STATE OF NEW HAMPSHIRE

Management Letter

Year Ended June 30, 2009

KPMG LLP
99 High Street
Boston, MA 02110-2374

Telephone +1 617 988 1000
Fax +1 617 507 8321
Internet www.us.kpmg.com

To the Fiscal Committee of the General Court
State of New Hampshire:

In planning and performing our audit of the financial statements of the State of New Hampshire (the "State") as of and for the year ended June 30, 2009, 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's internal control over financial reporting (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.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider deficiencies 2009 – 1 through 2009 – 5 in the State's internal control to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider deficiencies 2009 – 6 through 2009 – 8 in the State's internal control to be significant deficiencies.

Although not considered to be significant deficiencies or material weaknesses, we also noted the items in Section II during our audit which we would like to bring to your attention.

The State's written responses to the significant deficiencies and material weaknesses in Section I and the other comments in Section II 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 the Fiscal Committee, management, elected officials, and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

January 22, 2010

KPMG LLP is a Delaware limited liability partnership, the U.S. member firm of KPMG International Cooperative, a Swiss entity.

Boston Office Celebrating 100 years 1910–2010

STATE OF NEW HAMPSHIRE

Management Letter

Year Ended June 30, 2009

Table of Contents

Significant Deficiencies and Material Weaknesses	Section I
Other Comments	Section II

SECTION I

SIGNIFICANT DEFICIENCIES

AND

MATERIAL WEAKNESSES

2009 – 1 – MATERIAL WEAKNESS

Completeness of Accounts Payable

The State has established an annual process for identifying and recording expenses incurred in one fiscal year and paid in the subsequent fiscal year. Although this accrual process relies heavily on manual identification of payables by agency personnel, the process has worked well for the State for many years. In a given fiscal year, between all funds of the State, approximately $80 million of payments are identified in months subsequent to the fiscal year that are recorded in the financial statements as of the end of a fiscal year.

Effective July 1, 2009, the State went live with their new enterprise-wide resource program, NH First. The go-live in the beginning of fiscal year 2010 required the State to re-evaluate the accrual process described above. The new process was largely the same as in prior years with only minor exceptions and most agencies of the State were effective in identifying fiscal 2009 accounts payable.

However, instructions to agencies regarding the accrual process under the newly adopted NH First system were not sufficiently clarified for interfaced system data. As a result, procedures employed by the Department of Transportation Highway Fund (Highway Fund or Highway), did not properly identify accounts payable resulting in no accounts payable being recorded in that fund. Because no payables had been identified, the Department of Administrative Services (DAS), Bureau of Financial Reporting (BFR) performed manual and automated searches and identified and recorded approximately $20.5 million of accounts payable in the Highway Fund as of June 30, 2009.

While conducting our testing of Highway Fund accounts payable, we also noted various other transactions that were missed by BFR's searches totaling $3.8 million, or 19% of BFR's original balance. We then requested that BFR and the Highway Fund perform additional procedures, which yielded an additional $5.2 million of accounts payable. In all, the accounts payable balance reported by BFR in the Highway Fund financial statements was understated by $9.0 million, or 44% of the balance initially reported by BFR. All proposed adjustments were ultimately recorded in the Highway Fund financial statements. In addition, problems producing reports in NH First contributed to difficulties encountered in reporting and auditing the accounts payable balances.

The misstatements of accounts payable in the Highway Fund appeared to be the result of a lack of clarity concerning modifications of the year end accrual process, as they related to agencies interfacing with IFS, compounded by the go-live of NH First.

Similar issues were noted with the New Hampshire Turnpike System's financial statements, where an additional $2.2 million of accounts payable were identified. Please refer to the New Hampshire Turnpike's "Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*" for that finding.

Recommendation:

With NH First in use for future fiscal years, BFR should re-evaluate the manner in which accounts payable are captured at year-end for financial statement purposes. Given the familiarity of the current process with agency personnel, it may be in BFR's best interest to craft a policy similar to what has existed in the past. No matter what is decided, we recommend that BFR work to ensure that all agencies clearly understand the procedures and implement procedures to test their understanding and implementation. In 2009, problems were limited to the Department of Transportation. In 2010, if not properly handled, not only accounts payable, but all financial reporting activities, may experience more pervasive problems that could significantly delay the audit and release of the State's financial statements.

Management's Response:

Management agrees with the observations and recommendation. An integral part of the implementation of NH First involves the migration of the State to a procedure of timely recording of accounts payable into a system which will keep track of liabilities in conformity with Generally Accepted Accounting Principles on an interim basis. The controls are now being implemented to provide assurance that all liabilities are recognized as incurred. This should result in a reasonably accurate accounting of accounts payable as of the end of the fiscal year. We plan to develop a more efficient method for year end identification of unrecorded liabilities which recognizes these new accounting procedures and past experience.

