



STATE OF NORTH CAROLINA

DEPARTMENT OF TRANSPORTATION

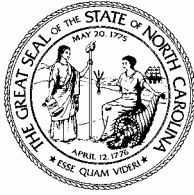
STATEWIDE FINANCIAL AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2005

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR



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March 30, 2006

The Honorable Michael F. Easley, Governor
Members of the North Carolina General Assembly
Mr. Lyndo Tippet, Secretary
Department of Transportation

We have completed certain audit procedures at the Department of Transportation related to the State of North Carolina reporting entity as presented in the *Comprehensive Annual Financial Report (CAFR)* and *Single Audit Report* for the year ended June 30, 2005. Our audit was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

In the *CAFR*, the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report*, the State Auditor presents the results of tests of internal control and compliance with laws, regulations, contracts and grants applicable to the State's financial statements and to its federal financial assistance programs. Our audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards* issued by the Comptroller General of the United States and the Single Audit Act as applicable. Our audit scope at the Department of Transportation included the following:

State of North Carolina's Financial Statements

Special Revenue: State Highway Fund
Special Revenue: State Highway Trust Fund
Capital Assets Used in Governmental Activities

State of North Carolina's Administration of Federal Financial Assistance Programs

Highway Planning and Construction Cluster
Formula Grants for Other Than Urbanized Areas

Our audit procedures at the Department of Transportation were less in scope than would be necessary to report on the financial statements that relate solely to the Department or its administration of federal programs. Therefore, we do not express such conclusions.

The results of our audit procedures yielded audit findings and recommendations for the Department related to the State's financial statements and federal financial assistance

programs that may require disclosure in the aforementioned reports. These findings are included in the findings and recommendations section contained herein. Our recommendations for improvement and management's response follow each finding.

North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

A handwritten signature in black ink that reads "Leslie W. Merritt, Jr." in a cursive script.

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

AUDIT FINDINGS AND RECOMMENDATIONS

Matters Related to Financial Reporting or Federal Compliance Objectives

The following findings and recommendations were identified during the current audit and discuss conditions that represent deficiencies in internal control and/or noncompliance with laws, regulations, contracts or grants. Finding numbers 2 and 7 were also reported in the prior year.

1. IMPROPER SYSTEM DESIGN RESULTS IN ACCOUNT OVERSTATEMENTS

The Department's accounting system did not accurately record transactions made between two of the entity's legally distinct funds. Transfers made during the year did not properly reduce receivable and payable balances due to a flaw in system programming.

As a result, the amounts submitted for inclusion in the State's *Comprehensive Annual Financial Report* for the Highway Fund receivables and transfers in; and Highway Trust Fund payables and transfers out were overstated by \$30.7 million respectively. Adjustments were made to correct the affected accounts.

Recommendation: The Department should revise the method of recording affected transactions in the accounting system to prevent future errors. Programming changes should be tested to ensure accurate reporting.

Agency's Response: The Department investigated the system generated accounting entries to reduce the receivable and payables between the Highway Fund and Trust Fund. Two thirds of the monetary impact was for two N.C. Railroad Dividend payments made during the year. A manual change was implemented for FY05-06 to clear the entries. A computer system change will be made to properly reflect this activity automatically.

2. YEAR- END FINANCIAL REPORTING PROCESS DID NOT IDENTIFY ALL LIABILITIES

The Department's method to identify liabilities at year end did not effectively discover all outstanding obligations. Therefore, liability and expenditure account balances submitted for inclusion in the State's *Comprehensive Annual Financial Report* were understated.

Upon review of a sample of expenditures subsequent to year end, we identified \$10.6 million in unrecorded liabilities. The portion applicable to the Highway Trust Fund required adjustment.

Recommendation: The Department should develop a method to capture all liabilities at year end and effectively implement procedures to achieve accurate financial reporting.

Agency's Response: The Department did not include ACH payments for contractor payments in the year end accrual process as well as some other invoices. The ACH

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

payments that should have been accrued accounted for 81.5% of the audit finding. The total audit finding is 3.34% of the total accruals for the year. Procedures have been put in place to include the ACH accruals in FY05-06.

3. TIME RECORDS NOT APPROVED

A review of documentation to support payroll expenditures revealed field payroll worksheets (FR-01 forms) that were not approved by the supervisor. Worksheets supporting one pay period for 80 employees were examined. At least one worksheet was not approved for five employees in our sample. In total, eight worksheets were not approved and five of these worksheets were not signed by the employee.

