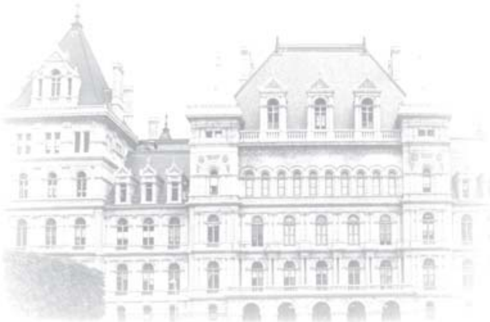

Financial & Audit Solutions

June 2006 ♦ Volume VIII ♦ Issue 3

Office of the State Comptroller | Alan G. Hevesi | Division of State Services

Most State agencies have interacted on numerous occasions with the various busines units that comprise the State Financial Services Group within OSC. During the next several issues, *Financial and Audit Solutions* will be presenting an overview of each of the organizational areas in the Group, beginning with the Bureau of State Expenditures. These overviews will provide the reader with a glimpse behind the scenes and explain how each unit in the Group works with other State agencies on an ongoing basis.

Risk-Based Contract Monitoring

Picture this – Bureau of State Expenditures auditors inform you at a closing conference about any one of the following scenarios:

· You paid over $1.5 million for registered nurses to perform services for wards of the State, not knowing that these "nurses" were not licensed or registered to practice in New York State.

· You paid over $3 million for security guards who were not appropriately registered with the Department of State and were grossly unqualified. Some guards tested positive for drug use, some had fake social security cards, and one was found drinking alcohol on the job.

· Your agency paid for maintenance people to work eight-hour shifts but the maintenance workers only clocked in six hours per day. Over time, this added up to over $100,000 for hours no one worked.

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The Bureau of State Expenditures

The Bureau of State Expenditures is responsible for carrying out the Comptroller's Constitutional mandate to audit all State transactions and refunds before payment. Using a risk-based audit approach, the Bureau works to improve State government by identifying fraudulent, wasteful and improper transactions. The combined actions of Bureau staff also have the effect of helping to improve the State's financial management system.

The Bureau audits about 35 million payments totaling more than $100 billion each year. The agencies audited are diverse and deliver essential services in areas such as: health, corrections, education, law enforcement, transportation and many more.

Bureau auditors play a key role in safeguarding State assets by applying state-of-the-art, innovative forensic audit techniques to identify patterns and trends indicative of fraud, waste or improper payments. By using these techniques, the Bureau has found:

· State employees operating their private businesses from their State offices

· Shell companies created by State employees who submitted fraudulent invoices for goods and services never delivered

· Unlicensed physicians providing services to State clients

· Security guard companies providing unregistered and unqualified services to State agencies

· Taxpayers poised to receive millions

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This Issue

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Contract Thresholds ⁎ Payroll's Agency Report Card Sees Results
Accounting and Financial Reporting for Derivatives ⁎ Comptroller's Bureau of Contracts' Statistics

Contract Thresholds

Contract Reporter Advertisement and Procurement Thresholds

Certain discretionary procurement thresholds have been increased (see below), but the Contract Reporter advertisement threshold has not been changed. What this means to procuring agencies is that while they do not have to undertake formal procurements for goods and services under the thresholds described below, they must advertise their discretionary purchases in the Contract Reporter when they exceed $15,000. Be sure to allow time for the required advertising when developing your timelines for informal procurements. We will consider exemption requests for emergency purchases or extraordinary circumstances.

Discretionary Thresholds

State agencies (other than SUNY/CUNY) may now purchase services and commodities under Section 163 of the State Finance Law in an amount not exceeding $50,000 ($85,000 for OGS) without a formal competitive process. This threshold was formerly $15,000.

