



A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Management Letter

Department of Economic Security

Year Ended June 30, 2004



Debra K. Davenport
Auditor General

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**STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL**

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

June 17, 2005

David A. Berns, Director
Department of Economic Security
1717 West Jefferson Street
Phoenix, AZ 85007

Dear Mr. Berns:

In planning and conducting our single audit of the State of Arizona for the year ended June 30, 2004, we performed the following as required by *Government Auditing Standards* (GAS) and Office of Management and Budget (OMB) Circular A-133:

- Considered the Department's internal controls over financial reporting,
- Tested its internal controls over major federal programs, and
- Tested its compliance with laws and regulations that could have a direct and material effect on the State's financial statements and major federal programs.

Specifically, we performed tests of revenues, receivables, expenditures, payables, transfers, cost allocation, payroll, purchasing, bank accounts, capital assets, financial reporting, and the Child Support Enforcement, Food Stamps Cluster, Foster Care—Title IV-E, Rehabilitation Services—Vocational Rehabilitation Grants to States, Workforce Investment Act Cluster, Temporary Assistance for Needy Families, and Unemployment Insurance programs.

All audit findings that are required to be reported by GAS and OMB Circular A-133 have been included in the State of Arizona's Single Audit Reporting Package for the year ended June 30, 2004, and have been communicated to your staff. In addition, our audit disclosed internal control weaknesses and instances of noncompliance with laws and regulations that do not meet the reporting criteria. Management should correct these deficiencies to ensure that it fulfills its responsibility to establish and maintain adequate internal controls and comply with laws and regulations. Our recommendations are described in the accompanying summary.

This letter is intended solely for the information of the Department of Economic Security and is not intended to be and should not be used by anyone other than the specified party. However, this letter is a matter of public record, and its distribution is not limited.

Should you have any questions concerning its contents, please let us know.

Sincerely,

Dennis L. Mattheisen, CPA
Financial Audit Director

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The Employment Administration should improve controls over unemployment insurance tax cash receipts

The Unemployment Insurance Tax Section collects payroll tax payments totaling approximately \$255 million annually from employers. Since cash receipts can be easily lost, stolen, or misused, the Administration should ensure that the Section properly controls and safeguards them. However, the Section did not have procedures to properly control and safeguard cash receipts. For example, cash receipts were not stored in a secure location or deposited daily, and checks were not restrictively endorsed. Also, pre-numbered cash receipt books were not sequentially used and, therefore, cash receipts were not accounted for. In addition, deposits were not reconciled to the amounts recorded on the Tax Employer Accounting System. As a result, during the period July 1, 2003 through June 30, 2004, receipts were recorded on the System that had not been deposited and could not be located. After auditors completed testwork, the Section performed a search and found some of the undeposited receipts. Furthermore, the Section's Supervisor had incompatible responsibilities such as collecting, recording, and depositing tax payments received. In addition, the supervisor was able to change payment information on the System.

To help strengthen controls over unemployment insurance tax cash receipts, the Administration should establish written policies and procedures for collecting, recording, reconciling, and depositing cash receipts, and periodically monitor that procedures have been placed in operation and are operating effectively. These procedures should include the following:

- Store undeposited cash and checks in a locked drawer or safe.
- Deposit cash receipts intact daily.
- Restrictively endorse all checks immediately upon receipt.
- Use prenumbered cash receipt books in sequential order and account for cash receipts as used, unused, or voided.

- Reconcile daily the totals from the sequence of receipts used to the amounts recorded in the System and deposited. This reconciliation should be prepared daily, and all differences should be investigated and corrected. In addition, the daily reconciliations should be reviewed by a supervisor.
- Separate responsibilities between employees so that the employee who collects cash receipts does not record and deposit the receipts.

