A Financial Review of

The Texas Department of Economic Development

May 2004

Report No. 04-031

State Auditor's Office
Lawrence F. Alwin, CPA
State Auditor

A Financial Review of the

Texas Department of Economic Development

SAO Report No. 04-031
May 2004

Overall Conclusion

The Texas Department of Economic Development (TxED) misclassified $2.8 million of unreserved undesignated fund balance as encumbrances on its balance sheet for the fiscal year ending August 31, 2003. This resulted in a material understatement of its unreserved undesignated fund balance. This means that TxED had $2.8 million more in unspent and unreserved funds than it reported.

We found that fiscal year 2003 expenditure data in TxED's accounting system (MIP) corresponds to the Uniform Statewide Accounting System (USAS); however, we also found accounting deficiencies in MIP that negatively affected MIP's accuracy and reliability. For example, TxED has not yet closed out MIP for fiscal year 2003. We have made recommendations to improve controls over MIP because the Office of the Governor reports that it may use TxED's accounting system as one of the data sources for TxED's fiscal year 2004 and 2005 financial statements. After fiscal year 2005, the Office of the Governor will discontinue using this accounting system.

Background

Senate Bill 275, 78th Legislature, abolished the Texas Department of Economic Development (TxED) effective September 1, 2003, and transferred certain TxED functions to the newly created Office of Economic Development and Tourism within the Office of the Governor.

The Office of the Governor's Accounting Division, which retained some TxED staff, assumed accounting responsibility for TxED. These former TxED staff prepared TxED's fiscal year 2003 annual financial report.

The Department of Economic Development was abolished effective September 2003, and its functions were transferred to the newly created Office of Economic Development and Tourism within the Office of the Governor. We performed this audit at the request of the Office of the Governor.

Summary of Information Technology Review

Our information technology work on this audit consisted of testing the accuracy and reliability of fiscal year 2003 expenditure data in TxED's accounting system. As discussed above, a reconciliation of the accounting system to USAS did not identify any material misstatements or omissions.

State Auditor's Office
Lawrence F. Alwin, CPA
State Auditor

This audit was conducted in accordance with Government Code, Section 321.0131.

For more information regarding this report, please contact Nick Villalpando, Audit Manager, at (512) 936-9500.

Detailed Results

Chapter 1

TxED's Fiscal Year 2003 Balance Sheet Contained a $2.8 Million Material Misclassification of Fund Balance and Other Errors

The Texas Department of Economic Development (TxED) misclassified $2.8 million of unreserved undesignated fund balance as encumbrances on its balance sheet for the fiscal year ending August 31, 2003. This means that TxED had $2.8 million more in unspent and unreserved funds than it reported. In addition, TxED incorrectly reported $425,747 as encumbrances rather than as accounts payable. These inaccuracies were the result of undetected accounting errors and the incorrect application of generally accepted accounting principles.

Other misapplications of accounting principles, weak internal controls, and undetected errors resulted in inaccurate reporting. The appendix documents all of our recommended adjustments to TxED's fiscal year 2003 balance sheet.

Chapter 1-A

TxED Made Errors in Accounting for Funds, which Resulted in a Material Misclassification of Fund Balance

Undetected accounting errors caused a $2.8 million misclassification of fund balance. TxED erroneously reported $2.8 million of unreserved undesignated fund balance as encumbrances on its balance sheet. Over half of this misclassification on the balance sheet was specifically caused by an undetected error in one of TxED's encumbrance ledgers.

TxED also incorrectly reported $425,747 of accounts payable as encumbrances. These transactions should have been recorded as accounts payable because they were for goods or services that TxED had received but had not paid for during the fiscal year. Encumbrances, however, are expenses that an entity anticipates incurring in the future for goods and services that it has contracted to receive.

Capital Access Program

The Capital Access Program provides access to capital for small and medium businesses and nonprofit organizations that may otherwise fall outside conventional lending guidelines. When a lender enrolls a loan in the program, the borrower, the lender, and the State contribute a percentage of the loan into a loan loss reserve account held at the lender's facility. Each lender has one account containing the pooled contributions for all of the lender's enrolled loans. If a loan in the lender's enrolled portfolio defaults, the lender may make a claim against the loan loss reserve account. All enrollments and claims are subject to TxED's approval.