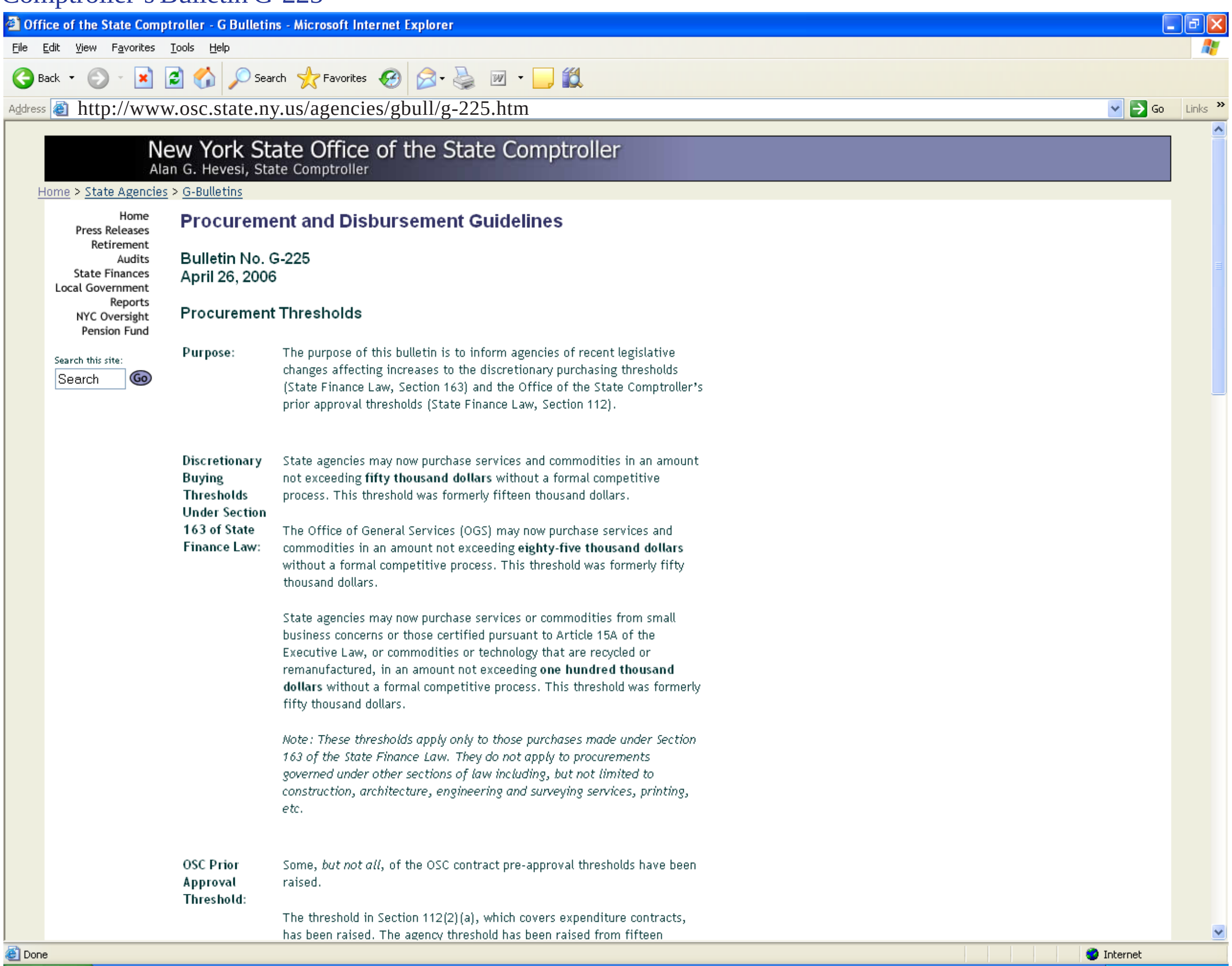
State agencies may now purchase services or commodities from small business concerns or those Minority or Women Owned Businesses certified pursuant to Article 15A of the Executive Law, or commodities or technology that are recycled or remanufactured, in an amount not exceeding $100,000 without a formal competitive process. This threshold was formerly $50,000.

