State Auditor's Office
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State Auditor

An Audit Report on

The Accuracy of the Fiscal Year 2001 Balance Sheets for the State's Telecommunications Systems

May 13, 2002

Members of the Legislative Audit Committee:

The General Services Commission (GSC) provided inaccurate balance sheets for the State's telecommunications systems to the Department of Information Resources (DIR) when these systems were transferred from GSC to DIR on September 1, 2001. The total net combined equity of the Texas Agency Network (TEX-AN) and the Capitol Complex Telephone System (CCTS) was understated by at least $5.3 million on GSC's fiscal year 2001 internal balance sheets for these two systems. GSC was abolished effective September 1, 2001, and the newly created Texas Building and Procurement Commission (TBPC) subsequently assumed most of its responsibilities.

Although nothing came to our attention indicating that funds were missing from the State's telecommunications programs, the significant accounting errors we identified demonstrate that it is critical for both TBPC and DIR to take corrective action to address these issues. While TEX-AN and CCTS were transferred to DIR when TBPC was created, it is important for TBPC to correct its accounting problems because it has a number of other cost recovery programs. Likewise, by making the recommended accounting adjustments, DIR will have an accurate starting point from which to manage TEX-AN and CCTS.

This $5.3 million understatement we identified is the sum of two sets of errors:

- GSC's Accounting Department made errors that resulted in the aggregate understatement of $10.1 million in assets for both TEX-AN and CCTS. The Accounting Department failed to manage and analyze the data on the internal balance sheets. This was the primary reason for the number and significance of the errors we identified.
- GSC's Telecommunications Services Division, which managed TEX-AN and CCTS and was transferred from GSC to DIR on September 1, 2001, made errors that resulted in the understatement of between $3.6 million and $4.8 million in liabilities on the balance sheet for TEX-AN.

These errors unnecessarily complicated the transfer of the management of TEX-AN and CCTS to DIR. Therefore, DIR's ability to make timely management decisions regarding TEX-AN and CCTS was limited because of uncertainty about the accuracy of the financial data GSC provided.

The errors in the TEX-AN balance sheet also impaired GSC's ability to manage this program as a cost recovery program. The adjusted TEX-AN balance sheet shows that GSC financed TEX-AN's reported loss of $9.5 million in fiscal year 2001 largely by spending cash left over from fiscal year 2000. After sustaining the $9.5 million loss, TEX-AN still had a net equity (the amount by which assets exceed liabilities) of $2.1 million at the end of fiscal year 2001.

Project delays, poor vendor performance, and GSC management decisions associated with an upgrade to TEX-AN telecommunications systems were major contributing factors in TEX-AN's fiscal year 2001 $9.5 million loss. DIR is aware of these vendor performance issues and its responsibility for ensuring that these telecommunications systems and vendor contracts are appropriately managed. These system upgrade problems resulted in additional expenditures

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of $12 million and reduced revenues by $3.9 million in fiscal year 2001. Additional causes for this loss included:

- The lack of effective cost accounting systems, which made ongoing monitoring of costs difficult.
- Failure to identify services the State no longer uses and have vendors disconnect these services, despite the fact that staff positions to perform these tasks existed but were not filled.
- Lack of adequate systems to ensure that TEX-AN customers reimbursed GSC for all charges GSC paid to vendors.

The attachment to this letter provides additional detail regarding our audit, as well as detailed adjusted balance sheets for TEX-AN and CCTS. This audit was conducted in response to a request from DIR. We appreciate the assistance and cooperation of management and staff at both TBPC and DIR throughout this audit. If you have any questions, please contact Nick Villalpando, Audit Manager, at (512) 936-9500.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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Attachment

cc: Texas Building and Procurement Commission
Mr. Tom Beard, Chair
Mr. Stuart S. Coleman, Commissioner
Mr. Noe Fernandez, Commissioner
Mr. Bob Jones, Commissioner
Ms Mary Ann Newman, Commissioner
Mr. Richard Salwen, Commissioner
Mr. Randall Riley, Executive Director
Department of Information Resources
Mr. Rolf R. Haberecht, Board Chairman
Mr. Lance K. Bruun, Board Member
Dr. Mario J. Gonzalez, Board Member
Ms. Carole S. Greisdorf, Board Member
Mr. Gary Johnson, Board Member
Dr. Larry R. Leibrock, Board Member
Dr. M. Adam Mahmood, Board Member
Mr. James Nelson, Board Member
Mr. Andrew Sansom, Board Member
Ms. Carolyn Purcell, Executive Director

Section 1:

GSC Provided Inaccurate Financial Information to DIR When the State's Telecommunications Systems Transferred from GSC to DIR

The General Services Commission (GSC) provided inaccurate balance sheets for the State's telecommunications systems to the Department of Information Resources (DIR) when these systems were transferred from GSC to DIR on September 1, 2001. The total net combined equity of the Texas Agency Network (TEX-AN) and the Capitol Complex Telephone System (CCTS) was understated by at least $5.3 million[1] on GSC's fiscal year 2001 internal balance sheets for these two systems. GSC was abolished effective September 1, 2001, and the newly created Texas Building and Procurement Commission (TBPC) subsequently assumed most of its responsibilities.

The Financial Statements We Reviewed

We reviewed the fiscal year 2001 internal balance sheets for TEX-AN and CCTS. GSC prepared these balance sheets for its internal use. However, GSC provided these balance sheets to DIR when TEX-AN and CCTS were transferred to DIR.

We examined the accuracy of all balance sheet accounts on GSC's internal balance sheets for TEX-AN and CCTS. Year-end, internal balance sheets should agree with both GSC's official accounting records and its annual financial report.