Finding 2009 – 2 – MATERIAL WEAKNESS

Highway Fund Financial Reporting Weaknesses

The Highway Fund is used to account for the revenues and expenditures associated with the State's construction and maintenance of most State highways, roads, and bridges, and the supervision of traffic thereon. During fiscal year 2009, the State spent approximately $490 million from the Highway Fund with approximately $460 million of revenues.

The primary focus of the readers of the State's financial statements has historically been the State's General Fund, however, recently the Highway Fund has been receiving increased attention and scrutiny, primarily because of dwindling fund balances and increased activity related to the American Recovery and Reinvestment Act (ARRA).

In prior years, we have made various recommendations to the State regarding improvements needed in Highway Fund financial reporting. In fiscal year 2009, the draft financial statements required various adjustments related to federal receivables, fund balances, encumbrances and accounts payable.

We also noted in the 2009 audit that the Department of Transportation (DOT) needs to continue to improve its financial management of its individual projects. The DOT needs to continue to make improvements on liquidating encumbrances and eliminating negative available appropriation balances in recent years. In its year end review of the Highway Fund, the DOT identified various encumbrances to be liquidated, expenditures to be transferred to balances available from bonding sources, and explored the possibility of increasing federal participation on individual projects. While it is certainly prudent to analyze the financial workings of the Highway Fund and make improvements in reporting, this effort should be managed on an ongoing basis, potentially on a project by project basis, rather than once a year for external financial reporting purposes.

Further, these issues appear to be the result of a loss of institutional knowledge due to staff turnover.

Recommendation:

We recommend the DOT improve communication between the DOT's project managers, who have significant knowledge and experience of project condition and status, with the DOT's financial personnel, who need current project information to properly account for these projects, including the close-out of encumbered and reserved funds.

The inner workings of the Highway Fund are sufficiently complex that documented policies and procedures are necessary to ensure continuity and efficiency of financial operations. Therefore, we recommend the DOT document the policies and procedures around project finances.

Management's Response:

Highway management agrees with these observations. The Highway Division of Finance (Division) for the second time in recent years has experienced turnover in key finance positions. Beginning January 2009, the lead staff member on audits resigned. In addition, the Director of Financial Reporting resigned in March 2009.

This change in management occurred in the middle of the budget session for which the Division is the lead office for agency budget development. In July, as the Department was undergoing implementation of the State's new accounting system, a second financial analyst was hired to assist in this process. In preparation for a Turnpike bond issue and annual audits (Turnpike, Highway Fund, and Single Audit) a third analyst and Administrator III was hired in August. By August, the Division was fully staffed with three financial analysts (2 new hires), a new Administrator III and newly promoted Director of Financial Reporting. In addition to the task and challenges of audit during this time, the Division was also able to assist the State Treasurer in developing the financial section of the Official Statement for the subsequent and successful issuance of $217 million in new and refunded bonds for the Turnpike System.

Now fully staffed as a cohesive new team, the department is in process of reviewing its "Audit Preparation Guide" and assigning tasks, duties, and responsibilities to Division staff in preparation of improving performance for next year's audit.

Concurrently, the Department is reviewing its business practices relative to the liquidation of encumbrances and federal participation of funds. The Department is now meeting with project managers as recommended and despite current software limitations, is exploring other avenues to reasonably compute federal to highway funding ratios. In the long term, the ability of the Department to create its own financials is also being discussed as a possible means to provide the Department the opportunity to review, make adjustments and identify trends in a more timely manner.

The Department understands the need to provide reliable and accurate information regarding revenue, expenses and account balances of the Highway Fund. To this end, the Department will continue an active dialog for improvement with staff of the Department of Administrative Services and Bureau of Financial Reporting.

2009 – 3 – MATERIAL WEAKNESS

Preparation of Tax Accounts Receivable Estimates

During preparation of the State's Comprehensive Annual Financial Report (CAFR) the BFR, using tax inputs from the Department of Revenue Administration (DRA), estimates the amount of tax revenue to accrue as a receivable for business taxes and interest and dividend taxes as of June 30.

During the 2008 audit of the DRA, the methodology used to estimate tax accounts receivable was questioned as it was based on budget projections that were inconsistent with the economic outlook at the time the estimate was made. Re-estimating the tax receivables using the same methodology with more relevant assumptions resulted in an audit adjustment totaling approximately $31 million. The 2008 management letter recommended that the DRA and BFR revisit the methodology for estimating tax accounts receivable.

In 2009, we noted that our recommendations related to the methodology for estimating accounts receivable was not addressed by management. We do note, however, that the responsibility for estimating accounts receivable was transferred from the BFR to the DRA as recommended. Since the estimate was based on more realistic budget projections, an audit adjustment was not required. We did, however, propose other audit adjustments that appeared to be the result of ineffective, or lack of, management review of information submitted for inclusion in the State's CAFR.

The calculation of tax accounts receivable is a manual process that is susceptible to error. We noted the preparer of the calculation failed to update percentages used from the prior year, causing a $10 million misstatement in the original calculation. The error was subsequently corrected by the posting of an adjustment.

