KPMG LLP
99 High Street
Boston, MA 02110-2371

Telephone 617 988 1000
Fax 617 988 0800
Internet www.us.kpmg.com

January 4, 2005

To the Fiscal Committee of the General Court
State of New Hampshire
Concord, New Hampshire

We have audited the financial statements of the State of New Hampshire for the year ended June 30, 2004, and have issued our report thereon dated January 4, 2005. In planning and performing our audit of the financial statements of the State of New Hampshire, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements. An audit does not include examining the effectiveness of internal control and does not provide assurance on internal control. We have not considered internal control since the date of our report.

A material weakness is a reportable condition in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that errors 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 internal control would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we noted no matters involving internal control and its operation that we consider to be material weaknesses as defined above.

Our audit procedures are designed primarily to enable us to form opinions on the financial statements, and therefore may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the State gained during our work to make comments and suggestions that we hope will be useful to you.

This report is intended solely for the information and use of the Fiscal Committee, management, and others within the State and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

KPMG LLP

STATE OF NEW HAMPSHIRE
2004 MANAGEMENT LETTER

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Department of Administrative Services

Implementation of Government-wide Enterprise Resource Planning System

The State has appropriated approximately $18.8 million to procure and implement a new financial accounting system or, enterprise resource planning (ERP) system, to replace the existing legacy system, New Hampshire Integrated Financial System (NHIFS) and the Government Human Resources System (GHRS). An ERP system is an integrated information system that is intended to serve all departments in an organization, enhance reporting capability and provide additional system functionality.

The ERP system implementation is an extremely complex, time consuming and expensive process and can severely impact continuing business activities. The State has dedicated a team of State employees to head up the procurement and implementation of the ERP.

We recommend that the State carefully consider its IT needs and goals. This is addressed by a due diligence process that should include a needs assessment, both present and future, across all aspects of the State's operations. Specifically, the State should:

- Develop a detailed timeline, including milestone dates, associated deliverables, and estimated time to achieve each milestone and be agreed to by the team, participating State agencies, and the ERP vendor.

- Ensure that the project plan and deliverables are clearly defined. A proposed work plan with appropriate detail for State management review should be properly addressed.

- Develop a reporting mechanism to make sure the team has access to the highest levels of State government for decision-making purposes.

- Ensure that the vendor implementation methodology fits the State's culture and management expectations.

- Ensure that all members of the organization are adequately trained to utilize the new systems and its capabilities and have access to system support after implementation.

- Establish a contingency plan in case of unexpected delays in implementation.

Overall, the State should recognize that the failure to adequately plan for and execute fundamental changes to the organization's business processes that will occur as a result of an ERP implementation would impact the outcome. Failures to review and develop future technical and business requirements, job descriptions, organizational structural changes, and adequate documentation of existing legacy systems are common difficulties.

Department of Administrative Services Response

We concur with all of the above comments. The specific recommendations have been incorporated into the Request for Proposal for a new ERP system, which was originally issued on February 20, 2004. The State has been very cautious in extensively monitoring and evaluating the bidding process, screening of vendors, and the final vendor selection.

Dedicating staff to this project will be a challenge, but we have requested Commissioners of the various departments to contribute staff to this critical project. We are aware of the risks associated with being spread too thin and we will constantly monitor our staffing to ensure that the project stays on track and that the current work still gets done. We are in the final process of selecting a vendor and are currently working with legal counsel on the contract.

Formal Fraud Prevention Program

In accordance with the Statement of Auditing Standards No. 99 *Consideration of Fraud in a Financial Statement Audit* (SAS 99), "management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. Management, along with those who have responsibility for oversight of the financial reporting process, should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management and those responsible for the oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly."

In an effort to adopt sound accounting policies and establish and maintain sound internal controls, management should establish formal broad programs that are designed to prevent, deter and detect fraud. During 2004, the Department of Administrative Services drafted two fraud prevention policies including "Policies Against Fraudulent or Other Wrongful Acts" and "Fraudulent Detection and Prevention Policies and Procedures". We understand that these documents remain in draft form with the Attorney General's office.