These inaccurate balance sheets unnecessarily complicated the transfer of the management of TEX-AN and CCTS from GSC to DIR. Therefore, DIR's ability to make timely management decisions regarding TEX-AN and CCTS was limited because of uncertainty about the accuracy of the financial data GSC provided.

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Nothing came to our attention indicating that funds were missing from the State's telecommunications programs. In addition, except for payments for some unneeded and unused services (which are discussed in Section 2-A), we did not identify any inappropriate TEX-AN and CCTS expenses during this audit. The material misstatements we identified were a result of significant accounting errors and demonstrate that it is

[1] As discussed in Section 1-B, we are aware of two factors that could change the amount of the misstatement. First, it is possible that there are unrecorded liabilities that the State may have to pay (in addition to the $3.6 million in Accounts Payable and $1.2 million in Contingent Liabilities discussed in Section 1-B). These liabilities are the disputed portions of outstanding charges to vendors that the Telecommunications Division did not enter into its accounting system. We were unable to determine the total amount of disputed billings because of the large volume of bills processed by the Telecommunications Division during fiscal year 2001. Second, we could not determine the accuracy of reported inventory values for TEX-AN and CCTS because we were unable to gain sufficient assurance regarding the accuracy of the recorded number of inventory items or the value of those items.

critical for both TBPC and DIR to take corrective action to address these issues.

The $5.3 million understatement we identified is the sum of two sets of errors:

- GSC's Accounting Department made errors that resulted in the aggregate understatement of $10.1 million in assets for both TEX-AN and CCTS. The Accounting Department failed to manage and analyze the data on the internal balance sheets. This was the primary reason for the number and significance of the errors we identified. (See Section 1-A for additional details.)

- GSC's Telecommunications Services Division, which manages TEX-AN and CCTS and was transferred from GSC to DIR on September 1, 2001, made errors that resulted in the understatement of between $3.6 million and $4.8 million in liabilities on the balance sheet for TEX-AN. In addition, the Telecommunications Services Division failed to maintain sufficient controls over its inventory to ensure accurate reporting of inventory balances. Because of this, we were unable to verify the accuracy of inventory balances for TEX-AN and CCTS. (See Section 1-B for additional details.)

Section 3 on page 18 contains detailed adjusted balance sheets for both TEX-AN and CCTS.

Section 1-A:

Total Assets are Understated by $10.1 Million Because of Errors GSC's Accounting Department Failed to Detect or Adequately Investigate

GSC's Accounting Department failed to critically evaluate accounting data, which led to errors in the internal balance sheets for TEX-AN and CCTS. Total assets are understated by $10.1 million, which is equal to 38 percent of the original asset balances on the internal balance sheets, because of errors the Accounting Department failed to detect or adequately investigate. These errors made it difficult for DIR to determine the actual financial status of TEX-AN and CCTS. This unnecessarily complicated the transfer of the management of these programs. For example:

- The original internal TEX-AN balance sheets made it appear that TEX-AN may have had $21.4 million available for use, despite having less than $1 million in reported cash. The corrected TEX-AN balance sheet shows that TEX-AN actually had $7.3 million in cash.

- The corrected CCTS balance sheet shows $4.8 million more in cash available for use than the $36,000 originally reported.

Some errors on the internal balance sheets occurred because the Accounting Department did not investigate questionable account balances. In addition, the Accounting Department did not review the balance sheets and, as a result, did not detect errors in them.

The specific fiscal year end 2001 internal balance sheet errors we identified included the following:

> **What is Donated Capital?**
>
> Donated Capital is permanent fund capital provided by an outside source. It is seed money that is designed to start or expand an entity's operations.

- TEX-AN Donated Capital was overstated by $21.4 million. GSC has erroneously reported $21.4 million as Donated Capital on its internal balance sheets for TEX-AN since fiscal year 1991. This error makes it appear as if TEX-AN has lost $22.2 million during its lifetime, when, in reality, TEX-AN has earned a net $2.1 million[2] during its lifetime. In addition, maintaining these funds as Donated Capital makes it appear as if TEX-AN has the $21.4 million available for use when, in fact, these funds have already been spent. These funds were appropriated to GSC between fiscal years 1986 and 1991 to defray costs associated with inter-city leased telecommunications service.

  Donated Capital accounts are accounts used to report permanent fund capital. However, the $21.4 million in funds GSC considered as Donated Capital more closely resemble non-operating revenues than permanent fund capital because these funds were appropriated to defray specific costs. Therefore, these funds should have been reported as non-operating revenue rather than Donated Capital.

> **What is Cash in Treasury?**
>
> Cash in Treasury is money in the State Treasury that a state entity has available to spend.

- Cash in Treasury was understated by $11.4 million. GSC reported a combined $664,000 in Cash in Treasury on its internal balance sheets for TEX-AN and CCTS. However, this amount was understated because it was calculated after GSC prematurely made several adjustments that erroneously affected its Cash in Treasury as of August 31, 2001. Most of these adjustments actually affected Cash in Treasury *after* August 31, 2001. This error occurred because GSC failed to correctly account for timing differences. This error compromised the usefulness of the internal balance sheets.

  This error caused the internal balance sheets representing the assets transferred to DIR to be materially misstated. However, GSC transferred 95 percent of the understated dollars to DIR as part of the transfer of all TEX-AN and CCTS assets to DIR. This transfer made DIR aware of the existence of these funds independent of the erroneous balance sheets.

- GSC management continued to improperly earmark $1.5 million for purchases that had already occurred. There was a $1,544,500 Reserve for

[2] The $2.1 million in net earnings calculation is based on the Donated Capital overstatement and other adjustments discussed in this report.