Further, we noted that the DRA tracks tax notices in two separate systems. Depending on the tax case, the receivable for a particular tax notice may be recorded in the DRA's primary accounting system, the Tax Information Management System (TIMS), an offline spreadsheet, or both. Upon collection or settlement of a tax notice, staff is instructed to review both TIMS and the offline spreadsheet and update the taxpayers balance in the appropriate ledger. When comparing tax notices recorded in TIMS and the offline spreadsheet, we noted one large tax notice totaling $10 million was included in both systems, causing a double counting of tax accounts receivable in the State's CAFR. The error was subsequently corrected by the posting of an adjustment.

In 2009, the BFR was able to utilize tax personnel at the DRA to help estimate and calculate tax accounts receivable, however, the methodology was not updated as recommended in 2008 and multiple errors as noted above were made in the 2009 calculations.

Recommendation:

We reiterate our recommendation from 2008 that the DRA is in the best position to estimate accounts receivable given their intimate knowledge and exposure to tax related issues. However, if the methodology used is simply re-performed by the DRA and is not updated to reflect the current economic conditions, the same issues will exist in the future. We again recommend the State take a

fresh look at how it prepares these estimates, and that the DRA be fully involved in determining annual estimates. We also recommend the DRA, with the help of the BFR, enhance their control structure to ensure that inaccuracies in year-end financial reporting be detected and corrected prior to inclusion in the State's CAFR. Finally, we recommend the DRA review the practice of maintaining two systems for the tracking of tax notices. The process as it stands now is intensely manual and prone to material error. The DRA should consider utilizing TIMS for maintenance of all tax notices if feasible.

Management's Response:

The Department of Revenue (DRA) concurs with the finding that the methodology of calculating the receivables should be revised and the responsibility of the calculation lies with DRA for the taxes administered by DRA. The Commissioner of DRA brought to the attention of the House Ways and Means Committee the deficiencies in the method of calculation and reporting receivables last fiscal year. The DRA was in the process of being audited by the LBA when the Commissioner was appointed. The Commissioner brought the deficiencies to the attention of the LBA auditors as well. Based upon these concerns and other reporting to the LBA auditors, the LBA made an observation that the calculations used in reporting the receivables for taxes administered by DRA should be transitioned to the DRA. These numbers would then be transferred to Department of Administrative Services (DAS) for inclusion in the CAFR. DRA was instructed to work with DAS in the current year preparation. Due to the timing of this transition, spreadsheets previously used by DAS were completed with the assistance of DAS and transferred to DAS for review and reporting. Errors in the DAS spreadsheet formulas and calculations were the basis of this finding of Material Weakness.

Further, this observation speaks to two tax notice systems within DRA, one alleging a completely manual system. DRA does have two systems, however both systems are automated using the same programming for interest and penalties. Both systems must utilize manual input in order to perfect the information necessary to create tax notices; DRA continues to develop further controls to eliminate the potential for over reporting. DRA was given a capital budget appropriation for FY '10/'11 to enhance the computer systems, and is in the process of working on integrating the various systems within DRA. These enhancements will tie the various operating systems in DRA together and supply further internal controls.

2009 – 4 – MATERIAL WEAKNESS

Accounting for County Nursing Facility Billings and Collections

New Hampshire's Counties are statutorily responsible for 100% of the non-federal share or 50% of the total costs for certain Medicaid long-term care costs, including nursing facility charges and home and community based care charges, up to an obligation cap of $95.8 million in fiscal year 2009. The actual County obligation cap was based on negotiations between the Counties and the Department of Health and Human Services (HHS) for the transition between the old and new funding partnership, which was affirmed by the legislature in the operating budget.

The Counties have agreed to the overall cap and individual County caps. Six of the ten Counties are billed a proportional monthly amount of the County's obligation of cap. The four remaining counties continue to request and are billed monthly based on Medicaid claims incurred and paid by the State. Under the current billing procedures, the total billed is added to a particular County's accounts payable balance and is not tracked or accounted for separately. When the State collects a payment from a County, the payment reduces the counties (facilities) accounts receivable balance and is not applied against a specific billing. This method of billing and collecting does not allow the State to determine which particular bills are fully paid, partially paid, or entirely unpaid by the Counties. The result is an accumulating balance of partially paid and unpaid bills that the State cannot trace back to individual billings.

As of June 30, 2009, it was noted that approximately $6.3 million of County receivables are not collectible. Approximately $1.8 million relates to an incorrect 2009 billing while approximately $4.5 million relates to County bills from prior fiscal years that remain either partially paid or unpaid. The State corrected the $1.8 million error in the 2009 financial statements.

Recommendation:

We recommend the HHS improve the current process for tracking the County billings and collections so that collections are applied against specific billings. We further recommend the State evaluate these receivables on an annual basis during the preparation of the financial statements and determine how much is uncollectible and write-off receivables prior to financial statement preparation. Finally, we recommend that HHS review all negative available balances in their appropriation statement. For those balances that will not be recovered through future revenues, such as certain nursing facility charges and multiple offender program charges, the HHS should explore the legislative options available to write-off those unrecoverable negative balances.

