



**State of New Hampshire
Management Letter
June 30, 2006**



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March 23, 2007

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

Ladies and Gentlemen:

We have audited the financial statements of the State of New Hampshire (the State) as of and for the year ended June 30, 2006, and have issued our report thereon dated March 23, 2007. In planning and performing our audit of the financial statements of the State of New Hampshire, 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, we considered the State of New Hampshire's internal control as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

The maintenance of adequate internal control designed to fulfill control objectives is the responsibility of management. Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, controls found to be functioning at a point in time may later be found deficient because of the performance of those responsible for applying them, and there can be no assurance that controls currently in existence will prove to be adequate in the future as changes take place in the State.

We noted certain matters involving internal control and its operation that we consider to be reportable conditions under auditing standards generally accepted in the United States of America. Reportable conditions are matters coming to our attention that, in our judgment, relate to significant deficiencies in the design or operation of internal control and could adversely affect the State's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions. Furthermore, reportable conditions do not include potential future internal control problems including control problems coming to our attention that do not affect the preparation of financial statements for the period under audit.

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.



To the Fiscal Committee of the General Court
State of New Hampshire
Page 2

We noted the matters in Section I involving internal control and its operation that we consider to be reportable conditions and material weaknesses as indicated. All of these matters have been discussed with the appropriate members of management.

Although not considered to be reportable conditions, we also noted other comments during our audit which we have presented in Section II for your consideration.

These conditions were considered in determining the nature, timing, and extent of the audit tests applied in our audit of the 2006 financial statements, and this communication does not affect our report on these financial statements dated March 23, 2007. We have not considered internal control since the date of our report.

The State's written responses to the reportable conditions, material weaknesses and other comments identified in our audit have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, the Fiscal Committee, 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

Management Letter

June 30, 2006

Table of Contents

Reportable Conditions and Material Weaknesses

SECTION I

Other Comments

SECTION II

SECTION I

REPORTABLE CONDITIONS AND MATERIAL WEAKNESSES

**State of New Hampshire
Index to
Reportable Conditions and Material Weaknesses
June 30, 2006**

	<u>Page</u>
Department of Administrative Services	I-1
Department of Transportation	I-5
Departments of Transportation and Administrative Services	I-13
Department of Revenue Administration	I-15
Department of Safety	I-19
Departments of Revenue Administration and Safety	I-21

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

DEPARTMENT OF ADMINISTRATIVE SERVICES

Finding 2006-1 - MATERIAL WEAKNESS

Financial Reporting - Statewide

For 2006, the State's annual financial reporting process was delayed significantly. While the delay was the result of several factors, the most significant factors were:

- A financial reporting process that is not appropriately documented or communicated, is not supported by adequate financial resources in key departments and is not consistent with the changing financial reporting environment the State faces,
- The inability of managers throughout the State to effectively plan and execute their individual annual financial reporting responsibilities,
- The lack or adequacy of skilled or properly trained financial staff in key departments,
- The concurrent implementation of the State's Enterprise Resource Planning (ERP) system project and the biennial budget process.

The inability of State officials to manage these projects has highlighted numerous weaknesses in the State's organizational structure that must be addressed immediately to help ensure that the State risks are effectively mitigated. Without timely and effective action by State officials, the risk of an ERP implementation failure and the risk of delayed and inaccurate financial reporting continues. Other risks that continue to exist include:

- Delays in Federal funding,
- Decline in credit rating,
- Loss of credibility.

Many of the difficulties encountered in the financial reporting process were evident at the State's Department of Administrative Services (DAS), Bureau of Financial Reporting (BFR). BFR personnel were impacted significantly by the ERP implementation project and staff turnover. Due to their high level of involvement in both the ERP implementation and the preparation of the State's annual financial statements, resources within BFR were significantly strained.

BFR is the primary group responsible for accumulating, analyzing and reviewing data from other agencies for reporting in the State's financial statements and is considered a critical control in the State's financial reporting process. Without appropriate analysis and review, the State runs the risk that data produced by the various departments and reported to BFR is incomplete or inaccurate. During the 2006 audit, several reporting items produced for BFR by State agencies, most notably Department of Transportation (DOT) and Department of Revenue Administration (DRA), were late, inaccurate or both. Additionally, BFR either did not, or did not have adequate time to, properly analyze and critically evaluate many of these as well as other deliverables and, consequently, significant additional input and effort was required by the Office of Legislative Budget Assistant (LBA) and KPMG before they were acceptable. Delays in delivery of data to BFR and the rework of inaccurate or incomplete departmental deliverables resulted in delays in delivery of auditable information to LBA and KPMG.

The inaccurate or late information produced by the various departments appears to have resulted from improperly skilled or an insufficient number of skilled financial resources. State officials must ensure that an adequate number of appropriately trained financial managers are resident in each department to ensure that the State's resources are being adequately protected and reported.

DAS -Management's Response:

DAS has communicated to the Legislature both during Fiscal Committee and Finance Committee - Budget Hearings their concern over the lack of skilled accounting staff members throughout state government.

The department does not have legislative authority to promulgate formal rules nor enforce agency specific rules which would require agencies to staff their accounting departments at a specific level nor to mandate the skill set of those staff members.

As was done at last year's annual closing meeting, time will be dedicated to this topic specifically, encouraging senior financial managers to document their year end closing activities, to formalize the process for their staff so that a strict calendar of closing events and responsibilities is developed.

DAS agrees with the comments that BFR staff was stretched thin by their participation in the ERP development process last fall. However, it is the feeling that issues at certain State agencies were the primary factors which ultimately resulted in the delay in the Comprehensive Annual Financial Report's (CAFR) completion.

The department recognizes its responsibility to accumulate and review data for the CAFR process, and it is working to develop a plan to minimize extraneous staff responsibilities during the normal CAFR preparation period.

State of New Hampshire
Schedule of Findings and Responses
June 30, 2006

Finding 2006-2 - MATERIAL WEAKNESS

Accounting System Documentation

Developing and updating the State's accounting system documentation is the responsibility of the Department of Administrative Services (DAS). Such documentation serves as the key information source for State agencies to ensure they are meeting the administrative requirements established by the State for its accounting and financial reporting systems. Much of this documentation is not updated on a timely basis, and some of it has not been updated for several years..