In addition, TxED made the following errors in accounting for transactions in the Capital Access Program Loan Loss Reserve Fund (see text box):

- TxED incorrectly recognized $116,429 in state contributions to loan loss reserve accounts as revenue instead of as transfers to the account. The Office of the Comptroller of Public Accounts (Comptroller) prescribes that these contributions are transfers. This error affected the accuracy of TxED's income statement.
- Although TxED reported the Loan Loss Reserve Fund in its annual financial report, as recommended in our previous audit (*An Audit Report on the Capital Access, Defense Economic Adjustment Assistance Grant, and Tourism Programs at the Department of Economic Development,* SAO Report No. 03-

034, May 2003), it has not yet recognized the Loan Loss Reserve Fund's contingent liability associated with defaults of existing loans. (Contingent liabilities are potential losses that depend on uncertain future events.) In fiscal year 2003, defaulted loans resulted in claims against the Loan Loss Reserve Fund totaling $550,036.

Generally accepted accounting principles require the recognition of a contingent liability as a current expense and a payable if the amount of the loss can be reasonably estimated. Recording a current expense and payable would also decrease the fund balance on the balance sheet. If the loss cannot be reasonably estimated, TxED is still required to disclose it in its financial statements.

Recommendations

As the Office of the Governor oversees the preparation of TxED's financial statements, it should:

- Ensure that there are adequate quality control processes for new accounting procedures used to produce TxED's financial reports, such as the balance sheet.
- Ensure that TxED's financial statements are in full compliance with Comptroller reporting requirements and generally accepted accounting principles.
- Determine whether the potential loss associated with defaults of existing loans in the Capital Access Program can be reasonably estimated. If so, the potential loss should be reported as a current expense with an associated payable. If not, the contingent liability should be disclosed in a note to the financial statements.

Management's Response

The Office of the Governor intends to supervise the preparation of the financial statements required for close out of financial activity of the Texas Department of Economic Development. This will include preparation of annual financial reports for fiscal year 2004 and, if necessary, for fiscal year 2005. The supervision and review processes will ensure that reports are accurate, complete and in compliance with all applicable requirements.

As the Office of the Governor assumes reporting responsibilities in its own report for programs formerly operated at the Texas Department of Economic Development, such as the Capital Access Program, documentation will be prepared detailing procedures for reporting these financial activities and balances. Particular attention will be paid to the reporting of the Capital Access Program and its Loan Loss Reserve account.

Chapter 1-B

Internal Control Weaknesses Caused Inaccuracies in Two Accounts

Two accounts on TxED's fiscal year 2003 balance sheet contain inaccuracies caused by internal control weaknesses: Loans and Contracts was overstated by approximately $67,000, and Restricted Cash in Bank was understated by approximately $150,000. These weaknesses, described below, existed before TxED was transferred to the Office of the Governor.

Texas Leverage Fund (Loans and Contracts). Leverage Fund staff calculated but did not consistently distribute current loan amortization schedules to all affected parties in a timely manner when interest rates fluctuated. As a result, Leverage Fund staff, TxED accounting staff, and Leverage Fund borrowers all provided different amounts for current loan balances. Leverage Fund loans have floating interest rates, and each group used a different amortization schedule to report balances as of August 31, 2003. Leverage Fund staff created and used many different Loans and Contracts amortization schedules without ensuring that all parties used a single, correct, and current authoritative version.

Unless all parties have current and accurate amortization schedules, they will have differing loan balances and calculations for loan interest paid by the borrowers. Leverage Fund staff members recently reconciled all loan files and are beginning to track the loans electronically. Additionally, staff members are planning to provide all parties with current amortization schedules.

Loan Loss Reserve Fund (Cash in Bank). In our May 2003 audit, we found that TxED was not adequately monitoring lenders participating in the Capital Access Program. As a result, lenders were not submitting statutorily required reports and were making unauthorized withdrawals from the Loan Loss Reserve Fund.

