STATE OF NEW HAMPSHIRE
DEPARTMENT OF ENVIRONMENTAL SERVICES

FINANCIAL AND COMPLIANCE AUDIT REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2004

STATE OF NEW HAMPSHIRE
DEPARTMENT OF ENVIRONMENTAL SERVICES

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STATE OF NEW HAMPSHIRE
DEPARTMENT OF ENVIRONMENTAL SERVICES

Reporting Entity And Scope

The reporting entity and scope of this audit and audit report is the New Hampshire Department of Environmental Services for the fiscal year ended June 30, 2004.

The following report describes the financial activity of the Department of Environmental Services, as it existed during the period under audit. Unless otherwise indicated, reference to the Department or DES refers to the Department of Environmental Services. The Department of Environmental Services provided the auditee responses included in the report.

Organization

The Department of Environmental Services was established effective July 1, 1986 by RSA 21-O under the direction of a Commissioner and consolidated and reorganized four previously separate agencies: the Air Resources Agency, the Office of Waste Management, the Water Supply and Pollution Control Commission, and the Water Resources Board. Each of these groups is now represented within the Department's three divisions: Air Resources, Waste Management, and Water. Also, The Department has units within the Office of the Commissioner whose roles are to coordinate such activities as agency-wide planning, enforcement, permitting, public information, laboratory services, geologic services, information resources, and financial and personnel management. At June 30, 2004, the Department employed 443 full-time and 61 part-time employees.

Responsibilities

The Department's Air Resources Division, with guidance from the N.H. Air Resources Council, is responsible for promoting cost-effective, sensible strategies and control measures to address complex and inter-related air quality issues. These issues include, but are not limited to, ground-level ozone, particulate matter, regional haze (visibility), mercury emissions, increasing concentrations of greenhouse gases, acid deposition, and air toxics.

The Department's Waste Management Division, in cooperation with the Air Resources and Water Divisions, provides a coordinated approach to addressing pollution sources and remediating contaminated sites. The Department's and Division's basic strategy is to prevent occurrences of events and practices that may lead to contamination, minimize the impacts of materials that become contaminants when misused or spilled, and efficiently and effectively utilize the Department's personnel and financial resources in environmental restoration.

Under guidance from the N.H. Water Council, the N.H. Water Resource Council, and the N.H. Wetlands Council, the Department's Water Division conducts a variety of programs designed to ensure the protection of the State's water including: overseeing public water supplies; wastewater control activities; surface water monitoring; wetlands permitting and enforcement; dam inspections, maintenance, and operation; and water resource and use planning.

The Office of the Commissioner includes the functions of Administrative Services, Environmental and Occupational Health, Geology, Human Resources, Laboratory Services, Legal, Planning, and Public Information and Permitting for the Department.

Funding

The financial activity of the Department of Environmental Services is accounted for in the General and Capital Projects Funds of the State of New Hampshire. A summary of the Department's revenues and expenditures for the fiscal year ended June 30, 2004 is shown in the following schedule and is shown graphically on page 3.

Summary of Revenues and Expenditures
Fiscal Year Ended June 30, 2004

	General Fund	Capital Projects Fund	Total Governmental Funds
Total Revenues	$ 90,461,299	$ 220,663	$ 90,681,962
Total Expenditures	$ 104,761,311	$ 4,026,648	$ 108,787,959
Excess (Deficiency) of Revenues Over (Under) Expenditures	**$ (14,300,012)**	**$(3,805,985)**	**$ (18,105,997)**

Prior Audit

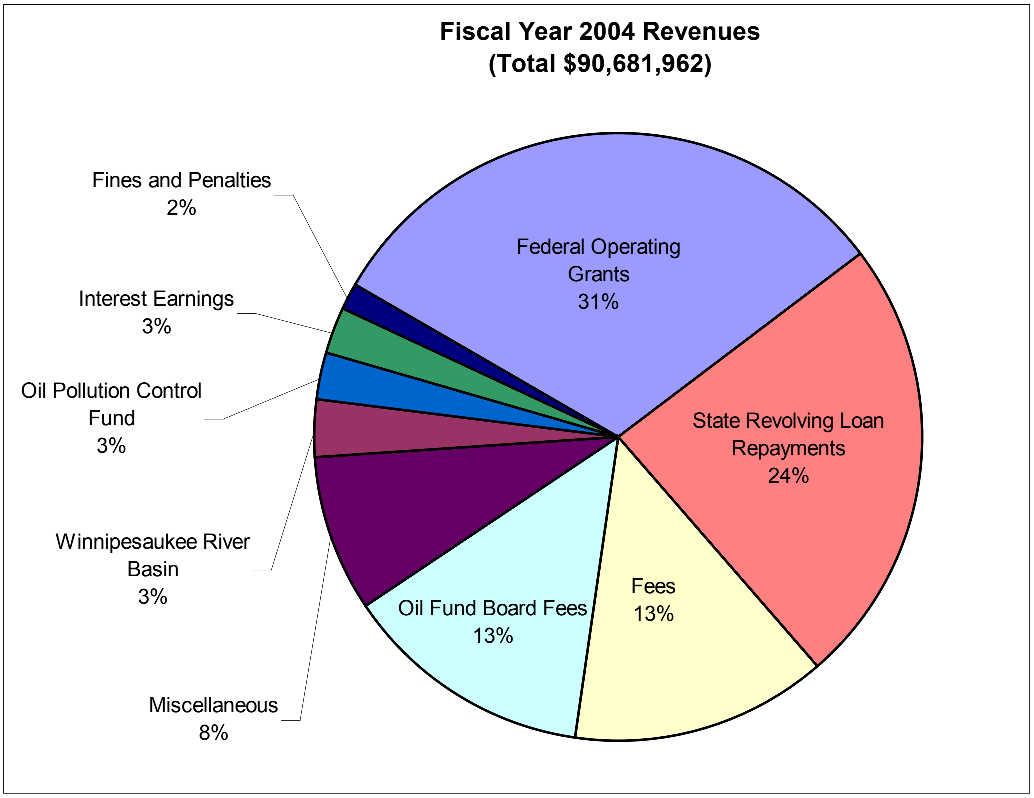
The most recent prior financial and compliance audit of the Department of Environmental Services was for the nine months ended March 31, 1995. The appendix on page 49 contains a summary of the current status of the observations contained in that prior report. Copies of the report can be obtained from the Office of Legislative Budget Assistant, Audit Division, 107 North Main Street, State House Room 102, Concord, NH 03301-4906.

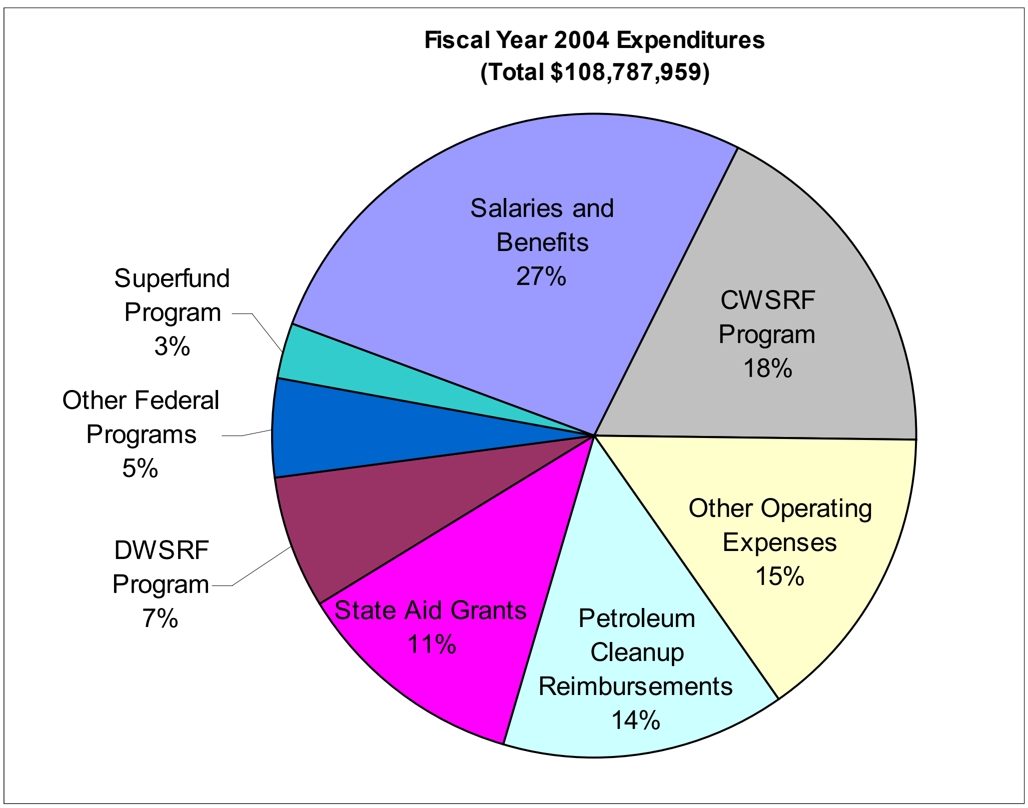
Audit Objectives And Scope

The primary objective of our audit is to express an opinion on the fairness of the presentation of the financial statements of the Department of Environmental Services for the fiscal year ended June 30, 2004. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we considered the effectiveness of the internal controls in place at the Department of Environmental Services and tested the Department's compliance with certain provisions of applicable State laws, rules, contracts, and grant agreements. Major accounts or areas subject to our examination included, but were not limited to, the following:

- Revenues and appropriations,
- Expenses and expenditures, and
- Federal Funds Compliance.

Our report on internal control over financial reporting and on compliance and other matters, the related observations and recommendations, our independent auditor's report, and the financial statements of the Department of Environmental Services are contained in the report that follows.





Source of Graph Information: State Accounting System (NHIFS) and Schedule of Expenditures of Federal Awards

CWSRF – Clean Water State Revolving Fund
DWSRF – Drinking Water State Revolving Fund

Auditor's Report On Internal Control Over Financial Reporting And On Compliance And Other Matters

To The Fiscal Committee Of The General Court:

We have audited the accompanying financial statements of the governmental activities and each major fund of the New Hampshire Department of Environmental Services for the fiscal year ended June 30, 2004, as listed in the table of contents, and have issued our reports thereon dated February 7, 2005, which were qualified with respect to the lack of presentation of the financial position of the Department of Environmental Services in the government-wide and fund financial statements. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department of Environmental Services' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Department Of Environmental Services' ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in Observations No. 1 through No. 18 of this report.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider Observation No. 1 to be a material weakness.

Compliance And Other Matters

As part of obtaining reasonable assurance about whether the Department of Environmental Services' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, rules, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. However, we noted certain noncompliance matters, which are described in Observations No. 19 through No. 25 of this report.

This auditor's report on internal control over financial reporting and on compliance and other matters is intended solely for the information and use of the management of the Department of Environmental Services and the Fiscal Committee of the General Court and is not intended to be and should not be used by anyone other than these specified parties.

Office Of Legislative Budget Assistant

Office Of Legislative Budget Assistant

February 7, 2005

Internal Control Comments
Material Weakness

Observation No. 1: Accounting Controls For Federal Programs Must Be More Structured

Observation:

The Department does not have sufficient written accounting and reporting policies and procedures for its federal programs. The lack of comprehensive policies and procedures contributed to a situation where payroll costs were inappropriately charged to the federal assistance programs during fiscal year 2004 and reported Department matches were not supported.