OSC Prior Approval Threshold

Generally the threshold for OSC prior approval has been increased from $15,000 to $50,000. One exception is OGS, whose threshold has been raised from $30,000 to $85,000. Also, the threshold did not change for contracts such as revenue contracts where the State agrees to a consideration other than the payment of money. The OSC prior approval threshold for these contracts remains at $10,000.

For more information, see Comptroller's Bulletin number G-225 at http://www.osc.state.ny.us/agencies/gbull/g-225.htm.

Comptroller's Bulletin G-225



Office of the State Comptroller - G Bulletins - Microsoft Internet Explorer

Address http://www.osc.state.ny.us/agencies/gbull/g-225.htm

New York State Office of the State Comptroller
Alan G. Hevesi, State Comptroller

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Procurement and Disbursement Guidelines

Bulletin No. G-225
April 26, 2006

Procurement Thresholds

Purpose: The purpose of this bulletin is to inform agencies of recent legislative changes affecting increases to the discretionary purchasing thresholds (State Finance Law, Section 163) and the Office of the State Comptroller's prior approval thresholds (State Finance Law, Section 112).

Discretionary Buying Thresholds Under Section 163 of State Finance Law: State agencies may now purchase services and commodities in an amount not exceeding **fifty thousand dollars** without a formal competitive process. This threshold was formerly fifteen thousand dollars.

The Office of General Services (OGS) may now purchase services and commodities in an amount not exceeding **eighty-five thousand dollars** without a formal competitive process. This threshold was formerly fifty thousand dollars.

State agencies may now purchase services or commodities from small business concerns or those certified pursuant to Article 15A of the Executive Law, or commodities or technology that are recycled or remanufactured, in an amount not exceeding **one hundred thousand dollars** without a formal competitive process. This threshold was formerly fifty thousand dollars.

Note: These thresholds apply only to those purchases made under Section 163 of the State Finance Law. They do not apply to procurements governed under other sections of law including, but not limited to construction, architecture, engineering and surveying services, printing, etc.

OSC Prior Approval Threshold: Some, *but not all*, of the OSC contract pre-approval thresholds have been raised.

The threshold in Section 112(2)(a), which covers expenditure contracts, has been raised. The agency threshold has been raised from fifteen

Payroll's Agency Report Card Sees Results

As reported in previous issues of Solutions, OSC's Bureau of State Payroll Services and the NYS Payroll Users Group have worked together for several years to identify and develop performance measures that could help OSC and State agencies assess payroll timeliness and accuracy, and the overall quality of payroll services.

Statewide performance standards to evaluate the performance of State agency payroll offices were established in two categories: Hires, when processed late, can result in late payments to employees and possible delays in providing employee benefits; and terminations, when processed late, result in potential overpayments to former employees and additional staff time to recover overpayments and correct payroll records.

The results of these measurements are communicated to State agencies on an "Agency Report Card" twice a year. The sixth statewide distribution of report cards occurred last month. Since the inception of the report card initiative, there has been dramatic improvement in on-time hire and termination rates. The current (FY 2005-06) statewide rates are 86.7% for on-time hires and 94% for on-time terminations.

This information is useful not only to payroll offices, but also to an agency's fiscal and human resource office. These offices can be adversely impacted when payroll operations are not executed in an efficient and effective manner. It's not just payroll offices that are responsible for results; fiscal, human resource, and program offices also play a vital role.

Recognizing the interdependence of payroll with other units within an agency, OSC disseminated the Agency Report Cards to agency human resource directors, fiscal officers and payroll officers as a way to reinforce the importance of collaboration between different areas of an agency in order to achieve desired outcomes.

According to a payroll survey conducted by the Bureau of State Payroll Services earlier this year, over 76% of the 111 agency payroll officers who responded viewed the report card initiative favorably and 63% said they are using the results. About one-quarter of those agencies changed their business practices and others are using the report card as a tool to improve internal controls, training and communication among their various offices. Robin Rabii, Director of the Bureau, has encouraged payroll officers to work with their human resource and fiscal officers and program areas to analyze the report card data and improve practices that will increase the number of on-time hires and terminations. "These efforts can and do lead to successful performance, and will ultimately translate into better quality of services for our employees," Mr. Rabii noted.

