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The Honorable David A. Cook, Commissioner
Members of the Audit Committee
State of Georgia's Department of Community Health

In planning and performing our audit of the financial statements of the State of Georgia's Department of Community Health (the "Department") as of and for the year ended June 30, 2012, in accordance with auditing standards generally accepted in the United States of America, we considered the Department's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control.

However, during our audit we became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and suggestions regarding those matters. A separate report dated November 28, 2012, contains our report on significant deficiencies and material weaknesses in the Department's internal control. This letter does not affect our report dated November 28, 2012, on the financial statements of the Department.

We have already discussed many of these comments and suggestions with various Department personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Metcalf Davis    Mauldin & Jenkins

Atlanta, Georgia
November 28, 2012

**MLC-1: Encumbrances**

The laws of the State of Georgia require funds appropriated for a specific fiscal year must be "expended or obligated" in that fiscal year, or "lapse" and be returned to the State of Georgia Treasury to be available for future appropriations. At the end of each June 30th fiscal year, the amount of each appropriation (except for the mandatory appropriations required by the Constitution of Georgia) remaining unexpended and not contractually obligated in writing shall lapse and cease to be available; and the State of Georgia Treasury shall not pay any unallotted appropriations and shall make the necessary adjustments in its appropriation accounts to charge off the amount of the lapsed appropriations. All appropriated funds (except for the mandatory appropriations required by the Constitution of Georgia) remaining unexpended and not contractually obligated at the expiration of the General Appropriations Act shall lapse.

Purchase orders issued and encumbered in a previous fiscal year that are paid in the following fiscal year for exactly the encumbered amount have no effect on "surplus".

Purchase orders issued and encumbered in a previous fiscal year that are paid (as final payment with purchase order closed) for an amount less than the encumbered amount will contribute the difference between original encumbrance amount and payment amount to "surplus". No journal entry or other action is required, since the "surplus" amount to be returned to the State of Georgia Treasury is already in the appropriate net asset account due to the previous fiscal year being closed using generally accepted accounting principles. As a reminder, generally accepted accounting principles do not expense encumbrances.

Purchase orders issued and encumbered in a previous fiscal year that need to be paid for an amount greater than the encumbered amount should have the excess amount charged to the current budget period. The original encumbered amount may be paid against the original budget period. The excess amount should be paid against the current budget period.

If a vendor cannot supply the item(s) ordered and the Department does not desire to reissue the purchase order to a new vendor, the purchase order can simply be cancelled. The entire purchase order amount will become surplus.

Purchase orders issued and encumbered in a previous fiscal year that are cancelled in a subsequent fiscal year may be reissued to a different vendor for similar goods and services in an amount not to exceed the original purchase order amount. The reissued purchase order must reflect the budget period of the original purchase order. If the reissued purchase order is less than the original purchase order amount, the difference will increase “surplus”.

During our audit, we noted encumbrances were recorded for purchase orders on contracts which were complete or whose term had expired, yet such funds continued to be encumbered. We recommend the Department analyze all encumbrances with the close of each fiscal year, and make the appropriate adjustments resulting in the possible return of surplus to the State of Georgia Treasury.

**MLC-2: Consistent Application of Encumbrances Policy**

We understand the Department utilizes encumbrances to indicate the intent to purchase goods or services. Additionally, we understand the Department reports its budget activity using budgetary basis of accounting, which includes encumbrances. We also understand the Department may at its discretion allow multi-year encumbrances to lapse at year end. However, historically, the Department has not taken such actions. For the fiscal year ended June 30, 2012, the Department selected certain multi-year encumbrances to lapse at year end. Not only was the decision not applied consistently across all multi-year contracts, the action was not applied across all funding sources for each of the multi-year encumbrances allowed to lapse. Additionally, we understand the decision did not rest solely with the Department.

We recommend management consistently apply the action of allowing or not allowing multi-year encumbrances to lapse at year end across all multi-year encumbrances and across all funding sources. Additionally, we recommend the decision and necessary actions be made in a timely manner to provide the opportunity for judicious communications and completion of the Department’s annual financial statements and Budget Compliance Report (BCR) by the established deadlines.

**MLC-3: Federal Receivable Amounts**

Prompted by the deficit budget issues facing the Department, we noted the Department recorded an amount of approximately $13,000,000 as revenue and receivable relative to fiscal year 2011 activity during the latter stages of the Department's fiscal year 2012 audit process. This amount was prospectively owed but, not formally agreed and approved by Center for Medicare and Medicaid Services (CMS).