Fixed Asset Purchase in the TEX-AN balance sheet equity section. State law required GSC to notify the Comptroller of Public Accounts (Comptroller) if it accumulated funds in excess of those needed to pay its bills. The law then required the Comptroller to transfer the funds to the Statewide Network Applications Account. In addition, a Reserve for Fixed Asset Purchase should represent funds reserved for the future purchase of assets. However, GSC had either purchased all assets associated with these funds (as of the reporting date), or, in one case, it had decided against purchasing the asset. Continuing to earmark funds for purchases that had already been made reduced the value of the Reserve for Fixed Asset Purchase as a management tool. In addition, continuing to reserve these funds erroneously makes it appear that management is maintaining fund balances for future purchases, rather than using them to reduce the costs of service.

What is a Reserve for Fixed Asset Purchase?

A Reserve for Fixed Asset Purchase is a management tool to reserve funds for future purchase of equipment or vehicles. For this to be a useful tool, the reserve amount must be materially accurate.

- GSC included a $1.3 million item it did not own among its reported assets. GSC reported $1.3 million in Investment: Non-Depreciating Asset. (This account appeared in both the asset and equity portions of the internal balance sheet for CCTS.) However, this amount represented an asset that actually belonged to another state agency. As a result, the balance sheet overstated assets by $1.3 million, the cost of the asset GSC never owned.

  What is Investment: Non-Depreciating Asset?

  Investment: Non-Depreciating Asset is an account used to report ownership of an asset that does not lose accounting value.

  Because of weak controls at GSC, both GSC and the agency that owned the asset reported the asset on the State Property Accounting System and on their respective balance sheets for the majority of the asset's useful life. This double counting has caused the State's financial records to be overstated by $1.3 million since October 1992. Assets should only be reported in the financial records of the entity that owns the assets.

- GSC management overstated the value of charges owed to GSC by its TEX-AN and CCTS customers by $485,000. At the end of fiscal year 2001, TEX-AN and CCTS had $485,000 in Accounts Receivable that were more than 268 days old. The customers that owed these funds to GSC did not pay the majority ($469,000 or 97 percent) of these amounts because they asserted that the charges resulted from phone calls fraudulently made by third parties. The customers have

  What are Accounts Receivable?

  In this case, Accounts Receivable refers to the amount that TEX-AN and CCTS customers owed the Commission on August 31, 2001, for services received during fiscal year 2001.

not been successful in recovering these costs from the third parties and, therefore, have refused to pay the charges.

GSC should have created an Allowance for Uncollectible Accounts Receivable (Allowance). Accounts Receivable that an entity does not expect to collect should be reported in an Allowance. Not reporting an Allowance when there is a significant risk that accounts receivable will not be collected overstates the value of assets.

- GSC understated the net value of TEX-AN and CCTS Equipment and Vehicles by $438,000. GSC reported a combined $23.6 million in Equipment and Vehicles and $21.2 million in accumulated depreciation for those assets in the internal balance sheets for TEX-AN and CCTS. However, GSC made a series of errors in calculating these account balances for the internal balance sheets. As a result, the net value of Equipment and Vehicles on the internal balance sheets was understated by $438,000.

  In addition to making accounting errors that affected the internal balance sheets, GSC entered incorrect cost data into the State Property Accounting system and removed from the system assets that were still in service. These errors affected the accuracy of data in the State Property Accounting system.

  Not accurately accounting for property increases the risk of property loss or theft. In addition, undervaluing equipment increases the risk that management will make errors in planning for asset purchase and replacement.

- GSC could not distinguish the $124,000 it reported in Contributed Capital from Retained Earnings. GSC has reported $124,000 in Contributed Capital for TEX-AN since 1982. However, GSC management was unable to determine the origin of these funds or specify how it intended to use them.

  The Comptroller's *Manual of Accounts* describes Contributed Capital as permanent fund capital. However, there is no evidence to support treating this $124,000 as permanent fund capital. Reporting these funds as Retained Earnings rather than Contributed Capital will simplify the balance sheet because it will eliminate an account that has no accounting meaning and place the funds in the sole remaining equity account. It will also provide DIR more accurate financial information with which to manage TEX-AN.

What is Contributed Capital?

Contributed Capital consists of assets given to an entity to be used as permanent fund capital, rather than as revenue.

Recommendations for TBPC:

Although TEX-AN and CCTS were transferred to DIR when GSC was abolished, it is still important for TBPC to correct its accounting problems. This is particularly important because TBPC has a number of other cost recovery programs that belonged to GSC.

- TBPC should institute procedures to ensure it regularly examines accounting data critically and takes needed action.

- TBPC should examine and update policies and procedures for preparing internal balance sheets to reduce the risk of error. These policies should require the chief fiscal officer to perform a thorough review of the internal balance sheets and compare them with accounting data in TBPC's accounting system.

- The Accounting Department should research the history of all accounts whose origin is uncertain.

TBPC Management's Response:

We agree with the SAO recommendations directed at improving TBPC accounting practices. In October 2001, new TBPC management established as a top priority the need to improve the accuracy and reliability of agency financial information. Since October, actions taken to correct longstanding accounting problems include the following:

- *A new Chief Fiscal Officer has been hired with responsibility and oversight for both the accounting and budgeting functions.*

- *Completed a reconciliation of internal accounting and budget records to the General Appropriations Act. This reconciliation had never been prepared in the past, and ensures that agency budgets and financial reports are based on funding levels approved by the Legislature.*

- *Initiated a complete reorganization/reengineering of TBPC budget and accounting functions to streamline operations, enhance cross training and staff qualifications, and ensure appropriate recording, reconciliation, and review of fiscal information.*

As a part of this effort, TBPC will institute a thorough formal review of both the data used in our internal accounting reports (e.g. accuracy, completeness, timing, variances, ratios, etc.) as well as the presentation and classification of the report content. All internal accounting reports used in cost recovery and/or revolving fund programs will be reviewed by either the Chief Fiscal Officer or Accounting Manager after completion and before distribution. In addition, the TBPC will reconcile and confirm both historical balances and operating amounts in all internal accounting reports.