We recommend these fraud policies be finalized as soon a possible and a “hot-line” or call center for State employees to anonymously report instances of suspected fraud or inappropriate activities be developed. The establishment of formal procedures for receiving and handling complaints could serve to facilitate disclosures, encourage proper individual conduct and alert the State to potential problems before they have serious consequences.

We also recommend that the Department of Administrative Services develop and distribute to the management of each State agency a formal risk assessment program to annually identify fraud risks resident at each respective agency, including the agency’s response to those risks.

Department of Administrative Services Response

We concur that a Statewide Formal Fraud Program needs to be established. Two documents titled "Policy Against Fraudulent or Other Wrongful Acts" and "Fraud Detection and Prevention Policies and Procedures” have been drafted. The two draft documents have been reviewed by the legal counsel at the Attorney General’s (AG) office and returned to DAS with preliminary comments and suggestions. It was also suggested by the AG’s legal counsel that DAS meet with the AG’s Criminal Bureau to obtain input on the process to be followed in cases where potential fraud is uncovered in State Government. The Department anticipates meeting with the AG’s Criminal Bureau shortly and we will be moving to the implementation phase soon.

GAAP Journal Entries

The State’s general ledger, New Hampshire Integrated Financial System (NHIFS), reports results of the State’s operations on a budgetary basis of accounting. In order to properly report the State’s financial position and results of operations in accordance with Generally Accepted Accounting Principles (GAAP), the Bureau of Financial Reporting is required to compile manual journal vouchers and post these “GAAP” entries to the financial reporting system, which is a series of Excel spreadsheets.

During the current year audit, we noted an instance where a GAAP entry was incorrectly posted to the excel spreadsheets. In this instance, the journal voucher was accurate and complete, however, the amount posted to the excel spreadsheets did not reflect that correct entry. This error caused general fund revenue to be overstated by $4.5 million. This error was subsequently corrected in the financial statements, however, it is evidence that the manual process in which the financial statements are compiled can be improved to incorporate additional controls that would prevent or detect such an occurrence.

We understand that the financial reporting process will change significantly when the new Enterprise Resource Planning system is implemented. However, we recommend that until that time, the Division of Accounting implement policies and procedures to ensure that a similar error would be prevented and/or detected. Such policies and procedures may include a reconciliation of the net affect of the manual entries to that posted to the Excel spreadsheets.

Department of Administrative Services Response

We concur with the observation. As with any manual system, data entry errors can occur. It is the policy of the Division to review all entries and spreadsheets prior to transmittal to the auditors, however as a result of being understaffed, the review was not as thorough as previous years. We hope to be fully staffed next year and will make sure additional reviews are in place to prevent this type of error going forward. It should be noted that the error was corrected prior to the release of the financial statements.

Federal Reimbursement

For financial reporting purposes, the State recognizes accounts receivable for Federal reimbursement on allowable accounts payable and payroll accruals.

The amount of this Federal reimbursement is based on the Federal reimbursement rate per the State's general ledger, NHIFS, which calculates the Federal reimbursement rate as the percentage of total Federal revenues to total expenditures within an organization code.

During the current year audit, we noted that the Federal reimbursement calculated on the accounts payable and payroll accrual amounts was understated by approximately $2.6 million. The understatement was a result of inaccurate reporting by NHIFS, where accounts payable on encumbrances established in the prior year was not being captured by the Federal reimbursement on accounts payable report.

Due to the impact of the Federal reimbursement on accounts payable on the State's financial reporting, we recommend that the Division of Accounting work to correct the NHIFS reporting to ensure that all allowable accounts payable is captured in future years. This will help ensure that the federal receivable reported is accurate.

Department of Administrative Services Response

We concur with the observation. The office has been working diligently with the Division of Financial Data Management (FDM) to reprogram the NHIFS accounts payable and federal reimbursement reports. The new reports will be available for the FY05 close, so that all accounts payables and related reimbursements are captured and appropriately reported.

Unexpended Appropriation Balances

In order to provide spending authority for State activities, the State's budgetary process establishes appropriations. Each fiscal year-end, unexpended appropriations are lapsed to undesignated fund balance and are available for future appropriations unless they have been encumbered or are legally defined as non-lapsing. Often included in an agency's unexpended appropriation are 'negative' available balances. Negative available balances are the result of encumbrances established for which Federal revenues have not been drawn, expenditures incurred but not yet billed by the State, or draw downs from the Federal government and other anticipated revenues not yet received.