Relative to the above situation, we offer the following observations:

1) The respective amount should have been addressed for potentially being receivable many months prior to the actual recording in November 2012;

2) Prior to recording, the respective amount should have been agreed and approved by the paying party; and,

3) Considering the cash sensitive needs of the State of Georgia as well as the Department, the request for reimbursement and the approval should have been sought many months earlier to provide for better cash management.

We recommend the Department address potential revenue sources and seek the receipt of respective cash funds from such sources in a more timely manner.

**MLC-4: Incurred-But-Not-Reported (IBNR)**

As noted in the fiscal year 2012 report issued by the Department's actuaries, the actual results for fiscal year 2011 were different from the original estimate that was recorded by the Department as of June 30, 2011. We understand the IBNR reported at June 30, 2011 was estimated with sound actuarial principles given the data that was made available at the time of the valuation. We further understand there is an equal probability of the IBNR estimate being overstated versus understated in any given year. However, it should be noted that oftentimes additional information outside of the existing lag triangles has the potential to impact the computed estimate and should be made available to the actuaries. Going forward, we recommend the Department develop a plan of action to determine if there are additional data or program assumptions that could be more timely provided to its actuaries to allow for a more accurate estimated IBNR liability. Further, the Department should stress the need for all interested and respective parties to better communicate any and all dynamics that may potentially affect such estimates.

**MLC-5: Executive Level Review of Non-Routine Processes and Outsourced Activity (Substantial Repeat of 2011 Audit Management Point)**

The Department's financial statements include a significant number of estimates which include allowances for bad debts, reserves and other accruals such as the estimate for claims incurred-but-not-reported (IBNR). Although some of the estimates are provided to management by Department employees, many of them are performed by outside actuaries, attorneys and consultants. Additionally, Department management utilizes over twenty-five (25) third party service providers to process transactions on behalf of the Department.

Based on our observations, inquiries and other audit procedures, we have noted Department management is not currently putting sufficient focus on understanding, reviewing, and challenging the assumptions or calculations provided to them by others within the Department or outside contractors (actuaries, attorneys, and consultants) causing incorrect or incomplete information to be included in the respective general ledgers as well as the fiscal year annual financial statements. This situation resulted in post closing journal entries to the financial statements this year and in prior years.

Currently, there is no documented review process in place. Additionally, we have noted Department management has not been timely in addressing its responsibilities to perform thorough reviews of all data and information that will be included in its various operations and financial statements whether obtained from internal or external sources.

A good example surrounds various situations related to the estimated IBNR liabilities. The Department employs external actuaries who assist the Department in estimating IBNR liabilities to be recorded and reported in the Department's financial statements. The Department's actuaries were required to reissue the June 30, 2012 Medicaid actuarial report due to a lack of timely review by Department management of the assumptions and data utilized to compute the Medicaid IBNR liability estimate.

As recommended in prior years, we continue to recommend Department management place priority on taking the time to thoroughly review and challenge information that is provided to them for inclusion in financial statements by both internal and external sources. We recommend the Department demonstrate a more proactive approach to addressing all of the concerns noted in the above paragraphs. The quantitative element of management in the accounting function is the demonstration that amounts balance and are supported. The qualitative element of accounting is diving into the various balances and determining their propriety and determining that all appropriate steps have been taken to turn all assets into a form of liquidity such as cash, and that all disbursements of funds are appropriate.

In conclusion, Department management should enhance its documentation to demonstrate that all of the above concerns are adequately addressed, and the quantitative and qualitative approaches to managing the accounting function are being employed.

**MLC-6: Internal Oversight Function**
**(Repeat of 2011 Audit Management Point)**

Department management is responsible for the quality and effectiveness of the Department's internal controls including reviewing and challenging information provided to them by internal and external sources and monitoring the controls related to financial processes. This also helps to ensure that employees perform high quality work and sets the tone for accurate financial reporting.

However, in an entity the size and complexity of the Department, even an excellent system of internal controls will only provide reasonable assurance that financial reporting errors, irregularities, fraud and operating inefficiencies will be identified, addressed and resolved. A primary method to significantly enhance the quality of internal control is to create a mechanism for additional internal oversight.

Presently, the Department's Office of the Inspector General (OIG) performs oversight in several important areas which is primarily related to operations and largely externally focused. We believe such oversight should be extended to the financial reporting arena as well. An internal oversight function would not be a substitute for management's review and monitoring. Rather, a plan would be developed for oversight personnel to conduct a series of continuous reviews in specific areas such as financial services, Medicaid and the State Health Benefit Plan which would result in focused fact-based reports that include their findings and recommendations for improvement. The plan should include monitoring the satisfaction of the findings and management recommendations made each year in the annual audit. The reports generated by the internal oversight function would be reviewed with Department management and corrective action plans developed. The internal oversight function would monitor the corrective action to see that it was implemented. Such an oversight function would also provide greater confidence to everyone in the Department's management relative to financial and non-financial information generated by the system and communicated to internal and external parties. The internal oversight function should be housed in with the OIG who reports directly to the Commissioner.