As the State implements its new Enterprise Resource Planning (ERP) system, it is imperative that accounting and financial reporting system documentation be created or updated to reflect the new policies and procedures that will support the new system. Analyzing and documenting the State's business processes that will support ERP is an integral part of the system implementation and must be adequately addressed before the system goes live. As such, timing for creating this documentation is critical so that State personnel can be properly trained on the new business processes, policies and procedures. Without properly documented processes and adequate training, the State runs a significant risk that operating procedures related to the new system will not be properly executed resulting in unreliable financial information and delays in financial reporting.

DAS - Management's Response:

DAS concurs. The Department feels it is imperative that a statewide training plan be developed to include the proper documentation of procedures associated with the new software modules for state employees before implementation takes place.

The Department is currently reviewing anticipated resource needs for the complete implementation of the ERP system and intends to incorporate a resource request to manage these responsibilities and properly maintain corresponding statewide policies and procedures.

Related to year end procedures, each year the Department updates its formal closing manual to address accounting policy changes that need to be followed so that information agencies are required to provide is accurate, complete, and processed in a timely manner. This manual is reviewed with agency accounting staff during mid-May, so that advance planning for year end modifications from the prior year can be incorporated into the individual agency's closing calendar.

State of New Hampshire
Schedule of Findings and Responses
June 30, 2006

Finding 2006-3 - MATERIAL WEAKNESS

Statewide Succession Planning Process

As noted previously, the delay in the issuance of the 2006 financial statements can be attributed, in part, to improperly skilled or an insufficient number of skilled financial resources around the State. The lack of critical resources highlights the need to immediately implement an appropriate personnel succession plan throughout the State. Such a plan will help ensure that adequate resources, in both financial and operational areas, are available in the future to adequately meet the ever increasing financial, operational and accountability demands being placed on the State. Such a plan needs to ensure that all key departmental roles are identified and reviewed to determine how best to plan for personnel replacements.

With the ongoing implementation of the Enterprise Resource Planning (ERP) system, it is also important to ensure that its impact on business operations is considered as the ERP system may result in key departmental roles becoming less critical.

DAS - Management's Response:

Although the Department of Administration (DAS) does not have the legislative authority to promulgate formal rules that would accept the responsible to carryout and enforce this succession planning initiative, we understand the importance and risks associated with employee turnover, recruitment challenges, and retirements.

As was done at last years annual closing meeting, time will be dedicated to this topic, specifically, we will encourage senior financial staff to stress to their agency heads the importance of a succession plan being developed at each agency for accounting personnel, as well as the need to cross train existing staff members for unplanned absences and vacancies..

The Department is currently evaluating positions in the Division of Personnel to determine whether we can dedicate resources toward assisting agencies in developing a formal succession planning strategy.

The Department of Administrative Services has presented to the legislature a copy of a consultant's report indicating the compensation of unclassified employees is too low to attract qualified candidates. This is true in the case of the State's Comptroller (Director, Division of Accounting Services). This is a major concern in succession planning.

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

DEPARTMENT OF TRANSPORTATION

Finding 2006-4 - MATERIAL WEAKNESS

Financial Reporting Process – Highway Fund

The financial reporting process over the Highway Fund financial statements was not effective at generating accurate financial information in accordance with generally accepted accounting principles (GAAP) in a timely or efficient fashion. Additionally, the process did not include an adequate supervisory review of the financial information prior to submission to KPMG for audit. Some of the deficiencies noted include:

1. Many of the schedules prepared by agency management contained incorrect information and lacked evidence of a management level review. Since many of these schedules are used by Department of Administration, Bureau of Financial Reporting (BFR) and Department of Transportation (DOT) to prepare GAAP adjustments, errors are not being detected by the State's system of internal controls,
2. The reporting process is extremely manual, not well documented and cumbersome to use making it vulnerable to errors, and
3. Documentation for journal entries and reconciliations and other key controls, when they are performed, is not always available.

The ineffective processes resulted in additional audit hours being incurred, numerous audit adjustments being identified and significant delays in finalizing the audited financial statements.

DOT- Management's Response:

We concur.

Due to substantial turnover in the Bureau of Finance and Contracts (Bureau), the prescribed preparation and review process for agency-generated financial information deteriorated. With the addition of a number of recent hires, and with three more positions just added to the Bureau, staffing is being established at appropriate levels.

The Bureau has adopted a formal Journal Voucher process. The process requires appropriate support to be gathered and further requires multiple levels of management review. The Bureau also is in the process of documenting policies and procedures for all of our accounting functions. Having these documented policies and procedures in place, will ensure transactions

are properly supported and will improve the efficiency, timeliness, and accuracy of the spreadsheets and other financial information prepared by the Bureau. The target completion date for documenting policies and procedures is June 15, 2007.

In addition, the Bureau is compiling all of the year-end deliverables in an Audit Preparation Guide. This guide is the checklist to ensure the information generated is accurate, timely, and complete. The document will not only include steps used to create the information but will include additional steps taken to test and verify the accuracy of the information. We have learned through the recent audits to challenge the information generated and to take the additional steps to reconcile this information against other sources and databases. The target completion date for the closing guide is May 21, 2007.

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

Finding 2006-5 - MATERIAL WEAKNESS

Capital Assets – Highway Fund

DOT does not effectively track its capital assets to ensure they are properly identified as either Construction in Progress or Depreciable Assets. During the audit, we noted that:

1. Management failed to transfer approximately \$92 million of completed construction in progress to capital assets, and
2. Management failed to identify over \$70 million of expenditures that should have been recorded as capital assets.

Both errors were identified in the audit process and corrected.

While these entries do not impact the balances reported in the Highway Fund, both have a material impact on the State's government-wide statements, and indicate a material breakdown in controls. We recommend that the capital asset recording and reporting process be updated to ensure that it is consistent with the needs of both internal and external financial reporting.