The Department should have a well-documented, current, and tested disaster recovery plan

The Department uses computerized information systems to process, record, and store information that is vital to its operations. Therefore, it is critical that the Department have an up-to-date contingency plan in place to provide for the continuity of operations and that electronic files are not lost should a major computer hardware or software failure or other interruption occur. However, the Department did not have a current and tested disaster recovery plan. The Department has contracted with an alternate computer facility that can be used to process daily transactions; however, this facility has not been tested. Also, although transactions were backed up daily, backup tapes were transferred only weekly to an off-site facility. Therefore, all data for the current week could be lost during a disruption or disaster.

To help ensure that the Department's computer systems are protected against system or equipment failure and to help prevent loss of data from a service interruption, the Department should update and test its disaster recovery plan annually. In addition, the Department should ensure that the plan includes the following:

- A listing of employees assigned to disaster teams, including telephone numbers.
- Employee assignments and responsibilities.
- A risk analysis identifying critical applications.
- Details of off-site storage locations.
- A list of procedures for processing critical transactions, including forms or other documents to use.

Further, the Department should test its alternate processing facility, and should back up transactions and store the information in an off-site facility daily.

A similar recommendation was previously provided in our Management Letter to the Department dated June 30, 2004.

The Division of Aging and Community Services needs to comply with federal cash management requirements

The Department receives federal funding on a reimbursement basis from the U.S. Department of Health and Human Services when eligible expenditures are incurred for the Temporary Assistance for Needy Families (TANF) program. When a program is funded on a reimbursement basis, the Department must pay program costs before requesting reimbursement from the federal government. In addition, the Department must monitor federal monies it passes through to subrecipients to ensure that the subrecipients are also funded on a reimbursement basis. However, the Division of Aging and Community Services advanced federal TANF funds to its subrecipients for administrative and programmatic expenses. In some cases, the subrecipient did not spend advanced monies for several months after receiving the advances. In addition, these advances were not included in the states federal interest liability calculation. We estimated that approximately \$5,000 of interest would have been earned from these advances.

To comply with 45 Code of Federal Regulations §§92.20(b)(7) and 92.21(c), the Division should follow the cash management procedures outlined in the Cash Management Improvement Act agreement between the State of Arizona and the U.S. Treasury for the TANF program, and only disburse monies to subrecipients on a reimbursement basis.

The Department should strengthen internal controls over purchasing

The Department has been given authorization to procure its own goods and services. Consequently, to ensure that the Department receives the best possible value for the public monies it spends and promotes open and fair competition among vendors, department management should ensure that all divisions purchasing goods and services establish and maintain written policies and control procedures to ensure that purchases are made in accordance with Arizona Revised Statutes and the Arizona Procurement Code. However, the Division of Employment Rehabilitation Services—Arizona Industries for the Blind did not always obtain or retain documentation of oral or written price quotations received and did not prepare written documentation of management's determination for sole source purchases. In addition, the Division of Business and Finance—Accounts Payable did not always prepare or retain documentation to support the authorization of adding vendors or making changes to the approved vendors' list.

To strengthen controls over competitive purchasing and to comply with procurement statutes and the Arizona Procurement Code, the Department should ensure that all of its divisions that purchase goods or services have written purchasing policies and procedures. Also, the Department should periodically monitor that those procedures are in place and being followed. Accordingly, those policies should include the following procedures:

- Obtain competitive sealed bids or proposals, as appropriate, for purchases of construction, materials, or services exceeding \$35,000 and retain all bid documentation, including prospective bidders' lists.
- Obtain oral price quotations from at least three vendors for purchases estimated to cost between \$1,000 and \$5,000; written price quotations from at least three vendors for purchases estimated to cost between \$5,000 and \$10,000; or quotations from the State Procurement Office's fax on demand system for purchases estimated to cost between \$10,000 to \$35,000. If three price quotations cannot be obtained, the vendors contacted and their reasons for not providing quotations should be documented and retained.
- Only award a contract for materials, services, or construction without competition when management determines in writing that there is only one vendor from which to purchase. Such written determination should be retained with other supporting documents. Sole source procurement should be avoided except when no reasonable alternative vendor exists.
- Prepare and retain documentation supporting the authorization of approved vendors.



