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January 14, 2013

Memorandum:

To: Senator John Arthur Smith, Chairman; Luciano "Lucky" Varela, Vice-Chairman; and Members of the Legislative Finance Committee

From: Maria Griego, LFC Program Evaluator; and Christine Boerner, LFC Fiscal Analyst

Thru: David Abbey, LFC Director; and Charles Sallee, LFC Deputy Director

Re: Status Report of DFA and STO Cash Reconciliation Issues and General Fund Adjustment

Problem. General ledger cash account balances do not match the balance in the state's cash accounts at the bank, which has been a chronic problem dating back to the implementation of SHARE in FY07, and possibly before. In the DFA's FY12 audit submitted to the State Auditor, the DFA reported an entry made against the state's general fund of \$70 million for historical cash variances between SHARE and the bank. However, the agency estimates the variance could be as high as \$460 million. Further research is necessary to determine whether an actual adjustment to the state's balance sheet is required.

During the 2012 legislative session, the Department of Finance and Administration (DFA) and the State Treasurer's Office (STO) reported to LFC staff that the state has hundreds of thousands of unreconciled entries in SHARE representing billions of dollars. Representative Varela initiated a special appropriation for \$200 thousand in the 2012 General Appropriation Act for the DFA to address the cash reconciliation problem. In July 2012, the DFA also received a \$400 thousand loan from the Board of Finance to continue this initiative. Deloitte Consulting Group was contracted to assist the DFA in this process.

The DFA has a plan in motion to address business processes related to cash reconciliation going forward, but has not yet addressed how they will address the outstanding historical variances in SHARE which is necessary to resolve this problem. Additionally, LFC staff has concerns over lack of coordination amongst various SHARE projects managed by different agencies and aggressive timelines for implementing business process changes and technical upgrades.

This memo seeks to update the status of the issue, analyze the DFA's plan to remedy the cash issue, and offer recommendations on next steps.

Background. When referring to cash transactions, the general ledger is the state's check register, and it is used to record all cash outflows (warrants) and all cash inflows (deposits). Having a general ledger that accurately reflects the state's finances is critical. Agencies use cash/fund balance data from SHARE to create budget requests, and the Legislature then uses this information to make appropriations.

The state implemented SHARE at the beginning of FY07 to serve as the state's central accounting system. This makes SHARE the general ledger. Additionally, SHARE houses other accounting processes that had previously been performed manually or through other systems at the DFA, STO, and other state agencies. In a 2007 LFC review of SHARE, staff stated that implementing a system like SHARE can optimize business processes, but only if agency practices are reengineered to fit the system.

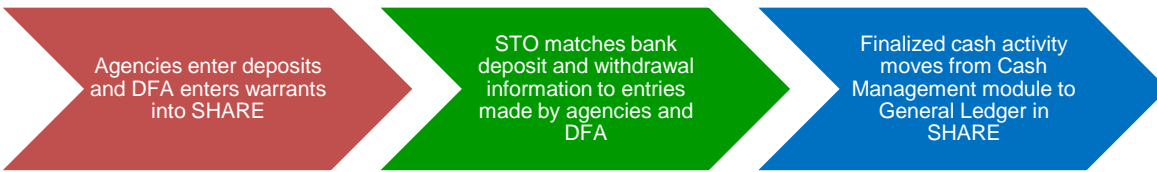
LFC staff has highlighted issues with SHARE in various reviews dating back to 2007. In FY12, LFC staff again looked at issues related to negative fund balances at agencies and the state's ability to accurately report cash balances within SHARE. Deloitte also released a diagnostic report of the state's cash controls in July 2012, identifying five factors contributing to the cash reconciliation issue at the DFA and STO, many of which had been noted in previous LFC reviews including:

1. Not implementing treasury management within SHARE,
2. Outdated business processes that do not match up to SHARE's system organization or capabilities,
3. Use of accounting methods that minimize the ability to reconcile cash accounts accurately,
4. Insufficient training of state employees processing transactions through SHARE, and
5. A bank account structure that does not allow visibility to all state agency funds.

Beyond the issues Deloitte identified, the Financial Control Act requires the DFA to complete monthly account reconciliations to ensure the general ledger in SHARE accurately reflects bank balances recorded at the State Treasurer's Office. The DFA has not been performing this monthly reconciliation which has removed a key oversight function of the state's finances. Furthermore, yearly audits performed by Moss Adams for the DFA did not identify the cash reconciliation problem or compliance issues with the Financial Control Act since SHARE was implemented.

Also in summer 2012, the State Controller identified various areas where accounting entries made in SHARE may have lead to variances between the general ledger and bank statements for the state's cash accounts. However, the DFA is unable to pinpoint the amount of entries causing the general ledger to be out of balance with cash account bank statements.

Exhibit 1. Daily Cash Process in SHARE



Accounting and IT Initiatives.

Cash Reconciliation Process. The DFA, in conjunction with Deloitte, initiated the Cash Management Remediation Project in summer 2012 with \$600 thousand in total monies received between the legislative appropriation and the Board of Finance loan. LFC staff attended a steering committee meeting for the project in December 2012, which provided an update on Deloitte’s work to identify and address issues in the cash reconciliation process in SHARE. The project team identified sixteen areas where process improvements were required including:

- The structure of depository and disbursement accounts,
- A process for recording third party warrants in SHARE (for Medicaid, income tax refunds, unemployment benefits, etc.),
- Uniform processes for creating accounting entries into SHARE,
- Data and process requirements for Financial Control Division to reconcile cash accounts monthly to comply with the Financial Control Act, and
- A clear delineation of responsibilities between the DFA and the STO regarding cash management in SHARE.