Management's Response:

Litigation has been successful in resolving some of the County accounts receivable in recent years. Some amounts owed are relatively small and litigation could cost more than the value of pursuing certain individual claims unpaid. Efforts to obtain legislative relief for the unrecoverable negative balances have been rebuffed in the past; nonetheless, HHS will continue to seek such relief. The new Medicaid Management Information System will have the capability to produce detailed County

bills for services provided, however, the extent of the recent changes in the county billing process to one based on proportional monthly payments of each Counties' obligation may render the detailed billing process both time-consuming and unnecessary.

2009 – 5 – MATERIAL WEAKNESS

Completeness and Accuracy of the Schedule of Expenditures of Federal Awards

Federal Office of Management and Budget (OMB) Circular A-133 requires the auditee (the State of New Hampshire) to prepare a Schedule of Expenditures of Federal Awards (SEFA) that reflects all federal funds expended by State during its fiscal year ended June 30. Additionally, as required by the American Recovery and Reinvestment Act (ARRA), auditees must separately identify ARRA expenditures on the SEFA. It is important that the SEFA be complete and accurate as it is used as the basis for determining the scope of the Federal Single Audit. If the schedule is incomplete or inaccurate, Federal programs required to be audited may not be audited resulting in erroneous reporting to the Federal government. Conversely, Federal programs that do not need to be audited may be audited resulting in unnecessary cost to the State.

While the State, specifically the Department of Administrative Services (the Department) has some procedures to help ensure that the SEFA is accurate and complete, the procedures in place are not sufficient to ensure the SEFA includes all federally funded expenditures and that ARRA funded expenditures are separately identified, as required.

The procedures that currently exist include a comparison of current year and prior year federal expenditures and a reconciliation of expenditures against federal revenue received. However, the comparisons and reconciliations were not performed by the Department for the programs administered by the Department of Health and Human Services (HHS) – the State's largest spender of federal funds. As a result, we noted numerous errors with regard to the HHS' expenditures included in the SEFA. Specifically,

- vaccines worth approximately $8.0 million were erroneously excluded from the SEFA
- expenditures of almost $6.0 million related to a program funded by the Centers for Disease Control were double counted
- ARRA expenditures were not separately identified on the SEFA, as required

Finally, we noted that the SEFA is prepared by one individual at the Department, but it is not reviewed by anyone prior to it being provided to KPMG for audit.

Recommendation:

We recommend that the SEFA be properly analyzed and reviewed, as proper internal control procedures dictate, to identify discrepancies prior to releasing it for audit. Additionally, DAS should ensure it reviews and implements all required reporting requirements for both federal ARRA and non-ARRA funds.

Management's response:

Management of BFR agrees that stronger controls need to be consistently applied to ensure that the information entered through the web-based SEFA input system is thorough and accurate. BFR has had a practice of working closely with many of the agencies, yet due to the significance of the HHS programs and attention paid by the audit firm to those programs, reliance was placed on that agency to clarify their information direction with the auditors. We will change our procedures for reconciliation to make them standardized for all agencies to the same degree.

2009 – 6 – SIGNIFICANT DEFICIENCY

Community College System of New Hampshire Financial Reporting Weaknesses

Chapter 361, Laws of 2007, established the Community College System of New Hampshire (the System) as a body politic and corporate. The System was formerly a department of the State and its financial activity was reported in the State's general fund.

Due to the passage of this law, the State was required to re-evaluate the manner in which the System was reported in the State's financial statements. The System went from being included in the general fund of the State to being separately reported as a discretely presented component unit. As a separate legal entity and component unit of the State, the System is responsible for all burdens and benefits of such status, including preparation of annual financial statements for inclusion in the State's Comprehensive Annual Financial Report (CAFR).

The System was unable to produce timely financial statements by the Annual Closing Review deadline for inclusion in the unaudited CAFR deadline of September 30. Further, when financial statements were completed, they were out of balance and required adjustment. The System is not currently required to produce separately audited financial statements but may be required to do so in the future and such errors could cause significant delays in issuing financial statements for both the System and the State.

Recommendation:

We recommend BFR work with the System to ensure that financial statements can be prepared timely and accurately for inclusion in the unaudited September 30 CAFR and other purposes. This should include a transfer of knowledge from BFR to the System, including documenting the System's financial reporting process.

Management's Response:

In the current period of transitioning away from State financial services, our revenue and expenditures transactions were separately identified within the State of New Hampshire's accounting records, but the balance sheet accounts were not. Therefore System staff needed to rely on several sources to produce financial statements.

On September 24, 2009 the System submitted financial statements which had been required by September 4th for inclusion in the State's unaudited CAFR. That same day BFR noticed that the System had understated total liabilities and net assets for the CCSNH Foundation by $7,289 recording the amount as $5,329,876 rather than $5,337,165. BFR adjusted the statements and included them in the September 30, 2009 unaudited CAFR.