The Department uses a database system to track its federal program expenditures. The system includes a ledger that mirrors the State accounting system, which is used to report direct charges to the programs based on budget-based expenditures, and an allocation module, which re-sorts payroll information from the ledger based on actual cost information derived from the employee timesheets. Since the direct payroll costs are reported to the federal awarding agency prior to re-sorting, reported amounts may not reflect the actual payroll costs for the programs as recorded on the employee timesheets. While the Department's allocation process could be used to determine and correct mischarges, the Department relies on supervisors to periodically advise the business office to initiate transfers to correct the records. Reportedly, lack of awareness of the need for transfers and a lack of communication between supervisors and the business office resulted in needed corrections not being made during fiscal year 2004. The lack of needed corrections to properly allocate direct payroll costs during fiscal year 2004 resulted in $616,500 of payroll costs being questioned, as it is not clear that the expenditures were reported in the proper program. The majority of these costs, $455,500, related to costs originally reported in the Performance Partnership Grant (PPG) program.

In addition, a change in employee duties resulted in employee unfamiliarity with the Department's allocation process. Consequently, the Department did not allocate its fiscal year 2003 program costs until late fiscal year 2004. Fiscal year 2004 program costs were not completely allocated until November 2004. Since the allocation was not performed during fiscal year 2004, the amounts reported to the federal awarding agencies as State matches for programs requiring an administrative match (including PPG) during this period were not supported.

The difficulties associated with a lack of written policies and procedures over accounting for and reporting federal programs became evident to the Department during fiscal year 2004. The Department struggled to learn the process of accounting for its federal programs after an employee previously responsible for this task left the agency, leaving behind little guidance on the process. This learning curve resulted in the fiscal year 2004 allocation not being performed at all during the year, as the Department was still catching up on previous periods. The lack of documentation of the Department's system for accounting for federal programs was noted in the prior audit of the Department.

Questioned Costs: $616,500 direct payroll costs

Recommendation:

The Department must institute more controls, including structure and guidance, over its accounting for, and reporting of, federal programs. Comprehensive written policies and procedures must be developed to ensure that Department processes are performed in a consistent and controlled manner. Once in place, the Department will need to monitor its processes to ensure that they continue to operate as intended. Failures in the accounting and reporting process such as problems in allocating costs to federal programs should be brought to the attention of an appropriate level of management to ensure that required corrective actions are taken in a timely manner.

The Department should consider the efficacy of relying upon supervisors to propose transfers to correct differences between paid and worked accounts. It appears that the Department's allocation module, if run more consistently, could provide an accurate and efficient determination of required adjustments and ensure that Department and federal records and reporting are accurate. If the Department determines the use of the allocation module for this process is not efficient and effective, the Department should establish sufficient policies and procedures, subject to regular Department monitoring for compliance, to ensure the needed corrections are made and reported timely.

The Department cannot rely upon an individual employee's experience or memory for continued performance of critical Department financial operations. Policies and procedures must be documented to ensure consistent performance over time.

Auditee Response:

We partially concur. The Department of Environmental Services maintains over 24 federal programs, totaling approximately $30 million in annual disbursements. DES does maintain written policies and procedures for the accounting of its federal programs. The area of concern noted in the observation deals with one area of DES accounting controls over its federal programs, the cost allocation system. Cost allocation is used by DES to identify and monitor federal matching requirements. While we acknowledge that the procedures for this area have not been well documented, the Department is in the process of completing written procedures. Staffing turnover and layoffs have contributed to the delay in processing transactions through the cost allocation system. The cost allocation for fiscal year 2004 has been completed. We have begun formally documenting the cost allocation procedures.

As to the questioned costs regarding the transfers of payroll costs, our review-to-date of those costs revealed that almost all costs were properly charged to the federal programs. We have reinstituted a quarterly review of payroll transfers to correct this issue.

Other Reportable Conditions

Observation No. 2: Federal Reimbursement Of Costs Should Be Drawn More Timely

Observation:

During fiscal year 2004, the Department did not draw federal funds, representing federal participation in the Department's costs of the Performance Partnership Grant (PPG), Drinking Water State Revolving Fund (DWSRF), and Clean Water State Revolving Fund (CWSRF) programs, as soon as allowed by federal rule. The State's cash flow is negatively impacted by unnecessary delays in drawing available federal funds.

The PPG, DWSRF, and CWSRF programs are structured to allow the Department to draw federal funds once the underlying State expenditure has occurred. While the Department complies with the program requirement of requesting reimbursement only after the expenditure has occurred, its procedures do not minimize the time elapsed between when the expenditure is eligible for reimbursement and when the reimbursement occurs.

A sample of fiscal year 2004 administrative draws revealed:

- Two draws (totaling $171,000) out of a sample of four PPG draws (totaling $2.5 million) tested were not drawn timely. Total fiscal year 2004 PPG reimbursable expenditures exceeded $5 million.
- Three draws (totaling $198,000) out of a sample of four DWSRF administrative draws (totaling $292,000) were not drawn timely. Total fiscal year 2004 DWSRF reimbursable administrative costs totaled nearly $2.2 million
- All four draws out of a sample of four 2004 CWSRF administrative draws (totaling $178,000) were not drawn timely. Total fiscal year 2004 CWSRF reimbursable administrative costs totaled over $700,000.

For the purpose of this test, drawing the federal funds within the Department's two-week guideline was considered timely. Some fiscal year 2004 draws occurred as late as 75 days after the expenditure report was available.

Recommendation:

The Department should draw federal funds as soon as provided by federal rule.

Auditee Response:

We concur and draws on the PPG and State revolving loan administrative grants will be drawn more timely.

Observation No. 3: Controls Should Be Improved Over The State Revolving Fund Collection Process

Observation:

During fiscal year 2004, the controls over the collection of repayments to the State Revolving Funds (SRF) were not operating as intended by the Department's policies and procedures. It is unclear whether management was unaware its control policies were not being adhered to or whether management knew and did not correct or mitigate the effects of the control failures.

During fiscal year 2004, duties related to collecting and recording SRF loan repayments were not sufficiently segregated to provide for a review and approval function over the process. One employee performed these functions for the Clean Water SRF and one employee performed these functions for the Drinking Water SRF. For both the Clean Water SRF and the Drinking Water SRF, one employee was responsible for the incompatible functions of preparing invoices, maintaining customer accounts, receiving loan repayments, and reconciling the bank accounts for their SRF program. Compounding this control weakness, the Drinking Water SRF program bank accounts were not reconciled timely during fiscal year 2004.

Proper segregation of duties includes segregating the custody of assets from the maintenance of the accounts, as well as segregating the maintenance from the reconciliation of those accounts. The Department has written policies and procedures over the SRF loan repayment collection process intended to segregate these incompatible duties, however the Department has not monitored compliance with these policies and the SRF accountants have in fact not followed them. The lack of appropriate controls in this process increases the risk that errors or fraud could occur and not be detected by the Department in a timely manner.

The original loans made through the SRF programs are federally funded. Interest and principal repayments on the loans are collected by the Department and deposited into the SRF accounts. During fiscal year 2004, more than $21.5 million were reported as repaid to the SRF programs.

Recommendation:

The Department should evaluate its written policies and procedures over the SRF accounts to ensure the controls are responsive to the risks faced by the Department and its programs. Once established, the Department must monitor employee compliance with those controls to ensure the controls are operating as intended, including proper segregation of duties over critical accounting functions, and the timely reconciliation of the SRF programs.

Auditee Response:

We concur. The controls over the collection of repayments to the State Revolving Fund were not operating as intended by the Department's policies and procedures due to staff turnover and shortages. This has now been rectified and the SRF accountants do deposits for each other's programs. Procedures are in the process of being updated. It should be noted that the customer accounts are not only monitored by the SRF accountants but also by program staff during the disbursement process, so there is constant review of SRF activity. The reconciling of the SRF bank accounts done here are only an additional checking process to confirm reconciliations done at Treasury and for program tracking. Only the DWSRF zero based account (ZBA) was not reconciled timely due to a backlog of statements left by the previous accountant in the position. The ZBA bank statements were checked each month to ensure that there was a zero balance and no discrepancies. The account was current and reconciled by the end of May 2004 and has been maintained since that time. The other DWSRF bank accounts were reconciled on a timely basis each month.

Observation No. 4: Policies And Procedures Should Be Established For The Accrual Of Accounts Receivable And The Recognition Of Revenues

Observation:

Department errors in establishing accounts receivable for its federal programs at June 30, 2003 overstated fiscal year 2003 revenues and understated fiscal year 2004 revenues by approximately $2 million.

At June 30, 2003, the Department inappropriately included encumbrances in determining the amount of expenditures eligible for federal participation. By including encumbrances as expenditures, the Department recorded approximately $2 million of federal revenue as a receivable that it was not entitled to at June 30, 2003. Federal funds are available to the Department on a reimbursement basis, and therefore were not revenue to the Department until the underlying expenditure actually occurred during fiscal year 2004.

By recognizing the revenue and recording a receivable in fiscal year 2003, the Department did not recognize revenue when the related federal funds were actually earned and received in fiscal year 2004, resulting in a $2 million understatement of fiscal year 2004 revenue.

The fiscal year 2004 financial statements have been adjusted for this timing difference. The calculation of federal receivables at the end of fiscal year 2004 did not appear to contain the same error.

Recommendation:

The Department should review the adequacy of its policies and procedures over the recognition of revenue and the accrual of receivables to ensure the policies and procedures are responsive to the needs of the State and the Department. As part of its normal operating controls, the Department must monitor employee performance and conformance with those policies and procedures to ensure the controls are properly and accurately performed.

Employees responsible for these functions should be adequately trained in the policies and procedures to help ensure that the policies and procedures are properly performed.

Auditee Response:

We do not concur. The Department does have established policies and procedures for the accruals of accounts receivables. The reason for the issue with the accrual of receivables for fiscal year 2003 was the result of miscommunication between this Department and the

Department of Administrative Services. As noted in the observation, this issue did not reoccur in fiscal year 2004. Fiscal year 2003 appears to have been an isolated incident.

Observation No. 5: Status Of Deferred Federal Revenues Should Be Resolved

Observation:

At June 30, 2004, the Department did not have a plan in place to address its deferred federal revenues. At June 30, 2004 the Department reported approximately $400,000 of deferred federal revenues. These deferred revenues had been carried forward from prior fiscal years and appear to represent federal funds drawn by the Department prior to a program expenditure having been made. Because the majority of the Department's federal assistance programs are only eligible to be drawn on a reimbursement basis, this deferred revenue appears to have been drawn inappropriately, leaving the Department susceptible to potential interest liabilities to the federal awarding agencies.

In calculating its June 30, 2004 accounts receivable, the Department did net approximately $68,000 of its deferred revenues against amounts due at June 30 from the federal grantors. While this reduced the deferred revenue balance, it also resulted in an equal understatement of fiscal year 2004 federal revenue.