To honor and applaud that successful performance, the third annual Comptroller's Payroll Achievement Awards ceremony will be held on June 26 in Albany. At that time, State agencies will be recognized for outstanding payroll performance. Congratulations to this year's Statewide winners: Department of Correctional Services Training Academy; Downstate, Sullivan, Groveland and Cape Vincent Correctional Facilities; Willard Drug Treatment Center; Legislative Bill Drafting Commission; Industrial Exhibit Authority; College of Staten Island; CUNY Management and Programs; and Suffolk County Judges Tenth Judicial District.

The list of the agency Gold Star Award winners is listed on OSC's website at www.osc.state.ny.us/payroll/achieve2006.htm.

Accounting and Financial Reporting for Derivatives

The Governmental Accounting Standards Board (GASB) today issued a Preliminary Views document that intends to improve the accounting and financial reporting of derivatives by state and local governments.

The proposal would require that the fair value of derivatives be reported in the financial statements as well as the change in that fair value. If, however, a derivative is effectively hedging (reducing) the risk it was created to address, then the annual changes in the derivative's fair value would be deferred and reported in a government's balance sheet. Governments also would disclose additional information about their derivatives in the notes to the financial statements.

A Few Basic Questions and Answers

1. What is the GASB?

The Governmental Accounting Standards Board or GASB is a private, independent, not-for-profit organization that—through an open and thorough due process—establishes and improves standards of financial accounting and reporting for state and local government.

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Risk-Based Contract Monitoring

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· Your agency's fiscal manager directed a contractor to renovate his mother's house to the tune of $96,000 of the State's money.
· A construction contractor overcharged the State $3.3 million for insurance and equipment costs.

Would you want to see this information printed in newspapers in your area? Of course not. Do you want to know how to avoid similar situations at your agency in the future? This article will tell you how. It's all about risk-based contract monitoring.

What is contract monitoring?

Monitoring is defined as ongoing activities, special evaluations, or a combination of both, used to ensure that controls, and ultimately the vendors, are operating as intended. Intent is best documented in comprehensive, clear contract specifications.

Monitoring can consist of procedures performed on a test basis, such as physical inspection to ensure that orders are being delivered and the controls over the ordering/receiving process are operating as intended. Or, it can be an overall evaluation to ensure that the process is operating as desired. This can be a self-evaluation, an internal audit of the process or an external evaluation.

Why is contract monitoring important?

In fiscal year 2004-2005, State agencies paid about $23 billion for goods and services. As of May 31, 2006, agencies had about 41,000 active contracts worth over $141 billion. As public servants, we each play a critical role in ensuring that the State gets what it pays for.

There are two times in the lifecycle of a contract when it's most vulnerable or at risk for fraud or abuse. These are: (1) when the contract is first put in place before monitoring systems are set up or running effectively; and (2) when the contract has been in place for some time and the agency employee no longer monitors the contract closely.

Engaging in effective contract monitoring reduces the opportunity of overpayment occurring and decreases the chance of fraud, waste and abuse. It does this by increasing the employees' knowledge of what to expect from the contract and by setting concrete expectations for the vendor. If the vendor knows you are paying attention and ensuring you only pay for goods or services that are delivered according to the contract specifications, they will be less likely to try to overcharge you.

Who should perform contract monitoring?

Not everyone can be an effective contract monitor. That's why it is important to select the right people for the job. Monitors should be knowledgeable about the contract specifications, have good communication skills, maintain professional skepticism and have the courage and management support to hold the vendor accountable for their actions.