At year-end, at the request of the Department, all State agencies review the "Statement of Appropriation" for unexpended appropriations and take appropriate action. During our audit work, we noted numerous 'negative' balances in the unexpended appropriations that were not properly classified in the general fund. These balances ranged from $.2 million to $1 million, and resulted in a decrease in the undesignated fund balance by approximately $2.2 million. Not properly assessing and recording the availability of funds in light of the laws defeats the merits of the budgetary process and provides State management with an inaccurate position of the State's funding availability.

A similar comment was noted in the State's fiscal year 2003 management letter.

We recommend that the State agencies, in cooperation with the Department, seek ways to improve the process to review and close out appropriations. Additionally, we recommend that the Department and the various agencies work to ensure that negative available balances are properly accounted for.

Department of Administrative Services Response

We concur. We will devote additional time at the Annual Closing meeting to discuss this issue with agencies. In addition our office will monitor the June and Mock Close Statement of Appropriations to review any balances that are negative. The Division of Accounting will work with the Budget Office to develop a process to identify problem accounts prior to year-end, so that appropriate budgetary decisions can be made on a timely basis.

Capital Asset Reporting

Governmental Accounting Standards Board Statement 34 – Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments, adopted by the State as of June 30, 2002, requires that capital assets be reported for all governmental and business-type activities.

In order to report capital assets, the Division of Accounting Services (the Division) requires that each agency manually prepare a spreadsheet to record its capital additions, deletions and ending balances and forward the schedule to the Division for Statewide compilation. Upon receipt, the Division manually enters this information into a master spreadsheet that consolidates all of the capital assets reported by the agencies. There are approximately forty-five State agencies, reporting seven different capital asset categories and the related accumulated depreciation. This process is extremely labor-intensive and is subject to error. Further, such a compilation process provides information for financial reporting purposes only and cannot be used for management analysis and decision-making.

Although agencies generally use a consistent format to report capital asset information to the Division, the agency level supporting information differs from agency to agency. Inconsistent tracking increases the likelihood of inaccurate financial reporting as certain items may or may not be included.

Additionally, at any given time, the State has many projects on going, which are categorized as construction in progress. When the project is substantially complete, it should be transferred to capital assets and depreciated. We noted a project that was completed during the fiscal year and not transferred out of construction in progress and therefore, not depreciated.

Further, we noted one instance related to the Turnpike System, whereby, traffic study costs equal to $400,000, may have been capitalized improperly or at a minimum should no longer be included in construction in progress. The invoices supporting these costs date back a few years.

We recommend that an automated capital asset reporting module be utilized to ensure that fixed asset reports are complete and accurate. The State may consider implementing such a module as a sub-ledger in NHIFS or including the module in the new ERP. The capital asset module should be utilized by all agencies to more uniformly track capital assets.

We also recommend that applicable Departments more accurately monitor their construction in progress accounts and perform a current review of the costs included to ensure that all costs included are properly capitalized, and that projects that are substantially complete and/or ‘in use’, are recorded as capital assets and depreciated. Further, the State should reinforce the capitalization guidelines to the Departments.

Department of Administrative Services Response

We concur. The consolidation of statewide capital assets for reporting in accordance with GASB 34 has become very labor intensive. Since the State’s current system, NHIFS, is unable to capture the necessary information for compliance with the new accounting standards, multiple advanced spreadsheets have been utilized to allow for the data to be consolidated in a central location. This is considered an interim step until a new ERP system is in place. Until then, we will continue to work with agencies to review capitalization thresholds and construction in progress accounts.

Turnpike System Response

To ensure projects are properly capitalized from construction in progress and deter the possibility of reoccurrences in the future, the Bureau of Turnpikes will utilize a unique project number for each study. This will enhance monitoring of construction in progress projects and ensure that all costs are properly capitalized.