DOT - Management's Response:

We concur.

As discussed in the response to finding 2006-4, we are compiling all our policies and procedures. The target completion date for these procedures relating to Capital Assets is May 31. As another means of ensuring that capital asset activity is complete, the Bureau of Finance and Contracts is revisiting the criteria used to evaluate projects expenditures for inclusion as a capital related asset. The procedures will also include project managers verification as to whether these major assets have been classified properly. In addition, as discussed in finding 2006-4, the fixed asset section of the Audit Preparations Guide will be completed by May 15, 2007.

The Bureau of Finance and Contracts is performing reconciliations of capital asset activity between the various project tracking systems and our fixed asset systems. This reconciliation will ensure that the data relied upon to generate capital asset activity reported to the Department of Administrative Services and, ultimately included on the financial statements, are complete and accurate. Our initial review will include an analysis of fixed asset activity through April 30. This effort will be completed by May 31. This reconciliation prior to year-end should facilitate a timely and accurate close for the fiscal year for this activity, which has been problematic for us in the past.

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

Finding 2006-6 - MATERIAL WEAKNESS

Inadequate processes over classification, billing and collecting of costs

The costs of the construction and rehabilitation of the State's roads and bridges are managed by the Department of Transportation (DOT). Such projects are typically considered capital projects and are funded with a combination of Federal, State and Local dollars.

It is the responsibility of DOT to track costs, monitor project budgets and bill and collect funding from the Federal and Local partners. The internal processes over recording reimbursable costs, unbilled and billed accounts receivables and Federal receivables are not adequate to generate accurate information in a timely and effective fashion. During 2006, the Department did not have adequate systems or processes in place to:

- bill and collect from the participating Federal and Local partners,
- properly classify costs as participating in the federal program or nonparticipating,
- maintain an appropriate listing of costs that were billed, but not collected,
- determine an accurate amount of costs unbilled at year end, or
- identify and properly track and record cash advance funded by local municipalities for capital construction.

As such, DOT's reporting of its construction costs and related third party billings during the year and at June 30, 2006 was not reliable.

Finally, DOT does not prepare an aging of its receivable balances as a way of analyzing the effectiveness of collection efforts. An aging analysis would allow the DOT to analyze outstanding balances and the length of time they have been outstanding. This may help DOT understand the magnitude of all receivables and for management to make appropriate financial or operational decisions.

A complete review of this area must be undertaken to ensure that the State is getting reimbursed for all appropriate expenditures and that the DOT can effectively and efficiently track and report its Federal and other participating expense activities.

DOT - Management's Response:

We concur.

The Bureau of Finance and Contracts did not have an understanding of costs flowing through Current Bill system. Complicating our situation, we fell dangerously behind in our closing of projects, also known as final vouchers. In November 2006, when it became apparent that there were substantial sums of federal funds not drawn, we realized that we would not be able to close-out the Fiscal Year 2006 audit until we were able to determine the magnitude of the problem. We reengineered the final voucher process and applied all available resources on this effort. During the period November 2006 and April 2007, we closed 225 projects and collected an additional \$7.3 million through this process. Further, we freed up \$9.4 million of federal funds that were being tied up on other projects. As of April 2007, we are now current in our processing of final vouchers and have implemented a tracking system to measure performance.

We now track accrued unbilled every week. Accrued unbilled is the amount of federal billing to Federal Highway Administration (FHWA) but some condition prevents the Bureau from successfully drawing these funds. For the billing period April 20, 2007, the accrued balance was reduced to \$4.3 million from a high of \$9.5 million on October 21, 2006.

Other actions taken:

- Implemented a Weekly Billing Worksheet to capture the critical billing elements. This worksheet includes: major accrued unbilled balances, error report analysis, and major billing adjustments.
- Developed procedures for recording nonparticipating expenses. We still need to research non-par accumulated balances.
- Implemented the Summary Level Transfers (SLT) form used to document our billing adjustments. The SLT form also requires supervisory review.

Developed a worksheet to track billings to local communities. Since our billing systems are deficient, we are attempting to be the pilot agency for the billing module for the new Enterprise Resource Planning (ERP) system.

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

Finding 2006-7 - MATERIAL WEAKNESS

Highway Fund Encumbrances

DOT does not have an effective control for ensuring that encumbrances are appropriately closed out. During the audit, we noted approximately \$20 million of encumbrances established prior to 2003 that still appeared as outstanding at June 30, 2006. Upon further review, several of these encumbrances were approved by the Governor and Council with expiration dates prior to June 30, 2006. Management's monitoring of the expiration dates of its encumbrances was not functioning effectively.

Without this control, the reserve for encumbrances can be and was overstated, thus resulting in a possible adjustment to other fund balance amounts reported in the financial statements. The DOT should implement controls to ensure all expired encumbrances are either liquidated in a timely manner or are approved to carry forward.

DOT - Management's Response:

We concur.

The Bureau of Finance and Contracts has not had an effective means of monitoring the closing of consultant type contracts. During the audit, an extensive review of these contracts was performed. In addition, the Bureau improved its system query skills to generate encumbrance listings to help identify dormant balances. A major shortcoming of the current system is that the contract end date is not captured so any review requires a manual file checking process. We have requested that the new Enterprise Resource Planning (ERP) system include a contract end date field.

On April 20, 2007, the Bureau of Finance and Contracts just completed another review of these contracts, which resulted in the liquidation of \$1.0 million of contract balances. Another year-end review will be conducted as of May 31st. Purchase order listing and contract listing will be forwarded to all of the bureaus for further review. Requests to carry forward balances will be thoroughly scrutinized and challenged by the Bureau of Finance and Contracts staff.

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

Finding 2006-8 - REPORTABLE CONDITION

Current Bill System

During the audit, it was noted that an error in the Department of Transportation's (DOT) current billing system computer code resulted in the doubling of overhead costs (the 'additive' amount charged to the Federal government). This computer code error has existed since fiscal 2000 (when a programming change was made to the system) and was not discovered by the DOT, due to its failure to adequately test and review the program change when made. Additionally, DOT failed to reconcile construction additives billed to FHWA to the actual additive amount that should have been charged.