Currently, the Office of the Governor has not completely reconciled all bank statements with the database it uses to account for the loans. Failing to ensure that all accounts are reconciled in a timely manner weakens the Office of the Governor's ability to monitor lenders' activities. It is also difficult to determine the exact account balance without current reconciliations. For the reconciliations that have been performed, we observed that Capital Access Program staff members are not following all the newly created procedures. For example, they keep a running account balance rather than showing the lender balances matched at a point in time on the reconciliations.

Recommendations

The Office of the Governor should complete its efforts to strengthen processes in the Texas Leverage Fund and Capital Access Program that ensure accurate reporting of financial data.

Texas Leverage Fund staff should:

- Determine correct current balances for all loans.
- Ensure that all borrowers consistently receive updated amortization schedules in a timely manner when interest rates change.

Capital Access Program staff should:

- Follow all current procedures for reconciling the statements from the lender banks to the Capital Access Program database.

- Complete these reconciliations in a timely manner.

Management's Response

Texas Leverage Fund Response:

- *Staff has determined correct current balances for all loans. These balances have been certified by the Office of the Governor's Accounting Department.*
- *The prime interest rate has not changed since 09/01/2003. To ensure timeliness of delivery of new amortization schedules when interest rates change in the future, the Division will deliver the schedules to all parties electronically.*

Capital Access Response:

Staff continues to reconcile outstanding accounts. Completed reconciliations are certified by the Office of the Governor's Accounting Department at static intervals and are continuously monitored in accordance with newly created procedures.

Chapter 2

Although Fiscal Year 2003 Expenditure Data in MIP Corresponds to USAS, Accounting Deficiencies Negatively Affect MIP's Accuracy and Reliability

We found that fiscal year 2003 expenditure data in TxED's accounting system (MIP) corresponds to the Uniform Statewide Accounting System (USAS); however, we also found that accounting deficiencies in MIP negatively affected MIP's accuracy and reliability. Specifically:

- TxED has not yet closed out MIP for fiscal year 2003. Until MIP is closed out for the last fiscal year, all fiscal year 2003 balances and beginning year fiscal year 2004 balances can continue to change. We also reported this issue in our May 2003 report, when we noted that TxED had not closed out MIP for fiscal year 2001 as of the report issue date. TxED has since closed out fiscal years 2001 and 2002.
- Efficient reconciliation of MIP to USAS requires considerable assistance from personnel with knowledge of system data and processing. It is difficult to reconcile MIP and USAS because some transactions are not referenced the same way in both systems.
- TxED has not yet set up the Loan Loss Reserve Fund in MIP. A recommendation to do so was also included in our May 2003 report.
- Neither TxED nor the Office of the Governor could directly download MIP data and change it into a usable format. Therefore, the Office of the Governor's accounting staff had to run a query in MIP to extract the data we needed. Because we were unable to directly download the data, we cannot certify that we received all necessary MIP data.

We have made recommendations to improve controls over MIP because the Office of the Governor reports that it may use TxED's accounting system as one of the data sources for TxED's fiscal year 2004 and 2005 financial statements. After fiscal year 2005, the Office of the Governor will discontinue using this accounting system.

Recommendations

The Office of the Governor should ensure that all Office of Economic Development and Tourism financial data entered into the Office of the Governor's internal accounting system can be easily reconciled to USAS. The Office of the Governor should also determine whether it would be more cost-effective to update and maintain MIP or find a different way to obtain the financial data it needs from TxED.

If the Office of the Governor chooses to continue using MIP, it should do the following until the final close-out of MIP:

- Close out fiscal year 2003 and ensure that yearly close-outs occur in a timely manner.

- Create new procedures for entering and structuring data in MIP to ensure that MIP entries can be easily traced to USAS.
- Consider resolving accounting deficiencies with MIP, such as the absence of the Loan Loss Reserve Fund.

Management's Response

Close out of fiscal year 2003 data is planned to occur following completion of this audit. Recommended adjustments from the State Auditor's Office will be thoroughly reviewed; action taken on those recommendations will be determined based on this review. Adjusting entries that affect balances in USAS will be considered as possible prior period adjustments.

Financial data for the Office of Economic Development and Tourism is processed in the same manner as financial data for all divisions within the Office of the Governor. No problems have been experienced or are anticipated in reconciling this data to USAS.