Recommendations for DIR:

DIR should:

- Make the following adjustments to the internal balance sheets it received from GSC for TEX-AN and CCTS:

  - Reduce Donated Capital on the TEX-AN balance sheet by its entire $21.4 million balance and increase Retained Earnings by the same amount.

  - Increase Cash in Treasury on the TEX-AN balance sheet by $6.6 million and increase Retained Earnings by the same amount.

  - Increase Cash in Treasury on the CCTS balance sheet by $4.8 million and increase Retained Earnings by the same amount.

  - Reduce Reserve for Fixed Asset Purchase on the TEX-AN balance sheet by its entire $1,544,500 balance and increase Retained Earnings by the same amount.

  - Reduce the Non-Depreciating Asset balance by its entire $1.3 million balance in both the asset and equity sections of the CCTS balance sheet.

  - Add a $484,000 Allowance for Uncollectible Accounts Receivable to the TEX-AN balance sheet and reduce Retained Earnings by the same amount.

  - Add a $1,000 Allowance for Uncollectible Accounts Receivable to the CCTS balance sheet and reduce Retained Earnings by the same amount.

  - Reduce Equipment and Vehicles on the TEX-AN balance sheet by $987,000 and Accumulated Depreciation by $887,000. Decrease Retained Earnings on the TEX-AN balance sheet by $100,000, which is the net value of these two accounts.

  - Reduce Equipment and Vehicles on the CCTS balance sheet by $7.2 million and Accumulated Depreciation by $6.5 million. Decrease Retained Earnings on the TEX-AN balance sheet by $723,000.

  - Allocate $7.4 million in equipment and vehicles and the corresponding $6.2 million in accumulated depreciation to the appropriate telecommunications programs.

  - Reduce Contributed Capital on the TEX-AN balance sheet by its entire $124,000 balance and increase Retained Earnings on the TEX-AN balance sheet by the same amount.

- Work with the Office of the Attorney General to resolve the status of long-standing accounts receivables for TEX-AN and CCTS, especially those accounts receivable associated with fraudulent telephone charges. Seek assistance in collecting all legitimate debts.

- Create a billing policy concerning future fraudulent calls and communicate the policy to customers. Customers should be responsible for recovering or paying the costs of future fraudulent calls unless they can prove DIR was responsible for the security breach resulting in the fraudulent calls.

- Discontinue use of reservations of fund balance as a management tool. State law requires DIR to finance capital improvements using funds in the Statewide Network Applications Account.

DIR Management's Response:

DIR would like to thank the State Auditor's Office for reviewing the internal balance sheets reflecting the transfer of assets, liabilities, and fund reserve balances from the General Services Commission.

We appreciate the professionalism of the audit staff and the cooperation provided to our agency during the audit.

We agree with the recommended adjustments.

- *Adjustments will be recorded to the balance sheets for TexAn and CCTS.*

We agree with the recommendation to work with the Office of the Attorney General to write-off uncollectible debt related to fraudulent phone charges.

- *The Chief Financial Officer will draft a letter to the Office of the Attorney General no later than May 15, 2002, to request their assistance in resolving this matter.*

  DIR hired a temporary to assist in collecting past due accounts. Current Accounts Receivable for telecommunications billings at the time of transfer was 45% of total receivables; as of April 1, 2002, Current Accounts Receivable for telecommunications billings was 89% of total receivables.

We agree that the billing policy on fraudulent calls needs to be re-stated.

- *Telecommunications Services Division staff will re-state the policy and submit it for approval to the Telecommunications Planning and Oversight Council no later than June 30, 2002. The updated policy will be communicated to customers.*

We agree that state law requires that all funds in excess of those needed to pay bills should be transferred to the Statewide Network Applications Account.

As stated in your note number 4, the Federal Office of Management and Budget's Circular A-87 states that functions such as the telecommunications operation need sufficient working capital to meet 60 days of cash expenses for normal needs. We estimate that amount to be approximately $12 million based on the FY 2002 forecast. DIR is forecasting a retained earnings balance of less than $3 million by the end of FY 2002. At such point in the future that the amount of retained earnings exceeds the working capital needs of the operation, we will work with the Comptroller's Office to establish the Statewide Network Applications Account and transfer excess funds to that account as required by law.

Section 1-B:

The Telecommunications Services Division Omitted Between $3.6 Million and $4.8 Million in Payments Owed to Vendors From Financial Information Used to Prepare the Internal Balance Sheet

The Telecommunications Services Division underreported Accounts Payable by at least $3.6 million on the TEX-AN balance sheet and failed to report $1.2 million in contingent liabilities for TEX-AN. Therefore, a significant amount of money the TEX-AN program owed to vendors did not appear on the August 31, 2001, TEX-AN balance sheet.

In addition, the Telecommunications Services Division failed to maintain sufficient controls over inventory to ensure accurate reporting of inventory balances. As a result, we were prevented from auditing the accuracy of the inventory balance.

TEX-AN owes $3.6 million more to vendors than was reflected on its fiscal year 2001 balance sheet. TEX-AN owes vendors $3.6 million more than was reported on the TEX-AN balance sheet on August 31, 2001. Several issues with the reporting of Accounts Payable caused this understatement on the balance sheet for TEX-AN. Specifically:

- The Telecommunications Services Division did not provide the Accounting Department with a complete list of Accounts Payable to prepare the internal balance sheets. The list did not contain $3.4 million in payables that it should have included. Because GSC's Accounting Department was not adequately analyzing the accounting data in the internal balance sheets (as discussed in Section 1-A), it failed to detect this omission.

