

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS
(Continued)**

**State of Washington
July 1, 2016 through June 30, 2017**

Financial Findings Reported Under Government Auditing Standards

2017-001 The State should improve internal controls over specific areas of processing, recording, monitoring and reporting of financial activity included in the State’s financial statements.

Background

State management is responsible for designing and following internal controls that provide reasonable assurance regarding the reliability and accuracy of information used for financial reporting. We identified deficiencies in internal controls that could adversely affect the State’s ability to accurately report its financial statements.

Government Auditing Standards, prescribed by the Comptroller General of the United States, requires the auditor to communicate material weaknesses, as defined below in the Applicable Laws and Regulations section, as a finding.

Employment Security Department (ESD)

The Employment Security Department (ESD) administers Washington’s unemployment insurance program. ESD implemented the Next Generation Tax System (NGTS) in March 2014 to process employer wage reports and payments.

During the past two audits, we issued a finding related to NGTS’s processing of employer wage reports and payments. NGTS processed about \$1 billion in Unemployment Insurance Premium payments during fiscal year 2017.

Health Care Authority (HCA)

The Health Care Authority (HCA) contracted with a vendor, which uses a system known as ProviderOne, to process payments for Medicaid. During the previous four audits, we identified and communicated deficiencies in controls over the ProviderOne system. For fiscal year 2017, ProviderOne processed about 94 million transactions totaling \$11.2 billion.

State Board of Community and Technical Colleges (SBCTC)

The Washington State Board for Community and Technical Colleges (SBCTC) advocates for, coordinates and directs Washington's system of 34 public community and technical colleges. One of SBCTC's responsibilities is to collect community and technical college financial data for reporting in the State's Agency Financial Reporting System (AFRS).

Department of Licensing (DOL)

The Department of Licensing (DOL) administers the State's Prorate and Fuel Tax Program. This program provides services related to fuel tax and commercial motor carriers including fuel tax collection, refunds, investigation of illegal fuel imports, licensing and registration for the International Registration Plan. For fiscal year 2017, the state reported fuel tax revenues of about \$1.7 billion.

Office of Financial Management (OFM)

The Office of Financial Management (OFM) is responsible for preparing the state's basic financial statements in accordance with Generally Accepted Accounting Principles (GAAP). These statements provide a thorough and detailed presentation of the state's overall financial condition.

OFM is responsible for the overall coordination of financial data across the state used to prepare these statements. At year-end, OFM is also responsible for ensuring the accuracy of the financial information presented in the statements.

Description of Condition

We identified the following deficiencies in internal controls over financial reporting that, when taken together, represent a material weakness over financial reporting:

ESD

The following deficiencies were identified in the fiscal year 2016 audit. Follow-up procedures with ESD staff indicate that these deficiencies still existed during fiscal year 2017.

System processing

- Adjustments can be entered and processed in NGTS without review and approval of a second person.
- Detail Benefit Charges within NGTS do not consistently match the Summary Benefit Charges.

System report issues

- Employer Unemployment Insurance Premium payments and tax and wage reports did not consistently post accurately to employer accounts in NGTS.
- Reports generated from NGTS were incorrect and could not be relied upon to verify the accuracy or completeness of changes made to employer accounts.

- NGTS account balance reports did not accurately reflect ending and beginning account balance from month to month. NGTS reports cannot be relied upon for use in reconciling premiums to the State's general ledger account system, AFRS.

Reconciliations

- Controls were not adequate over interfaces between internal and external systems. There are no reconciliations between systems to ensure information transmitted by interfaces is accurate and complete.
- Summary and detail wage reports filed by employers are not reconciled and are sometimes out of balance. As a result, filing errors that could cause an incorrect calculation of premiums and benefits may not be identified and resolved timely.
- Daily reconciliations between the bank and NGTS are attempted, but due to a variety of system errors, the bank and NGTS are often out of balance.