Entries for the Loan Loss Reserve Fund are planned to be added. Data from TxED's MIP, TxED program records, and USAS will be reviewed and reconciled to determine proper beginning balances for accounts to be reported by the Governor's Office in FY 2004.

Other Information

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to determine whether:

- The Texas Department of Economic Development (TxED) accurately represented its assets, liabilities, and fund reserve balances in its annual financial report for fiscal year 2003.
- Information in TxED's internal accounting system is accurate and reliable and if it corresponds to the information maintained in the Uniform Statewide Accounting System (USAS).

This audit was added to our audit plan as a result of a request from the Office of the Governor.

Scope

This audit covered the assets, liabilities, and fund reserve balances reported in TxED's fiscal year 2003 annual financial report, its internal accounting system (MIP), and in USAS. We also audited expenditure data in MIP for fiscal year 2003.

Methodology

We gained an understanding of TxED's overall control structure (control environment, control procedures, and accounting systems) to enable us to audit all balance sheet accounts. We tested internal controls, as needed, and audited all balance sheet accounts, either directly or through auditing another account, to try to determine accurate balances for all accounts. Tests of account balances included tests of detailed supporting transactions and analytic procedures. We examined a random sample of employees to test the accuracy of compensable leave calculation by projecting the results across the population. In addition, we interviewed former TxED personnel and reviewed the annual financial statements.

Project Information

Audit fieldwork was conducted from February 2004 through April 2004. We conducted this audit in accordance with generally accepted government auditing standards. The following members of the State Auditor's staff performed the audit:

- Greg Adams, CPA, CGFM, MPA (Project Manager)
- Donna Hopson, CPA (Assistant Project Manager)
- Kathy Aven
- Fred Bednarski
- Serra Tamur, MPAff, CISA

- Mary Wise, CPA
- Dennis Ray Bushnell, CPA (Quality Control Reviewer)
- Nick Villalpando, CPA (Audit Manager)
- Frank N. Vito, CPA (Audit Director)

Appendix

Adjusted Fiscal Year 2003 Balance Sheet

Account	Governmental and Enterprise Funds		
	Amounts Reported	Adjustments Needed	Adjusted Amounts
Assets			
Current Assets			
Cash:			
Cash on Hand			
Cash in Bank	$ 10,050	$ 0	$ 10,050
Cash in State Treasury	35,280,009	0	35,280,009
Legislative Appropriations	1,465,846	0	1,465,846
Receivables from:			
Federal	1,030,805	(416) [a]	1,030,389
Interest and Dividends	0	64,291 [b]	64,291
Other	0	0	0
Bad Debt Reserve	0	0	0
Interfund Receivable	0	0	0
Due from Trustee	0	66,786 [b]	66,786
Consumable Inventories	63,760	(46,959) [c]	17,590
		789 [c]	
Prepaid Postage	0	46,959 [c]	100,337
		51,626 [c]	
		1,752 [c]	
Deferred Charges	278,792	(278,792) [d]	0
		(51,626) [c]	
		51,626 [e]	
Loans and Contracts	11,095,961	(66,786) [b]	10,980,684
		(48,491) [f]	
Total Current Assets	**$ 49,225,223**	**$ (209,241)**	**$ 49,015,982**
Non-Current Assets			
Restricted:			
Cash and Cash Equivalents:			
Cash in Bank	$ 1,013,778	$ 150,073 [g]	$ 1,163,851
Due from Others (Loan Loss Reserve Account [LLRA] fund 9999)		9,500 [g]	9,500
Cash in State Treasury	0	0	0
Capital Assets:			
Depreciable			
Furniture & Equipment	719,288	6,738 [h]	726,026
Accumulated Depreciation	(690,959)	(6,738) [h]	(697,697)
Other Capital Assets	0	0	0