- There was a cumulative difference of $184,000 between estimated accrued expenses and actual expenses. This difference was caused by estimating the amount of unbilled liabilities at the end of the year. The amount of the difference is reasonable for this type of estimate.

- Telecommunications Services Division accounting staff members do not enter into division accounting systems portions of vendor invoices they plan to dispute. Identifying portions of vendor invoices that may be incorrect and disputing them is a regular step in the Telecommunications Services Division's processing of vendor invoices. However, not tracking these disputed amounts prevents the Telecommunications Services Division from accurately determining the total of outstanding charges to vendors, outstanding charges under dispute, and disputed charges resolved in the State's favor. As a result, it is possible that additional unrecorded liabilities exist that the State may have to pay.

The State may also owe vendors an additional $1.2 million in fees. There are approximately $1.2 million in universal service fee charges that vendors have billed to TEX-AN and CCTS that the Telecommunications Services Division is contesting. However, the Telecommunications Services Division may ultimately have to pay these fees at some point in the future. These fees are the result of a tax that the federal government requires vendors to pay. However, the Telecommunications Services Division has a legal basis for asserting that the vendors had agreed to absorb this cost. DIR management has determined that it is possible that some amount will have to be paid. Therefore, the year-end balance sheet needs to reflect this liability. The amount of this liability can be estimated based on actual invoice amounts.

Inventory control problems prevent the determination of an accurate inventory value. GSC reported an inventory balance of $1.5 million for TEX-AN and CCTS. However, we could not verify the accuracy of this balance because we could not gain adequate assurance regarding the accuracy of reported inventory quantities and reported inventory valuations. Specifically:

- We were unable gain assurance that there was less than 10 percent error in the inventory records that were necessary to verify the number of items in the TEX-AN and CCTS inventories.

- We were precluded from testing the value of inventory items because valuation data in the Telecommunication Services Division's automated inventory system was not accessible. Despite the inaccessibility of valuation data, we were able to independently detect one error in the value of one inventory item, and this affected the accuracy of inventory value in the system.

During our testing, we also observed that inventory items were being used without having been properly checked out. Inventory needs to be controlled to prevent losses. In addition, data in automated systems should be accessible to allow verification of data accuracy.

Recommendations for DIR:

DIR should:

- Improve accounting for Accounts Payable by:

- Increasing TEX-AN Accounts Payable by $3.6 million and decreasing Retained Earnings by the same amount

- Requiring all clerks to enter the total amount billed into the accounting system. In addition, identify any portions of Accounts Payable that are disputed and billing amounts that vendors agree not to charge. Consider reporting all or portions of the disputed billings as Contingent Liabilities.

- Add a $1.2 million contingent liability for the potential payment of universal service fees and decrease Retained Earnings by an equal amount.

- Improve accounting for Inventory by:

  - Performing a complete physical inventory as soon as practical to determine actual inventory levels.

  - When it is time to replace the current inventory system, purchasing an inventory system that allows examination of all data stored in the system. Until it purchases a new system, management should consider testing the current system's processing to ensure that the system processes data correctly.

DIR Management's Response:

We agree with the need to improve accounting for Accounts Payable (AP).

- *Retained earnings will be adjusted for the unrecorded AP for fiscal year 2001.*

- *A project is underway to review enhanced capabilities of a separate AP system currently utilized by the Telecommunications Services Division that would allow tracking of budgeted and actual AP by vendor, by month. That system will also be used to track the total amount billed by vendors, including disputed amounts. An interface is being developed to import the data into DIR's primary accounting system. Since the system is currently used only for bill validation, importing the data to the primary accounting system would also eliminate duplicate entry done by the agency's AP staff. Although disputed charges often relate to sales taxes billed in error or billings for services that were canceled, DIR will record any contingent liabilities as appropriate. Our goal is to complete this project by May 31, 2002.*

We agree with recording the $1.2 million contingent liability for potential payment of universal service fees at August 31, 2001.

We agree with the need to complete a full inventory of the Material Management Warehouse.

- *Teams of two people will conduct the inventory, a Support Services Inventory Coordinator familiar with the inventory who will count each item and a representative of the Financial Services Section who will audit the counts. The inventory will be completed by June 1, 2002.*

We agree with the importance of utilizing an inventory system that allows examination of all data stored in the system.

- *DIR will investigate the possibility of replacing the existing inventory system with an inventory module available for the bill validation and AP system currently in use by the Telecommunications Services Division. System functionality and cost will be reviewed and a decision made no later than May 31, 2002.*

Section 2:

TEX-AN Lost a Reported $9.5 Million in Fiscal Year 2001 Partially Because There Was Inadequate Financial Data to Monitor the Program

TEX-AN is required to be a cost recovery program, which means its revenues should cover its expenses and its service rates to customers should be competitive. The adjusted TEX-AN balance sheet shows that GSC financed TEX-AN's reported loss of $9.5 million in fiscal year 2001 largely by spending cash left over from fiscal year 2000. After sustaining the $9.5 million loss, TEX-AN still had a net equity (the amount by which assets exceed liabilities) of $2.1 million at the end of fiscal year 2001.

The Telecommunications Services Division has a history of inadequately managing costs and revenues in its cost recovery programs. To properly manage the rates they charge their customers, organizations must adequately plan major capital projects and accumulate sufficient cash balances to pay the costs of those projects. However, in prior audits, we found that Telecommunications Services Division management overcharged customers and accumulated excessive cash reserves.[3] This still may be a problem for CCTS, which has an adjusted net equity of $7.2 million.[4] However, in

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[3] In *A Follow-Up Audit Report on Management Controls at the General Services Commission* (SAO Report No. 99-029, February 1999), the State Auditor's Office reported on management's accumulation of a combined fund balance of $32 million. The report cited customer overcharges as a major contributing factor to the excessive fund balance. In *An Audit Report on Management Controls at the General Services Commission* (SAO Report No. 97-080, August 1997), the State Auditor's Office noted that Commission management set service rates for its cost recovery functions without considering the efficiency of its operations.