During the period since 2000, DOT billed the government approximately \$15.3 million more than intended, but because the total amount billed did not exceed the additive rate agreed to by FHWA, these funds will not need to be returned.

In addition to the additive error, we also noted the DOT does not reconcile the expenditures recorded in the Current Bill System to the expenditures recorded in NHIFS. A reconciliation done for the audit yielded a \$5 million unexplained difference between these two amounts.

We recommend DOT management fully understand what costs are included in the current bill system and establish an effective reconciliation of federal aid awards received for each project with actual costs charged to each project. These costs should then be reconciled to NHIFS and any differences investigated and resolved timely. Additionally, the DOT should follow proper protocols for system changes to ensure that all changes are appropriately documented and tested before being put into production.

DOT - Management's Response:

We concur.

When the DOT implemented a blended indirect cost rate in 2000, the existing computer logic was not understood. When the rate change occurred, the billing process was not properly controlled and verified. In 2007 when the computer program was modified to correct this billing situation, the required change management was properly followed and the results were verified by FHWA.

While this additive billing issues has been resolved, it clearly demonstrated that we don't have a full understanding of our billing function. We have since taken snapshots of billing cycles and balanced these costs through our billing systems. However, with multiple billing percentages and accrued unbilled issues, we have not fully implemented this reconciliation process. We have contacted the FHWA resource center to review our current billing system and to request additional assistance with this control function. This review process will be completed by May 31, 2007.

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

DEPARTMENT OF TRANSPORTATION AND

DEPARTMENT OF ADMINISTRATIVE SERVICES

Finding 2006-9 - REPORTABLE CONDITION

Interagency/ Interfund Activity

We noted instances where the Department of Administrative Services, Bureau of Financial Reporting (BFR) and the Department of Transportation (DOT) did not effectively eliminate duplicative activity recorded in the General and Highway Funds. Example areas where duplication existed include:

- Motor Fuel receivables - \$1 million receivable from DOT,
- Revenue and Expenditure related to the Motor Fuel purchases/sales related to the above receivable,
- Federal Emergency Management Agency (FEMA) Revenue double counted by the Department of Safety and DOT.

Elimination of such activity is critical to reporting information accurately and appropriately in accordance with generally accepted accounting principles. We recommend BFR implement and communicate policies and procedures for eliminating such activity.

DAS - Management's Response:

The Bureau of Financial Reporting (BFR) will work with the Department of Transportation (DOT) to ensure such activity is properly eliminated. While working with DOT, BFR identified the type of transactions that were not captured in the elimination analysis. BFR has modified its elimination queries to ensure these transaction types are captured and will coordinate with DOT to ensure all interagency / interfund transactions are identified.

DOT - Management's Response:

We concur.

DOT will coordinate with the Department of Administrative Services to ensure all interagency / interfund transactions are properly identified and eliminated. A preliminary list of these transactions has been prepared. This list will be used to compare to the system generated listing and any differences will be researched. The section in the DOT's year-end Audit Preparation Guide has been completed. The guide also includes additional steps to further identify any interagency receivables.

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

DEPARTMENT OF REVENUE ADMINISTRATION

Finding 2006-10 - REPORTABLE CONDITION

Cooperation of DRA Officials

Throughout the audit, KPMG received the full cooperation of the financial and operational personnel around the State with one exception. We did not receive the full cooperation of the Commissioner of the Department of Revenue Administration (DRA) who sought to bar KPMG access to information needed to complete the audit of the department's revenue.

While the Commissioner, by statute, has the authority to protect confidential taxpayer information, there is some disagreement regarding the definition of what constitutes confidential information.

KPMG has not and did not request access to any tax returns, any DRA audit files or any other information pertaining to specific taxpayers or specific tax returns. KPMG does not request or receive access to this type of information in any of the states we audit and agree with the Commissioner that such information would constitute confidential taxpayer information and would only be available for review or testing by the LBA.

The data requested by KPMG focused only on the accounting records supporting the financial statement amounts for the DRA - not on tax returns or tax audits performed by the DRA. Audit requests included daily batch reports for the TIMS system, cash receipt analyses supporting the tax revenue accruals, cash disbursement analyses supporting the estimated tax refunds payable and routine revenue reconciliations including the reconciliations between TIMS and NHIFS and support related to those reconciliations.

Although KPMG and the LBA developed an alternative audit plan to work around this confidentiality issue, including obtaining information (requested from the Department) from NHIFS, the Department's initial refusal to provide information not only resulted in increased audit effort for both KPMG and LBA, but prompted discussions about whether the Commissioner's action constituted an audit scope limitation that would impact the State's overall financial statement audit opinion. As such, we believe that the actions of the Commissioner constituted uncooperative behavior that is reportable under generally accepted auditing standards.

We recommend that the Department establish appropriate policies and standards for confidentiality to balance the protection of taxpayer information with the need to conduct efficient and effective financial statement audits.

KPMG Preface to Management's Response:

The response below is presented as written by DRA personnel. As with the other management responses in this report, it has not been edited or changed and has not been subjected to the auditing procedures applied in the audit of the financial statements. Accordingly, we express no opinion on it.

However, the response does not address the auditors' recommendation to establish appropriate policies and standards for confidentiality to balance the protection of taxpayer information with the need to conduct efficient and effective financial statement audits.

Without the implementation of appropriate policies and standards, the difficulties encountered in auditing the Department are likely to continue.

DRA - Management's Response:

The statute, RSA 21-J:14, does not allow KPMG access to the Department's tax records. This task is statutorily given to the Legislative Budget Assistant. The Legislative Budget Assistant was given unimpeded access to Department records and found no material errors or omissions. A clear conflict of interest would arise if KPMG were allowed to review the Department's tax records and audit files given its tax preparation and tax shelter operations.

The law is clear that all tax records in the custody of the Department are confidential, and the Department and its employees are charged with protecting these tax documents. This is a charge we take seriously. The General Court has clearly provided more stringent confidentiality provisions within this State's statutes than those of other states.