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Comptroller's Bureau of Contracts' Statistics

In the fiscal year ending March 2006, OSC's Bureau of Contracts reviewed 44,341 contract transactions valued at $59.7 billion dollars, representing a 7% increase in reviewed contracts and an increase of $30 billion dollars from the prior year. The enormous increase in dollars is due to some very large multi-year contracts OSC reviewed in the fiscal year ended March 2006. They included $20 billion dollars for 24 multi-year contracts for the Family Health Plus Program and two contracts for the Empire Plan prescription drug plan, one

of which was approved and one of which was not approved.

While it is difficult to project to what extent the new, higher pre-audit threshold will affect the number of contract transactions submitted for OSC Pre-Audit, we estimate a 23% reduction in transaction volume with only a 1% decrease in the dollar value of contracts subject to prior review. This will provide administrative efficiency to both OSC and agencies and allow a greater focus on transactions with higher risk.

Risk-Based Contract Monitoring

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Five-step Process To Risk-Based Contract Monitoring

When OSC Bureau of State Expenditures auditors schedule a visit to your agency to review payments made under a certain contract, wouldn't you rather they chose a contract you were already effectively monitoring? It's a sure-fire way to have a short experience with the auditors.

When State Expenditures auditors decide to audit payments under a contract, it's because they have gone through a five-step process to identify contracts with the highest likelihood of fraud, waste and abuse and the biggest impact if it is happening. Monitoring is not that far from auditing. In fact, if you look at the five-step processes for auditing and contract monitoring side-by-side, you'll see only two differences:

Five Steps	Monitoring	Auditing
1. Identify Risky Contracts	Yes	Yes
2. Understand Contract Specifications	Yes	Yes
3. Assess Risk	Yes	Yes
4. System to Test Risk	**Ongoing monitoring**	**Limited audit tests**
5. Follow Up On Anomalies	**Investigate internally or with vendor**	**Expanded audit**

1. Identify Risky Contracts

It is not cost-effective to apply the same level of monitoring to every single contract. Agencies just don't have the resources. That's why this process is called risk-based contract monitoring – the first step is to identify risky contracts based on several factors. This way, you can leverage your resources to target the highest risk areas.

You should consider enhancing your monitoring of contracts that are for high dollar amounts, present a potential risk to the health and safety of New York State citizens, or could potentially cause damage to the agency's or the State's reputation.

It is important to study fraud schemes and select contracts most susceptible to those schemes. Plug into the fraud mindset by visiting the website for the Association of Certified Fraud Examiners (ACFE) (http://www.acfe.com, www.albanyacfe.org), attending continuing education offered by the ACFE or OSC, or subscribing to Google News Alerts (http://www.google.com/alerts?hl=en) with key words like "fraud," "kickbacks," "bribes," "falsified" or the name of a vendor whose contract you're going to monitor. Information you gain here can help you select which contracts to monitor.

2. Understand Contract Specifications

How do agency employees and vendors know what is required under the contract? The best way to determine what is required is by looking at the contract specifications. This is why it's important that the contract contain clear specifications.

Contract specifications should be detailed enough so that they're easily understood by both the agency and the vendor. They should include information such as:

- · Outline of deliverables with both descriptions and benchmarks
- · Performance measures including quantities, timing, expertise, licenses, degrees, required test results, etc.
- · Payment provisions such as payment triggers and invoice formats
- · For service contracts, invoices should include information such as: names of workers performing services, hours for each worker, etc.
- · Reporting requirements, such as whether records should be provided in electronic or paper format and how often the vendor should submit reports
- · Clarification that records should be retained for a minimum of six years and that the agency and OSC have the right to audit
- · Penalties for non-compliance.

Before letting the contract, it is important to think about how clear and detailed the specifications are and how agency personnel will be able to monitor them. If you take this into consideration from the beginning, it makes monitoring much easier. For example, instead of writing a contract specification that calls for "periodic maintenance" of equipment, write a specification that calls for "annual maintenance" with details about what maintenance tasks should be performed, when they should be performed and who is responsible for making sure they are performed. Even if you didn't design the specifications with this in mind, you may be able to arrive at a reasonable understanding of expected deliverables by analyzing the contract to see what the vendor is supposed to provide.