HCA

During the previous four audits, we identified and communicated deficiencies in controls over the ProviderOne system. HCA has made improvements, including obtaining a service organization control audit report (also called SSAE 16) for six months of the prior fiscal year; however, HCA did not obtain this report for fiscal year 2017. This report is essential because it determines whether controls are properly designed and operating as intended in the processing and recording of Medicaid payments.

SBCTC

SBCTC implemented a new computer system to replace the existing legacy software with modern technology. Two colleges converted to the new PeopleSoft system in 2015.

At the time of the audit, these Colleges had not closed their financial records for fiscal year end 2016. As a result, beginning balances for balance sheet accounts related to these Colleges were omitted from the State's financial statements.

No adjustments were created to ensure the State's financial statements were accurate and agreed to supporting financial documentation at the College level.

Due to time restrictions, SBCTC was unable to perform a reconciliation between amounts in AFRS and their system's information.

GET

The legislative change to the GET program resulted in complicated and unique accounting of the program's activities. The Office of Financial Management (OFM) and GET program staff did not ensure program activities were correctly recorded in the State's general ledger accounting system and financial statements.

DOL

DOL accounting staff detected an error in reported revenue within the Prorate and Fuel Tax Program. A journal voucher was posted to correct reported fuel tax revenues. However, the voucher was not completed correctly, resulting in misclassified revenue.

OFM

To prepare the state's financial statements OFM makes a number of year-end adjustments. Many of the required adjustments are not posted to the state's accounting system, but are manually entered into the financial statements. Several year-end adjustments were not posted correctly.

Cause of Condition

ESD

This is the third year that ESD has used NGTS. Before implementing the system, ESD did not perform adequate testing to ensure the system could process accurate and complete Unemployment Insurance Premium payments, tax and wage reports, unemployment insurance rates and employer receivables. In addition, the lack of some key reconciliations increases the likelihood that system errors will not be detected and corrected promptly.

HCA

HCA and its vendor did not adequately outline in their original contract the responsibilities, controls and requirements for monitoring the ProviderOne system. Specifically, the contract did not require the vendor to obtain an SSAE 16 report. At the time of the contract, HCA did not have complete knowledge of the extent of its monitoring responsibilities for ProviderOne.

SBCTC

SBCTC does not have adequate staffing resources or time to completely reconcile all the Community College system's balances to AFRS. SBCTC has not performed a year-end reconciliation between balances reported by the Community and Technical Colleges and balances reported in AFRS.

SBCTC has chosen not to reconcile any information to AFRS or to make adjustments to agree information to AFRS until records kept in PeopleSoft are accurate. Due to the current software conversion implementation plan, underlying data for fiscal year 2016 is still being reconciled for accuracy in PeopleSoft and does not agree to AFRS.

GET

GET program staff did not perform adequate accounting research before recording negative revenues into AFRS. OFM did not adequately monitor the unique GET program activities to ensure correct reporting in AFRS and on the financial statements.

DOL

Although DOL accounting staff reviewed and approved the journal voucher, the error was not detected. OFM staff detected the unusual transaction as part of its routine monitoring procedures; however, it did not perform follow-up procedures to verify that the error was corrected.

OFM

OFM has consistently produced one of the fastest statewide financial reports in the nation. As a result of this goal, OFM has a short turnaround time for the final review over the financial statements, notes, and schedules.

The State's financial statements are complex, and reviewing year-end adjustments requires a significant amount of time. The State did not dedicate enough review time over year-end adjustments.

Effect of Condition

During our testing, we identified the following misstatements:

ESD

- Testing of 89 employer receivable balances found 17 instances in which the employer paid amount recorded in NGTS varied from what was recognized as receivable at year-end, resulting in a misstatement of \$775,924.
- We sampled 59 experienced-rated employers with delinquent accounts to determine if NGTS assessed the correct tax rate. We found that 11 (19%) of these employers were not actually delinquent and were improperly assessed at a higher rate. For these 11 employers the errors resulted in overstated unemployment insurance revenues of \$995,710. When projected into the population of all employers with delinquent accounts, the likely overstatement would be \$ 7.5 million.