There is an increased risk of errors or irregularities in payroll expenditures when time and attendance records do not receive adequate review.

The Department had not implemented adequate controls to ensure that documents used to record time and attendance were approved in accordance with its *Field Fiscal Procedures Manual*.

Recommendation: The Department should strengthen management oversight to ensure that established internal control procedures are followed regarding the approval of documents supporting time and attendance.

Agency's Response: The Department contacted the areas impacted by the eight timesheets not signed and stressed the importance of signing time entry documents and having them available for audit. The Department sent a directive January 23, 2006 to DOT employees stressing time entry policies and procedures and will continually reinforce this to staff.

4. WEAKNESS IN CONTROL OVER DISASTER RECOVERY

The Department did not have a disaster recovery plan for a computer center which houses a variety of systems and data including the Highway Construction and Materials System (HiCAMS), an application containing information critical to construction activities, expense reporting and compliance with federal requirements.

A disaster recovery plan, containing instructions necessary to rebuild a computer center if a disaster occurs, is necessary to reduce the risk of interruption of critical business functions.

Recommendation: The Department should strengthen controls over disaster recovery to ensure that an approved plan is in place for critical applications. Disaster recovery procedures should be tested periodically to ensure recoverability of the data center.

Agency's Response: DOT Information Technology has recently hired an Information Security Analyst to concentrate on the Business Continuity Planning (BCP) process as

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

required by the State Chief Information Officer. This Security Analyst will work with the HiCAMS application development team, Infrastructure Services, and business (the Construction and Materials & Tests Units) to develop a business continuity plan for the HiCAMS system.

5. EXPENDITURES BILLED TO FEDERAL HIGHWAY PROJECTS INCORRECTLY

The Department incorrectly billed some costs to the Federal Highway Administration (FHWA). In our examination of 91 billed expenditure documents totaling \$168 million we found the following:

- Right of Way costs for two purchases totaling \$39,000 were billed to incorrect projects. We are questioning the federal share of \$31,200;
- Office furniture totaling \$1,747 was incorrectly billed to a specific project. We are questioning the federal share of \$1,572;
- Paralegal training totaling \$378 was incorrectly billed to a specific project. We are questioning the federal share of \$302;
- Plumbing repair cost totaling \$85 was incorrectly billed to a specific project. We are questioning the federal share of \$68;
- One invoice totaling \$162 was billed twice to the same project. We are questioning the federal share of \$146.

Each FHWA project is funded separately and is assigned a specific federal participation percentage. Errors in coding or keying can limit the availability of funds for valid expenditures and can also result in questioned costs. Since the questioned cost exceeds \$10,000, we are questioning costs of \$33,288.

Recommendation: The Department should emphasize the importance of proper coding and review of expenditure transactions to ensure that only allowable costs are billed to federal highway projects.

Agency's Response: The Department examined the expenses for five projects and found the following:

- The right of way cost for two purchases totaling \$39,000 was charged to the incorrect federal project due to a coding error at entry. A correcting entry was subsequently made to transfer the cost to the correct federal project number. FHWA was given credit for the error and the correct federal project was billed at the same billing percentage.
- The Department has transferred the cost for the office furniture to the correct project thereby giving Federal Highway credit for the federal share of \$1,572. The requestor did not route the purchase requisition properly in the system for

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

appropriate approvals prior to purchase. The cost would have been disallowed if proper procedures were used.

- User identified the incorrect project to charge training cost. The cost has been transferred to the correct project and Federal Highway has been given credit for \$302.
- User identified the incorrect project to charge plumbing repair. Credit has been given to Federal Highway for \$68.
- An invoice was paid twice to the same project due to coding error. Federal Highway has been given credit for \$146.

The Department will reinforce the appropriate procedures to follow for purchase requisitions and remind staff of the guidelines that must be followed for charging to federal projects. This will be discussed at the Operations staff meeting and a directive will be sent to all employees dated March 13, 2006.

6. FINANCIAL STATUS REPORTS CONTAIN INACCURATE DATA

Errors were noted in Financial Status Reports for two projects funded by the Formula Grants for Other Than Urbanized Areas program for the period ended September 30, 2004. These errors may reduce the usefulness of data submitted to federal funding agencies.

The non-federal portion of program expenditures was not calculated correctly. The methodology used to calculate the amounts did not allow for differences in matching requirements. As a result:

- The non-federal portion of program expenditures was understated by \$1.6 million and \$1.4 million for the two projects;
- The non-federal share of unliquidated obligations and the total unliquidated obligations were understated by amounts ranging from \$104,214 to \$143,519 for the two projects.