[4] State law allowed GSC to maintain adequate amounts in telecommunication revolving funds to pay TEX-AN and CCTS bills. Federal guidance for internal service functions such as TEX-AN and CCTS states that such functions need sufficient working capital to meet 60 days' cash expenses for normal operating purposes. In addition, state law required GSC to transfer funds in excess of the amount needed to pay its bills to the statewide

two of the last three fiscal years, the Telecommunications Services Division has failed to recover TEX-AN's costs. The Telecommunications Services Division's failure to adequately analyze its costs adversely affected the operation of TEX-AN as a cost recovery program. Inadequate financial data was a factor in this lack of analysis.

Section 2-A:

TEX-AN's Fiscal Year 2001 Loss Resulted Primarily From a Failure to Recover the Costs of Upgrading The System

TEX-AN incurred $12 million in additional, unplanned expenses because of delays in implementing a significant upgrade to the telecommunications services provided by this system. These cost overruns were the major factors that led to TEX-AN losing a reported $9.5 million in fiscal year 2001. GSC was able to offset this loss with net equity from prior years and still have a net equity of $2.1 million at the end of fiscal year 2001.

Telecommunications Services Division management intended for upgrades on TEX-AN's telecommunications services to be completed during December 2000. However, these upgrades still have not been completed because of vendor performance issues. As a result, the Telecommunications Services Division must maintain the legacy telecommunications system to provide service to all its customers until the upgrades are complete. The Telecommunications Services Division incurred $12 million in additional expenses between December 1, 2000, and August 31, 2001, because it was forced to maintain the legacy telecommunications system.

There were several additional reasons the TEX-AN program incurred losses:

- The Telecommunications Services Division does not have an effective cost accounting system that enables it to readily monitor key costs. For example, management had to research the costs that led to the fiscal year 2001 loss, rather than having this information readily available.

- Telecommunications Services Division management has identified services that it is no longer using but for which it is still paying. The vendor billed the State for these services, but Telecommunications Services Division staff did not detect this in a timely manner and continued to pay for these services. Telecommunications Services Division staff have been unable to determine the cost of paying for these unneeded and unused services.

- The billing process for TEX-AN is very complex, and the section of the Telecommunications Services Division responsible for analyzing TEX-AN bills was understaffed for long periods of time. Staff positions to perform these tasks existed, but were not filled. Being understaffed made it more

network applications account where the funds could be appropriated for capital improvements to TEX-AN and CCTS. These laws will now apply to DIR, since it now operates TEX-AN and CCTS.

difficult for the Telecommunications Services Division to identify charges for services that it was no longer using.

- Some of the first telecommunications services that were upgraded were services for which the Telecommunications Services Division had historically charged a rate that was higher than the cost of these services. The Telecommunications Services Division used the excess revenue to subsidize other telecommunications services. However, the amount of this excess revenue began decreasing when customers shifted from these higher-cost services to newer services that generated less profit for TEX-AN. TEX-AN lost approximately $3.9 million in revenue because of this.

<u>Recommendations for DIR</u>:

Although TEX-AN had sufficient cash and retained earnings to absorb the fiscal year 2001 loss, DIR should be more methodical in its future financial planning. DIR should implement procedures that will enable it to charge competitive rates to customers and identify and recover its costs. Specifically, DIR should:

- Ensure there is proper accounting and control of profits and losses generated from cost recovery programs by routinely evaluating the reasons for the profits and losses. This evaluation should include analysis of both revenue and expenditure trends. Based on the results of the evaluation, either the rates or expenses should be adjusted accordingly. DIR should neither charge rates in excess of what is required to recover costs nor allow the programs to lose money because it does not pass all costs on to its customers. DIR should know its actual costs and base its rate-setting on these costs. In addition, management should benchmark these charges with similar services in the private sector. The costs billed to customers should reflect TEX-AN's cost structure. For example, costs that TEX-AN incurs for maintaining the legacy telecommunications system should be passed along to customers using the system.

- Ensure that the Telecommunications Services Division continues to strive to keep key positions filled.

- Regularly analyze key financial data to ensure that TEX-AN and CCTS are operating as cost recovery programs. If the Telecommunications Services Division's new telemanagement system does not provide the financial data management needs to analyze costs, management should examine alternative means for obtaining this data.

<u>DIR Management's Response</u>:

We agree with the recommendation to charge competitive rates to customers and identify and recover all costs.

- *DIR management staff routinely meets to review and update forecast revenues and expenditures for this program based on revenue trends and changes in the business environment. These forecasts assist in expenditure reductions and the rate setting process.*

  In addition to review by the DIR management staff, the Telecommunications Planning and Oversight Committee (TPOC), and the newly created Telecommunications Billing Task Force review financial data and assist the Telecommunications Services Division in determining rates and cost recovery. Both groups consist of state and local customer representatives from the telecommunications services user community.

  Included in the quarterly performance measure information provided to the Legislative Budget Board (LBB) is a measure benchmarking DIR telecommunications costs against private sector costs. The Telecommunications Services Division is working with the task force and the private sector providers to improve the process of compiling and reporting that data in order to make it a more effective management tool.

  Losses in fiscal 2001 and 2002 were a result of maintaining the TexAn III network while customers were being converted to the TexAn 2000 network. All customers are projected to complete the conversion by May 2002. Written notice has been sent to all agencies in the process of converting to advise them that costs of maintaining the TexAn III network after the target date of May 31, 2002, will be billed to the agencies remaining on that network.