**MLC-7: Financial Statement Review**

The Department's management is responsible for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions consistent with management's assertions embodied in the financial statements. Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility. Internal control over financial reporting should include the comparison of expected amounts to reported amounts. We noted that management had reasonably estimated the SHBP allowance for doubtful claim refunds. We further noticed that management correctly segregated cash and cash equivalents into unrestricted and restricted amounts. However, the drafted financial statements received from management did not accurately reflect those amounts.

We recommend management include additional steps in the financial statement preparation process that would compare expected amounts to the supporting detail. We also recommend management formally compare prior year reported amounts to current year reported amounts and reconcile any unexpected difference.

**MLC-8: Violations of Purchasing Card Policy**
**(Partial Repeat of 2011 Audit Management Point)**

Management imposes Single Transaction Limits (STL) on Purchasing Card (P-Card) holders for a variety of reasons, including budgetary constraints and job requirements, in order to control the amount a cardholder can spend at one time. The Department has sixteen (16) employees that have been issued P-Cards. The Department's P-Card Policy prohibits a cardholder from splitting a purchase between two or more transactions on one or more cards in order to circumvent the STL.

During our test work, we noted one purchase of $2,584 which was split between two purchases in order to over ride the P-Card holders STL of $2,500. We understand the Department's procedures provide for increasing the STL with prior approval in order to accommodate a particular purchasing need. However, no prior approval to increase the STL was obtained for this transaction.

Further, we noted the Department's P-Card policy was updated as of April 27, 2012, but the revised policy does not incorporate the Department's current P-Card procedure which allows for the practice of increasing the STL with proper approval.

Finally, we noted a review conducted by the Department of Administrative Services of the Department's P-Card transactions made between July 1, 2011, and September 30, 2011 revealed instances of non compliance that included the failure to use statewide contracts without obtaining a waiver, inadequate documentation supporting purchases and the lack of timely reconciliation in Team Georgia Marketplace.

We recommend management evaluate the need for P-Cards. Mechanisms for purchasing outside the Department's normal accounts payable policies and procedures add an additional level of risk. Should management determine the use of P-Cards is both effective and efficient for such purchases, we recommend management provide training for each new card holder and periodic training for all existing card holders as well as employees that approve P-Card purchases. The training should emphasize the importance of the controls set forth in the Department's P-Card policy and stress that the Department's P-Card policies are used to protect the employee as well as the Department.

**MLC-9: Employee Personnel Files**

During our review of employee personnel files, we noted one (1) of the files included in our review of three (3) did not contain an employee personnel action form from the employee's termination date. We recommend the Department follow its policies and procedures which require personnel action forms be completed and properly approved when employees are terminated.

**MLC-10: Documentation of Provider Eligibility**
**(Repeat of 2011 Audit Management Point)**

During our testing of provider eligibility for Medicaid, we noted that it took the Department an extended period of time to locate provider eligibility documentation. The documentation, which the Department believes it has stored electronically but has not properly indexed, included the Statement of Participation, Power of Attorney, and the Provider License. The information included on those documents was ultimately provided. We recommend the Department initiate a system to properly scan and maintain all files related to provider eligibility.

**MLC-11: Reconciling Bank Statements Regularly**
**(Repeat of 2011 Audit Management Point)**

During the audit, we noted a bank account of the Composite State Board of Medical Examiners, an attached agency of the Department, had not been reconciled to the general ledger during the fiscal year ended June 30, 2012. The bank account is a zero-balance account in which all deposits represent online credit card payments that are swept daily to other State of Georgia or Department bank accounts. However, the Department reported an unreconciled balance of $219,100 in the general ledger account at June 30, 2011 and 2012. The $219,100 balance is the net effect of four (4) amounts posted to the account during fiscal year 2011.

Timely and accurate reconciliations between the monthly financial institution statements and the general ledger are important in order for errors or fraud to be detected and corrected in a timely manner as well as ensuring the Department's balances are properly reported. We recommend priority be placed on completing all bank reconciliations and adjusting the general ledger when necessary in a timely manner. Such reconciliations should be performed and reviewed monthly.