3. Assess Risks

The next step is to call a meeting to brainstorm how the vendor could possibly "beat" the agency on each contract specification. For example, if the contract calls for services provided by licensed, registered nurses (RN's) for $50 per hour, the vendor could cheat on this specification by providing unlicensed nurses or by charging more than $50 per hour.

Invite staff people, managers, or anyone who specializes in the area and might have a different insight to your brainstorming session. Consider inviting program people as well as finance people. For example, if you want to

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The Bureau of State Expenditures

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Staff of the Bureau of State Expenditures, from left to right: Teresa Mezz, Barbara Akers, Paul Kosachiner and Marian Chaney.

in improper tax refunds
· State employees making fraudulent personal purchases with State funds
· Copier companies charging more than the contract price for equipment and maintenance agreements
· Inmates and State employees collecting unemployment insurance checks
· State managers using taxpayer funds to rehabilitate relatives' homes.

The Bureau's risk-based approach to auditing payment transactions evaluates agencies' processing systems as a whole. Professional audit staff now review systems and examine the agencies' internal controls. Assessments of the control environment, risk assessment process, control activities, information and communication systems and monitoring of operations are completed using the Standards for Internal Controls in New York State Government issued by the Office of the State Comptroller. After all the risk factors are identified and recorded by the Bureau's Knowledge Management Unit, a judgment is made on how well an agency's systems will prevent or detect improper transactions.

Bureau auditing resources are applied relative to the level of risk identified. If the Bureau determines an agency has a low level of risk, then fewer audit resources can be dedicated to auditing the agency's payments. If an agency's risk level is high, more audit resources will be dedicated. No doubt, the Bureau's operational activities result in substantial cost savings for taxpayers and the State as a whole.

Mission Statement

Our mission is to improve State government's fiscal operations and identify fraudulent, wasteful and improper disbursements from State funds.

Accounting and Financial Reporting for Derivatives

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The Board currently has on its agenda an active project to improve the accounting for derivatives by state and local government by encouraging greater consistency and transparency.

2. What is a derivative and how does it benefit state and local governments?

A derivative is often a complex financial arrangement in which two parties agree to make payments to each other. Each party has a different obligation. Derivatives are leveraged and are entered with no or a small initial investment. Most derivatives are entered into with the intent to lower the costs of borrowing, lock-in prices or lower price volatility.

3. What risks do derivatives present?

While a valuable financial instrument, derivatives also present significant risks to governments which users of financial statements should be aware:

· They are complex and it may be difficult to comprehend the precise payment terms.
· There is potential for untimely and material termination payments which may cause a squeeze on a government's liquidity.
· By entering into a derivative contract, a government becomes exposed to the credit risk of the counter party—which overtime could become a concern.
· As a leveraged instrument, changes in markets and prices cause derivative fair values to amplify what has the potential to generate significant fair value gains and losses, and potential termination payments.
· Depending on the structure of the derivative, state and local governments may need special expertise to monitor the transaction.

4. Why is an accounting standard on derivatives by governments necessary?

Current accounting standards for derivatives are not consistent. Many derivatives are reported on the financial statements as their associated cash

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Risk-Based Contract Monitoring

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determine how to monitor a contract for cleaning supplies, consider asking some maintenance people to join the meeting. Identify and target the risks most likely to happen or that would have the most impact if they did. These are the areas you will want to monitor.

4. Design Systems to Address Risks

This is the first difference between auditing a contract and monitoring a contract.

Auditors assess risks and design tests to determine whether the risks are actually occurring. Sometimes these tests yield nothing and auditors learn that the system is working as planned. However, sometimes the auditors find the opposite and discover the system is not working as intended. In these cases, the auditors may find material instances of fraud, waste or abuse like the ones described in the opening paragraphs of this article.

When monitoring a contract, you should identify the risks and design systems to address them. If there is a potential risk of a vendor supplying unlicensed nurses, an agency representative could be assigned the task of verifying the validity of licenses through the State Education Department's website (http://www.op.nysed.gov/opsearches.htm.) In addition, finance office staff can spot check invoices to confirm the information.