We agree that maintaining staffing levels for key positions is critical to the efficient operation of the division.

- *In the past few years, attracting and maintaining qualified telecommunications staff has been challenging due to the higher salaries paid in the private sector for telecommunications resources. DIR has been able to fill a significant number of vacancies in the past six months for the following reasons: demand in the private sector has decreased, DIR has adjusted salaries in the Telecommunications Services Division to be more competitive with those paid in the private sector, retention bonuses are awarded to key positions when appropriate, and career ladder opportunities are provided within the division and the agency.*

We agree with the need to regularly analyze financial data to ensure that TexAn and CCTS are operating as cost recovery programs.

- *Detailed financial statements for reviewing actual and forecast revenues and costs have been developed and are regularly reviewed with DIR management staff and updated for the changing business activities.*

<u>Recommendations for TBPC</u>:

Although TBPC does not manage TEX-AN and CCTS, it has other cost recovery programs. TBPC should examine the financial planning procedures for these programs to ensure that these procedures adequately reduce the risk of failing to recover all costs and the risk of overcharging customers.

TBPC Management's Response:

We agree with the SAO recommendation to examine the financial planning procedures for all remaining TBPC cost recovery programs. As part of the reorganization of the Fiscal Department discussed in our response to Report Section 1-A, TBPC has hired a cost accountant, starting on June 1, 2002, to aid in both financial planning and to develop accurate and efficient cost recovery rates. The Fiscal Department, under the direction of the new CFO, will take the lead role in establishing the rates charged to state agencies and universities for a variety of services. In the past, cost recovery rates have been primarily established by program personnel responsible for providing the services, with only minimal input and guidance from the Fiscal Department.

The TBPC is also currently reviewing all cost recovery programs to ensure that the programs are cost competitive with private sector firms, but do not compete in areas best left to private industry.

Section 2-B:

The Telecommunications Services Division Cannot Ensure That It Recovers All Expenses From Its Customers

Although TEX-AN and CCTS are required to be cost recovery programs, the Telecommunications Services Division does not have procedures in place to ensure that it adequately manages revenues and expenses to ensure cost recovery. The Telecommunications Services Division receives two sets of bills from telecommunications vendors: (1) a summary bill showing what the Telecommunications Services Division needs to pay the vendor and (2) a detailed bill that the Telecommunications Services Division uses to bill customers so that it can be reimbursed for what it paid the vendor. Although matching the two sets of bills is possible, Telecommunications Services Division management has stated that it has not instituted this control for all transactions because of a lack of staff.

The fact that the Telecommunications Services Division processes a large number of transactions increases the risk that it may not recover all expenses. According to Telecommunications Services Division management, the division processed approximately 7,200 bills from vendors and approximately 22,500 invoices to customers in fiscal year 2001. Management asserts that its current automated systems do not have the ability to use the same data to both pay the bills for TEX-AN and CCTS and to prepare the bills to send to customers for reimbursement.

One reason the Telecommunications Services Division does not match expenses with revenues is that it must perform in-depth examination of billing information provided by vendors. This examination is necessary to detect potential overcharges. Management estimates it saved the State between $1 million and $1.6 million in potential billing overcharges in fiscal year 2001 through this examination. We did not verify the accuracy of this estimate.

Recommendation for DIR:

DIR is in the process of implementing a new automated system to replace at least one of its current systems. DIR should ensure that it obtains system modules that can use the same information to process both the phone bills it must pay and the invoices it sends to customers. This will help to ensure that its customers will reimburse charges paid by the Telecommunications Services Division. In addition, DIR should research the feasibility of increased use of automation to analyze billings from vendors.

DIR Management's Response:

We agree that an automated system should be used to verify that all vendor costs have been correctly validated and recovered in full through billings to customers.

Staff is being trained at this time on functionality of the new telemanagement system in preparation for implementation of the customer billing module. The telemanagement system does not have functionality to process vendor payments; however, beginning with fiscal 2002 expenditures are being tracked through a job control system to allow for enhanced matching of service costs to revenue billings for those services.

Section 3:

Detailed Adjusted Balance Sheets for TEX-AN and CCTS

Table 1

Capitol Complex Telecommunications System
8/31/01 Revised Balance Sheet

	Original 8/31/01 Balance Sheet	Adjustments	Adjusted 8/31/01 Balance Sheet
ASSETS			
Cash in State Treasury	$ 36,488	$ 4,792,177 [a]	$ 4,828,665
Accounts Receivable	1,076,614		1,076,614
Less: Allowance for Uncollectible Accounts Receivable		(963) [b]	(963)
Prepaid Expenses (office supplies)	8,766		8,766
Inventory	862,406		862,406
Equipment and Vehicles	18,630,838	(7,228,892) [c]	11,401,946
Less: Accumulated Depreciation	(16,759,924)	6,506,003 [c]	(10,253,921)
Investment Non Depreciating Asset	1,282,786	(1,282,786) [d]	0
TOTAL ASSETS	**$ 5,137,974**	**$ 2,785,539**	**$ 7,923,513**
LIABILITIES			
Accounts Payable	$ 566,975		$ 566,975
Employees Compensable Leave Time	97,536		97,536
Accrued Indirect Support Expense	10,282		10,282
TOTAL LIABILITIES	**$ 674,793**	**$ 0**	**$ 674,793**
FUND EQUITY			
Investment: Non-Depreciating Asset	$ 1,282,786	$ (1,282,786) [d]	$ 0
Retained Earnings:	3,180,395		7,248,720
Cash in State Treasury		4,792,177 [a]	
Allowance for Uncollectible Accounts Receivable		(963) [b]	
Equipment and Vehicles - Net		(722,889) [c]	
TOTAL FUND EQUITY	**$ 4,463,181**	**$ 2,785,539**	**$ 7,248,720**
TOTAL LIABILITIES AND FUND EQUITY	**$ 5,137,974**	**$ 2,785,539**	**$ 7,923,513**