Compilation of the State's Schedule of Federal Financial Awards

In accordance with Office of Management and Budget Circular A-133 section .310, management of the State is responsible for compiling the Schedule of Federal Financial Awards (the Schedule). As such, management has the responsibility for, among other things: (a) identifying, in its accounts, all Federal awards received and expended and the Federal programs under which they were received. Federal program and award identification shall include, as applicable, the Catalog of Federal Domestic Assistance (CFDA) title and number, award number and year, name of the Federal agency, and name of the pass-through entity; and (b) preparing appropriate financial statements, including the Schedule of Expenditures of Federal Awards.

Currently, the Schedule is compiled by the Office of Legislative Budget Assistant (LBA) because the State does not have a system in place for gathering the Federal expenditure data needed to prepare the Schedule and the State's general ledger, the New Hampshire Integrated Financial System (NHIFS), is unable to record the information that would enable the State to electronically prepare the Schedule.

The State is in the process of developing and implementing a new financial management system. The State should ensure that this system allows them to generate the needed information to identify Federal awards and prepare the Schedule.

A similar comment was noted in the State's fiscal year 2003 management letter.

We recommend that management of the State implement the necessary steps to ensure that all federal awards are properly identified within the financial accounting system. This will help to ensure that all expenditures are properly reported within the Schedule of Expenditures of Federal Awards. Also, in order to reconcile the Schedule to the State's accounting system, it is important that the new financial management system has the capability of tracking and reporting Federal expenditure data.

Most importantly, the State should reassign the responsibility for preparing the Schedule to the Department of Administrative Services, as this function is truly a management function similar to the preparation of financial statements.

Department of Administrative Services Response

As part of the new ERP project, federal award information will be properly identified and the system will have the capability to track and report federal expenditure data. During FY04 additional information was added to the Annual Closing Guide and the LBA office developed a new database to capture federal information in order to more efficiently prepare the Schedule of Expenditures of Federal Awards. We will work with the LBA office to transition the compilation of the Schedule from their office to ours going forward.

Implementation of Government Accounting Standards Board Statement #40

In March 2003, GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures*. GASB 40 requires communication of key information in the financial statements about deposit and investment risks covering four principal areas:

- Investment credit risk disclosures, including credit quality information issued by rating agencies;
- Interest rate disclosures that include investment maturity information, such as weighted average maturities or specific identification of the securities;
- Interest rate sensitivity for investments that are highly sensitive to changes in interest rates (e.g., certain variable-rate investments and asset-backed securities); and
- Foreign exchange exposures that would indicate the foreign investment's denomination.

The provisions of GASB No. 40, which will supersede the custodial credit risk disclosures currently required by GASB No. 3, are effective for the State and its component units for the June 30, 2005 financial statements. Because the State will be required to adopt the new standards for fiscal 2005, the State and its component units will need to develop plans to ensure timely reporting compliance. We believe the assessment of information relative to debt instruments will be the most burdensome compliance aspect, and that compilation of the underlying data will require the up-front involvement of investment custodians. We encourage the State to consider the guidance contained in the Implementation Guide issued by GASB to help develop a comprehensive implementation plan.

Department of Administrative Services Response

We have received the Implementation Guide issued by GASB for Statement No. 40. We will work with the Treasury Department and contact other states to aid in the implementation of this new standard.

Department of Health and Human Services

Improved Accounting and Reporting over Medicaid Liability

Changes in economic conditions and Federal and legislative changes have resulted in significant increases in the Department of Health and Human Services (the Department) spending over the past several years. As the State's largest agency, spending over $2 billion in Federal and State resources in State fiscal year 2004, it is imperative that proper internal controls over the receipt and expenditure of State and Federal resources be in place and that the operations of the Department be reported in an accurate and timely fashion.

The Department's programs, activities and initiatives – including Medicaid, Drug Rebates, Disproportionate Share Hospital, 'ProShare', County programs and others – require strong internal controls and the timely reporting of relevant information for subsequent in-depth analysis by the Department's management. Without accurate, timely reporting, review and analysis, decisions by the Department's management may be incorrect and, in turn, errors could occur in the State's financial statements.

During the prior year audit, we noted several errors in State fiscal year 2003 information produced by the Department that resulted in adjustments to the financial statements of several million dollars and a reportable condition.