HCA

- The failure to ensure that the vendor received an internal control audit for the ProviderOne system could lead to:
 - Inaccurate financial reporting in the state's General Fund
 - Misuse, loss or misappropriation, inaccurate payments, and unauthorized software changes to the ProviderOne system

SBCTC

- SBCTC has not performed a year-end reconciliation of College data to AFRS. Several unreconciled differences are as follows:
 - Revenues for "Education – higher education – Charges for services" have an unreconciled difference of \$110.7 million
 - Higher Education Special Revenue fund "Education expenses" have an unreconciled difference of \$13.8 million

- Expenses for “Education – higher education” have an unreconciled difference of \$89.9 million
- Revenues for “Education – higher education - Operating Grants and Contributions” have an unreconciled difference of \$53.5 million
- Higher Education Special Revenue fund revenues for “Federal grants – in aid” have an unreconciled difference of \$56.1 million
- Higher Education Special Revenue fund revenues for “Charges for services” have an unreconciled difference of \$1.4 million.
- Cash was underreported at the two Colleges by \$72.8 million and \$29.6 million.
- The SBCTC’s amounts for Capital Assets are not reconcilable to the State’s AFRS system. Capital assets reported by SBCTC are negative \$2.04 million and negative \$2.03 million. The College’s records report capital assets of \$97.2 million and \$156.7 million

These errors were not corrected on the financial statements.

GET

- Refunds to program participants were accounted for as a reduction to revenues, which resulted in negative revenues of \$124 million in the charges for services balance in AFRS. Rather than a negative revenue, this should have been accounted for as an expense. This error was corrected on the financial statements.

DOL

- Fuel tax revenue was overstated and licenses, permits and fees revenue was understated, each by \$146 million. This error was corrected on the financial statements.

OFM

- Local Government Investment Pool cash and cash equivalents were overstated and investments: liquidity was understated, each by \$2.97 billion.
- Operating transfers in and operating transfers out were both overstated, each by \$320 million.
- Restricted cash and investments were overstated and cash and cash equivalents were understated, each by \$69 million.
- These errors were corrected on the financial statements

Recommendations

We recommend the following:

NGTS

- Establish internal controls to ensure complete and accurate processing of employer payments and tax and wage reports for Unemployment Insurance Premium payments
- Identify and correct defects within NGTS, including inaccurate and incomplete reports
- Perform reconciliations between systems to ensure information transmitted by interfaces is accurate and complete

HCA

- Work with its vendor to obtain, each year, a service organization control audit report that covers an entire fiscal year

SBCTC

- Perform a timely reconciliation of recorded amounts in AFRS to the SBCTC's data at year-end.
- Work with its PeopleSoft vendor and the Colleges to ensure complete data from PeopleSoft is included at year's end for the State's financial reporting

GET

- Work with OFM to ensure adequate research is performed to ensure the correct accounting of unique transactions

DOL

- DOL and OFM staff perform more effective monitoring, including an analytical review at year's end to detect and correct accounting errors and to follow up on errors to ensure they are properly addressed when identified

OFM

- OFM dedicate more resources and time towards review of year-end adjustments to ensure the accuracy and completeness of the basic financial statements.

State's Response

The State recognizes the significance and priority of internal controls over recording and reporting financial transactions.

OFM will continue to work with Employment Security Department, Department of Licensing, Health Care Authority, State Board of Community and Technical Colleges, and the Washington Student Achievement Council to improve their internal controls over the processing and reporting of financial activities.

OFM will review and strengthen its process for identifying and adjusting entries that are material to the state's financial statements.

Auditor's Remarks

We appreciate the state's commitment to resolving this finding and thank the state for their cooperation and assistance. We will review the status during the next audit.

