State of Maine
Report on Internal Control
Over Financial Reporting

For the Year Ended
June 30, 2007

State of Maine Department of Audit
Neria R. Douglass, JD, CIA
State Auditor

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LETTER OF TRANSMITTAL

Honorable John Elias Baldacci
Governor of the State of Maine

Honorable Beth G. Edmonds
President of the Senate

Honorable Glenn Cummings
Speaker of the House

We are pleased to submit our Report on Internal Control Over Financial Reporting for the Year Ended June 30, 2007. In the course of our audit of the basic financial statements of the State of Maine, and our consideration of internal control, we identified certain deficiencies in internal control that we consider to be significant deficiencies according to Statement on Auditing Standard No. 112 (SAS 112) issued in May 2006 by the American Institute of Certified Public Accountants Auditing Standards Board effective for financial statement audits for periods ending on or after December 15, 2006. SAS 112 applies whenever an auditor expresses an opinion on financial statements. It establishes standards on communicating matters related to internal control over financial reporting and requires written communication of control deficiencies identified in an audit of financial statements within sixty days. Our opinion on the basic financial statements of the State of Maine was issued December 19, 2007.

Please feel free to contact me with any questions that you may have. Like you, we are committed to improving our State government for the benefit of our citizens. I welcome your thoughts and inquiries on these matters.

Respectfully submitted,

Neria R Douglass

Neria R. Douglass, JD, CIA
State Auditor
State of Maine

February 19, 2007

State of Maine
Financial Findings Letter for the Year Ended June 30, 2007

Table of Contents

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REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To the President of the Senate and the
Speaker of the House of Representatives

In planning and performing our audit of the financial statements of the State of Maine as of and for the year ended June 30, 2007, in accordance with auditing standards generally accepted in the United States of America, we considered the State of Maine's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State of Maine's internal control. Accordingly, we do not express an opinion on the effectiveness of the State of Maine's internal control.

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 entity'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 likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicate them to management and the Legislature in the following pages.

This communication is intended solely for the information and use of management and the Legislature and is not intended to be and should not be used by anyone other than these specified parties.

Neria R. Douglass

Neria R. Douglass, JD, CIA
Maine State Auditor
December 19, 2007

2007 Findings
Internal Control over Financial Reporting

<u>Department of Administrative and Financial Services</u>

(1) Inadequate controls over accrual calculations

Bureau: Office of the State Controller
Prior Year Finding: No

Criteria: Generally accepted accounting principles

Condition: The Department does not have adequate controls in place to ensure that the Taxes Receivable balance, related to the Highway Fund, was reasonable stated.

Context: Audit adjustments totaling $4.45 million were necessary to ensure the financial statements were reasonably stated.

Cause: Inadequate oversight.

Effect: The State's financial statements were misstated prior to audit adjustments.

Recommendation: We recommend that the Department implement procedures to ensure that the accrual calculations are performed correctly.

Management's Response:

In order to meet the draft statement reporting deadline, the Controller's Office posted an adjustment for taxes receivable in the highway fund based upon the best information available to the Controller's Office from the agency at the time.

Title 5 MRSA §1547, subsection 4 requires agencies to provide financial information to the Office of the State Controller (OSC) by September 1, following the close of the fiscal year. A detailed closing package is provided to agencies identifying the information that must be submitted to the OSC in order to prepare financial statements that are in accordance with GAAP. Information on tax accruals is included in this request.

In the future, the OSC will take measures to ensure that all the accrual information is received from Maine Revenue Services and that supporting worksheets are sufficiently reviewed in order to properly report receivables and revenues.

Contact: *Brenda Palmer, Principal Financial Management Coordinator, 626-8437*

(2) Inadequate controls to ensure compliance with governmental accounting standards

Bureau: Office of the State Controller (OSC)
Prior Year Finding: No

Criteria: GASB 34

Condition: The Department does not have adequate controls in place to ensure that the entity-wide Statement of Net Assets is presented in accordance with the applicable governmental accounting standards. Certain asset and liability accounts were not presented with the distinction between short-term and long-term classification prior to an audit adjustment.

Context: Audit adjustments totaling $46.3 million to Taxes Receivables, $25.3 million to the equity in Treasurer's Cash Pool, and $11.5 million to Deferred Revenue were necessary to ensure the financial statements were reasonably stated.