Potential interest liability: $5,200 (Estimated interest of 1.3% on $400,000 for one year)

Recommendation:

The Department should review its federal revenue accounts for deferred revenues. A plan should be developed to eliminate deferred revenues from improperly drawn federal funds over a reasonable period of time. The Department should contact the appropriate federal awarding agencies to determine whether interest is owed on the funds that were drawn prior to eligibility.

The Department should review the circumstances that resulted in its holding deferred federal revenue at June 30, 2004. The Department should ensure that it draws federal funds only when authorized by the federal programs. Timely federal draws allow for optimal cash management practices and lessen the need to unnecessarily defer revenue and incur interest liabilities. If the State's accounting system is reporting deferred revenues in error, the Department should take the appropriate steps to correct the erroneous accounts.

Auditee Response:

We concur. We are in the process of reviewing the federal revenue accounts to address State accounting reporting issues with regards to federal programs. The issue of the appearance of deferred federal revenue is not one of this Department having overdrawn its federal grants but one of how that revenue was posted to the State accounting system (NHIFS) over time. For example, the Keefe Hazardous Waste Site grant was identified by the auditors as being overdrawn by $211,317, but according to both DES and federal Environmental Protection Agency (EPA) records, the grant is not overdrawn. What appears to be the issue is how revenue was posted to this account since its inception in 1982. The Department is in the process of reviewing the NHIFS transaction history to determine where posting errors occurred and to determine the best course of action to resolve this issue.

Observation No. 6: System Documentation Should Be Improved

Observation:

It is not clear that system documentation supporting the Department's business applications is available to assist computer support personnel to understand and fix any system problems. This issue was noted in our prior audit of the Department.

Office of Information Technology (OIT) staff responsible for supporting the Department's business applications report system documentation may be available but are unsure where it is and suggest it is most likely old and outdated.

The purpose of systems documentation is to provide information regarding how those systems were created, how they function, and to provide guidance to help troubleshoot and fix application problems and to provide information necessary to assist in further developing the systems. Without comprehensive system documentation, system maintenance, repair, and further development are at a considerable disadvantage and the Department is at a considerable risk that system failures will not be efficiently repaired.

Recommendation:

The Department should develop and maintain a comprehensive library of system documentation for all critical computer applications, including its business applications, to assist OIT staff in maintaining, repairing, and otherwise supporting the Department's systems.

Auditee Response:

We concur. The Department concurs with the recommendation to develop and maintain system documentation for all critical computer applications and is working with Office of Information Technology staff to make this happen.

With limited technology staff resources available to develop and maintain the information systems needed to support the Department in carrying out its mission, the focus has been on getting the hardware, software and applications in place for use by the multitude of programs. While system documentation is a required element of the system design methodology used by the OIT programmers supporting DES, the pressure to move on to the next project has often taken precedence over completing the documentation for the one just finished.

Recent departures of key programming staff, and the difficulties experienced by other staff asked to pick up maintenance of their applications without adequate documentation, have highlighted the need for greater diligence in enforcing this part of the system design methodology. Steps have already been taken to ensure that adequate time is allotted in the estimated schedule for all future application development projects. Also, each of the programmers in the group is being asked to use their down time during or between projects (e.g. when there are delays at the business staff end) to go back and clean up documentation for existing applications and systems.

Observation No. 7: Inter-Agency Accounts Receivable Should Be Collected Timely

Observation:

As of December 10, 2004, the Department had not collected over $400,000 of accounts receivable that were owed to the Department by other State agencies at June 30, 2004. According to Department personnel, workloads have prevented Department employees from making efforts to collect the amounts from the other State agencies.

According to the State's accounting policies, revenues are recognized for fund financial statement purposes as soon as they are both measurable and available. The State generally considers revenues to be available if they are collected within 60 days of the end of the current fiscal period. Because these inter-agency receivables had not been collected more than five months after fiscal year end, they do not meet the available criteria and should not be reported as revenue on the Department's fiscal year 2004 fund financial statements.

Recommendation:

The Department should be more proactive in collecting receivables, including amounts owed by other State agencies.

Auditee Response:

We concur and inter-agency receivables will be collected in a more timely manner.

Observation No. 8: Controls Over Cash Receipt Process Should Be Improved

Observation:

During fiscal year 2004, the Department did not maintain compliance with its control policies and procedures for collecting cash and checks at its various revenue collecting locations. The Department apparently did not recognize its cash receipt processes fell out of compliance with its control policies and procedures as it did not take steps to correct control process failures or otherwise mitigate the risks associated with those control failures.

The Department has written policies and procedures intended to provide controls over its cash receipt process. However, during fiscal year 2004, the following situations occurred that were contrary to Department policies and procedures:

- Checks were not consistently recorded and restrictively endorsed immediately upon receipt,
- Pre-numbered cash receipt documents were not periodically accounted for,
- Responsibilities for preparing certain invoices were not adequately segregated from the incompatible responsibilities for collecting and initially recording cash receipts, and

- Reconciliations of certain amounts collected to amounts credited to individual accounts were not consistently performed.

An effective control system is designed to provide reasonable assurance that management's objectives for effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations are met. A primary component of that control system is an effective system of monitoring the continued performance and effectiveness of control procedures and activities. If monitoring efforts are not in place, the organization is at risk of unknowingly falling out of compliance and placing undue reliance on an ineffectual control. Similar control issues over the cash receipt process were noted in the prior audit of the Department.

Recommendation:

The Department should improve its control system by improving its control monitoring efforts. Employees should be reminded of the requirement for compliance with Department controls. Monitoring efforts should provide reasonable assurance that the Department would become aware when controls are not functioning as intended.

The Department should review its current cash receipt practices for compliance with its intended controls. If circumstances prohibit compliance, procedures to mitigate the additional risks from noncompliance should be considered.

Auditee Response:

We concur. We will review our current cash receipts procedures for compliance with controls and adjust procedures as necessary.

Observation No. 9: Lab Fees Should Be Reviewed

Observation:

The Department uses two separate fee schedules to charge for tests performed by its water quality lab. Public water supplies and individuals are charged fees provided for in RSA 131:3-a. State agencies are charged according to a second fee schedule. While both fee schedules are intended to recover costs, the fee schedule in statute is revised every few years and the fee schedule charged to State agencies is revised annually.

The Department was unable to provide documentation to establish the lab had authority to use a second fee schedule however lab management indicated that, in its reading, the statute contemplated a second schedule based on the federal cost allocation method. Department management was unaware that the lab used a separate fee schedule to charge State agencies.

While the Department reports this second fee schedule is subject to annual revision, the Department did not completely update this schedule for fiscal year 2004 due to data not being available. The Department was unable to document that the fees remained accurate and appropriate for their intended purpose.

This dual fee structure generally resulted in higher fees charged to State agencies, including other areas of the Department and to federal programs administered by the Department.

Recommendation:

The Department should review the statute and the need and authority for multiple lab fee schedules.

If the Department determines that having the fees listed in statute prevents the timely revision of fees necessary to ensure the recovery of costs, the Department should request the statute be revised. If it is determined that it is appropriate to continue to have a two-tiered fee structure, the Department should fully document the appropriateness and accuracy of its calculations supporting the fees. The Department should also review with its federal grantor agencies whether the higher fees may be charged to the federal programs.

Auditee Response:

We concur. The Department, with the full concurrence of federal Environmental Protection Agency (EPA), requests reimbursement from the federal programs for various environmental analysis work performed for the grants based on the cost to perform the sample work. This practice was established many years ago to provide a cost recovery methodology for work performed by DES for EPA for specified analyses. The work performed is not covered by the list specified in RSA 131:3-a, I or II. The Department does, as required by 131:3-a, follow cost allocation methods established for reimbursements. This methodology was reviewed and approved by EPA. We will bring this methodology back before EPA for their review. The Department is currently seeking legislation to amend RSA 131:3-a to clarify the fee structure.

Observation No. 10: Formal Fraud Risk Mitigation Efforts Should Be Developed And Implemented

Observation:

The Department has not established a formal fraud assessment, prevention, deterrence, and detection program and has not established a fraud reporting policy.

Fraud encompasses an array of irregularities and illegal acts characterized by intentional deception. Persons outside or inside the organization can perpetrate it for the benefit or to the detriment of the organization. Fraud runs the spectrum from minor employee theft and unproductive behavior to misappropriation of assets, fraudulent financial reporting, and intentional noncompliance with a law or rule to an undue benefit.

Management is responsible for assessing the risk of fraud and implementing measures to reduce the risks of fraud to an organization. Fraud assessment, prevention, deterrence, and detection are crucial to the controlled operations of an organization.

- Assessment is critical since risks can only be effectively managed if risks are identified.

- Prevention reduces opportunities. Preventative methods are typically part of the organization's internal control – tone at the top and control procedures.
- Deterrence consists of those actions taken to discourage the perpetration of fraud and limit the exposure if fraud does occur. The principal mechanism for deterring fraud is the establishment of effective internal controls. Management has the primary responsibility for establishing and maintaining controls.
- Detection consists of identifying indicators of fraud sufficient to warrant recommending an investigation. These indicators may arise as a result of controls established by management, tests conducted by management or staff, and other sources both within and outside the entity.

Management is responsible for assisting in the deterrence and detection of fraud by examining and evaluating the adequacy and effectiveness of controls, commensurate with the extent of the potential exposure/risk in the various segments of an entity's operations.

The attributes of an effective fraud reporting policy include:

- The policy is in writing;
- The reporting policy describes fraudulent activities and the actions required when fraud is suspected or detected;
- The policy is communicated to all employees; and
- Management obtains written assurance from each employee that the policy and related reporting mechanism is understood.

The effectiveness of a fraud reporting policy is enhanced when employees have a clear understanding of fraud indicators and what constitutes a fraudulent act. It is important that the reporting procedure is non-threatening for the reporter and provides for the reasonable protection of all parties.

Recommendation:

The Department should establish formal fraud risk mitigation policies to help limit the Department's exposure to fraud and to promote timely detection.

- The Department should establish a formal fraud assessment, prevention, deterrence, and detection policy to help limit the Department's exposure to fraud and promote early detection of fraud that might occur. The Department should take measures to foster a high degree of control consciousness among its employees and ensure that its employees understand that adhering to controls is a primary concern of management.
- The Department should establish a fraud reporting policy and provide its employees with fraud awareness training. The Department should take measures to ensure that the policy facilitates and encourages reporting and protects all parties involved.

Auditee Response:

We concur that formal fraud risk mitigation policies should be developed. We will work with the Department of Administrative Services who is currently developing statewide policies in this area, to ensure Department policies are in concert with new State policies.

Observation No. 11: Controls Should Be Established Over Revenues Collected For The Department By The Department of Safety

Observation:

The Department does not have control procedures in place to ensure the accuracy and completeness of the revenues collected on its behalf by the Department of Safety (DOS). Instead, the Department relies on the internal controls in place at the DOS.

The DOS collects revenue for the Department in accordance with various statutes. The DOS also performs the associated accounting functions and deposits the revenues into Department accounts. Monthly, the DOS forwards supporting documents to the Department's accounting employees, however no one at the Department performs a regular review of the revenue collected and posted on its behalf by the DOS.

During the fiscal year ended June 30, 2004, the DOS collected and posted approximately $17 million of revenue to the Department's accounts. Much of this revenue related to oil handling and storage fees.

This same observation was made during our prior audit of the Department for the nine months ended March 31, 1995. In response to that observation, the Department indicated that it would review the revenue for reasonableness.