During the current year audit, we noted significant improvements in the Department's accounting and reporting, particularly for the Medicaid liability. During the current year, the Department implemented a new Medicaid reporting system, where one of the systems functions is to calculate the year-end Medicaid liability. Our testing of the current year Medicaid liability showed the Department had an in-depth understanding of the methodology of the liability, and, therefore, was able to accurately report the Medicaid liability. Additionally, the documentation provided by the Department supporting the liability, including Departmental testing of the information and analysis, was complete and useful.

We encourage the Department to continue to provide outside parties, including auditors and other State agencies, with the same quality and accurate documentation that was provided in support of the Medicaid Liability.

Department of Health and Human Services Response

The Department has made significant efforts to improve its financial reporting practices and welcomes acknowledgment of the efforts. We continue to pursue improvements to our financial accounting processes including:

- Reorganization of financial and business functions as part of the Department-wide reorganization.

- Submitting waivers for approval to fill vacancies in key financial positions.

- Active follow-up of corrective actions resulting from recommendation from the LBA, KPMG and others.

Department of Revenue Administration

The State uses the services of a third party vendor for the eFileNH system. Functions provided include:

1. A web interface that New Hampshire taxpayers access for the eFileNH system over the internet,

2. Collection of tax filings (tax payments) via eFileNH,

3. Payment of taxes using Automated Clearing House debit transactions to a taxpayer's authorized bank account,

4. An off-site data center, where the application is hosted, with maintenance that is 24 hours, 7 days a week.

Reports on Processing of Transactions by Service Organizations

The State depends on this third party vendor, GovConnect, to provide services for the eFile application. The internal controls for GovConnect are unknown and may (or may not) pose a risk (for example, in terms of data security and/or data integrity). Also, whether GovConnect outsources any of its operations (e.g. overseas) is unknown. Similarly, this could pose a risk for the State, since taxpayers provide sensitive and confidential information.

To gain comfort over the controls in place at GovConnect, the State should request an audit report in accordance with Statement on Auditing Standards (SAS) No. 70, Reports on the Processing of Transactions by Service Organizations. If the vendor does not currently have a SAS70 report, the State may want to request that the vendor obtain one annually as a condition in its contract with the State. The SAS70 should provide an objective outside review and opinion on the vendor's internal controls.

Department of Revenue Administration Response

The Department of Revenue Administration (DRA) concurs with the recommendation that a SAS70 should be obtained from First Data Government Solutions ("FDGS" formerly known as GovConnect). Currently the Cincinnati Data Center hosts the DRA's e-File application and, while there is an internal Security Policy for that center, it is not SAS70 certified. However, the FDGS Data Center located in Denver, Colorado is SAS70 certified. FDGS is in the process of exploring either putting plans in place to certify the Cincinnati Data Center or to move applications requiring this certification to the Denver Data Center. FDGS will have determined whether or not to certify the Cincinnati Data Center or move the application to the Denver Data Center by June of 2005. A detailed plan for accomplishing the direction taken may not be complete at that time, but will have been initiated. Any plans that affect the DRA application will need to be approved by the DRA. The DRA expects that any cost for the vendor to become SAS70 compliant will be at the expense of FDGS.

FDGS does not outsource any of its operations overseas including the help desk.

Manual Interfaces

The eFileNH application relies on a number of manual interfaces:

1. Visual inspection (by Department of Revenue Administration (DRA) staff) of the bank report to check on amounts credited (ACH transactions)

2. Typing in of dates and file names and other detailed "point and click" procedures (by computer operator)

3. Error processing, which can involve manual overrides by applications staff

Manual interfaces can be a risk due to errors in reading, typing, and applying procedures (e.g. using the wrong procedure for a similar operation, or mistakenly skipping steps). Also, training of staff to perform manual interfaces can become a time consuming and costly (error prone) venture. While the volume of Internet transactions stands at about 500 (Source: NH DRA Administration 2003 Annual Report) as of 2003, or about $2.5 million, the volume is expected to increase.

As the volume of transactions increases, we recommend, the DRA consider having an automated (software) comparison of the bank report to GovConnect figures, as the first pass in checking the results of eFileNH processing with the banks.