Cause: The OSC had not completed its final review prior to delivering the financial statements to the Department of Audit.

Effect: The State's financial statements were misstated prior to audit adjustments.

Recommendation: We recommend that the Department implement procedures to ensure that the entity-wide Statement of Net Assets is presented in accordance with the applicable governmental accounting standards.

Management's Response:

This issue resulted from an adjustment to the fund level statements to present the balance sheet in order of liquidity, instead of designating between current and noncurrent assets and liabilities to be in compliance with GASB 34. This change did not initially roll up to the government wide statements correctly.

In order to meet our draft statement reporting deadline, the draft statements were submitted to the Dept of Audit prior to conducting our final analytical review, which would have allowed us to identify and correct the error to ensure the final financial statements were accurately stated.

In the future, we will take measures to perform our final analytical review prior to submitting draft financials to the Department of Audit.

***Contact:** Brenda Palmer, Principal Financial Management Coordinator, 626-8437*

(3) Inadequate controls over accrual calculations

Bureau: Security and Employment Service Center (SESC)
Office of the State Controller
Prior Year Finding: No

Criteria: GASB Statement No. 34, footnote 34 "state unemployment compensation funds should be reported in enterprise funds".

Condition: The Department does not have adequate controls in place to ensure that the financial statements for the Employment Security Fund were reasonably stated. SESC incorrectly calculated the revenue accrual for the final quarter of the fiscal year. This accrual entry was calculated using an incorrect basis of accounting. Additionally, SESC incorrectly posted a revenue transaction to deferred revenue.

Context: Audit adjustments totaling more than $15 million were necessary to ensure the financial statements were not misstated.

Cause:

- Change in accounting standard
- Staff turnover
- Inadequate training
- Lack of oversight

Effect: The State's financial statements related to Employment Security Fund revenue were understated prior to the audit adjustment.

Recommendation: We recommend that SESC develop procedures to ensure that the accounting transactions for this fund are in accordance with GAAP (Generally Accepted Accounting Principles). We further recommend that the Office of the State Controller provide oversight to agency personnel to ensure that changes in accounting standards are correctly implemented.

Management's Response:

SESC: *We concur with the finding. At the start of each State fiscal year, the Securities & Employment Service Center will contact the department's liaison at the Controllers' Office to seek guidance on any new GASB's that may affect the Employment Security Fund. Following the GASB 34 model, we will be able to record revenue based on historical information prior to the end of the State's fiscal year; which in turn will eliminate the need for some of the off-balance sheet entries after the close of the State's fiscal year.*

Contact: *Dennis Corliss, Director, 626-6701*

OSC: *The OSC agrees with the finding. We worked with agencies at the implementation of GASB 34. Each year, a closing package is sent to agencies and the service centers* *with detailed instructions on the information that must be submitted to the OSC in order to prepare financial statements that are in accordance with GAAP. The OSC will continue to work with the Service Center to ensure amounts reported in the State's financial statements are properly stated.*

Contact: *Brenda Palmer, Principal Financial Management Coordinator, 626-8437*

(4) Revenue incorrectly reported as transfers

Bureau: Office of the State Controller (OSC)
Prior Year Finding: 06-04

Criteria: Governmental Accounting Standards Board (GASB) Statement 34, paragraph 112

Condition: Electronic and manual statewide accounting procedures did not ensure the accuracy of amounts reported as transfers in the State's financial statements. Two misclassifications between revenue and transfers were not detected and required adjustments.

Context: Audit adjustments totaling $23 million were necessary to ensure the financial statements were not misstated

Cause: Account coding for similar transactions is inconsistent.

Effect: The State's financial statements were misstated prior to adjustments.

Recommendation: We recommend that the Department work with the State agencies to implement written accounting procedures that will standardize the account codes used for miscellaneous income, transfers-in, and transfers-out.

Management's Response:

The Office of the State Controller agrees that rules and policies regarding transfers appear complicated. Our office will continue to work with agencies to standardize account coding regarding transfers; however, when considering the different types of transfers depending on the type of fund, the nature of the transaction, the budget rules and laws, the volume of transactions and the size of the entity it is unlikely that any cost effective measures would totally prevent errors within the transfer versus revenue category.