21-J:14 Confidentiality of Department Records. –

- I. Notwithstanding any other provision of law, and except as otherwise provided in this chapter, the records and files of the department are confidential and privileged. Neither the department, nor any employee of the department, nor any other person charged with the custody of such records or files, nor any vendor or any of its employees to whom such information becomes available in the performance of any contractual services for the department shall disclose any information obtained from the department's records, files, or returns or from any examination, investigation or hearing, nor may any such employee or person be required to produce any such information for the inspection of any person or for use in any action or proceeding except as hereinafter provided.

With respect to Legislative Budget Assistant audits the law is equally clear.

21-J:14 Confidentiality of Department Records

- (4) The legislative budget assistant in the performance of his or her duties under RSA 14:31-a, I(a) and (b) only, provided that disclosure of department records, files, returns, or information to the legislative budget assistant shall be only for the purpose of, and to the extent necessary for, conducting audits of the department's accounts and records as are

required by law as provided in section 6103(d)(2)(A) and (B) of the Internal Revenue Code of 1954, as amended. This exception shall not be construed to authorize disclosure to any member of the legislature or to any expert consultants, including certified public accountants and data processing experts, hired by the legislative budget assistant to assist the legislative budget assistant in the carrying out of his or her duties (emphasis added).

The Legislative Budget Assistant is charged by law to protect taxpayer information from further disclosure and they were given copies of our disclosure procedures. During the opening meeting with Department of Revenue senior staff and KPMG senior staff for the Fiscal Year 2005 Financial Audit, **KPMG demanded its employees be given unfettered access to tax documents. The Commissioner, citing the law, rejected the demand, but noted the Legislative Budget Assistant could have access to any and all records.** Further, the Attorney General's Office issued a letter to the Legislative Budget Assistant noting that the law did not allow the Department to give tax information to KPMG. No other major discussions were held with KPMG as a result of the Fiscal Year 2005 Audit. No scope limiting comment was issued as a result of that audit.

Unlike Fiscal Year 2005, no standard opening meeting was held by and between KPMG and Department senior staff relative to the Fiscal Year 2006 financial audit. At no time, either during the audit or at the conclusion of same, was scope limitation mentioned to the Commissioner with respect to the Fiscal Year 2006 audit.

During the Fiscal Year 2006 audit, ongoing discussions were held with the Legislative Budget Assistant regarding what data could be included in the information turned over to KPMG. At no time were discussions held regarding access to NHIFS data with KPMG or the Legislative Budget Assistant, however, the fact that information is available from another source does not render tax information public information. Although it was agreed that monthly totals could be turned over to KPMG, cautionary instruction was given to the Legislative Budget Assistant, as past experience has proven that it is possible to identify taxpayers based on daily receipts. Again, the law is clear.

21-J:14 Confidentiality of Department Records

- IV. The records and files deemed confidential and privileged under this section shall not include records or files related to the following areas of the department's activities:
- (a) Municipal service and regulatory responsibilities including, but not limited to, responsibilities under RSA 21-J:9, except RSA 21-J:9, I(e) and II, and RSA 21-J:15-24.
 - (b) Tax related statistics, reports, summaries or other data prepared by the department which do not identify, or permit identification of, particular tax returns, reports, or related documents (emphasis added).

It should be noted that the detailed records of revenue collected can be used to determine where Department audit resources are being focused providing a significant advantage to one tax preparer over another.

New Hampshire business and other taxes have their start point in federal tax reporting. On August 29, 2005 the Internal Revenue Service released IR-2005-83 detailing KPMG involvement in fraudulent tax shelters and the payment of \$456 million in fines penalties and criminal violations. This is a very public illustration of the conflict of interest between KPMG and most state tax authorities including the Department of Revenue Administration.

The Legislative Budget Assistant has been given access to any and all documents requested. This access included very sensitive audit results and tax returns; this disclosure may have contained returns prepared by KPMG. Nothing they asked for has been denied to them. The statutory limitation on outside auditors does not limit the scope of an audit, but rather prevents conflicts of interest.

Every agency in government should be subject to financial audit, and the people have a right to see that their agencies function efficiently and honestly. It is clear the General Court foresaw that a conflict of interest would occur between an outside auditor and the taxing agency. They provided for this in the statute by placing the Department of Revenue Administration audit responsibility upon the Legislative Budget Assistant. The General Court has made it possible to audit its tax authority without allowing the fox in the hen house.

Ultimately, the Commissioner of Revenue followed his statutory responsibility to withhold tax information from KPMG.

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

DEPARTMENT OF SAFETY

Finding 2006-11 - REPORTABLE CONDITION

Department of Safety – Motor Vehicle Revenue

In performing analytical reviews of motor vehicle registration revenue, it became evident that reports and financial information generated by the Department of Safety's (DOS) Integrated Data Management System (IDMS) is either unavailable or is not currently being used by the Department's management to analyze the DOS' business and to assist in determining whether amounts recorded in the financial statements are proper and reasonable. In response to requests for management information, such as statistical information, the Office of Information Technology developed a report to assist in 'proving' motor vehicle revenue. However, this report did not accurately calculate the total revenue reported and the total revenue reported did not agree with the amounts reported in NHIFS by approximately \$800,000.

Due to the lack of management analysis and effective reconciliation, errors or omissions may not be identified by management in a timely manner. A properly prepared reconciliation with an appropriate level of analysis will help ensure that internal controls over this revenue are functioning properly.

Management should validate the information in IDMS. Specifically, management should timely analyze this information to ensure:

1. Reliable information is being provided for decision-making, and
2. Trends or variances are identified that may indicate data errors or omission.

DOS - Management's Response:

We concur.

This is the first time that an audit has required this particular type of reconciliation. Since the time of this request for reconciliation of Motor Vehicle Registration data, we have been working with the Office of Information Technology to develop reports that will enable us to reconcile this revenue source, which is made up of a myriad of different fees based on multiple RSA's. Town Clerk/Agents collect some of these fees and the transaction records are forwarded electronically by some communities and in others require manual keying at the Division of Motor Vehicles (DMV). Others are collected directly by DMV in Concord or at our

substations. These reports are currently being tested for accuracy, and work is ongoing to ensure that this type of reconciliation of the Fiscal 07 Registration revenue is available in time for the Fiscal 07 audit. In addition DOS and the Office of Information Technology (OIT) are jointly committed to develop the same strategies for other revenue sources to provide more effective management analysis and reconciliation and provide the auditors the tools they need for the type of audit testing they wish to perform.