Similarly, the computer operator procedures could be automated. The DRA should consider having a secure software program that automatically does most of the functions that are currently required of the operator, generates a log, audit trail, produces an exception report, if needed, writes a completion report, and notifies appropriate parties (e.g. the operator, applications support).

Additionally, we recommend the State consider having a detailed, objective, and systematic review and analysis of the operational procedures, software, and hardware performed. The objectives of such a review would be:

1. To identify where business processes could be streamlined or simplified

2. To identify areas where technology could be used to make the business operation more efficient or effective.

Automation of some manual interfaces may be appropriate, but this should be approached with caution. Processes should be re-engineered first to eliminate redundancies and unnecessary manual procedures**.**

Department of Revenue Administration Response

The DRA concurs with the recommendation that an automated (software) comparison of the bank report to GovConnect figures would be beneficial, as the first pass in checking the results of eFileNH processing with the bank. An AIS action form to research this automation has been created. A task group of application, and technical staff, and end users (including an internal auditor) will meet to review this process in March 2005.

The task group findings will be documented and placed into the e-File project manual.

Exception Reporting

The people who support eFileNH look at a number of reports concerning the running of the application. Management reports on exceptions that look at activities that relate to the overall context of the application do not appear to be part of what State staff regularly examine. An example of such exception reporting is repeatedly incorrect withdrawal of funds (e.g. too much or too little) over a period of time (such as several months or a year). Without such reporting, the State risks sustaining application performance issues that should be corrected by the vendor.

The State should consider having State personnel routinely (e.g. monthly, quarterly, or semi-monthly) scrutinize certain management reports, which either State personnel or GovConnect staff generates. Examples include monthly management reports that:

- Summarize and list all instances of incorrect withdrawal amounts for the current month (e.g. too much withdrawn, or too little, and with what accounts and on what dates)

- Summarize and list all instances of system failures (i.e. application/system downtime and on what dates)

In addition, the State should consider what other management reports are needed to allow NH personnel to monitor application performance activity (e.g. affecting data security or data integrity) that may be improved. Once the State compiles such a list of reports, it should take steps to generate the reports and have assigned staff review those reports routinely. Reviews of reports should be documented.

Department of Revenue Administration Response

The DRA concurs with the recommendation that State personnel routinely (e.g. monthly, quarterly, or semi-monthly) scrutinize certain management reports, which either State personnel or GovConnect staff generates. Currently DRA staff reviews reports on a daily basis. These reports are checked and filed daily. If there are any discrepancies, they are brought to the attention of the lead programmer analysts.

The March 2005 review of automated file transfers and password changes will include report verification procedures. If any improvements can be made in this area and cost justified, it will be documented and the actual changes logged into the e-File project manual.

Rooms and Meals Tax Distribution

According to RSA 78-A:26, a portion of the meals and rooms tax revenue is to be distributed to the unincorporated towns, unorganized places, towns and cities of the State based on a distribution formula. The distribution formula incorporates the Department of Revenue Administrations (DRA) costs of administration of the meals and rooms tax.

The cost of administration is calculated as the prior year DRA expenditures, less expenditures not associated with tax collection, multiplied by the percentage of total department revenues to meals and rooms tax revenues. This amount, the cost of administration of meals and rooms taxes subtracted from gross meals and rooms tax revenues is the basis for the revenue distribution calculation, net meals and rooms tax revenue.

The DRA incorrectly calculated estimated cost of administration of meals and rooms taxes. The error related to the percentage of total department revenues to meals and rooms tax revenue. This error caused the meals and rooms tax distribution to be overstated by a minimal amount; however, this error is indicative of the lack of review by the DRA.

We recommend that the DRA implement policies and procedures to ensure that an adequate review of the meals and rooms tax distribution is performed, ensuring the accuracy of the distribution calculation.

Department of Revenue Administration Response

In the past, the calculation was done by the Assistant Commissioner with the assistance of the Business Administrator. The Business Administrator will perform the calculation following the guidelines established from this point forward. Once the worksheet is completed, the Commissioner or his designee will review the calculation before it is sent to the Department of Treasury.