There are several ways to monitor, including observation, analysis, independent oversight, unannounced visits, reviewing vendor records and comparison to industry standards. The monitoring method you select should be appropriate based on the associated risk. It's important to design specific monitoring tasks so people know what their roles are, how they're going to document what they find and who they're going to give this documentation to, including information on anomalies.

5. Follow Up on Anomalies

This is the second difference between auditing and monitoring.

If Bureau of State Expenditures auditors find significant anomalies in limited tests, they will conduct an expanded audit. In contrast, if you find anomalies during the process of contract monitoring, you should follow up appropriately. Make sure everyone involved with the monitoring process knows the answers to the following questions: If you find something wrong, what do you do? Who does it? Who communicates it? Who do you communicate it to? You need to ensure anomalies are resolved to everyone's satisfaction and the outcome conforms to contract specifications. You may consider withholding payment until you're sure the vendor delivered according to the contract specifications.

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Accounting and Financial Reporting for Derivatives

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payments are made or received. On the other hand, some derivatives are reported at their fair values. In all cases, current disclosures require information to be disclosed to financial statement users in the notes to the financial statements

Derivatives are highly complex vehicles which can represent significant resources or claims against governmental resources. For example, certain terminations of derivative contracts can have a material impact on a government's financial position. Accordingly, GASB believes that the best way to inform financial statement readers about the use of these instruments is to report them on the face of the financial statements in a consistent manner that reflect their current prices or fair values.

5. What would an accounting standard on derivatives accomplish?

The proposed accounting standard would require derivatives to be reported on the financial statements at their fair values. In cases where a derivative is designed to hedge a future transaction, it must meet certain requirements for changes in the fair value of the derivative to be deferred. (However, ineffectiveness associated with many of these derivatives must be disclosed in the financial statements.)

6. What are the most common misconceptions about governments' use of derivatives?

a. Financial statement users have no information with which to evaluate a government's usage of derivatives. Financial statements of state and local governments are required to disclose the governments' use of derivatives that currently are not reported at fair value. Management's objectives, key terms, fair values, risks assumed, and projected pay-outs are required disclosures.

b. Failure to understand that reducing one risk may increase another. A derivative may be understood to reduce a risk, but there may be no

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Financial & Audit *Solutions*

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Risk-Based Contract Monitoring

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Conclusion

Employing a risk-based contract monitoring approach can save your agency and New York State taxpayers thousands to perhaps millions of dollars and help you avoid embarrassing audit findings. If you are not effectively monitoring your contracts, don't be surprised when State Expenditures auditors come knocking at your door with news of high-impact findings. It really boils down to a race. Who's going to get there first – you, through effective monitoring, or us, through an audit?

If you'd like assistance in addressing anomalies you discovered through contract monitoring, consider contacting the Director of State Expenditures, Bernard McHugh, at (518) 402-4104 or bmchugh@osc.state.ny.us.

If you'd like training in risk-based contract monitoring tailored to your agency, please contact Chris Bielawski, Bureau of State Expenditures, at (518) 408-4349 or cbielawski@osc.state.ny.us.

Coming Soon........

State Financial Services Group's Annual Conference

Details on dates, times, curriculum and location will be announced shortly.

If you are interested in receiving information on the Annual Conference, please e-mail the State Financial Services Group at OutreachSFS@osc.state.ny.us or telephone Kim Peacock at (518) 474-5701.

Accounting and Financial Reporting for Derivatives

Continued from page 7

consideration that other risks may have been increased. Many derivatives represent a way of managing risks. In any given transaction, a specific risk may be reduced while increasing another.

For example, an interest rate swap may be entered to reduce a government's exposure to increasing interest rates. While that swap may address that risk, the intrinsic nature of the swap requires that a counterparty stand ready to make payments to the government in certain circumstances. Whether that counterparty will in the future be able to make those payments exposes the government to the credit risk of the counterparty.