**State of New Hampshire
Schedule of Findings and Responses
June 30, 2006**

DEPARTMENT OF REVENUE ADMINISTRATION AND

DEPARTMENT OF SAFETY

Finding 2006-12 – REPORTABLE CONDITION

Tax and Motor Vehicle Revenue Reconciliations Not Performed Timely

The Department of Revenue Administration (DRA) and Department of Safety (DOS) both perform monthly reconciliations for various revenue areas. DRA performs a monthly revenue reconciliation that reconciles all revenues per their Tax Information Management System (TIMS) to the revenues per the New Hampshire Integrated Financial System (NHIFS). DOS performs monthly reconciliations of Motor Vehicle cash receipts posted in the IDMS Motor Vehicle system to NHIFS.

During our interim control test work in May 2006, we noted that for both departments, these important reconciliations were only completed through December 2005. The potential effect of not performing these monthly reconciliations in a timely manner is that non-reconciling items or shortages could go unidentified for extended periods of time. Resolving any differences may become more difficult, and potential interest earnings on cash not collected timely could be lost.

We recommend State management ensures monthly reconciliations are completed and reviewed in a timely manner.

DRA - Management's Response:

DRA acknowledges that reconciliation is a key internal control and has put in place a monthly follow-up to insure timely and accurate accomplishment of this duty.

DOS - Management's Response:

We concur.

However, DOS is unable to close any given month in Integrated Data Management System (IDMS) and then reconcile IDMS to NHIFS until all Division of Motor Vehicle (DMV) transactions are entered and proven. This delay is caused by the necessity of re-keying off-line municipal agents work once the hard copy paperwork is received in Concord. The process of doing this keying and resolving all out-of-balance transactions causes the monthly closing and reconciliation to be two to three months late except at year end. During fiscal 2006 the backlog

was particularly long due to the implementation of the new MAAP registration and title program. During implementation of this new software it was determined that taking all existing on-line towns off-line would be the best way to proceed. Thus every municipal agent was back on paper requiring re-keying until they were gradually put on the new system.

During fiscal 2007 the backlog has been significantly reduced. DMV and the DOS, Division of Administration work closely together to resolve out-of-balance transactions as expeditiously as possible, thus allowing the closing and reconciling in as timely a manner as possible. The long-term solution to this problem is to have all 200 +/- municipal agents on-line with DMV so that their transactions are recorded in IDMS live and any out-of-balance transactions are resolved by the agent before the transaction is closed.

SECTION II

OTHER COMMENTS

State of New Hampshire

**Section II
Other Comments
June 30, 2006**

	<u>Page</u>
Department of Transportation	II-1
Turnpike System	II-3
Insurance Department	II-7
Treasury Department	II-9
Department of Health and Human Services	II-10
Department of Administrative Services	II-12

State of New Hampshire

Section II Other Comments June 30, 2006

DEPARTMENT OF TRANSPORTATION

Municipally Managed Projects

The DOT has approximately 210 Municipally Managed projects on the books. Seventy-five of these projects are active and account for approximately 10% of all ongoing construction projects at the DOT. Under these arrangements, the municipalities manage the individual projects and account for 100% of the project cost. During the course of the projects, the municipalities submit proof of expenditures to DOT in order for DOT to request Federal reimbursement.

During the course of the audit, we noted the following control weaknesses in this process that exposes the State to unnecessary risks:

- Documentation supporting requests from the municipalities for reimbursement by the State is not always sufficient and may not be in accordance with the provisions of the State's contract,
- The database of expenditures requested for reimbursement by municipalities is maintained by the Bureau of Planning and Community Assistance and it is not reconciled to the project database of expenditures maintained within the Bureau of Finance and Contracts.

These weaknesses expose the State to the risk of overpaying municipalities or paying municipalities for unsupported or unallowable expenditures.

We recommend the process be reviewed and controls be strengthened to ensure that risks to the State are adequately addressed.

DOT - Management's Response:

We concur. Municipally Managed projects are an increasing popular manner of executing the work plan and more state oversight is required.

- DOT is developing specific language in the contracts with the Municipalities to detail the responsibilities for record keeping.
- DOT will require copies of vendor invoices and other supporting documentation for each reimbursement request.
- DOT will also consider how to improve the post audit evaluation to verify terms of the contracts are adhered to.

Further, the Bureau of Planning and Community Assistance will evaluate the internal database and consider how best to use the information in the Department's data warehouse.

TURNPIKE SYSTEM

Automated Toll Collection (E-Z Pass) Information System

As part of our consideration of internal controls over the toll collection process, we performed certain procedures related to the general controls over The Revenue Markets, Inc., Accord, New York (TRMI), the State's E-ZPass information processor, and noted the following items:

- Password parameters at the TRMI server and application level are not adequately configured or aligned with Statewide IT policies,
- Generic "administrator" accounts exist that allow outside vendors – TRMI and ACS – unrestricted access to the TRMI server which increases the risk that data can be viewed and potentially changed or damaged by unauthorized personnel,
- TRMI application level access is not adequately controlled via the use of user profiles and groups. Rather, individual accounts have been established with access rights in excess of those associated with their group/profile,
- Virus definitions on the TRMI server are outdated,
- Access to the TRMI application is granted without appropriate documented approvals,
- An effective process does not exist for timely notification of TRMI application level administrators of employee terminations to facilitate the deletion/deactivation of application user accounts,
- Periodic management reviews of user access right for the TRMI application are not performed,
- The Bureau of Turnpikes does not follow a formal and documented change management process for changes that are made to the TRMI application by the vendor, who has unrestricted and unmonitored access to make changes to the application,
- OIT has not performed adequate monitoring of TRMI data backups to verify that they are performed consistently and successfully and to follow-up on backup failures,
- Bureau of Turnpike personnel do not monitor the vendor to ensure that system incidents are being properly tracked and acted upon in a timely and effective fashion.