Recommendation:

The Department should establish and implement controls over revenues collected on its behalf by the DOS. At a minimum, the Department should establish review procedures so that it has reasonable assurance that the revenues collected by DOS are accurate and complete.

Auditee Response:

We concur. We will work with the Department of Safety to establish review procedures to obtain reasonable assurance that revenues collected by Safety are accurate and complete.

Observation No. 12: The Department's Ledger Should Be Periodically Reconciled To The State's Accounting System

Observation:

The Department did not have policies and procedures in place to ensure a complete and comprehensive reconciliation of expenditures as recorded in its in-house general ledger (ledger) to the State accounting system (NHIFS) was performed during fiscal year 2004. While the Department reported various Department employees were responsible for performing reconciliations on individual accounts, these reconciliations were not consistently documented and no reporting procedures were in place to ensure that management could ascertain that the reconciliations had been timely and successfully performed. The Department reported an agency-wide reconciliation is generally performed after year-end in conjunction with the allocation process, however the allocation for fiscal year 2004 was not completed until five months after fiscal year-end. (See Observation No. 1)

Differences between the ledger and NHIFS can result in inaccurate financial reporting at both the State and federal levels. The Department uses information from its ledger to report expenditures to its federal awarding agencies. Since there is no overall reconciliation between the ledger and NHIFS, the amounts reported to the federal agencies may not be supported by the State's financial records as reflected in NHIFS.

Recommendation:

The Department should implement policies and procedures to ensure that reconciliations of its ledger and NHIFS accounts are performed in a timely manner. The reconciliations prepared by the Department should be documented and reviewed by supervisory personnel.

Auditee Response:

We partially concur. The Department does reconcile ledger on an account by account basis to NHIFS monthly and in the case of the federal grant accounts, the reconciliation is performed twice a month. We do agree that the reconciliation process is not well documented and will improve our documentation of the process.

Observation No. 13: Employee And Dependent Benefits Eligibility Status Should Be Regularly Reviewed

Observation:

The Department does not review the benefit eligibility status of the dependents of its employees to ensure that it only pays benefits for eligible individuals. During our testing we noted one out of a sample of 30 employees tested (3%) had an ineligible child covered by State paid health and dental benefits.

The State implemented an online benefits system for its employees during October 2003. This new system made employees responsible for updating their health and dental benefits status, including changes in dependents and dependent status. Prior to this change to an online system, the Department's human resources staff was responsible for reviewing and implementing changes in an employee's benefit status based on notification from the employee. Under the prior system, the Department's involvement in processing the changes in benefit coverage allowed the Department to become aware when changes in employee and dependent status, such as children aging out of coverage, were not processed in a timely manner. Since the change in the benefit systems, the Department is no longer routinely made aware of an employee's dependent status and therefore is unable to effectively monitor for timely updates.

While the Department's controls over employee benefits status have been negatively impacted by the new benefit system, the Department's human resources employees did recognize that this individual had not removed the ineligible child from the system and had advised the employee to remove coverage for the child. The employee did not remove the child from coverage until the child's status was again questioned during the audit.

Recommendation:

The Department should work with the Department of Administrative Services, the agency responsible for the State's benefits program, to establish formal monitoring policies and procedures to review employee and dependent benefit plan status. Errors detected in benefit coverage should be immediately resolved to minimize the risk of improperly paying for noncovered services.

Auditee Response:

We concur. We will work with the Department of Administrative Services in this area. As commented in the observation, Departmental control over benefits has been negatively impacted by the institution of the "Choice Links" system.

Observation No. 14: Controls Over Equipment Should Be Improved To Prevent Errors And Inconsistencies

Observation:

The Department does not consistently follow the controls over equipment established by the Department of Administrative Services (DAS). As a result, the Department's fiscal year 2004 equipment inventory contained several errors and inconsistencies, creating a total projected overstatement of equipment of over $700,000. Similar errors were noted in our previous audit of the Department covering the nine months ended March 31, 1995.

DAS has established statewide controls over equipment as outlined in the *State of New Hampshire's Long-Term Assets Policy and Procedures Manual*. Equipment items with an original cost of at least $100 and a useful life of at least one year are to be tracked for accountability purposes, and documentation supporting the recorded cost is to be maintained for the life of the equipment. Additionally, ancillary charges incurred in obtaining the equipment are to be included in the cost of the item.

During equipment testing, we noted that four out of a sample of 25 equipment items tested (16%) could not be located. While items were observed that matched the item descriptions, there was no identification tag or other means of discretely identifying the items as the selected equipment. One additional item did not have an identification tag but was otherwise identifiable as the selected item. One item out of the sample of 25 tested (4%) should not have been included on the equipment inventory because it was no longer serviceable and was only used for parts.

Four of the 25 equipment items tested (16%) did not have complete documentation to support the recorded cost. However, documentation for one similar item was available, and the other three items were purchased more than 20 years ago. Other equipment items were recorded inconsistently. For example, two items differed in the way freight charges were applied to the equipment cost, and three items that exceeded the $100 threshold were not recorded as equipment.

Recommendation:

The Department should improve its controls over equipment in order to prevent errors and inconsistencies. Controls should be in place to ensure that all items purchased for $100 or more with a useful life of at least one year are recorded as equipment, and that the equipment items are properly identified with a numbered tag. Methods of allocating ancillary costs should also be established and consistently applied.

Auditee Response:

We partially concur. The Department has an established control system over equipment that it believes provides more than adequate control over its equipment. However, with an inventory of over 9,100 pieces of equipment, valued at approximately $13 million, it is inevitable that tags will fall off, items will be moved and documentation will be lost. We will review and update our procedures for the recording of ancillary costs.

Observation No. 15: Controls Over Reporting Real Property Should Be Improved

Observation:

The Department has not monitored compliance with and continued suitability of established policies and procedures for documenting and reporting the Department's real property. The results of this control failure were omissions from the reported property listing as well as property values being unsupported.

The Department reported that it owned $101,737,000 of real property at June 30, 2004. This amount was provided to the Department of Administrative Services (DAS) for inclusion in the State's fiscal year 2004 Comprehensive Annual Financial Report (CAFR).

Several Department employees are responsible for different portions of the Department's real property. Each of these employees is responsible for informing the business office of any changes to real property during the year. The business office is responsible for reporting the Department's real property according to the State's reporting guidelines to the DAS. The Department owns unique types of properties, including dams and hazardous waste sites, for which the DAS has not provided specific guidance on valuation. The Department has independently developed valuation guidelines for these assets. The business office reports the real property values, and changes thereto, to DAS annually for inclusion in the State's records and CAFR. However, during fiscal year 2004, not all of the changes to real property were reported to the business office, and the business office did not inquire of the responsible employees as to whether all changes to the real property values had been reported. This lack of communication resulted in the continued omission of one property from the reports to the DAS since the property was acquired in 1999, and of land and building improvements that occurred in fiscal year 2003. Formal policies and procedures would likely have avoided these omissions.

In addition to the above noted communication issues, the Department has not maintained complete documentation supporting the valuation of its properties. This condition was also noted as a material weakness in our prior 1995 audit of the Department. Two of 13 properties tested [Rowe Dam and Upper Factory Privilege] did not have documentation supporting the reported cost of the property. Four of 11 parcels of land tested (36%) [Angle Pond, Lochmere, Grafton Pond, and Horn Pond dams] did not have adequate documentation to support the reported acreage of the land.

Recommendation:

The Department should continue in its efforts to improve its controls over real property. Lines of responsibility and communication should be clearly defined. Valuation methods should be explicitly outlined for each type of property owned by the Department. Guidelines for the valuation for property unique to the Department should be developed in coordination with DAS. Additionally, the Department should seek to develop and maintain adequate supporting documentation on its properties to support reported amounts. This documentation should support the costs reported for all Department properties meeting the State's reporting guidelines. In accordance with State real property policies, determination of historical cost can be based on a reasonable estimate if supported by adequate documentation.

Auditee Response:

We concur and will continue to improve our controls over the recordkeeping and reporting of real property owned by the Department.

Observation No. 16: Policies And Procedures For Reporting Commuter Use of Department Vehicles Should Be Established

Observation:

The Department has not established policies and procedures to track and report the commuting use of Department vehicles.

Code of Federal Regulations Title 26, Part 1 Section 61-21, requires the value of the commuting use of an employer-provided vehicle be included in the determination of the employee's gross income. The Department of Administrative Services (DAS) requires agencies to report annually the number of days each State employee used a State vehicle to travel from home to work. Commuting use can include regular, everyday commuting use of a vehicle or irregular use of a pooled vehicle, which includes an overnight stop at the employee's home.

The *State Vehicle Use Report* is used to satisfy the IRS requirement that the value of using an employer-provided vehicle for commuting use be included in the gross income of the employee. The report, submitted by the Department for the year ended October 31, 2003 reported that only one employee had commuting use of a State-owned vehicle. It appears that at least one additional employee, the Commissioner, was assigned a State vehicle for commuting use and should also have been included on the report. It is also probable that with an agency owning approximately

100 vehicles, there would be significantly more than one or two employees having income tax consequences from the commuting use of State vehicles.

The Department's human resources employees are responsible for completing the report of commuting use of State owned vehicles. The Department's facility services section is responsible for tracking assigned vehicles, however human resources does not contact facility services to determine if there are any employees who should be listed on the report. According to the Department, only employees who reported commuting use on prior reports or who self-report commuting use to human resources were considered for inclusion on the report. The lack of communication within the Department regarding the reporting criteria including confusion over the types of vehicles subject to the reporting requirements appears to have contributed to the Department's problems in accurately completing the report.

Recommendation:

The Department should establish controls, including appropriate policies and procedures, for tracking and reporting commuter use of Department vehicles. Included should be efforts to educate employees on reporting requirements and establishing lines of communication to ensure that employees responsible for completing the *State Vehicle Use Report* are notified and periodically reminded of the requirement for reporting commuting use of vehicles.

The Department should seek DAS guidance on how to address past omissions from reported income of the value of employee commuting use of an employer-provided vehicle and also on which Department vehicles if any may be exempt from reporting.

Auditee Response:

We concur and will develop policies and procedures to track employee use of Departmental vehicles for commuting reporting purposes.

Observation No. 17: A Formal Disaster Recovery Plan Should Be Developed

Observation:

The Department does not have a formal disaster recovery plan covering its information technology (IT) systems. While the Department backs up its IT system information daily, the Department has not established a comprehensive and tested plan to minimize the impact of and time needed to recover from an IT system failure. The lack of a suitable disaster recovery plan increases the risk that the recovery from any significant IT system failure will not be as controlled and efficient as it might otherwise be if a well considered plan was in effect.

The Department is highly dependent on its IT systems to operate, including its processing of programmatic, financial, and administrative data. As agencies become dependent upon their IT systems for efficient operations, it becomes crucial to minimize the risk associated with having those systems become unavailable due to internal or external circumstances. A disaster recovery plan is intended to provide employees documented procedures to follow in the event of a system failure to minimize the effects on operations. A well-designed plan includes tested disaster recovery strategies and plans and procedures necessary to implement a recovery process in the most efficient manner.

Once established, it is important to keep the plan current and relevant by performing regular tests of the plan including determining the effects on agency operations of an IT disaster or systems failure and the expected recovery times from such situations.