The DFA advised this project is on track to be completed by February 1, 2013. While they anticipate the changes will mostly impact business processes at the STO and reconciliation activities at the DFA, there will be some impact to agency staff responsible for processing deposits and warrant requests. Deloitte’s plan involves activating capabilities that already exist in SHARE that will facilitate the cash reconciliation, as well as educating users on processing cash-impacting transactions in SHARE. LFC staff advises to continue monitoring the progress of this project.

The STO is also in the process of updating bank account structures at Wells Fargo to provide greater visibility to cash balances down to the fund level. The new account structures are anticipated to be completely in effect by April 1, 2013.

Correcting historical differences in cash balances between SHARE and bank statements. The DFA’s Financial Control Division (FCD) identified thirty-six areas where errors may have occurred across an estimated 1.6 million transactions recorded in SHARE since FY07. However, the FCD is not currently able to pinpoint the cause of these errors. Moreover, the possibility exists that balances transferred into SHARE from legacy systems were not accurate, creating variances from inception. Until these errors are resolved, any future reconciliation of cash accounts will still result in a variance between SHARE and bank account balances.

According to the DFA, their auditor has required they identify a dollar amount for a potential write-off to bring SHARE in line with the state’s bank accounts, and that this item be recorded as a contingent liability in SHARE and noted in the DFA’s FY12 financial audit. The DFA complied, recording a conservative \$70 million entry of a potential \$70-460 million in historical

variances estimated. The audit is currently under review at the State Auditor's Office. The DFA has stated this initial dollar range is a rough estimate. LFC staff is not entirely confident in the method the DFA used to calculate this liability nor that the DFA booked the minimum potential write-off. Furthermore, LFC staff is concerned that the DFA booked this entire liability against the general fund and not proportionately across accounts held at the STO.

Identifying the source of the historical variances and correcting them would require additional resources at the DFA. However, when compared to a potential write-off of up to \$460 million, expending less than one percent of that cost to contract the required accounting expertise to address the issue is a cost-effective and appropriate next step.

SHARE Upgrade. The DoIT has various projects underway for SHARE that impact cash reconciliation and other processes, and the executive budget recommendation includes \$8.8 million to support these various SHARE initiatives. The LFC has performed several evaluations of SHARE since implementation, identifying concerns in how the system was implemented and being used. These reports are available on the LFC website.

While correcting the cash issue in SHARE can occur independently of DoIT's work plan in the near term, it is important to look at how all of these projects will affect the end user in the long term. It is critical that SHARE be upgraded, since state is operating a version that is seven versions old and is no longer supported by the vendor Oracle. At this time, the DoIT is testing to move the SHARE database off of the current system hardware onto new hardware, which is a required first step in the upgrade process. The DoIT has experienced setbacks in this process but anticipates testing throughout the legislative session. Issues in the testing process also raised concerns over the size of the SHARE database. In light of this, the DoIT plans to archive older SHARE data, which will impact how users run reports and require additional user training.

Once the SHARE database has been moved to new hardware and older data has been archived, the greatest change to SHARE will be upgrading to version 9.2. The upgrade will provide added benefits including better capability to manage cash at the STO and the DFA. However, this will be a significant change that will require planning and training of almost three thousand state employees. The DoIT anticipates bringing SHARE financials 9.2 online at the end of CY 2013.

An implementation of this magnitude would typically require a lead time of 15-18 months to allow sufficient time for all technical aspects of the upgrade, design of procedures, and training of all impacted users. Currently, the state plans to implement various changes to SHARE, including a system upgrade, within the next 12 months.

The DFA and the STO are reengineering business processes for cash management in SHARE which will occur as the state prepares to make a significant technical upgrade to the entire SHARE system. When assessing total impact to users, this is an extensive change within a short period of time (12 months.) While it is pressing to stop the root cause of the cash reconciliation issue, LFC staff is concerned that the DFA, STO, and DoIT are not assessing the overall impact of all planned process and technical changes within SHARE under the current aggressive timelines. A rushed timeline in the 2006 implementation of SHARE contributed to many of the issues that are now requiring correction, and the state risks repeating this with the current plan to upgrade SHARE and redesign associated business practices. Moreover, projects related to SHARE are being addressed in a piecemeal fashion with no unified focus or strategy among the DFA, STO, and DoIT, increasing the potential for error.

Conclusion. Current cash discrepancies in the general ledger are the product of continued use of obsolete or ineffective business practices, as well as inadequate training when transferring deposit management duties to individual agencies. In addition to these operational weaknesses, the DFA is not meeting its statutory responsibility to ensure the general ledger correctly reflects bank account balances on a monthly basis. This type of oversight is crucial to ensuring that the state's finances are properly managed. It is also imperative to address the historical variances in SHARE by dedicating adequate time and resources to identify the cause of these variances and the solution. Updating cash processes for SHARE will not be successful without resolving these variances. Finally, the uncoordinated and rapid sequence of changes planned within SHARE could further exacerbate issues such as cash reconciliation.

Next Steps.

LFC staff recommends:

- The DFA identify how it plans to meet statutory obligations under the Financial Control Act for monthly cash reconciliation;
- The DFA, DoIT, and STO bring an appropriation strategy before the Legislature during the 2013 session to address outstanding cash reconciliation issues that are not yet resolved;
- The DFA then move forward on contracting experts to address the historical entries that created cash variances between SHARE and the state's bank accounts before any write-off is taken; and
- The DoIT, DFA, and STO evaluate all projects related to SHARE (unreconciled cash balances, hardware transition, database archiving, software upgrade, etc.) and create a unified strategy for moving forward. This plan should allow adequate time for technical testing, business process design and user training, and should also detail required resources.