Account	Governmental and Enterprise Funds						
		Amounts Reported		Adjustments Needed			Adjusted Amounts
Total Assets	**$**	**50,267,330**	**$**	**(49,668)**		**$**	**50,217,662**
Liabilities and Fund Balance							
Current Liabilities							
Payables							
Accounts Payable	$	1,615,706	$	(416)	a	$	1,860,615
				29,272	i		
				(291)	j		
				(575)	i		
				(208,828)	k		
				425,747	l		
Payroll Payable		220,310		291	j		472,575
				12,267	j		
				236,066	j		
				3,641	j		
Other		15,908		(12,267)	j		0
				(3,641)	j		
Interfund Payable		0		0			0
Employees' Compensable Leave – Short Term		226,920		208,828	k		435,748
Notes and Loans Payable		13,258,000		0			13,258,000
Deferred Revenue (Loan Loss Reserve Acct [LLRA])		0		87,791	g		87,791
Due to Other Funds (LLRA to 5035 Capital Acc)		0		9,500	g		9,500
Total Current Liabilities	**$**	**15,336,844**	**$**	**787,385**		**$**	**16,124,229**
Non-Current Liabilities							
Employees' Compensable Leave	$	161,843	$	(231)	m	$	161,612
Total Non-Current Liabilities	**$**	**161,843**	**$**	**(231)**		**$**	**161,612**
Total Liabilities	**$**	**15,498,687**	**$**	**787,154**		**$**	**16,285,841**
Fund Financial Statement - Fund Balances							
Fund Balances (Deficits)							
Reserved for:							
Encumbrances	$	3,987,984	$	(91,324)	l	$	675,262
				(3,221,398)	l		
Inventories		16,801		789	c		17,590
Imprest		10,050		0			10,050
Unreserved Designated for:							
Other		23,198,564		60			23,198,624
Undesignated		6,256,742		1,752	c		9,104,889
				(48,491)	f		
				62,282	g		
				9,500	g		
				(9,500)	g		

Account	Governmental and Enterprise Funds						
		Amounts Reported		Adjustments Needed			Adjusted Amounts
				(27,650)	i		
				(236,066)	j		
				575	i		
				208,828	k		
				91,324	l		
				2,795,593	l		
Total Fund Balances	**$**	**33,470,141**	**$**	**(463,726)**		**$**	**33,006,415**
Total Liabilities and Fund Balance	**$**	**48,968,828**	**$**	**323,428**		**$**	**49,292,256**

Government-Wide Statement - Net Assets

Net Assets:							
Unrestricted	$	1,710,563	$	(278,792)	d	$	1,494,437
				64,291	b		
				(1,625)	i		
Invested in Capital Assets, Net of Related Debt		28,329		0			28,329
Restricted for Debt Retirement		(388,763)		(208,828)	k		(597,360)
				231	m		
Total Net Assets:	**$**	**1,350,129**	**$**	**(424,723)**		**$**	**925,406**

Explanation of Adjustments

a. TxED incorrectly stated balances relating to a federal pass-through grant, resulting in the following adjustments:
   - Accounts Receivable was overstated by $416.
   - Accounts Payable was overstated by $416.

b. TxED understated August 2003 loan payments due from the trustee for its Leverage Fund program, resulting in the following adjustments:
   - Increases of $64,291 in both Interest Receivables and Net Assets – Unrestricted.
   - An increase in Due from Trustee and a decrease in Loans and Contracts for $66,786.

c. TxED incorrectly stated balances for Consumable Inventories and Prepaid Postage, resulting in the following adjustments:
   - Consumable Inventories decreases and Prepaid Postage increases by $46,959 due to TxED incorrectly classifying Prepaid Postage as a Consumable Inventory.
   - Increases of $789 in both Consumable Inventories and Reserve for Inventories due to errors made in supporting schedules' balances. TxED incorrectly calculated the actual inventory amounts.
   - Prepaid Postage increases and Deferred Charges decreases by $51,626 because TxED incorrectly classified Prepaid Postage as a Deferred Charge.
   - Increases of $1,752 in both Prepaid Postage and Fund Balance – Unreserved, Undesignated to adjust balance to supporting documentation amount. TxED understated the amount of prepaid postage verified by the post office.

d. TxED reported $278,792 in deferred charges for start-up costs from prior years associated with the Leverage Fund program. No supporting documentation could be found to identify the nature and timing of these charges. As a result, the following adjustments were made: a decrease to Deferred Charges and a decrease to Net Assets – Unrestricted for $278,792.

e. An adjustment adding $51,626 to Deferred Charges was needed because this amount was omitted from the combined Balance Sheet/Statement of Net Assets for Governmental Funds on the Annual Financial Report (AFR). This amount was included on the supporting schedules in Exhibit A-1 of the AFR.