During the ensuing audit of the CAFR, the System made changes to reflect certain items not included in the September 30th draft. The major item was the elimination of reported revenue and expenditure items paid from one internal CCSNH unit to another. This elimination also required subsequent revision of the final statements.

CCSNH will work with BFR as recommended to ensure that the financial reporting process can result in more timely and accurate reporting.

2009 – 7 – SIGNIFICANT DEFICIENCY

Bank and Investment Reconciliations

The Treasury Department (Treasury) is the primary department responsible for managing all cash received and disbursed by the State of New Hampshire. As of June 30, 2009, Treasury reported $357.9 million of cash and investments. Treasury utilizes bank statement reconciliations as a key control to ensure that all cash is accounted for and all activity is reconciled between the State's books and the banks.

During our audit of cash and investments, we noted four new investment accounts which had not been reconciled by Treasury. For the two accounts where the failure to perform reconciliations was noted by us before year end, Treasury corrected the error and performed the reconciliations as of June 30, 2009. The balance of those accounts totaled $37.7 million at June 30, 2009. For the other two accounts where the failure to perform timely reconciliations was noted during our fieldwork in September, Treasury subsequently reconciled those two accounts as of June 30, 2009 and forward. The balance of those accounts totaled $35.5 million at June 30, 2009.

Also, in connection with the review of the Treasurer's bank reconciliations, we noted several large deposits totaling approximately $4 million that were labeled as reconciling items. Upon further investigation, it was determined those funds were actually received in advance for fiscal year 2010. While these technically represented a cash receipt on account of deferred revenue, the receipts were for a newly adopted assessment for which legal establishment of accounts for revenue source were not effective until July 1, precluding the ability to record these on the ledger on their receipt date of June 30. Unable to record this transaction on the ledger until July 2010, a reversing 'CAFR only' entry should have been made by Department of Administrative Services Bureau of Financial Reporting (BFR) to properly reflect the receipt in accordance with GAAP. This was done after identification of the omission by KPMG and such an entry was proposed.

Recommendation:

We recommend Treasury enhance its existing control structure and monitoring activities to ensure that all new cash and investment accounts be added to reconciliations performed on existing accounts. We also recommend formal procedures be established for the review of reconciliations by the proper Bureau of the Division of Accounting to identify that reconciling items do not require adjustment for reporting.

Management's Response:

Treasury concurs with the recommendation and has put in place procedures to ensure that all existing and new accounts are reconciled at least monthly. A detailed procedures checklist will be signed off on when new accounts are opened to document that the reconciliation section has been properly informed of all new accounts. Also, additional supervisory review procedures have been instituted to ensure all existing and new accounts are signed off by the reconciliation team.

The Department of Administrative Services Bureau of Accounts management also agrees with the recommendation above and, in particular, will establish procedures to require review of reconciliations of major control accounts, in connection with the closing of accounts for financial reporting in accordance with GAAP.

2009 – 8 – SIGNIFICANT DEFICIENCY

Policies And Procedures Should Be Established For Unemployment Compensation Fund Financial Accounting And Reporting

The Department of Employment Security (DES) does not have comprehensive policies and procedures for Unemployment Compensation Fund (UCF) financial accounting and reporting activities.

DES's UCF Treasurer is currently responsible for choosing and applying UCF accounting policies, including methodologies for compiling estimates of year-end accounts receivable and accounts payable and other liabilities. The UCF accounting and reporting practices of the Department have largely been based upon the knowledge and experience of the long-standing Department employee and have not regularly been subject to a formal vetting process or review for continued appropriateness. Because the policies and procedures are not fully documented, the Department has become somewhat reliant upon the incumbent employees to perform these critical Department responsibilities.

Examples of DES financial reporting errors that occurred that may have avoided if comprehensive financial accounting and reporting policies and procedures were available and followed include:

- The DES June 30, 2008 UCF financial statements understated accounts receivable and liabilities by $1.3 million, as a result of not accurately accruing the effects of administrative contributions at June 30, 2008. The Department's UCF June 30, 2009 financial statements understated accounts receivable and revenue by $1.3 million as a result of misapplication of a journal entry in the Department's general ledger. The June 30, 2009 error was corrected in the State's financial statements.

The DES reliance on incumbent employees to perform critical financial accounting and reporting responsibilities without having documented and approved policies and procedures exposes the State to the risk that errors or frauds may not be detected and continuity of operations may be jeopardized if key employees unexpectedly terminate their employment or otherwise no longer perform the functions.

Recommendation:

The Department should establish and document comprehensive policies and procedures for all critical Unemployment Compensation Fund (UCF) financial accounting and reporting activities.

Policies and procedures should be vetted by management and sufficiently detailed to provide guidance for routine processes and activities and also provide guidance for accounting and reporting non-routine financial activity and transactions. The policies and procedures should be sufficiently developed and descriptive to allow employees involved in performing the functions and those responsible for the review and approval of that activity to determine adherence to the policies and procedures.