[a] Increase Cash in Treasury by $4.8 million and increase Retained Earnings by the same amount. **(Section 1-A)**

[b] Add a $1,000 Allowance for Uncollectible Accounts Receivable to the TEX-AN balance sheet and reduce Retained Earnings by the same amount. **(Section 1-A)**

[c] Reduce Equipment and Vehicles by $7.2 million and Accumulated Depreciation by $6.5 million. Decrease Retained Earnings by $723,000, which is the net value of the two accounts. **(Section 1-A)**

[d] Reduce the Non-Depreciating Asset by its entire $1.3 million balance in both the asset and equity sections of the balance sheet. **(Section 1-A)**

Note: DIR received an additional $7.4 million in Equipment and Vehicles with $6.2 million in Accumulated Depreciation from GSC, in addition to the Equipment and Vehicles reported on the TEX-AN and CCTS balance sheets. DIR should determine which program each of these assets belongs to and assign them accordingly.

Table 2

TEX-AN
8/31/01 Revised Balance Sheet

	Original 8/31/01 Balance Sheet	Adjustments	Adjusted 8/31/01 Balance Sheet
ASSETS			
Cash in State Treasury	$ 627,750	$ 6,641,401 [a]	$ 7,269,151
Accounts Receivable	19,832,990		19,832,990
Less: Allowance for Uncollectible Accounts Receivable		(484,173) [b]	(484,173)
Prepaid Expenses (office supplies)	8,766		8,766
Inventory	599,264		599,264
Equipment and Vehicles	5,008,849	(986,808) [c]	4,022,041
Less: Accumulated Depreciation	(4,437,045)	887,264 [c]	(3,549,781)
TOTAL ASSETS	**$ 21,640,574**	**$ 6,057,684**	**$ 27,698,258**
LIABILITIES			
Accounts Payable	$ 20,293,205	$ 3,604,128 [d]	$ 23,897,333
Contingent Liability		1,244,846 [h]	1,244,846
Employees Compensable Leave Time	136,880		136,880
Accrued Indirect Support Expense	342,275		342,275
TOTAL LIABILITIES	**$ 20,772,360**	**$ 4,848,974**	**$ 25,621,334**
FUND EQUITY			
Donated Capital - Prior Years	$ 21,428,572	$ (21,428,572) [e]	$ 0
Contributed Capital	123,933	(123,933) [f]	0
Reserve - Fixed Asset Purchase	1,544,500	(1,544,500) [g]	0
Retained Earnings:	(22,228,791)		2,076,924
Cash in State Treasury		6,641,401 [a]	
Allowance for Uncollectible Accounts Receivable		(484,173) [b]	
Equipment and Vehicles - Net		(99,544) [c]	
Accounts Payable		(3,604,128) [d]	
Donated Capital		21,428,572 [e]	
Contributed Capital		123,933 [f]	
Reserve for Fixed Assets		1,544,500 [g]	
Contingent Liability		(1,244,846) [h]	
TOTAL FUND EQUITY	**$ 868,214**	**$ 1,208,710**	**$ 2,076,924**
TOTAL LIABILITIES AND FUND EQUITY	**$ 21,640,574**	**$ 6,057,684**	**$ 27,698,258**

[a] Increase Cash in Treasury by $6.6 million and increase Retained Earnings by the same amount. **(Section 1-A)**

[b] Add a $484,000 Allowance for Uncollectible Accounts Receivable to the TEX-AN balance sheet and reduce Retained Earnings by the same amount. **(Section 1-A)**

[c] Reduce Equipment and Vehicles by $987,000 and Accumulated Depreciation by $887,000. Decrease Retained Earnings by $100,000, which is the net value of the two accounts. **(Section 1-A)**

[d] Increase Accounts Payable by $3.6 million and decrease Retained earnings by the same amount. **(Section 1-B)**

[e] Reduce Donated Capital by its entire $21.4 million balance and increase Retained earnings by the same amount. **(Section 1-A)**

[f] Reduce Contributed Capital by its entire $124,000 balance and increase Retained earnings by the same amount. **(Section 1-A)**

[g] Reduce Reserve for Fixed Asset Purchase by its entire $1,544,500 balance and increase Retained Earnings by the same amount. **(Section 1-A)**

[h] Add a $1.2 million Contingent Liability and decrease Retained Earnings by the same amount. **(Section 1-B)**

Note: DIR received an additional $7.4 million in Equipment and Vehicles with $6.2 million in Accumulated Depreciation from GSC, in addition to the Equipment and Vehicles reported on the TEX-AN and CCTS balance sheets. DIR should determine which program each of these assets belongs to and assign them accordingly.

Summary of the Objectives, Scope, and Methodology

Our objectives were to determine whether GSC:

- Accurately represented assets, liabilities, and fund reserve balances on the internal balance sheets for TEX-AN and CCTS.
- Accurately accounted for funds it collected from other state agencies for TEX-AN and CCTS.
- Ensured that incurred expenses were appropriate to revolving fund programs.

The scope of this audit was limited to examining the fiscal year 2001 internal balance sheets for TEX-AN and CCTS, as well as the underlying data and the control systems that produced the underlying data.

Audit procedures included tracing amounts reported on the internal balance sheets to GSC's annual financial report and general ledger; reviewing applicable laws, policies and procedures; and testing selected transactions that affected, or had the potential to affect, the internal balance sheet. Fieldwork was conducted from December 2001 through March 2002.

This audit was conducted in response to a request by DIR and was conducted in accordance with generally accepted government auditing standards.