**MLC-12: Bank Account Reconciling Items**
**(Partial Repeat of 2011 Audit Management Point)**

We noted the Department's management has made a significant improvement in the routine reconciliation of the Department's bank and investment accounts. However, at the time of our audit, we noted numerous small outstanding checks. Approximately, 745 checks were noted that had been outstanding for more than six (6) months.

Further, at the time of our audit fieldwork, we noted several other transactions which were reported as reconciling items. Because of the Department's management efforts during the fiscal year 2012, both the number and the dollar amount of these items were significantly reduced from those reconciling items noted at June 30, 2011.

Investigating and resolving outstanding checks and reconciling items is an important control procedure that helps to ensure transactions are properly reflected in the Department's accounting records and mitigates the possibility that errors or irregularities can occur and not be corrected and addressed in a timely manner. Therefore, we recommend management continue its efforts to reduce the number of outstanding checks and other items by investigating and resolving such items in a timely manner.

**MLC-13: Lack of Current Service Organization Control Reports**

The Department's management is responsible for implementing and maintaining effective internal controls over financial reporting whether the processing is performed at the Department or the processing is outsourced to an outside service organization. If the Department does not obtain the appropriate level of service auditor report on its key processes, it may be unaware of changes in the controls at the service organization which could cause transactions to be processed incorrectly. This could affect the amounts and disclosures in the financial statements.

Bank of America is responsible for the Department's lockbox services. During the current year, the Service Organization Control (SOC 1) report requested from Bank of America was not available. Instead, Bank of America provided the Department with a bridge/gap letter prepared by Bank of America's management asserting that controls previously documented and tested by Bank of America's service auditor for the period May 1, 2010 – October 31, 2010 were still in effect and functional.

As communicated in prior years, we continue to recommend the Department regularly obtain current SOC 1 reports from all service organizations whose services could affect the Departments' financial reporting process. Additionally, the Department should continue to review the service auditor's report and understand what user controls the service organization assumes the Department has in place and continually monitor the adherence to such user controls.

**MLC-14: SHBP and Trust Fund Operations**
**(Substantial Repeat of 2011 Audit Management Point)**

As part of our audit, we perform various analytical reviews of amounts reflected in the Department's annual financial statements. As part of that analysis, we noted the Department continues to report negative net assets in the SHBP. At June 30, 2012, the Department's SHBP reflected a negative balance of $272 million which includes an additional decrease in net assets of $89 million reported during fiscal year 2012. The negative net assets are caused primarily by benefits payable of $203 million which includes $162 million of incurred-but-not-reported claims (IBNR). In addition, the SHBP reports a $41 million liability due to other funds, primarily the Georgia State Employees Post-Employment Health Benefit Fund (State OPEB fund) and the Georgia School Employees Post-Employment Health Benefit Fund (School OPEB fund). Although there have been various increases noted in the contribution rates of participants and employers, the total contributions plus the State appropriations have not been sufficient to cover the growing costs of providing healthcare to the participants. Thus, the SHBP operates on a pay-as-you-go basis.

Further, we noted the total liabilities in the State OPEB fund and the School OPEB fund are each equal to the total assets reported by the funds. Thus, both the State OPEB fund and the School OPEB fund report no net assets held in trust for other post-employment benefits. We further noted, the total assets reported by the two funds are comprised of only receivables and amounts due from other funds. The amount due from other funds in both the State OPEB fund and the School OPEB fund which totals $41 million is due from the SHBP and represents more than two thirds of the total assets reported in each of the two trust funds. As noted above the SHBP reported negative net assets of $272 million at June 30, 2012.

We understand management recognizes these shortfalls and the reduction of assets used to satisfy claims and have communicated their concerns to appropriate State of Georgia officials. We believe the Department should continue communicating such concerns to appropriate State of Georgia officials.

**MLC-15: Controls Over Cash Receipts**

During our testing of the SHBP, we noted the Eligibility Department maintains various logs of cash receipts for the SHBP. However, no reconciliation was performed between these cash receipt logs and actual deposits to the bank. We noted that all incoming checks for the SHBP Eligibility Department are tracked on a daily basis by the receptionist on a master cash receipts log and that these checks are then routed to the individual Eligibility Specialist responsible for that particular cash receipt. After each specialist updates the MEMS system for each check, the checks are deposited in the bank by one of two designated individuals.

We recommend the deposits to the bank made by each of the two designated individuals for the SHBP be reconciled to the master cash receipts log maintained by the receptionist in the Eligibility Department. We recommend that this reconciliation be performed by someone who is separate from the cash receipts function to ensure that all the receipts were deposited intact and on a timely basis. By establishing this procedure, the Department will be able to more accurately track all incoming cash and strengthen its system of internal controls over cash receipts.