ARIZONA DEPARTMENT OF ECONOMIC SECURITY

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Janet Napolitano
Governor

David A. Berns
Director

Debra K. Davenport
Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Ms. Davenport:

Thank you for the opportunity to respond to the Single Audit Financial Management Letter of the Department of Economic Security for Fiscal Year 2003-04. It is understood that this response will be included in the published management letter.

The Department wishes to express its appreciation to you and your staff for the time and effort invested in these audits. If you have any questions, please contact Mary Mirocha, Accounting Administrator, at 271-0084 extension 7042.

Sincerely,

David A. Berns

Enclosure

**DEPARTMENT OF ECONOMIC SECURITY
RESPONSE TO THE FISCAL YEAR 2003-04
MANAGEMENT LETTER**

The Employment Administration should improve controls over Unemployment Insurance tax cash receipts

To help strengthen controls over Unemployment Insurance (UI) tax cash receipts, the UI Tax Section reviewed and revised existing written procedures for all Remittance Processing Unit (RPU) cash handling, bank corrections, and check processing. The revisions to the procedures were completed in November 2004 and include updating policies and procedures on a quarterly basis by the RPU Supervisor and distribution of amendments that will also be available in the UI tax public folder. Procedures established to help strengthen controls over UI tax cash receipts include the following:

- *Storage of undeposited cash and checks in a locked drawer or safe* – All unprocessed checks are secured in the locked storage cabinet located in the RPU, and all cash continues to be locked in the safe throughout the day until the vendor pickup at 2:30 p.m. daily.
- *Deposit of cash receipts intact daily* – Effective November 22, 2004, all cash is deposited on a daily basis, and no cash payments are accepted after the 2:00 p.m. daily pickup for deposit.
- *Restrictive endorsement of all checks immediately upon receipt* – Currently, checks are endorsed by the remittance processing machine once they are assigned to an account. The current contract with Bank of America does not allow both a manual “stamped” endorsement and an electronic endorsement via the remittance processing machine. The Department will pursue solutions for updating the current process through business process re-engineering or outsourcing as funding becomes available.
- *Use of prenumbered cash receipt books in sequential order and accounting for receipts as used, unused, or voided* – Effective August 2004, only one cash receipt book is being utilized, which is maintained in sequential order, and a log has been prepared and is being utilized to account for all of the issued, prenumbered cash receipt books.
- *Daily reconciliation of the totals from the sequence of receipts used to the amounts recorded in the System and deposited. This reconciliation should be prepared daily, and all differences should be investigated and corrected. In addition, the daily reconciliations should be reviewed by a supervisor* – As a result of the use of only one cash receipt book and a log to account for all issued, prenumbered cash receipt books, the Unit Supervisor is able to account for and reconcile all cash receipts on a daily basis. The payments are then reconciled to the amounts deposited through the Employment Administration’s Budget and Planning Office. The Budget and Planning Office works with the State Treasurer’s Office to conduct the reconciliation, and any differences are then investigated and resolved.

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- *Separation of responsibilities between employees so that the employee who collects cash receipts does not record and deposit the receipts* – Effective November 2004, procedures have been established to ensure that the staff responsible for collecting cash and issuing receipts will not also process the cash, modify the employer records, or be responsible for the deposit. The Unit Supervisor processes cash payments received, and the Accounting Manager verifies any discrepancies to cash payments.

The Department should have a well-documented, current, and tested disaster recovery plan

During the last fiscal year, the Department continued to refine and complete more sections of its Disaster Recovery Plan (DRP).

In November 2004, the Department contracted with IBM for disaster recovery “hot site” services. Since then, the Department has worked closely with IBM staff to plan the first two tests of the back-up site, which will be performed in June and August 2005. Such testing is a very complex process. The Department will continue to perform increasingly complex tests with IBM on at least an annual basis.