f. An adjustment to Loans and Contracts was made because TxED could find no supporting documentation to support this balance. A decrease in Fund Balance – Unreserved, Undesignated and a decrease in Loans and Contracts were made, each for $48,491.

g. TxED incorrectly reported the balance in the Loan Loss Reserve Account. Reconciling items existed at year-end that were not reflected in the AFR balance. This error resulted in the following adjustments:
   - An increase in Restricted Cash by $150,073
   - An increase in Due from Others (due to LLRA fund 9999) by $9,500
   - An increase in Deferred Revenue (LLRA) by $87,791
   - An increase in Due to Others (due to fund 5035) by $9,500
   - An increase in Fund Balance – Unreserved - Undesignated by $62,282
   - An increase in Fund Balance – Unreserved - Undesignated (fund 5035) by $9,500
   - A decrease in Fund Balance – Unreserved – Undesignated (fund 9999) by $9,500

h. TxED incorrectly reported the balance in Capital Assets. Furniture & Equipment and Accumulated Depreciation were both understated by $6,738.

i. TxED understated the Accounts Payable balance by $84,166, resulting in the following adjustments:
   - A decrease in Accounts Payable for $416 (see Note a.)
   - An increase in Accounts Payable for $29,272,
   - A decrease to Fund Balance – Undesignated for $27,650,
   - A decrease in Accounts Payable and an increase in Fund Balance – Undesignated for $575. This amount was incorrectly included twice in the Accounts Payable balance.
   - A decrease in Accounts Payable of $208,828 (see Note k.)
   - An increase in Accounts Payable of $265,005 (see Note l.)
   - A decrease in Net Assets – Unrestricted for $1,625 to accrue expenditures incurred but not yet paid.
   - A decrease in Accounts Payable for $291 (see Note j.)

j. TxED understated the Payroll Payable balance by $252,265, resulting in the following adjustments:
   - A decrease in Accounts Payable and an increase in Payroll Payable for $291. This amount was incorrectly recorded in Accounts Payable.
   - An increase in Payroll Payable and a decrease in Payables - Other for $12,267. This amount was incorrectly recorded in Payables - Other.
   - An increase in Payroll Payable and a decrease in Fund Balance for $236,066. This balance was understated due to some incorrect reversing entries made by TxED.
   - An increase in Payroll Payable and a decrease in Payables - Other for $3,641. This adjustment is to correct a balance incorrectly recorded as Payables - Other instead of a Payroll Payable.

k. TxED understated the Employees' Compensable Leave – Short Term balance by $208,828 and should make the following adjustments: A decrease in Accounts Payable, an increase in Employees' Compensable Leave, an increase in Fund Balance, and a decrease in Net Assets Restricted for Debt Retirement, each for $208,828. These adjustments are to move the balance incorrectly recorded in Accounts Payable to Employees' Compensable Leave.

l. TxED overstated the balance for Encumbrances by $3,312,722, resulting in the following adjustments:
   - An increase in Accounts Payable for $423,824. This increase is for expenditures that were incurred during the year but not yet paid at year end.
   - A decrease in Reserved for Encumbrances and an increase in Fund Balance – Unreserved, Undesignated for $91,324. This balance was incorrectly reported as a Reserve for Encumbrances by TxED.
   - A decrease in Reserved for Encumbrances for $3,221,398. This is due to encumbered amounts that were actually paid during the year but had not been liquidated out of the reserved amount.
   - An increase in Fund Balance – Unreserved, Undesignated for $2,797,516 and an increase in Fund Balance Unreserved, Designated for Other for $60.

m. A decrease in Employees' Compensable Leave – Long Term and a decrease in Restricted for Debt Retirement for $231. This is to adjust the balance due at year-end to the actual amount owed by TxED.

Distribution Information

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Tom Craddick, Speaker of the House, Joint Chair
The Honorable Steve Ogden, Senate Finance Committee
The Honorable Thomas "Tommy" Williams, Senate
The Honorable Talmadge Heflin, House Appropriations Committee
The Honorable Brian McCall, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor
Mr. Mike Toomey, Chief of Staff
Mr. Jeff Moseley, Director, Office of Economic Development and Tourism