Recommendation:

The Department should implement and maintain a formal disaster recovery plan for all critical IT systems. In developing a suitable plan, the Department should perform an appropriate risk and cost-and-benefits analysis. The plan should consider the risk to the Department of system failure and the cost of implementing certain aspects of the plan against the benefits to the Department of minimizing the effects of those failures.

A program of regular testing of key provisions of the plan should be encompassed in the plan, including the testing of any other computer systems to be used as backup. The testing program should include employee training in the operation of the plan and a critique of the plan's effectiveness. It should address any need for revisions including any systems and technology changes. All employees should be trained in their roles and responsibilities relative to the plan.

Auditee Response:

We concur. The Department recognizes the value of a formal disaster recovery plan for its critical information technology (IT) systems. This value, however, has to be weighed against the costs associated with developing and implementing such a plan and the risks of an IT system failure actually occurring. The Office of Information Technology (OIT) has begun a statewide project to look at options for disaster recovery for all of its customer agencies and to evaluate the costs and benefits of the options. The Department will work with OIT to ensure that the disaster recovery needs of DES are adequately considered in this effort.

As recognized in the observation, the Department had already implemented a comprehensive backup and recovery system for all of the file and print, electronic mail, and information system application servers used by the staff in the Concord office and at the field offices. The responsibility for this backup and recovery system has been taken over by OIT and continues to be implemented with a regular schedule of incremental and full backups. The backup tapes are stored off-site as a precaution, and are used regularly to help individuals or groups recover from personal pc [personal computer] failure or problems with a particular database application.

To take the next step would involve a significant investment in hardware, software, personnel and training to establish redundant systems to use in the event of a catastrophic failure of the existing systems. The Winnipesaukee River Basin Program is putting its own formal disaster recovery plan in place for the IT systems used to automate operation of the regional wastewater treatment system, including the purchase of redundant servers and operating system software licenses. This approach could be used as an example with OIT to look at meeting the needs of the rest of the department.

Observation No. 18: Contract Escrow Accounts Should Be Closed Once Their Intended Purpose Is Fulfilled

Observation:

The Department did not close a contract retainage escrow account once the contract was fulfilled.

As a result of unknown errors made over a period of time, an escrow account with a $16,000 balance remained open after the associated project was completed and the contractor was paid in full. Reportedly, the Department was unsure how to disburse the remaining balance in the account and the account remained open without action.

Recommendation:

The Department should monitor its escrow accounts carefully to make sure that correct amounts are retained and disbursed in accordance with the contract agreement. Escrow accounts should be closed soon after serving their intended purposes.

Accounts that appear to contain errors or otherwise appear problematic should be brought to the attention of an appropriate level of management to ensure that errors and problems are addressed in a timely manner.

The Department should seek the advice of the Treasury Department and the Department of Justice to determine the proper course of action with regards to this account.

Auditee Response:

We concur and will revise policies and procedures regarding proper closure of escrow accounts and issue resolution.

State Compliance Comments

Observation No. 19: Required Administrative Rules Should Be Adopted

Observation:

The Department has not adopted administrative rules required by the following statutes.

STATUTE	DESCRIPTION
146-C:12	• Leaking underground storage tank trust fund
146-D:5-a	• Oil discharge and disposal competitive bidding
149-M:30, II	• Administration of cleanup of waste sites
149-N:4; 5	• Standards and requirements for Recycling Logo
339:74	• Packaging materials – procedures and fines
483-A:7, II	• Lakes management and protection program grants
486:2	• Aid to municipalities for regional treatment facilities
486:10, parts II, III	• Payment of waste treatment costs
486-A:8, III	• Prioritization factors for applications
487:5	• Control of marine pollution and aquatic growth
487:18	• Prioritization of project approvals

Recommendation:

The Department should adopt administrative rules required by statute.

If the Department determines that the rules are not required, the Department should request the statutes be amended to eliminate the requirement or clearly permit the Department discretion in adopting rules.

Auditee Response:

We concur. We will review the statutes and the Department's administrative rules to ensure that required rules are properly adopted and that unnecessary rule-making requirements are brought to the attention of the Legislature.

Observation No. 20: Air Resources Fund Should Be Established

Observation:

The Department has not requested the establishment of the air resources fund to account for the air pollution control activities of the Department. As a result, no interest has been credited on the funds collected by the Department for its administration of its air pollution control functions.

According to RSA 125:C-12, IV, all permit fees, monetary grants, gifts, donations, or interest generated by the Department's air pollution control permitting process shall be deposited with the State Treasurer in a special non-lapsing fund to be known as the air resources fund and shall be continually appropriated to the Department for the administration of its air pollution control responsibilities. While the Department was aware of the requirement for the establishment of the fund, no action has been taken to have the fund established and all pertinent revenue has been deposited as restricted revenue in a non-lapsing account in the State's General Fund.

Based on the average balance in the respective accounts and an estimated rate of return, approximately $12,500 of interest would have been posted as earnings on the fund during fiscal year 2004.

Recommendation:

In accordance with statute, the Department should request the Department of Administrative Services and the State Treasurer establish the air resources fund, and request that interest earned on the fund be credited to the fund for the administration of air pollution control statutes. If the Department determines that the establishment of the fund is not in the best interests of the operation of the Department and its responsibility to the State, the Department should request an appropriate amendment to the statute.

Auditee Response:

We concur. All air fees collected are credited to non-lapsing accounts within the State accounting system and are maintained for the department's administration of RSA 125-C. We will consult with the State Treasurer as to the crediting of interest to the account.

Observation No. 21: Winnipesaukee River Basin Program Assessments Should Be Billed In Accordance With Statute

Observation:

The Department's billing procedures for charging Capital Cost Recovery and Operating and Maintenance Costs to users of the Winnipesaukee River Basin Program (WRBP) are inconsistent with statute.

RSA 485-A:50 authorizes the Department to annually assess each municipality served by the WRBP a sum sufficient to recover its proportional share of the costs. The payment terms are specified in RSA 485-A:50 III, which states that both Capital Cost Recovery and Operating and Maintenance Costs should be billed quarterly, yet Capital Cost Recovery is billed annually. Additionally, adjustments should be made in the first quarter but are not made until the second quarter of the year, due to the untimely availability of adjustment information.

Also, the Department does not charge the Department of Corrections (DOC), considered a community user of the WRBP, its share of the Capital Cost Recovery. Instead, the DOC's share of the Capital Cost Recovery is charged to a fund established within the program with contributions from all users, known as the Equipment Replacement Fund. Paying the DOC's share of the Capital Cost Recovery does not appear to be a use of the fund intended by RSA 485-A:51. The Department could not provide justification for its current WRBP billing practices.

Recommendation:

The Department should bill WRBP assessments in compliance with statute. If the Department determines the statutes are not responsive to the Department's needs, the Department should seek amendment to the statutes to ensure compliance is feasible.

Auditee Response:

We concur. We agree that billings are done quarterly rather than annually for O&M [Operating and Maintenance Costs] and collections for Cost Recovery are received annually rather than quarterly. We will seek amendment to the statute to reflect current practice.

With regards to adjustments, it is impossible for us to adjust the first quarterly bill for prior year over/under billings as the first quarter bill is sent out before the prior year financials are closed. We will also seek amendment to the statute to reflect current practice.

With regards to not billing DOC for Capital Cost Recovery, we will review current practices and adjust the Capital Cost Recovery billings as deemed necessary.

Observation No. 22: Required Fees Should Be Assessed/Collected Or Action Taken To Remove Requirement

Observation:

During fiscal year 2004, the Department did not have policies and procedures in place to collect two statutorily required fees. In one instance, concerns over federal prohibitions to a surcharge fee caused the Department not to collect a fee and in the second instance, the Department reported that it was unaware that it was required to collect a fee.

1. The Department does not collect a statutorily mandated surcharge on the disposal of out-of-state solid waste reportedly due to concerns as to whether the surcharge is contrary to federal commerce law. Had the surcharge been collected, the Department would have collected approximately $750,000 in surcharge revenue during fiscal year 2004. According to RSA 149-M:6, XI, the Department is required to assess a surcharge on the disposal of out-of-state solid waste in the amount of $1 per ton. The proceeds are to be used to reduce and offset general fund expenditures for solid waste management.

   In 1994 the Supreme Court ruled that Oregon's surcharge on disposal of out-of-state solid waste was invalid under the negative Commerce Clause. The Department decided that this was likely applicable to them as well, and stopped assessing the surcharge.

2. The Department does not collect the statutorily mandated fee for grant of right petitioners. According to RSA 482-A:25, petitioners for a grant of right are required to make a deposit of $50 with each petition to pay for expenses related to the petition. While no petitions were filed during fiscal year 2004, the responsible Department personnel indicated they were unaware of the requirement to collect a fee.

Recommendation:

The Department should collect the fees required by statute. If the Department determines that there are legitimate reasons the fees can or should not be assessed, then an amendment to the statutes should be sought to remove the requirement.

The Department should establish policies and procedures to ensure that its responsible employees are aware of statutory requirements, including the collection of statutorily required fees.

Auditee Response:

We partially concur. The Department will collect the hearing costs required by RSA 482-A:25 in the event that a grant of right proceeding is initiated under the provisions of RSA 482-A:22. The Department was informally advised by the Attorney General's Office that RSA 149-M:6,XI, which establishes a $1 per ton surcharge on the disposal of out-of-state solid waste, violated the Commerce Clause of the U.S. Constitution. The Department will consult with the Attorney General's Office on the feasibility of repealing or otherwise revising this statute.

Observation No. 23: Capital Project Status Reports Should Be Submitted

Observation:

The Department did not file any capital projects status reports during fiscal year 2004 even though the Department had approximately seven capital projects open and subject to the reporting requirement during the year.

Per RSA 17-J:4, each agency with capital budget projects is required to submit a status report on each project every 60 days to the Capital Budget Overview Committee. The last report filed by the Department was submitted in October 2002. As of September 2004 no status reports had been filed since that time.

Recommendation:

The Department should resume their preparation and submission of capital project status reports every 60 days as required by RSA 17-J:4.

Auditee Response:

We concur. The Department has established new procedures for filing capital budget project status reports to ensure that reports will be filed every 60 days.

Observation No. 24: Conflict of Interest Pledge and A Statement of Financial Disclosure Should Be Filed

Observation:

The Commissioner of the Department had not filed a *Conflict of Interest Pledge* and a *Statement of Financial Disclosure* as of the end of the audit period, June 30, 2004.

Per *Executive Order 2003-02*, the head of the agency is required to file a *Conflict of Interest Pledge* with the Secretary of State. Per *Executive Order 98-1*, which promulgates a *Code of Ethics* for the Executive branch, all agency heads are required to file a *Statement of Financial Disclosure* with the Secretary of State. The Commissioner of the Department believed that he had filed the documents; however, these documents were not on file with the Secretary of State, and the Department had not retained copies of the filings in its records to support the claim that filings had been made and misfiled by the Secretary of State.

The Commissioner filed a *Conflict of Interest Pledge* and a *Statement of Financial Disclosure* with the Secretary of State on October 17, 2004.

Recommendation:

The Department should implement procedures to ensure that all required disclosures and statements are filed with the Secretary of State in a timely manner and should maintain copies of those filings for Department records.