The weekly back-up of all systems produces over 1,300 tapes and takes approximately 12 hours. Those tapes are produced and taken off site once per week. In October 2004, the Department procured four 3592 tape drives, a controller, and associated ICON channels. The new tape drives have dramatically reduced the time and the number of tapes needed to back-up the Department’s systems. This new tape drive technology will allow the Department to implement daily incremental back-up procedures by the end of June 2005. The daily back-up tapes will be removed for off-site storage on a daily basis.

The Department’s DRP includes:

- A listing of employees assigned to disaster teams, including telephone numbers;
- Employee assignments and responsibilities; and
- Details of off-site storage locations.

The project work plan includes tasks to add the following to the DRP:

- A risk analysis identifying critical transaction cycles; and
- A list of procedures for processing critical transactions, including forms or other documents to use.

The Division of Aging and Community Services needs to comply with federal cash management requirements

The Division of Aging and Community Services is exploring options that will help ensure compliance with federal cash management requirements while facilitating the Community Action Agencies in meeting their cash flow needs to provide crisis services to low income individuals. The Division is in the process of gathering information from the Community

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Action Agencies and other sources and will work with the Department's Financial Services Administration to help ensure that the Division follows the cash management procedures outlined in the Cash Management Improvement Act Agreement between the State of Arizona and the U.S. Treasury for the Temporary Assistance for Needy Families program.

The Department should strengthen internal controls over purchasing

Arizona Industries for the Blind (AIB) management recognized that there were issues in the area of procurement within AIB and has worked diligently with the Department's Office of Procurement to bring AIB policies and procedures into compliance with Arizona Revised Statutes and the Arizona Procurement Code. AIB staff has now received both internal and Department of Administration, Enterprise Procurement Services training, and internal procedures are in place to ensure that AIB remains compliant. Additionally, AIB meets bi-weekly with the Office of Procurement to review and coordinate all purchases over \$5,000. While AIB had made great progress toward compliance by the time of the audit, there were several areas where further work was necessary. One of those areas involved providing supporting documentation to AIB Accounting. Although AIB's buyer was obtaining the necessary quotations, the quotation information obtained was maintained in the buyer's office. The State contracted vendor's number (or copies of quotations when a State-contracted vendor is not available) is now included with the purchase order that is forwarded to AIB Accounting. AIB will continue to ensure that purchases are made in accordance with procurement statutes and the Arizona Procurement Code.

To help strengthen controls over competitive purchasing department wide, the Office of Procurement is in the process of centralizing procurement authority through the implementation of SPIRIT, Arizona Department of Administration's (ADOA) electronic solicitation software. This system will facilitate the standardization of the procurement process (quotations and solicitations) and centralize the records documentation, including support for emergency, sole source and competition impracticable procurement determinations. In addition, the Office of Procurement holds monthly procurement meetings for a department-wide Contract Management Committee to ensure timely transmittal of procurement-related information to the Department's programs.

It is the Department's policy to retain all supporting documentation required to establish and/or maintain a vendor on the AFIS and FMCS electronic vendor files. During and subsequent to an examination of internal controls relating to the vendor file setup and vendor file maintenance functions of the Department's Division of Business and Finance, Accounts Payable Unit by ADOA's General Accounting Office in August 2003, the Accounting Administrator and the Accounts Payable Manager implemented a number of improvements to vendor file setup and maintenance policies and procedures, which included implementation of ADOA's recommendation in November 2002 to retain a State of Arizona Substitute Form W-9 for all additions, changes and/or deletions to the Department's electronic vendor files. To help ensure that all supporting documentation required to establish and/or to maintain a vendor on the AFIS and FMCS electronic vendor files is

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retained in the Department's files, the Accounts Payable Manager and Supervisor will continue to monitor and review the setup and maintenance of vendor files for compliance with existing policies and procedures.