EXHIBIT A

Outstanding Prior Year Comments

The following represents comments identified in our previous management letter that were reexamined during this year's audit and may require further attention by State management. The full text of the finding is included in the applicable prior year management letter.

Department of Administrative Services

***Reports on Processing of Transactions by Service Organizations* (2001 management letter)**

The Department's Bureau of Risk Management contracts with a third party to provide claims administration, and accumulate financial and statistical data for the State's workers' compensation program. The State places a great deal of reliance on the controls in place at the third-party service bureau to input, process, track and expedite claims accurately and properly.

To gain comfort over the controls in place at the service bureau, the State should request a service bureau audit report in accordance with Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations,* and include SAS No. 70 provisions/requirements in future third party service bureau contracts.

Department of Administrative Services Response

We concur that a SAS 70 audit would provide the State with additional comfort regarding controls at our third-party service bureau that administers the workers compensation program. Unfortunately, funding for such an audit has been difficult to secure. Our previous contract with our third-party service bureau, for the workers compensation program, expired July 1, 2004 and did not contain a SAS 70 requirement. During FY 04, the Bureau of Risk Management issued a Request for Proposal for a new contract that contained language that vendors offering proposals would provide the State with a SAS No. 70 report on an annual basis. Unfortunately, all bidders who offered proposals, including the previous vendor, would not provide a SAS 70. Since the State was in such need of a vendor to provide the claims administration service, the contract was awarded without the SAS 70 requirement. The current contract covers through July 1, 2008.

***Transfers to the Education Trust Fund* (2002 Management Letter)**

In fiscal 2002, the Education Trust Fund (ETF) operated at a deficit of $16.6 million prior to General fund transfers. The ETF deficit was eliminated by a transfer from the General Fund, in accordance with generally accepted accounting principles. However, we observed that there was no legislation authorizing transfers from the General Fund operating surplus to eliminate such a deficit. In fiscal 2003 and fiscal 2004, the ETF had a surplus from operations of $5 million and $7.8 million, respectively, that was transferred to the General Fund as of June 30, 2003 and 2004 despite no legislation authorizing such a transfer.

We recommend that the State establish legislation to authorize year-end transfers from one reporting fund to another.

Department of Administrative Services Response

We concur. Since the funding for the Education Fund is so closely tied to the General Fund, and any shortfalls in the ETF are absorbed by the General Fund, it appears appropriate in years where a surplus in the ETF occurs, monies should be transferred back. However, we agree that legislation should be proposed to authorize these year-end transfers. During the FY06-07 budget process, which is currently underway, this has been brought to the attention of the new administration so that legislation can be considered to authorize these transfers.

Treasury Department

***Debt Management System Should Have the Capacity To Provide Complete Debt Accounting* (Issued by the LBA 2002 Management Letter)**

There are several shortcomings in Treasury's long-term direct and contingent debt management system (DMS), resulting in inaccurate or unavailable debt information. Treasury's DMS was implemented in 1992.

While the system appears to adequately track the outstanding principal on bond issuances, DMS has several limitations, including:

- Inability to maintain historical data.
- No mechanism to record changes to the debt repayment schedules (Direct Debt Payment Report, or DDPR) produced by DMS.
- Limitation on tracking interest payments outside of normal increments.
- No function for maintaining information related to bond anticipation notes (BANs).

- The Business Finance Authority (BFA) State guaranteed loan program was excluded from the contingent debt report.

Treasury should consider obtaining or developing a debt management system that has the capacity to accurately track and keep current all information related to long-term direct and contingent liabilities. The system should be sufficient to provide historical data and to accept changes as necessary. If obtaining a new system or updating the current system is not feasible, Treasury should, at least, improve the current procedures for tracking information outside of DMS to keep the information complete and current and to strengthen controls over the information. Additionally, Treasury should document the propriety of any changes made to information in the debt system, and review and approval of those changes should be evidenced.

Treasury Department Response

Treasury continues to operate under the existing debt management system, however, the shortcomings outlined in the 2002 LBA management letter are exaggerated. Treasury is looking to procure or add functionality to its existing debt management system within its budgetary constraints. Additionally, requirements were considered and added by Treasury to the Enterprise Resource Planning (ERP) Request for Proposal that may address some of these debt management needs.