Management's Response:

The Department concurs with the recommendation to establish comprehensive policies and procedures for all critical Unemployment Compensation Fund (UCF) financial accounting and reporting activities. The Department recognizes the importance of establishing comprehensive written UCF policies and procedures. The Department does maintain informal written procedures on UCF financial accounting and reporting, much of which is governed by the United States Department of Labor (USDOL) via handbooks and program letters, and is enforced by the accounting principles included in the ACCPAC accounting software program utilized by the Department for UCF accounting and reporting. The development of comprehensive policies and procedures for UCF accounting and reporting has been an objective of the Department. With limited staff resources available in the area of UCF financial accounting and reporting, the primary focus has been on meeting strict cash management deadlines as well as USDOL reporting deadlines.

The Department's management, business office and legal staff will work collectively to review existing policies and procedures and to develop and maintain comprehensive policies and procedures for UCF financial accounting and reporting. The Department will evaluate the need for additional staff dedicated to the development and maintenance of comprehensive UCF financial accounting and reporting policies and procedures.

SECTION II

OTHER COMMENTS

2009 – 9 – MANAGEMENT LETTER COMMENT

Reporting under the American Recovery and Reinvestment Act

On February 13, 2009, Congress passed the American Recovery and Reinvestment Act of 2009 (ARRA). Four days later, the President signed the legislation into law. The Recovery Act's three main goals are to:

- Create and save jobs
- Spur economic activity and invest in long-term economic growth
- Foster unprecedented levels of accountability and transparency in government spending

In order to achieve the three main goals noted above, the Recovery Act contains reporting requirements imposed upon grantees and contractors receiving ARRA monies. These reporting requirements are commonly referred to as Section 1512 reporting. The specific reporting requirements vary depending on whether an entity is a prime recipient (receives funds directly from a federal agency), a subrecipient (receives funds from a prime recipient), or a vendor.

This $787 billion Recovery plan includes federal tax cuts and incentives, an expansion of unemployment benefits, and other spending on social entitlement programs. In addition, federal agencies are using ARRA funds to award contracts, grants, and loans around the country. Specifically, the State of New Hampshire has been awarded $539,953,024, as of December 31, 2009, through ARRA Programs which are subject to Section 1512 Quarterly Reporting. Additional ARRA funds are expected to be received in 2010 and 2011, but these amounts are not predictable as the political environment at the Federal Government level in Washington, D.C. is subject to change.

Given the unprecedented levels of accountability and transparency being sought, it is imperative that the State be prepared to provide timely and accurate information. However, there are various forces at play that will complicate the goal of timely and accurate information:

- Timeliness – Historically, the State has been geared towards federal and state reporting deadlines of 45-days subsequent to a calendar quarter-end. However, the State now has 10 calendar days from the end of each calendar quarter to report the requested information. Further, in many instances, the State is required to accumulate information from its vendors and subrecipients in order to compile its own report.

  The more stringent deadlines will force entities to change the way they collect and report information. If not properly managed, these changes can affect the accuracy of information being reported.

- New information – The State is required to report information it has not historically accumulated within the required deadlines, primarily data on jobs saved and jobs created. In certain circumstances, the State is required to obtain that information from its vendors and subrecipients in order to complete the 1512 report.

- Internal Controls – As the results of this reporting exercise will be the basis for jobs created and/or saved reported by the government, there is an expected level of scrutiny that these figures will receive. Therefore, entities are required to have adequate controls and processes in place to minimize the risk of reporting erroneous figures and perform quality assurance reviews.

- Audits – The level of audit activity with these funds will be unprecedented. The Offices of Inspectors General (OIG) at all federal agencies have increased their staffs in order to handle the increased workload. The various OIG offices are expected to be even more visible and vigilant than previous encounters. Additionally, the requirements of 1512 reporting are expected to be highlighted and emphasized in the 2010 Compliance Supplement for Single Audits under OMB Circular A-133. Because of the risks surrounding this reporting exercise, auditor scrutiny and skepticism will match those risks.

This reporting exercise is certainly daunting for any entity. However, the more prepared an entity can be, the easier the transition.

Recommendation:

As of the date of this letter, the deadline for the second reporting period has come and gone. The State successfully completed its Section 1512 reporting by the January 10th deadline. However, the level of activity required to be reported in October and January was very limited. It is expected that the level of activity required to be reported in April 2010 and future periods will increase dramatically and require the State to have robust systems in place to control, accumulate and report the requisite data.

We recommend the State assess the adequacy of the reporting operations for significant ARRA grants. The risk assessment should focus on determining if the State has the processes in place to capture accurate information, if internal controls exist to ensure accurate reporting, if a quality assurance is being performed, and if an audit readiness assessment had been performed or planned.

Management's Response:

The Governor's Office of Economic Stimulus (OES) continuously strives to improve the adequacy of State of New Hampshire ARRA Section 1512 reporting processes. Past actions have included training sessions for State of New Hampshire Departments and Agencies on the most current Section 1512 reporting guidance provided by the Federal Office of Management and Budget (OMB). New Hampshire chose a decentralized method of reporting, with the Office of Economic Stimulus ensuring data accuracy as described below.