The unobligated balance of federal funds was overstated by \$25,808 for one of the projects. The amount reported represented the total unobligated balance instead of the federal share.

Title 49 CFR section 18.20(b) requires accurate, current, and complete disclosure of the financial results of financially assisted activities in accordance with the financial reporting requirements of the grant.

Recommendation: The Department should implement procedures to ensure that data reported on the financial status reports is accurate and agrees with the accounting records or other supporting documentation. The reports should be reviewed by someone other than the preparer.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

Agency's Response: The Department's Financial Statements were correct, however, funding allocations in the financial status report prepared by Public Transportation did not accurately reflect the non-federal funding shares on two projects. This will be rectified by modifying an existing report inquiry. The status reports will be reviewed by a supervisor for correctness.

7. TESTING STANDARDS NOT MET IN ACCORDANCE WITH QUALITY ASSURANCE PROGRAM

The Department of Transportation (DOT) did not present documentation to demonstrate that the required testing of highway construction materials was performed. This condition limits the Department's ability to ensure that materials used in construction projects conform to approved specifications. A review of information in the Highway Construction and Materials System (HiCAMS) for aggregate types used in current contracts indicated:

- The required number of DOT's Quality Assurance (QA) tests was not performed on materials received from three of 39 producers tested. These tests are used by DOT to verify the performance of the Producer's Quality Control plan;
- The required number of Roadway Quality Assurance (RA) tests was not performed on materials received for two of 39 contracts reviewed. Insufficient testing was cited on one of these contracts in the prior year. These tests are performed to verify the quality of the in-place material used on a specific project;
- The required number of Independent Assurance (IA) tests was not performed on materials received for nine of the 14 affected federal contracts. Insufficient testing was cited on four of these contracts in the prior year with three contracts having no IA testing for two consecutive fiscal years. The IA tests are to provide an independent test to verify the performance of DOT's acceptance program to the Federal Highway Administration.

The testing standards are part of a quality assurance program developed by the DOT and approved by the Federal Highway Administration for Federal-aid highway construction projects. Title 23 CFR section 637.205 requires the DOT to develop a quality assurance program, which will ensure that the materials and workmanship incorporated into each Federal-aid highway construction project on the National Highway System are in conformity with the requirements of the approved plans and specifications.

Recommendation: Internal controls should be enhanced to ensure that testing information is accurately entered into HiCAMS and that the required numbers of tests are performed in accordance with standards approved by the Federal Highway Administration for Federal-aid highway construction projects.

Agency's Response:

- The Materials and Tests Unit will reinforce the importance of communication between quarry and materials inspectors to ensure that an adequate number of Department's

AUDIT FINDINGS AND RECOMMENDATIONS (CONCLUDED)

quality assurance samples are taken to correspond to producer's quality control samples. Additionally the Quality Control/Quality Assurance Program has been modified to require electronic transfer of QC data from producers to ensure timely and accurate reporting of test data.

- The deficiency in the number of Roadway Quality Assurance tests identified in the Audit decreased from 20.5% in 2004 to 5.1% in 2005. The improved audit results are attributed to the new HiCAMS functionality to evaluate compliance with material sampling and testing requirements that was deployed in December 2004. The current HiCAMS functionality is judged to be adequate. Training and coaching of personnel in the use of the new functionality will continue.

Greater emphasis will be placed on compliance with the minimum sampling requirements during the 2006 Construction Engineers Conference (to be held the week of March 20, 2006).

- The workload on the IA section has remained constant during the last two years, but the vacancy rate within the group has increased from 0% to 18%.

In March of 2006 the IA section was completely restructured resulting in their being assigned to the 8 Section Materials Specialists who are already responsible for aspects of the IA process. This will provide more local supervision and will allow a supervisor to re-allocate personnel as needed to provide better coverage of projects. Also, under this structure a "team approach" will be used to monitor the progress of work, and will provide a better exchange of information between project personnel and IA inspectors.

On March 9, 2006 all IA inspectors met with Materials and Tests Management and the Director of Construction to reinforce the importance of compliance with the program. This audit, the projects reviewed, and the exact details of the results of this audit were discussed in detail. Tracking of projects/project data was heavily emphasized to ensure that material quantities and the subsequent sampling frequency are captured and samples are taken appropriately. In addition, Materials and Tests Unit management will also track and perform periodic checks to ensure that sampling frequency requirements are met.

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