***Timely Escheatment of Abandoned Property* (Similar Comment in 2003 Management Letter)**

Treasury did not file its annual escheatment for calendar year 2000 timely, thus delaying funds available to the State and counties.

RSA 471-C:30 requires the administrator of the State Treasury's Abandoned Property Division to pay or deliver to the counties all abandoned property, less the State deduction, within 36 months after the close of the calendar year in which the property was presumed abandoned. Therefore, an escheatment should be completed by December 31 of each year.

During our audit period, one escheatment was completed. According to the statute, the calendar year 2000 escheatment should have been completed by December 31, 2003. The 2000 escheatment was completed on June 23, 2004, approximately six months late.

We recommend that Treasury comply with the statutory deadlines outlined in RSA 471-C:30 for the escheat of abandoned property.

Treasury Department Response

Treasury has processes in place to effectively comply with escheatment provisions of RSA 471-C in a timely manner.

RSA 471-C: 30, I states: " Within 36 months after the close of the calendar year in which any property presumed abandoned under this chapter is paid or delivered to the administrator, if no claim for the property has been made and established by any person, not including another state, entitled to the property, the administrator shall pay or deliver all such property to the appropriate county treasurer as required under RSA 471-C:31, subject to the state deduction under paragraph II."

The Abandoned Property Division receives delivery of properties, not only on or about the statutory deadlines of November 1st and May 1st, but also at varying times throughout the remainder of the year. As the result of the ongoing delivery and receipt of properties the "Report Year", which is the basis of the escheatment process, has been adapted to coincide with the state's fiscal year. Therefore, properties presumed abandoned and delivered are from two (2) different calendar years.

Under current processes the tasks necessary to complying with all escheatment provisions of RSA 471-C are completed and funds paid or delivered before the June 30th close of each fiscal year.

Treasury believes the current processes are compliant with the legislative intent and the spirit of the applicable law. If there were any impact resulting from timeliness of the payment and/or the availability for use of the funds it would be de minimis.

Department of Education

Financial Reporting Redundancy (2003 Management Letter)

The NH Department of Education (the "Department") Bureau of Business Management (BBM) is responsible for the accounting and record keeping of the Department's many Federal grants, including, but not limited to, Special Education, Title I – Grants to LEAs, Vocational Education, Child Nutrition and Title II – Improving Teacher Quality.

Currently, the BBM accounts for Federal programs through four separate accounting systems including: the Form 2 system, the Federal Ledgers, the Grant Control Ledgers, and the state financial accounting system (NHIFS).

These four systems were developed independent of each other and are not integrated, resulting in transactions having to be posted multiple times and a duplication of effort on the part of the State's employees.

The lack of integration leads to tremendous inefficiencies in posting transactions, increases the risk of errors, and increases the cost to the State by virtue of having a duplication of efforts. The lack of integration also creates difficulties in providing information requested by the Department's internal and external users on a timely basis.

We recommend that the Department consider integrating the existing systems or implementing a new integrated management system, which would include a grants management module, that will meet the current and future needs of the Department and their external users.

Department of Education Response

The Department concurs that the lack of a modern integrated accounting/management system leads to inefficiency and potential for errors. The Department anticipates that an Enterprise Resource Planning (ERP) system that completely addresses this need will be implemented statewide in approximately 15 months. As specified by the State's Strategic Information Technology Plan (SITP), the ERP will consist of multi-module application software packages designed to serve and support several business functions across the organization. It will be a strategic tool that helps the State improve operations and management by integrating business processes and helping to optimize the allocation of available resources. Key functional areas of the State's ERP software will include budgeting, financial accounting, accounts payable, grants, projects, assets, inventory, purchasing, human resources, revenue and receipts, and cross function requirements. The Department of Administrative Services has been working with all State agencies including the Department of Education to develop an ERP replacement to NHIFS. Contract negotiations are underway with an ERP system provider. Implementation is expected to begin immediately upon contract approval by the Governor and Council. Implementation will allow the Department to migrate all current business office accounting functions to the ERP system.