Auditee Response:

We concur and will develop procedures for timely filing of required disclosure forms.

Federal Compliance Comments

Observation No. 25: Federal Reports Should Be Submitted Timely

Observation:

The Department did not consistently comply with federal program reporting requirements during fiscal year 2004. The Department filed numerous reports late and other reports were not filed at all.

Each of the several federal programs administered by the Department requires regular financial and/or performance reports to be submitted to the federal grantor agency. These reports document the Department's operation of and the activity in the federally assisted programs. We tested the Department's compliance with the four major federal programs it administers. The Department received over $26 million in assistance for those four programs during fiscal year 2004. Testing revealed that reports were filed late or not at all for three of the programs during fiscal year 2004.

- One performance report, a Drinking Water State Revolving Fund biennial report, was submitted seven months late, and two of five (40%) financial status reports were submitted up to 57 days late.
- One financial status report for the Performance Partnership Grant was not submitted, while another was submitted 29 days late.
- For the Superfund program, 21 of 36 (58%) required quarterly progress reports were submitted late. The Department could not locate two additional reports.

Our previous audit of the Department in 1995 also noted the Department was not in consistent compliance with federal reporting requirements.

Recommendation:

The Department should establish procedures to ensure that federal reports are filed according to program requirements.

The Department should review current procedures to determine why it is not able to consistently submit required federal reporting in a timely manner. Based on that review the Department should take appropriate steps to allow it to submit required reports in compliance with program requirements. If the Department determines that program reporting requirements are unreasonably burdensome or due to other circumstances it is unable to regularly meet the reporting requirements, the Department should discuss with the federal grantor agency options that would allow the Department to file necessary reporting in a regular and timely manner.

Auditee Response:

We concur that reports should be submitted timely in accordance with federal reporting requirements. We will review our procedures regarding the timeliness of report filings. It should be noted, however, that the majority of the late quarterly reports were filed within a few weeks if not a few days of the filing deadline date.

Independent Auditor's Report

To The Fiscal Committee Of The General Court:

We have audited the accompanying financial statements of the governmental activities and each major fund of the New Hampshire Department of Environmental Services for the fiscal year ended June 30, 2004, as listed in the table of contents. These financial statements are the responsibility of the Department of Environmental Services' management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

As discussed in Note 1, the financial statements referred to above are not intended to present the financial position of the Department of Environmental Services in the government-wide or fund financial statements.

As discussed in Note 1, the financial statements of the Department of Environmental Services are intended to present certain financial activity of only that portion of the governmental activities of the State that is attributable to the transactions of the Department of Environmental Services. They do not purport to, and do not, present fairly the financial position of the State of New Hampshire as of June 30, 2004 and the changes in its financial position for the fiscal year ended June 30, 2004 in conformity with accounting principles generally accepted in the United States of America.

In our opinion, except for the matter discussed in the third paragraph, the financial statements referred to above present fairly, in all material respects, certain financial activity of the governmental activities and each major fund of the Department of Environmental Services for the fiscal year ended June 30, 2004, in conformity with accounting principles generally accepted in the United States of America.

The Department has not presented the management discussion and analysis that the Government Accounting Standards Board has deemed necessary to supplement, although not required to be part of, the basic financial statements.

The Budget to Actual (Non-GAAP Budgetary Basis) Schedule - General Fund on page 45 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements referred to in the first paragraph. The Schedule Of Expenditures Of Federal Awards on page 48 is presented for the purpose of additional analysis and is not a required part of the basic financial statements of the Department of Environmental Services. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements referred to in the first paragraph and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards,* we have also issued a report dated February 7, 2005 on our consideration of the Department of Environmental Services' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, rules, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Office Of Legislative Budget Assistant

Office Of Legislative Budget Assistant

February 7, 2005

STATE OF NEW HAMPSHIRE
DEPARTMENT OF ENVIRONMENTAL SERVICES

STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

		Program Revenues			Net (Expenses)
	Expenses	Charges For Services	Operating Grants And Contributions	Capital Grants And Contributions	Revenues And Change In Net Assets
Governmental Activities					
Water Division	$ 37,697,086	$ 9,490,485	$ 25,521,172	$ -0-	$ (2,685,429)
Waste Management Division	31,630,358	2,436,029	5,827,859	-0-	(23,366,470)
Office Of The Commissioner	6,512,931	5,615,472	385,230	-0-	(512,229)
Air Resources Division	5,499,640	3,232,172	1,756,474	-0-	(510,994)
Depreciation Expense	1,158,953	-0-	-0-	-0-	(1,158,953)
Interest On Debt	359,592	-0-	-0-	-0-	(359,592)
Total Governmental Activities	**$ 82,858,560**	**$ 20,774,158**	**$ 33,490,735**	**$ -0-**	**(28,593,667)**
General Revenues					
Net Appropriations					27,877,605
Oil Fund Board Fees					16,294,069
Total General Revenues					**44,171,674**
Change In Net Assets					**$ 15,578,007**

The accompanying notes are an integral part of this financial statement.

STATE OF NEW HAMPSHIRE
DEPARTMENT OF ENVIRONMENTAL SERVICES

STATEMENT OF REVENUES AND EXPENDITURES
GOVERNMENTAL FUNDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

	General Fund	Capital Projects Fund	Total Governmental Funds
Revenues			
Water Division	$ 55,000,809	$ 220,663	$ 55,221,472
Waste Management Division	24,559,629	-0-	24,559,629
Office Of The Commissioner	5,912,350	-0-	5,912,350
Air Resources Division	4,988,511	-0-	4,988,511
Total Revenues	**90,461,299**	**220,663**	**90,681,962**
Expenditures			
Water Division	61,957,251	3,552,660	65,509,911
Waste Management Division	31,098,852	381,133	31,479,985
Office Of The Commissioner	6,293,597	92,855	6,386,452
Air Resources Division	5,411,611	-0-	5,411,611
Total Expenditures	**104,761,311**	**4,026,648**	**108,787,959**
Excess (Deficiency) Of Revenues Over (Under) Expenditures	**(14,300,012)**	**(3,805,985)**	**(18,105,997)**
Other Financing Sources (Uses)			
Net Appropriations	21,102,260	6,775,345	27,877,605
Total Other Financing Sources/(Uses)	**21,102,260**	**6,775,345**	**27,877,605**
Excess (Deficiency) Of Revenues And Other Financing Sources Over (Under) Expenditures And Other Financing Uses	**$ 6,802,248**	**$ 2,969,360**	**$ 9,771,608**

The accompanying notes are an integral part of this financial statement.

STATE OF NEW HAMPSHIRE
DEPARTMENT OF ENVIRONMENTAL SERVICES

RECONCILIATION OF THE STATEMENT OF REVENUES AND EXPENDITURES - GOVERNMENTAL FUNDS - TO THE STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Excess (Deficiency) Of Revenues And Other Sources Over (Under) Expenditures And Other Uses	$ 9,771,608
Amounts Reported For Governmental Activities In The Statement Of Activities Are Different Because (See Note 1-C):	
Some Revenues Provide Current Financial Resources In The Governmental Funds But Are Not Recognized On The Statement Of Activities:	
SRF Loan Program	(20,123,000)
Some Expenses Reported In The Statement Of Activities Do Not Require The Use Of Current Financial Resources And Therefore Are Not Reported As Expenditures In The Governmental Funds:	
Changes In Compensated Absences And Workers Compensation	(574,148)
SRF Loan Program	27,067,585
Bond Proceeds Provide Current Financial Resources To Governmental Funds, But Issuing Debt Increases Long-Term Liabilities In The Statement Of Net Assets. Repayment Of Bond Principal Is An Expenditure In The Governmental Funds, But The Repayment Reduces Long-Term Liabilities In The Statement Of Net Assets And Therefore Is Not Recognized As An Expense In The Statement Of Activities:	
Bond Principal Repayments	693,159
Governmental Funds Report Capital Outlays As Expenditures. However, In The Statement Of Activities, The Cost Of Those Assets Is Allocated Over Their Estimated Useful Lives As Depreciation Expense. This Is The Amount By Which Depreciation Exceeded Capital Outlays In The Current Period: (See Note 2)	(1,257,197)
Change In Net Assets Of Governmental Activities	$ 15,578,007

The accompanying notes are an integral part of this financial statement.

STATE OF NEW HAMPSHIRE
DEPARTMENT OF ENVIRONMENTAL SERVICES

NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements of the Department of Environmental Services (Department) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and as prescribed by the Governmental Accounting Standards Board (GASB), which is the primary standard-setting body for establishing governmental accounting and financial reporting principles.

A. Financial Reporting Entity

The Department of Environmental Services is an organization of the primary government of the State of New Hampshire. The accompanying financial statements report the financial activity of the Department.

The financial activity of the Department of Environmental Services is accounted for and reported in the State's General and Capital Projects Funds in the State of New Hampshire's Comprehensive Annual Financial Report (CAFR). Assets, liabilities, and fund balances are reported by fund for the State as a whole in the CAFR. The Department of Environmental Services, as a department of the primary government, accounts for only a small portion of the General and Capital Projects Funds and those assets, liabilities, and fund balances as reported in the CAFR that are attributable to the Department cannot be determined. Accordingly, the accompanying financial statements are not intended to show the financial position or change in fund balances of the Department in the General and Capital Projects Funds.

B. Government-Wide And Fund Financial Statements

Government-Wide Financial Statements

The Statement of Activities reports information on the financial activities of the Department of Environmental Services. As none of the Department's activities are business-type, the activities reported in the Statement are all governmental. Business-type activities rely significantly on fees and charges for support. Governmental activities are normally supported through taxes and intergovernmental revenues.

The Statement of Activities demonstrates the degree to which the direct expenses of a given function or segment are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function or segment. Program revenues include: 1) charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided by a given function or segment and 2) grants and contributions that are restricted to meeting the operational or capital requirements of a particular function or segment. Taxes and other items not meeting the definition of program revenues, including resources that are dedicated internally, are reported as general revenues. Certain indirect costs are included in program expenses reported for individual functions.

Fund Financial Statements

Separate financial statements are provided for governmental funds. The General and Capital Projects Funds are reported as separate columns in the fund financial statement.

C. Measurement Focus and Basis of Accounting

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements have been met.

Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay the liabilities of the current period. For this purpose, the State generally considers non-grant revenues to be available if they are collected within 60 days of the end of the current fiscal period. Grant revenues that the State earns by incurring obligations are recognized in the same period the obligations are recognized. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. However, expenditures related to debt service, compensated absences, and claims and judgments are recorded only when payment is due.

D. Financial Statement Presentation

A fund is a separate accounting entity with a self-balancing set of accounts. Fund accounting is designed to report financial position and the results of operations, to demonstrate legal compliance, and to aid financial management by segregating transactions related to certain government functions or activities. The Department of Environmental Services reports its financial activity in the following governmental funds:

<u>Governmental Fund Types:</u>

General Fund: The General Fund is the State’s primary operating fund and accounts for all financial transactions not specifically accounted for in any other fund.

Capital Projects Fund: The Capital Projects Fund is used to account for certain capital improvement appropriations which are or will be primarily funded by the issuance of State bonds or notes, other than bonds and notes for highway or turnpike purposes, or by the application of certain federal matching grants.