Applicable Laws and Regulations

RCW 43.88.160 Fiscal management – Powers and duties of officers and agencies, states in part:

- (4) In addition, the director of financial management, as agent of the governor, shall:

- (a) Develop and maintain a system of internal controls and internal audits comprising methods and procedures to be adopted by each agency that will safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies for accounting and financial controls. The system developed by the director shall include criteria for determining the scope and comprehensiveness of internal controls required by classes of agencies, depending on the level of resources at risk.

Government Auditing Standards, December 2011 Revision, paragraph 4.23 states:

- 4.23 When performing GAGAS financial audits, auditors should communicate in the report on internal control over financial reporting and compliance, based upon the work performed, (1) significant deficiencies and material weaknesses in internal control; (2) instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the audit and any other instances that warrant the attention of those charged with governance; (3) noncompliance with provisions of contracts or grant agreements that has a material effect on the audit; and (4) abuse that has a material effect on the audit.

The American Institute of Certified Public Accountants defines material weaknesses and significant deficiencies in its *Codification of Statements on Auditing Standards*, Section 265 as follows:

- .07 For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

Material weakness. A deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Significant deficiency. A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

- .A11 Indicators of material weaknesses in internal control include:

- Identification of fraud, whether or not material, on the part of senior management. For the purpose of this indicator, the term “senior management” includes the principal executive and financial officers as well as any other members of senior management who play a significant role in the entity's financial reporting process;
- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to fraud or error;
- Identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected and corrected by the entity's internal control; and
- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

The Office of Financial Management's *State Administrative and Accounting Manual* (SAAM), states in part:

Section 20.15.30.a *Who is responsible for internal control?*

The agency head or authorized designee is ultimately responsible for identifying risks and establishing, maintaining, and reviewing the agency's system of internal control. If the agency head delegates this responsibility, the designated person should have sufficient authority to carry out these responsibilities. Normally, this person is a senior agency manager who does not serve in the internal audit function.

Section 20.15.40.c *Control Activities*

Control activities help ensure risk responses are effectively carried out and include policies and procedures, manual and automated tools, approvals, authorizations, verifications, reconciliations, security over assets, and segregation of duties. These activities occur across an agency, at all levels and in all functions, and are designed to help prevent or reduce the risk that agency objectives will not be achieved. Managers set up control activities to provide reasonable assurance that the agency and business unit objectives are met. An example of a control activity is something as simple as listing tasks assigned to staff members and then periodically checking the list to verify that assignments are completed on time. Refer to Section 20.25 for further discussion of control activities.

Section: 20.15.50.a - Annual assurance

A risk assessment and internal control review process provides management with reasonable assurance that controls are operating as expected. In addition, the process should be used to determine if internal control modifications are needed by considering events that have occurred, processes or procedures that have changed, new projects or programs that are being planned or implemented, and other changes within the agency that may have additional risks. If the review uncovers internal control weaknesses or if prior weaknesses still exist, they should be documented and addressed.

Periodically, an agency should conduct a comprehensive review of the internal control structure to determine if it is adequately addressing agency risks. This can be done agency-wide at one time or by sections of the agency over a period of time.

Agencies must maintain adequate written documentation of activities conducted in connection with risk assessments, review of internal control activities and follow-up actions. This documentation includes any checklists and methods used to complete these activities. Refer to Subsection 20.25.50 for required documentation. For sample checklists and procedures, refer to the OFM Administrative and Accounting Resources website at: <http://www.ofm.wa.gov/resources/default.asp>.

Agencies have the flexibility to assign appropriate staff to complete the risk assessments and review of internal control activities required by this policy. The internal control officer is the person appointed by the agency head who is assigned responsibility for coordinating and scheduling the agency-wide effort of evaluating and reporting on reviews and improving control activities. The internal control officer also provides assurance to the

agency head that the agency has performed the required risk assessments and the necessary evaluative processes. This communication may be ongoing and informal, but at least once per year, this assurance must be made in writing to the agency head. The internal control officer is responsible for ensuring that the required documentation is maintained and available for review by agency management, the State Auditor's Office (SAO), and OFM.