These control weaknesses expose the State to unnecessary risks that data can be corrupted, destroyed or otherwise compromised and that such data may not be recoverable. Additionally, these weaknesses indicate State personnel are not adequately monitoring the third-party vendor hired to perform services on behalf of the State to ensure the State is receiving all of the services it is supposed to receive.

We recommend that a more complete review of the IT controls be performed and all weaknesses be promptly addressed and remediated by the appropriate personnel.

Turnpike System - Management's Response:

We concur and are making the following changes:

- Passwords at the server level have now been modified to conform to Statewide standards. Application passwords are being tightened within the limits of the TRMI software.
- Named user accounts have been established for all vendors and generic accounts are being disabled and deleted.
- The Bureau of Turnpikes is establishing user profiles for all system users and reviewing existing user privileges to remove unneeded privileges and assign staff to the proper profiles.
- Virus definitions on the TRMI server are current.
- The Bureau of Turnpikes is establishing a formal documented approval process to grant TRMI application access.
- Steps have now been taken to automatically notify the Bureau of Turnpikes of employee terminations. Unused accounts are now disabled after 45 days of inactivity and then deleted after an additional 60 days of non-use.
- The Bureau of Turnpikes is now performing an extensive review of user access rights.
- OIT is now transitioning the backup functions of this system to a more controlled environment following Statewide guidelines.
- The Bureau of Turnpikes staff has now prioritized incidents for regular review as part of the MOMS system. Top priority incidents will now receive timely review.

Violation Receivables

The State hired ACS to perform E-ZPass transaction processing that is critical to the State's financial accounting and reporting functions. Many of these processes require Turnpike management business decisions that should not be outsourced to a third party. For example, during 2006 ACS 'wrote off' over \$500,000 in toll violations as uncollectible without any approval by Turnpike management.

We recommend that Turnpike management establish protocols and formal approvals over the 'write off' of amounts due to the State. Further, we recommend that Turnpike management be involved and approve any significant decision that affects the Turnpike's operations or financial information.

Turnpike System - Management's Response:

We concur in part.

The State has business rules that are followed by ACS. However, in FY 2006, greater oversight should have been extended over this function to gain a better understanding of the violation activity.

Bureau of Turnpikes has been working closely with ACS and in the last quarter of FY 2007, Bureau of Turnpikes has been taking major steps in order to clean up the violation receivable activity. The Bureau of Turnpikes has given specific direction to ACS to properly manage this effort. The initiative will allow for the Bureau of Turnpikes to effectively manage this business function on an ongoing basis, which will allow for the Bureau to properly report accounts receivable for this activity as of June 30, 2007.

Transponder Inventory Control

ACS physically controls the transponder inventory for the Turnpike System, and also maintains the transponder inventory system. During our audit, we noted errors in the accounting for this inventory. Turnpike management did not perform an annual physical inventory count of the transponders and did not perform a monthly reconciliation of transponders sold to funds remitted by ACS.

We recommend that Turnpike management ensure periodic inventory counts of the transponders are performed and that inventory balances are maintained by the Bureau of Turnpikes to prove that transponder sales by ACS equate to funds remitted to them.

Turnpike System - Management's Response:

We concur.

For FY 2006, we relied on ACS to provide the transponder inventory levels.

During FY 2007, we have evaluated our risks and have concluded that a trip to New Jersey to observe the year-end physical inventory taking will probably not be necessary. Bureau of Turnpikes will rely on other means of verification, which includes:

- Secure SAS 70 audit reports, which include an evaluation of controls and processes of transponder inventory.
- Review of monthly inventory activity reports.
- Review of internal auditing reports conducted by ACS.

Bureau of Turnpikes will observe the physical inventory taking at the three customer service centers located in New Hampshire.

INSURANCE DEPARTMENT

Late Filing Penalty Fees

This observation was also included in the Management Letter for the year ended June 30, 2003 and appears that the finding has not been resolved to date.

Pursuant to RSA 400-A:32, any insurer failing to file the report required by RSA 400-A:31 or failing to remit the proper tax within the time for filing shall pay a penalty equal to 10 percent on the amount of the tax due. If the tax or the estimated tax is not paid when due, the Commissioner may suspend or revoke the insurer's certificate of authority.

The Department does not consistently enforce the late filing penalty fee as directed by the Statute. During audit test work for Fiscal Year 2006, there were two instances when the Department should have charged a late filing fee. The two instances ranged from one week late to one month late with a total possible penalty revenue to the Department of \$5,134. One company was a surplus lines company and the other was a licensed insurance company.

The effect of not consistently applying late filing penalty fees is a loss in revenue that the State has the statutory right to impose on delinquent payments. It also could lead to more serious collection issues in future years if insurance companies are made aware that late penalties are not consistently imposed.

We recommend Department management consistently enforce the provisions of RSA 400-A:32 for imposing these penalties.

INSURANCE DEPARTMENT - Management's Response:

The question regarding late payment fees is more complicated than it appears to be on the surface. There are basically three sources for insurance coverage, licensed companies, surplus lines companies, and unlicensed companies. Each of these types of business have separate laws that address payment of premium tax.

The premium tax on licensed companies comprises 97% of premium tax receipts. RSA 400-A:32 IV, provides that "Any insurer failing to file the report required by RSA 400-A:31 or failing to remit the proper tax within the time for filing shall pay a penalty equal to 10% on the amount of the tax due." If the tax is paid on time and the form happens to arrive late, the department will not assess a ten percent penalty. The intent of the law is to encourage timely payment. Since licensed company premium tax is due at regular intervals, it is fairly easy to monitor the receipts to ensure timely payment. Those companies that are not in compliance are charged a ten percent late fee. Should a company feel that the imposition of a late fee is inequitable, they may provide a written request to the Department for the late fee to be waived. In rare cases, the fee may be waived for purposes of equity.