E. Interfund And Intra-Agency Transactions

As a general rule, the effect of interfund and intra-agency activity is eliminated from the government-wide statements, with the exception of activities between funds that are reported in different functional categories of governmental activities. Elimination of these activities would distort the direct costs and program revenues for the functions concerned.

F. Revenues And Expenditures/Expenses

In the government-wide Statement of Activities, revenues and expenses are listed by activity type (governmental or business-type). Additionally, revenues are classified between program and general revenues. The Department of Environmental Services' program revenues include 1) charges for services provided, 2) operating grants and contributions, and 3) capital grants and contributions. In general, resources not dedicated to a program, as well as resources that are internally dedicated, are reported as general revenues rather than program revenues. The general revenues reported on the Department's Statement of Activities include net appropriations and unrestricted revenues. These unrestricted revenues are collected by the Department but are not dedicated for use by the Department.

In the governmental fund financial statements, revenues and expenditures are reported by division. For budgetary control purposes, revenues are further classified as either "general purpose" or "restricted". General-purpose revenues are available to fund any activity accounted for in the fund. Restricted revenues are, either by State law or by outside restriction, available for only specified purposes. When both general purpose and restricted funds are available for use, it is the State's policy to use restricted resources first.

Other Financing Sources – these additions to governmental resources in the fund financial statements result from financing provided by net appropriations.

G. Capital Assets

Capital assets, which include property, plant, equipment and infrastructure assets, are reported by the State in its CAFR in its government-wide financial statements. Such assets, whether purchased or constructed, are recorded at historical cost or estimated historical cost. Donated capital assets are recorded at estimated fair value at the date of donation. The Department of Environmental Services' capital assets are reported in Note 2.

Equipment is capitalized when the cost of the individual items exceeds $10,000 and all other capital assets are capitalized when the cost of individual items or project exceeds $100,000. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend asset lives are not capitalized. Depreciation expense is recognized in the government-wide financial statements. Capital assets are depreciated using the straight-line method over the following useful lives:

Equipment	5 years
Computer Software	5 years
Building Improvements	20 years
Buildings	40 years
Infrastructure	50 years

H. Budget Control And Reporting

General Budget Policies

The statutes of the State of New Hampshire require the Governor to submit a biennial budget to the Legislature for adoption. This budget, which includes a separate budget for each year of the biennium, consists of three parts: Part I is the Governor's program for meeting all expenditure needs and estimating revenues. There is no constitutional or statutory requirement that the Governor propose, or that the Legislature adopt, a budget that does not resort to borrowing. Part II is a detailed breakdown of the budget at the department level for appropriations to meet the expenditure needs of the government. Part III consists of draft appropriation bills for the appropriations made in the proposed budget.

The operating budget is prepared principally on a modified cash basis and adopted for the governmental and proprietary fund types with the exception of the Capital Projects Fund. The Capital Projects Fund budget represents individual projects that extend over several fiscal years. Since the Capital Projects Fund comprises appropriations for multi-year projects, it is not included in the budget and actual comparison schedule.

In addition to the enacted biennial operating budget, the Governor may submit to the Legislature supplemental budget requests necessary to meet expenditures during the current biennium. Appropriation transfers can be made within a department without the approval of the Legislature; therefore, the legal level of budgetary control is at the department level.

Additional fiscal control procedures are maintained by both the Executive and Legislative Branches of government. The Executive Branch, represented by the Commissioner of the Department of Administrative Services, is directed to continually monitor the State's financial operations, needs, and resources, and to maintain an integrated financial accounting system. The Legislative Branch, represented by the Joint Legislative Fiscal Committee, the Joint Legislative Capital Budget Overview Committee, and the Office of Legislative Budget Assistant, monitors compliance with the budget and the effectiveness of budgeted programs.

Unexpended balances of appropriations at year-end will lapse to undesignated fund balance and be available for future appropriations unless they have been encumbered or legally defined as non-lapsing, which means the balances are reported as reservation of fund balance. The balance of unexpended encumbrances is brought forward into the next fiscal year. Capital Projects Fund unencumbered appropriations lapse in two years unless extended or designated as non-lapsing by law.

Contracts and purchasing commitments are recorded as encumbrances when the contract or purchase order is executed. Upon receipt of goods or services, the encumbrance is liquidated and the expenditure and liability are recorded. The Department of Environmental Services' unliquidated encumbrance balances at June 30, 2004 were $36,594,637 and $2,754,339 in the General and Capital Projects Funds, respectively.

A Budget To Actual (Non-GAAP Budgetary Basis) Schedule - General Fund is included as required supplemental information.

NOTE 2 - CAPITAL ASSETS AND OTHER EQUIPMENT

In addition to capital assets, the Department of Environmental Services also accounts for equipment and other assets with an original cost between $100 and $10,000. While only capital assets are reported on the Department's financial statements, State policies require departments to inventory all assets with an original cost of $100 or more and a useful life of greater than one year for accountability purposes.

Capital asset and other equipment activity for the fiscal year ended June 30, 2004 was as follows.

	Balance July 1, 2003	Additions	Transfers/ Deletions	Balance June 30, 2004
Capital Assets Not Being Depreciated:				
Land	$ 17,119,893	$ -0-	$ 215,051	$ 16,904,842
Total Capital Assets Not Being Depreciated	**17,119,893**	**-0-**	**215,051**	**16,904,842**
Other Capital Assets:				
Buildings And Building Improvements	32,816,520	201,600	-0-	33,018,120
Land Improvements	51,814,065	-0-	-0-	51,814,065
Capital Equipment	5,775,469	444,228	529,021	5,690,676
Total Other Capital Assets	**90,406,054**	**645,828**	**529,021**	**90,522,861**
Less Accumulated Depreciation For:				
Buildings And Building Improvements	20,102,844	889,048	-0-	20,991,892
Land Improvements	48,958,336	268,272	-0-	49,226,608
Capital Equipment	4,620,568	530,654	529,021	4,622,201
Total Accumulated Depreciation	**73,681,748**	**1,687,974**	**529,021**	**74,840,701**
Other Capital Assets, Net	**16,724,306**	**(1,042,146)**	**-0-**	**15,682,160**
Capital Assets, Net	**33,844,199**	**(1,042,146)**	**215,051**	**32,587,002**
Equipment With Original Cost Between $100 And $10,000	6,968,542	615,881	368,429	7,215,994
Net Capital Assets And Other Equipment	**$ 40,812,741**	**$ (426,265)**	**$ 583,480**	**$ 39,802,996**

NOTE 3 - EMPLOYEE BENEFIT PLANS

New Hampshire Retirement System

The Department, as an organization of the State government, participates in the New Hampshire Retirement System (Plan). The Plan is a contributory defined-benefit plan and covers substantially all full-time employees of the Department. The Plan qualifies as a tax-exempt organization under Sections 401 (a) and 501 (a) of the Internal Revenue Code. RSA 100-A established the Plan and the contribution requirements. The Plan, which is a cost-sharing, multiple-employer Public Employees Retirement System (PERS), is divided into two membership groups. Group I consists of State and local employees and teachers. Group II consists of firefighters and police officers. All assets are in a single trust and are available to pay retirement benefits to all members.

Group I members at age 60 qualify for a normal service retirement allowance based on years of creditable service and average final compensation (AFC). The yearly pension amount is 1/60 (1.67%) of AFC multiplied by years of creditable service. AFC is defined as the average of the three highest salary years. At age 65, the yearly pension amount is recalculated at 1/66 (1.5%) of AFC multiplied by years of creditable service. Members in service with ten or more years of creditable service who are between ages 50 and 60 or members in service with at least 20 or more years of service, whose combination of age and service is 70 or more, are entitled to a retirement allowance with appropriate graduated reduction based on years of creditable service.

Group II members who are age 60, or members who are at least age 45 with at least 20 years of creditable service can receive a retirement allowance at a rate of 2.5% of AFC for each year of creditable service, not to exceed 40 years.

All covered Department of Environmental Services employees are members of Group I.

Members of both groups may qualify for vested deferred allowances, disability allowances, and death benefit allowances subject to meeting various eligibility requirements. Benefits are based on AFC or earnable compensation, service, or both.

The Plan is financed by contributions from the members, the State and local employers, and investment earnings. During the fiscal year ended June 30, 2004, Group I and II members were required to contribute 5% and 9.3%, respectively, of gross earnings. The State funds 100% of the employer cost for all of the Department's employees enrolled in the Plan. The annual contribution required to cover any normal cost beyond the employee contribution is determined every two years based on the Plan's actuary.

The Department of Environmental Services' payments for normal contribution costs for the fiscal year ended June 30, 2004 amounted to 5.90% of the covered payroll for its Group I employees. The Department's normal contributions for the fiscal year ended June 30, 2004 were $834,855.

A special account was established by RSA 100-A:16, II (h) for additional benefits. The account is credited with all the earnings of the account assets in the account plus the earnings of the remaining assets of the plan in excess of the assumed rate of return plus ½ of 1%.

The New Hampshire Retirement System issues a publicly available financial report that may be obtained by writing to them at 4 Chenell Drive, Concord, NH 03301-8509 or from their web site at http://www.state.nh.us/retirement.

Post-Employment Health Care Benefits

In addition to providing pension benefits, RSA 21-I:30 specifies that the State provide certain health care benefits for retired employees. These benefits include group hospitalization, hospital medical care, and surgical care. Substantially all of the State's employees who were hired on or before June 30, 2003 may become eligible for these benefits if they reach normal retirement age while working for the State and receive their pensions on a periodic basis rather than a lump sum. During fiscal year 2003, legislation was passed that requires State Group I employees hired after July 1, 2003 to have 20 years of State service in order to qualify for health insurance benefits. These and similar benefits for active employees are authorized by RSA 21-I:30 and provided through the Employee Benefit Risk Management Fund, which is the State's new self-insurance fund implemented in October 2003 for active State employees and retirees. The State recognizes the cost of providing these benefits by paying actuarially determined contributions into the fund. An additional major source of funding for retiree benefits is from the New Hampshire Retirement System's medical premium subsidy program for Group I and Group II retirees.

During the fiscal year ended June 30, 2004, the State paid for the cost of health benefits for the Department of Environmental Services' retired employees and spouses on a pay-as-you-go basis. The cost of the health benefits for the Department's retired employees and spouses is a budgeted amount paid from an appropriation made to the administrative organization of the New Hampshire Retirement System. Accordingly, the cost of health benefits for retired Department of Environmental Services employees and spouses is not included in the Department's financial statements.

NOTE 4 - FEDERAL FUNDS

The Schedule of Expenditures of Federal Awards (the Schedule), on page 48, is presented for the purpose of additional analysis. The expenditures presented in the Schedule are presented on the cash basis of accounting; expenditures are recorded when paid rather than when the obligation is incurred.

NOTE 5 – CASH, CASH EQUIVALENTS AND INVESTMENTS

Deposits

The following statutory requirements and New Hampshire Treasury Department policies have been adopted to minimize risk associated with deposits.

RSA 6:7 establishes the policy the State Treasurer must adhere to when depositing public monies. The statute restricts deposits to national banks, trust companies, and savings banks within the United States that have a branch in the State of New Hampshire. In addition, all depositories used by the State must be approved at least annually by the Governor and Executive Council.