New Hampshire instituted a state monthly reporting requirement beginning in July 2009 to ensure federal compliance with Section 1512 reporting. This monthly report was required up until the 12/31/2009 federal quarterly report. New Hampshire ARRA recipients are still required to submit a report for the month prior to the quarterly reporting period, so sub-recipient and vendor reporting data is submitted on a timely basis.

In addition, non-Section 1512 guidance and training has been provided by a dedicated OES Davis - Bacon Compliance Expert to State of New Hampshire Departments, Agencies, and Vendors.

For all ARRA Section 1512 Programs, responsible State of New Hampshire Program Managers have completed one training session, and in most cases, two or more ARRA Section 1512 training sessions, beginning in June 2009.

OES has a dedicated staff person reviewing and providing feedback on ARRA Section 1512 quarterly submissions in order to improve their overall quality over time. This person is often the first resource that ARRA Program Managers turn to when they have an ARRA related question; and is considered a Section 1512 Subject Matter Expert (SME). This OES staff member scheduled and participated in one-on-one reviews of every NH Section 1512 report for the 9/30/2009 quarterly report, and one-on-one reviews with the more complex and higher programs for the 12/31/2009 quarterly report. For the remaining programs, the staff member reviewed each report from the OES office. OES checks expenditures and revenues in each report with the state accounting system to ensure proper data is reported.

OES is performing an additional review of all 51 active, ARRA Section 1512 programs and this effort is expected to occur during both the first quarter and second quarter of calendar year 2010. This effort is expected to further assist in assessing the ability of program managers to adequately control the accuracy and quality of their Section 1512 information.

The results of this effort will be quantified and run through a risk assessment analysis to select ARRA programs that would be most appropriate for a more in-depth review. Proxy factors for audit readiness are also incorporated into this risk assessment analysis.

2009 – 10 – MANAGEMENT LETTER COMMENT

Information Technology General Control Weaknesses

Today's businesses increasingly rely on information technology (IT) to help them reach their daily and long-term objectives. The challenges entities face in this environment is creating a strong and robust internal control structure over information technology general controls (ITGC) that does not compromise the adequacy of the overall internal control environment.

The underpinning of a strong internal control environment includes strong ITGC's. Given the integration of computer systems into today's businesses, a weak ITGC environment can compromise an otherwise strong manual control environment.

As part of performing an audit of the State's financial statements, we obtained an understanding and also assessed the State's ITGC environment in order to determine the adequacy of the State's overall internal control environment.

IT systems and applications reviewed during our audit of the State's fiscal year 2009 financial statements included:

- Tax Information Management System (TIMS), Department of Revenue Administration
- New Hampshire Unemployment System (NHUS) and New Hampshire Accounting
- Contribution Tax System (NHACTS), Department of Employment Security

During our review, we noted an overall strong ITGC environment, however, we did note certain areas for improvement, which are summarized below.

Access to Programs and Data

Super user level access to an application should be limited to appropriate personnel and monitored to detect inappropriate activity. We noted that the developers of NHACTS have super user access. Developers with this level of access can result in changes being made without the proper approval. Super user access should be limited to the non-development members of the information technology team.

Change Management

Access to migrate program changes into production should be restricted to personnel who do not have development responsibilities in NHUS. We noted that Employment Security developers have access to migrate program changes into production. A developer could migrate modified code into production without proper approvals in these circumstances. Access to migrate program changes into production should be limited to the non-development members of the information technology team.

Computer Operations

A process should be in place to periodically test the process for restoring backup data from storage medium. We noted that the backup data related to TIMS is not periodically restored to ensure adequacy of the backup process. The absence of a process to periodically test the procedures for restoring backup data increases the risk that the data and code may not be restored successfully when needed. A process should be implemented to test the procedures for restoring backup data.

Management's Response:

Access to Programs and Data

DOIT management confirms that the two NH ACTS programmers located at NHES have "Super User" rights to the NH ACTS system. However, they are not allowed to load any program or system changes directly into the NH ACTS production environment. That is controlled by the Data Base Analysts (DBA) from the DoIT Operations Division that are located at NHES.

What would happen with a change in NH ACTS is as follows: the NH ACTS program staff would complete the code changes and compile that code and changes into a package that is first loaded up into the NHES test environment and then tested by another programmer and the end users. At that time the programmer will fill out a DoIT Changer Request ICR and get the proper approvals from the directors. Once that ICR is approved and the associated time has passed the DBA's working with the programmers will promote the code into production.

NHES we also use a paper request form to up load code into production that gets signed by the agency testers, the end customer (Director of TAX) and the IT Manager.

Change Management

This section refers to the NHUS system, which since this audit has been replaced with the NHUIS system, KPMG was informed this would happen when they were conducting the audit. So, this one item is no longer applicable. However, with the new NHUIS system, programmers do not have the ability to load any changes into production. That is done by a combination of the Computer Operations staff and the DBA staff, with no involvement by the programmers. Also, changes in the system would require the same ICR process and paper process described above.