Tax on surplus lines business comprises 2.5% of premium tax receipts. There is no late payment provisions contained in the law for surplus lines companies. Normally, surplus lines receipts are received with a reasonable time period of the due date.

The tax on premiums written by unlicensed companies comprises .5% of total premium tax receipts. Although the official due date for premium tax on premiums written by unlicensed companies is March 1, these reports are received throughout the year. In many cases, particularly Industrial Insurance, the policy may be finalized after the effective date, and/or in some cases, may be a retroactive policy. For these reasons, it is possible that a late payment may slip by unnoticed. In the case of one of the late filers noted by KPMG, the department will investigate the circumstances under which this policy was issued and take such action as is appropriate.

TREASURY DEPARTMENT

Escheated Property

KPMG observed that escheated property was not escheated based on statute. The clear language of the statute dictates that "Within 36 months after the close of the calendar year in which property 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... the administrator shall pay or deliver all such property to the appropriate county treasurer..."(RSA 471-C:31).

The statute indicates that abandoned property should be escheated to the counties by December 31, the end of the calendar year. Treasury however, distributes abandoned property to the counties based on the state's fiscal year. For fiscal year 2006, abandoned property was escheated in June of 2006.

In delaying the escheatment of abandoned property by six months, the State Treasury is delaying the receipt of cash to the county treasurers.

The Treasury should either escheat abandoned property by the end of the calendar year instead of the state's fiscal year. If the Treasury wishes to continue its practice of escheating property at the end of the fiscal year instead of the calendar year, they should suggest changes to the clear language of the statute accordingly.

TREASURY DEPARTMENT- Management's Response:

We concur. In an effort to avoid confusion over reporting years for abandoned property, Treasury has made its abandoned property reporting year and escheatment requirements consistent with the State fiscal year. Unclaimed property escheats to the State and a portion is paid to the counties within 36 months of the close of the fiscal year in which property presumed abandoned is reported and remitted to Treasury, rather than within 36 months of the calendar year end.

Treasury will seek legislation to amend the statutory requirement from calendar year to fiscal year.

**DEPARTMENT OF
HEALTH AND HUMAN SERVICES**

**Ensure Factors Used to Calculate Medicaid Claims Liability is Accurate According to
Agreed on Procedures with MedStat**

The Health and Human Service Department (HHS) is responsible for estimating the liability for outstanding Medicaid claims as of June 30, 2006. A significant portion of the liability is calculated using historical trend factors to estimate the amount of claims incurred in fiscal 2006 that will be paid in future fiscal years.

For fiscal 2006, the Department changed the liability estimation process by changing the period from which the historical lag factors were drawn. The period should have changed entirely from a 5-year paid and incurred trend factor to a 3-year paid and incurred trend factor.

However, we noted the change prescribed was not fully implemented, as the 5-year incurred factors continued to be used to estimate the Medicaid liability for the State's financial statements.

HHS management did not ensure that changes they initiated were correctly implemented by their third party processor. We recommend that any program changes requested be followed up on, reviewed and tested to ensure requested program changes are operating properly.

HHS - Management's Response:

DHHS will "build" the lag factors every twelve months beginning in May 2007 with April data. At the same time DHHS will move the methodology that was tested in UAT, to production. This method is 36 months paid and 36 months incurred. Data triangles will be sampled and manually tested to ensure the results of the build and method change is accurate. The DHHS will use the new lag factors and 36/36 paid/incurred method to support the MMIS liability estimate for SFY 2007.

Management Should Monitor the Backlog of Medicaid Claims at Fiscal Year End

KPMG observed that suspended claims were not monitored on a monthly basis, causing a backlog of claims to be held at EDS, the State's Medicaid claims system provider at year end.

Health and Human services (HHS) accounts for claims that have been processed but not received via a report issued by EDS at year end. The report lists the dollar value of suspended items. There appears to have been no direct monitoring by HHS during the year for suspended claims. In addition, there was an effort to process as many claims as possible by June 30.

HHS should implement a monthly monitoring process to ensure that monthly changes in the amount of suspended claims is known, analyzed, reported and corrected on a timely basis throughout the year.

HHS - Management's Response:

In February of this year, OMBP Finance initiated efforts to resolve the backlog of suspended claims within 4 to 6 weeks in all locations. This effort included the cooperation and reprioritizing of workload for several staff, and was successful. OMBP now reviews suspended claims at its monthly staff meeting. A Program Specialist has been assigned the task of tracking and reporting the suspended claims by location on a weekly basis. An action plan is then developed at the monthly finance staff meeting to resolve any outstanding issues. The Program Specialist also generates a monthly Suspended Claims Benchmark Report, which summarized the activities by location of the suspended claims.

DEPARTMENT OF ADMINISTRATIVE SERVICES

State Health Benefits – Gym Memberships

The health insurance package with state employees includes a provision that the State will pay the monthly gym fees if the state employee attends a certain number of times. It also includes health education classes.

Currently, the cost of these benefits does not appear on the employees' W-2 forms as income. According to IRC Reg. 1.61-21, an employee's gross income must include all compensation paid for services, including taxable fringe benefits. A fringe benefit will be taxable unless a specific exclusion applies (IRS Sec. 132). In general, an employer-provided benefit membership in a health club is a taxable fringe benefit (IRC Reg. 1.61.21). If the gym were on the State's property, and operated by the state for the use of its employees, an exclusion would be available [IRC Sec. 132(j)(4)] The exclusion does not extend to commercial gym memberships for personal use.

We recommend that the State characterize the employer-provided gym membership and health education class reimbursements as compensation on employees' W-2 forms. We also recommend that management have a tax review preformed to ensure that the State is complying with all Federal tax regulations pertaining to its employee benefit programs.

DEPARTMENT OF ADMINISTRATIVE SERVICES - Management's Response:

The State of New Hampshire began including the 3 working wonders benefits; health clubs, exercise equipment and educational classes, offered as part of the state's health plan in employee's 2006 W-2's as a taxable fringe benefit whether paid on behalf of the employee or reimbursed directly to them. A Tax Managing Director at KPMG reviewed this procedure.