established and maintained on OVHA collected receivables (i.e. provider tax) mitigating the need for complex spreadsheets. A simplified spreadsheet, however, is under development to ensure the transition to the subsidiary system occurs properly.

Review of provider tax assessments: Historically the Director of Reimbursement was responsible for the calculation of provider tax assessments, with a review performed by the Program Integrity Manager. Upon the Director of Reimbursement's retirement (December, 2007), this responsibility transitioned to a Medicaid Fiscal Analyst within the Program Integrity Division with cross training and subsequent thorough review performed by an Account C within the Business Administration Unit.

Segregation of duties: Processes are being implemented in SFY '08 to ensure proper segregation of duties; and a policies and procedures manual in addition to a functions inventory worksheet are currently under development outlining specifically how this will occur. Anticipated date of completion: 6/30/08.

Controls over processing and documenting of cash receipts: The OVHA has struggled with how to address this issue, because checks received by OVHA are split into two sections ~ one processed and deposited by OVHA and one processed and deposited by EDS. These are deposited into two different accounts; therefore, two different endorsements are required. However, as of 3/17/08, three separate stamps were ordered:
(1) For deposit only, State of Vermont; (2) OVHA account number; and (3) EDS account number. Checks will be immediately endorsed upon receipt with stamp #1. Stamps #2 and #3 will be applied once proper assignment is determined.

Reviews and reconciliation of provider taxes to the general ledger: Agreed. The OVHA will implement this reconciliation process. A policies and procedures manual in addition to a functions inventory worksheet are currently under development outlining specifically how this will occur. Anticipated date of completion: 6/30/08.

Supporting documentation: Upon the Director of Reimbursement's retirement (December, 2007), this responsibility transitioned to a Medicaid Fiscal Analyst within the Program Integrity Division with cross training and subsequent thorough review performed by an Account C within the Business Administration Unit. Written procedures are under development that will address both how the computations and reviews will occur as well as what relevant supporting documentation needs to be retained. Anticipated date of completion: 6/30/08.

Appendix VIII: Response from the Department of Liquor Control

VERMONT

State of Vermont
Department of Liquor Control
13 Green Mountain Drive, Drawer 20
Montpelier, VT 05620-4501
http://liquorcontrol.vermont.gov/

[phone] 802-828-2339
[fax] 802-828-1031

Michael J. Hogan, Commissioner

March 24, 2008

Thomas M. Salmon, CPA
Office of the State Auditor
132 State Street
Montpelier, Vt. 05633-5101

Dear Tom:

I am responding to your letter of March 17 regarding internal controls and compliance with laws and regulations that pertain to my department. My staff is in the process of working on the issues you pointed out under Segregation of Duties- Control Finding 2007-12.

Special Purchase Allowance: I believe the issue is one of segregating duties. I am having the IT Division, Accounting Division, and Purchasing meet and make recommendations to automate the process. A draft proposal for these changes should happen in the next few months. The analysis and programming changes will then have to fit into the schedule of the many IT projects underway in our department. I would estimate that it will be completed by the end of this year.

If you have further questions, please don't hesitate to contact me.

Michael J. Hogan

Michael J. Hogan
Commissioner of Liquor Control