RSA 6:11 establishes depositing procedures and procedures for making payments to State Treasury accounts. All accounts opened by departments require the State Treasurer's concurrence. RSA 6-B:2 requires the State Treasurer to submit quarterly financial reports to the Governor and Executive Council, the Commissioner of Administrative Services, and the Legislative Fiscal Committee.

The Treasury Department examines the financial condition of its depositories quarterly. The State Treasurer is not required to collateralize bank deposits. The Department of Environmental Services' bank deposits are FDIC insured for up to $100,000. The total bank balance represents amounts on deposit as reported by the banking institutions at June 30, 2004. The carrying amount represents the balance per the Department's records at June 30, 2004. The difference between the bank balance and the carrying amount consists of checks and deposits that have not cleared the bank as of June 30, 2004.

The balances of the Department of Environmental Services' deposit accounts at June 30, 2004, listed by custody risk category, are shown in the following schedule.

Category 1	Insured or collateralized with securities held by the State, or by its agent in the State's name.
Category 2	Collateralized with securities held by pledging institution's trust department or agent in the State's name.
Category 3	Uncollateralized.

	Categories			Total Bank	Carrying
Description	1	2	3	Balance	Amount
Pooled Deposits:					
Demand Deposits	$ 100,000	$ 19,807,609	$ -0-	$ 19,907,609	$ 19,395,334
Savings Accounts	220,392	-0-	129,839	350,231	350,231
Certificates Of Deposit	-0-	-0-	14,000,000	14,000,000	14,000,000
Total Deposits	$ 320,392	$ 19,807,609	$ 14,129,839	$ 34,257,840	$ 33,745,565

Investments

Statutory requirements and Treasury policies have been adopted to ensure reasonable rates of return on investments while minimizing risk factors. In accordance with GASB Statement No. 3, investments are classified as to risk by the three categories described below:

Category 1	Insured or registered in the State's name, or securities held by the State or its agent in the State's name.
Category 2	Uninsured and unregistered held by the counterparty's trust department or agent in the State's name.
Category 3	Uninsured and unregistered held by the counterparty or by its trust department or agent but not in the State's name.

In accordance with GASB Statement No. 3, mutual fund investments should be disclosed but not categorized. The Department's investments at June 30, 2004, summarized by type and risk category, are shown in the following schedule.

	Categories				Fair
Description	**1**	**2**	**3**	**Uncategorized**	**Value**
Open-Ended Mutual Funds	$ -0-	$ -0-	$ -0-	$ 24,022,463	$ 24,022,463
Total Investments	**$ -0-**	**$ -0-**	**$ -0-**	**$ 24,022,463**	**$ 24,022,463**

NOTE 6 – LONG-TERM DEBT

The following is a summary of changes in the long-term liabilities during fiscal year 2004 for bond amounts related to the Department of Environmental Services' projects.

Governmental Activities	Beginning Balance	Increases	Decreases	Ending Balance	Current	Long-Term
General Obligation Bonds Payable	$ 7,547,729	$ -0-	$ (693,159)	$ 6,854,570	$ 682,309	$ 6,172,261
Total Governmental	$ 7,547,729	$ -0-	$ (693,159)	$ 6,854,570	$ 682,309	$ 6,172,261

All bonds issued by the State, except for Turnpike revenue bonds, are general obligation bonds, which are backed by the full faith and credit of the State. The anticipated source of repayment is the General Fund. The annual maturities are as follows:

Year Ended June 30,	Principal	Interest	Total
2005	$ 682,309	$ 378,894	$ 1,061,203
2006	656,367	337,425	993,792
2007	672,824	309,263	982,087
2008	653,858	273,217	927,075
2009	640,909	237,162	878,071
2010-2014	2,194,695	948,776	3,143,471
2015-2019	1,072,538	424,612	1,497,150
2020-2022	281,070	15,721	296,791
Total	**$ 6,854,570**	**$ 2,925,070**	**$ 9,779,640**

NOTE 7 – SUBSEQUENT EVENTS

During the period following the audit, effective July 1, 2004, the Bureau of Environmental and Occupational Health within the Office of Community and Public Health, Department of Health and Human Services, and the Office of State Planning and Energy programs relating to the Coastal Management Program and the New Hampshire Estuaries Project, were transferred to the Department of Environmental Services. The budget and financial activity of these programs was recorded in the State accounting system under the Department of Health and Human Services and the Office of State Planning and Energy, respectively, during fiscal year 2004.

STATE OF NEW HAMPSHIRE
DEPARTMENT OF ENVIRONMENTAL SERVICES
REQUIRED SUPPLEMENTARY INFORMATION

BUDGET TO ACTUAL (NON-GAAP BUDGETARY BASIS) SCHEDULE
GENERAL FUND
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

	Budgeted Amounts		Actual	Variance With Final Budget
	Original	Final	(Budgetary Basis)	Positive (Negative)
Revenues				
Water Division	$ 95,245,449	$ 92,885,184	$ 54,135,474	$ (38,749,710)
Waste Management Division	48,354,859	48,785,732	25,427,999	(23,357,733)
Office Of The Commissioner	8,504,008	8,748,727	6,020,249	(2,728,478)
Air Resources Division	7,106,052	7,384,136	4,938,380	(2,445,756)
Total Revenues	**159,210,368**	**157,803,779**	**90,522,102**	**(67,281,677)**
Expenditures				
Water Division	145,119,186	112,929,376	61,816,721	51,112,655
Waste Management Division	72,210,966	71,368,436	32,994,332	38,374,104
Office Of The Commissioner	7,116,600	7,890,614	6,158,849	1,731,765
Air Resources Division	8,091,730	8,176,175	4,997,648	3,178,527
Total Expenditures By Division	**232,538,482**	**200,364,601**	**105,967,550**	**94,397,051**
Capital Outlays	1,336,143	1,336,143	1,336,143	-0-
Debt Service	866,593	866,593	866,593	-0-
Total Expenditures	**234,741,218**	**202,567,337**	**108,170,286**	**94,397,051**
Excess (Deficiency) Of Revenues Over (Under) Expenditures	**$ (75,530,850)**	**$ (44,763,558)**	**$ (17,648,184)**	**$ 27,115,374**

The accompanying note is an integral part of this schedule.

Note To The Required Supplementary Information – Budgetary Reporting
For The Fiscal Year Ended June 30, 2004

The Department of Environmental Services' biennial budget is prepared principally on a modified cash basis and adopted for governmental and proprietary funds. The "actual" results column of the Budget To Actual Schedule is presented on a "budgetary basis" to provide a meaningful comparison to budget.

The budget is composed of the initial operating budget, supplemented by additional appropriations. These additional appropriations and estimated revenues from various sources are authorized by Governor and Council action, annual session laws, and existing statutes which require appropriations under certain circumstances. For reporting purposes, the original budget is equal to the initial operating budget plus any additional appropriations, balances brought forward, and other legally authorized legislative and executive changes made before the beginning of the fiscal year. The final budgeted amount includes the original budget plus supplemental appropriation warrants and transfers made throughout the fiscal year, and excludes the effect of prior year encumbrances.

The variance column on the Budget To Actual Schedule highlights differences between the final budget and actual revenue and expenditures. For revenue, a favorable variance is caused by actual revenue exceeding budget. For expenditures, a favorable variance results from actual expenditures being less than the amount budgeted for the fiscal year.

Budgetary vs GAAP basis

Because the budget is prepared on a budgetary basis and not in accordance with generally accepted accounting principles (GAAP) there are differences in the revenue and expenditures amounts reported in the Statement of Revenues and Expenditures and the Budget To Actual Schedule. The major differences between the budgetary basis and the GAAP basis are:

1. Expenditures are recorded when cash is paid or committed (budgetary), rather than when the obligation is incurred (GAAP). In addition, revenue based on these accruals is adjusted on a GAAP basis only.
2. On a GAAP basis, major intra-agency transactions are eliminated in order to not double count revenues and expenditures reported in the Department of Environmental Services' financial statements.

The following schedule reconciles the differences between budgetary accounting methods and the GAAP basis accounting principles for the fiscal year ended June 30, 2004.

RECONCILIATION OF BUDGETARY TO GAAP

Excess (Deficiency) Of Revenues	
Over (Under) Expenditures (Budgetary Basis)	**$ (17,648,184)**
Adjustments And Reclassifications:	
To Record The Effect Of Encumbrances	49,746
To Record Net Accrued Salaries And Benefits	
And Other Accounts Payable	3,298,426
Net Adjustments	3,348,172
Excess (Deficiency) Of Revenues	
Over (Under) Expenditures (GAAP)	**$ (14,300,012)**

STATE OF NEW HAMPSHIRE
DEPARTMENT OF ENVIRONMENTAL SERVICES

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Federal Catalog Number	Federal Grantor *Federal Program Title*	Expenditures	Pass Thru Percent
	U.S. Department of Defense		
12.113	*State Memorandum of Agreement Program for the Reimbursement of Technical Services*	$ 146,588	0%
	U.S. Department of the Interior		
15.616	*Clean Vessel Act*	80,621	0%
	U.S. Environmental Protection Agency		
66.458	*Capitalization Grants for Clean Water State Revolving Funds (CWSRF)*	9,521,023	94%
66.468	*Capitalization Grants for Drinking Water State Revolving Funds (DWSRF)*	8,404,403	46%
66.605	*Performance Partnership Grants (PPG)*	5,118,705	0%
66.802	*Superfund State, Political Subdivision, and Indian Tribe Site-Specific Cooperative Agreements*	3,958,380	0%
66.Various	*Various Environmental Programs*	3,435,135	0%
	U.S. Department of Energy		
81.119	*State Energy Program Special Projects*	15,991	0%
	U.S. Department of Homeland Security		
97.041	*National Dam Safety Program*	55,638	0%
		$ 30,736,484	

APPENDIX

CURRENT STATUS OF PRIOR AUDIT FINDINGS

The following is a summary, as of February 7, 2005, of the current status of the observations and other issues and concerns contained in the audit report of the Department of Environmental Services for the nine months ended March 31, 1995. A copy of the prior report can be obtained from the Office of Legislative Budget Assistant, Audit Division, 107 North Main Street, State House Room 102, Concord, NH 03301-4906.

	Status
Internal Control Comments	
Material Weakness	
1. Documentation For Real Property *(See Current Observation No. 15)*	● ● ○
Other Reportable Conditions	
2. Lack Of Control Over Permit And License Fees *(See Current Observation No. 8)*	● ● ○
3. Equipment Errors *(See Current Observation No. 14)*	● ● ○
4. Documentation Of Computer System *(See Current Observation No. 6)*	○ ○ ○
5. Federal Financial Reporting System *(See Current Observation No. 1)*	○ ○ ○
6. Segregation Of Duties – Payroll	● ● ●
7. Oil Fund Disbursements Audit Trail	● ● ●
8. Understatement Of Total Indirect Costs	○ ○ ○
State Compliance Comments	
9. State Aid To Municipalities	● ● ●
Federal Compliance Comments	
10. Federal Program Income	● ● ●
11. Federal Grant Reporting *(See Current Observation No. 25)*	○ ○ ○
12. Indirect Cost Plan	● ● ○

Status Key

Fully Resolved	● ● ●
Partially Resolved	● ● ○
Unresolved	○ ○ ○

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