Contact: *Brenda Palmer, Principal Financial Management Coordinator, 626-8437*

(5) Inadequate controls to ensure complete and accurate recording of capital assets

Bureau: Office of the State Controller
Prior Year Finding: 06-02

Criteria: State's fixed assets internal control policies and GASB 34

Condition: Controls were not in place to ensure accurate financial reporting of all capital assets. Currently, the State is utilizing a spreadsheet to financially report capital asset balances, current year additions, current year deletions, accumulated depreciation, and depreciation expense. Due to the volume of assets being reported, this spreadsheet allows for a significant margin of error to exist. The spreadsheet is complex and allows for assets to be easily added, deleted, and modified without the ability to track those changes. Furthermore, the Department did not sufficiently monitor agencies to ensure that assets were properly valued, acquisitions were appropriately recorded, and physical inventories were performed.

Context: This is a systemic problem that has existed since fiscal year 2002.

Cause: Insufficient reporting system and monitoring procedures

Effect: The State's financial statements and related notes regarding capital assets could be misstated.

Recommendation:

- The Department needs to implement a more accurate and accountable way of financially reporting capital assets that would be interfaced with the State's accounting system to track additions and deletions using the information already entered into the accounting system. (It was noted during our audit that the new AdvantageME software that is expected to be implemented in FY 2008 should address this issue.)
- The Department should monitor and provide clear and specific guidance to agencies on implementing fixed asset internal control policies.
- Each agency should follow established internal control policies included in the fixed asset manual.

Management's Response:

The OSC agrees that large spreadsheets are not ideal and may occasionally contain an error, however, they are a valuable and acceptable tool, and we believe that other compensating controls in place are effective to prevent a misstatement from occurring.

In June 2007, the OSC created a team of staff members to review statewide fixed asset policies and procedures in an effort to update, clarify, and simplify fixed asset polices, identify and address internal control deficiencies, and develop an ongoing fixed asset training program. We believe significant improvements have been made in this area, but *we recognize the need to continue to look for ways to improve communication with agencies, provide additional training, and improve the financial reporting process. Now that Advantage is available, the goal is to use it to track assets, acquisitions, dispositions, and calculate depreciation expense.*

The plan to establish Advantage as the main tool for all capital asset accounting and reporting statewide is:

- *Update all related policies and procedures to be inline with the new software.*
- *Address agencies that currently do not use the accounting system, or use it on a limited basis.*
- *Provide training to all agencies on the proper accounting of capital assets, how to use Advantage, and why it is important for financial reporting.*

Contact: *Brenda Palmer, Principal Financial Management Coordinator, 626-8437*

Department of Defense, Veterans and Emergency Services and

Department of Administrative and Financial Services

(6) Inadequate controls over Fund Accounting

Bureau: Maine Military Authority (MMA)
Office of the State Controller
Prior Year Finding: No

Criteria: Generally accepted accounting principles

Condition: The Department does not have adequate controls in place to ensure that the financial statements were reasonably stated regarding revenue and expenses of the Maine Military Authority. Maine Military Authority made an accounting error when processing a non-routine transaction to the State's accounting system. Further compounding this error, the Office of the State Controller did not make an adjustment to the State's financial statements necessary to ensure proper reporting.

Context: An audit adjustment totaling $16 million was necessary to ensure the financial statements were not misstated.

Cause:

- Staff turnover
- Inadequate monitoring of unusual transactions by both Departments

Effect: The State's financial statements regarding Maine Military's revenues and expenses were significantly overstated prior to the audit adjustment.

Recommendation: We recommend that the Office of the State Controller improve their procedures and provide clear and specific guidance to agencies when non-routine transactions need to be posted to the State's accounting system.

Management's Response:

DVEM: *We concur with the finding.*

The MMA erroneously posted a non-routine financial transaction to the State accounting system twice. The error was discovered during the FY07 close-out. MMA has changed its processing procedures relating to billings in order to discover and correct this type of error in a timely fashion.

Contact*: Karen Roderick, Director, 430-2197*

OSC: *The MMA is using the new accounting system to record its receivables, revenues and deferred revenues using the accrual basis of accounting. OSC is working with the agency to monitor accounting activity on an ongoing basis.*

In the future, the OSC will take measures to review all infrequent and unusual transactions to ensure proper financial reporting.

Contact: *Brenda Palmer, Principal Financial Management Coordinator, 626-8437*

Department of Health and Human Services and

Department of Administrative and Financial Services

(7) Inadequate controls over the calculation of the Medicaid hospital settlement accrual

Bureau: Office of the State Controller (OSC)
DHHS Office of Audit – MaineCare and Social Services
Prior Year Finding: No

Criteria: Paragraphs AAG-SLV 12.110 and AAG-SLV 12.111 of the AICPA Audit and Accounting Guide *State and Local Governments* with Conforming Changes as of May 1, 2007

Condition: The Medicaid hospital settlement accrual methodology was logically sound but the worksheet used included formula errors. Additionally, the Office of the State Controller did not sufficiently review the support for the accrual to detect the formula errors.

Context: An audit adjustment of $43.4 million was necessary to ensure that the State's financial statements were not misstated.

Cause: Formula errors

Effect: The accounts payable and federal receivable balances were overstated prior to the audit adjustment.

Recommendation: We recommend that DHHS ensure the correct worksheet formulas are used when calculating accruals for proper financial statement presentation. We further recommend that OSC carefully review all support submitted to them from State agencies for accrual purposes.

Management's Response:

DHHS: *The finding identifies an internal control weakness in that the spreadsheet calculating the hospital settlement accrual contained formula errors that were not detected upon review by the DHHS Division of Audit or the Office of the State Controller. The Division of Audit agrees that the spreadsheet contained several formula errors which would have resulted in the accrual being misstated. In the future, the Division will prepare the calculations earlier and ensure that all spreadsheets are reviewed by the Audit Program Manager prior to release. Additionally, future calculations of the hospital accrual will incorporate the formula changes identified in the finding.*

Contact: *Herb Downs, Director, 287-2778*

OSC: *In the future, the OSC internal audit division will work with the financial reporting staff to audit the support provided by agencies for significant and complex accruals.*

Contact: *Brenda Palmer, Principal Financial Management Coordinator, 626-8437*

Department of Transportation and

Department of Administrative and Financial Services

(8) Inadequate controls to properly account for the transfer of capital assets between funds

Bureau: Office of Capital Resource Management
Office of the State Controller (OSC)
Prior Year Finding: No

Criteria: Generally accepted accounting principles

Condition: The Department does not have controls in place to properly account for the transfer of capital assets between funds. As a result, the State's financial statements were misstated prior to an audit adjustment.

Context: Audit adjustments totaling $25 million were necessary to ensure the financial statements were reasonably stated.

Cause:

- Lack of agency understanding to properly account for the transfer of capital assets
- Insufficient review of agency documentation by the OSC

Effect: The State's financial statements were misstated prior to audit adjustments.

Recommendation: We recommend that the OSC improve their monitoring procedures and provide clear and specific guidance to agencies on how to properly account for capital assets that are transferred between funds.

Management's Response:

DOT: *The Department of Transportation agrees with the finding and will adjust all capital assets transferred to the Enterprise Fund, with the guidance of the Office of the State Controller.*

Contact: *Mike Mckenna, Financial Analyst, 624-3134*

OSC: *The OSC worked closely with DOT to properly report the transfer of assets from a governmental fund to an enterprise fund. When DOT made changes to their calculations, they also changed the useful lives of the assets, which the OSC was not made aware of resulting in the understating of accumulated depreciation ($10.5 million) in our draft financials. As a result, Funds invested in capital, net of related debt was overstated by ($7.5 million). Additionally, several assets that were under the capitalization threshold in the governmental fund were subsequently transferred to the enterprise fund (6.9 million). These were discovered through the audit process.*

In June 2007, the OSC created a team of staff members to review statewide fixed asset policies and procedures in an effort to update, clarify, and simplify fixed asset polices, identify and address internal control deficiencies, and develop an ongoing fixed asset training program. We believe significant improvements have been made in this area, but we recognize the need to continue to look for ways to improve communication with agencies, provide additional training, and improve the financial reporting process.

We will continue to work with agencies on proper accounting for all capital asset transactions.

Contact*: Brenda Palmer, Principal Financial Management Coordinator, 626-8437*

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