Computer Operations

DOIT concurs with this recommendation and will coordinate with the Department of Revenue Administration (DRA) to implement a testing plan schedule. As part of a two year Capital Improvement project, DRA and DoIT are evaluating a solution involving redundancy of services that would include regularly scheduled restores of production data and code as standard operating procedure.

2009 – 11 – MANAGEMENT LETTER COMMENT

Implementation of NH First

On July 1, 2009, the State went live with its new enterprise-wide resource planning system, NH Fundamental Improvements to Revitalize Systems/Services and Technology (NH First). NH First is replacing a system that has been in place for decades, effectively eliminating years of institutional knowledge.

Although the system is up and running, the work is not complete. The users and management have become very familiar with the business processes and internal control structure under the previous system, New Hampshire Integrated Financial System (NHIFS), and the capabilities of NHIFS and NH First vary widely. The following are some areas in which major system implementations can cause problems post-implementation:

- NH First represents a major change in the way the State conducts its day-to-day business. Over the years, the users became extremely familiar with the previous control structure under NHIFS and will be required to adapt to a new business process and internal control structure. A major change such as this implementation can often lead to lapses in basic internal controls.

- While management expects the reporting capabilities of NH First to be very robust when compared to NHIFS, the State experienced some delays in retrieving basic reports from NH First in early fiscal 2010 and reporting continues to be problematic. The full capabilities of NH First certainly will not be realized in year one, but the State should continue working to determine the best and highest use for this new tool.

- The State designed a strong closing process under NHIFS that worked very well for many years. Many entities experience significant financial reporting delays when they perform a year end close of a financial system for the first time. Proper planning is the key to ensuring a smooth closing and audit process.

To date, the State has faced many challenges with this implementation and will no doubt face many more.

Recommendation:

Given the risks that still exist, management should be as proactive as possible in identifying and appropriately responding to problem areas and ensuring others do not materialize.

Management should work to ensure the internal control structure is appropriate for the new business process and monitor to ensure users comply with the required control structure. This will involve testing of control effectiveness and providing additional training to agency staff where necessary.

Now that management is generating some basic reports from NH First, it is inevitable that more reporting will be utilized as the users become more familiar with the new tool. However, without appropriate controls in place, the State faces the risk that poorly designed reports that are either

incomplete or inaccurate may be placed in use. The State should have a process in place to test the completeness and accuracy of new reports generated from NH First prior to the public release of those reports to ensure that business decisions are made on complete and accurate data.

The 2010 year-end closing process is sure to be challenging. We recommend the State start assessing the process and begin training its financial managers as soon as possible.

Management's Response:

1. Management agrees with these comments and recommendations. Specifically, the Financial Data Management (FDM) group is working diligently by:
    a. managing a call center for user difficulties which it has now managed outstanding tickets to under 100 for the two most recent weeks. (These were nearly two hundred in mid-Fall.)
    b. working to deliver numerous reporting capabilities by directly writing reports. FDM has a rigorous testing procedure for new reporting to establish the credibility of data presented.
    c. Making query tools available and
    d. Developing an IFS format data warehouse is under near term development, for agencies to use with legacy Crystal and other reporting mechanisms, as a bridge to delivery of new report solutions.
2. The Functional Leaders in BOA are finding far greater compliance and fewer operating difficulties experienced in the agencies at this time.
3. The Treasurer's office reports that, while behind on cash reconciliations, two months of the new fiscal year are now complete and a full catch up to timely reconciliation is targeted by end of March.
4. Most importantly to Financial Reporting integrity, we have already started meeting in the Division of Accounting to identify risk areas concerning year-end close, financial reporting and audit ability. We are developing a comprehensive plan to address key areas, having already developed a new methodology for identifying unrecorded liabilities, with greater reliability than the double asterisk method of the past. Closing and audit guides will be developed early, with extensive communication and clarification in an attempt to avert the unexpected.

2009 – 12 – MANAGEMENT LETTER COMMENT

Liquor Commission Fixed Assets

During fiscal year 2009, the Liquor Commission (the Commission) wrote-off approximately $680,000 of various fixed assets. The fixed assets were primarily computer software and equipment and did not have a carrying value as of June 30, 2009. The assets written-off were removed from service in prior fiscal years but inappropriately remained on the Commission's fixed asset records. The process currently in place to identify fixed asset disposals does not appear to be designed or operating properly as it did not detect these fixed asset disposals.

Recommendation:

We recommend the Commission review its fixed asset policies and amend them, if necessary, to ensure that all assets removed from service are properly removed from the Commission's fixed asset records.

Management's Response:

The Commission has reviewed all fixed asset policies and procedures and made amendments to ensure all assets removed from service are properly removed from the Commission's fixed asset records. Subsequent to this review, changes were implemented including annual fixed asset audits now being performed by the newly formed Internal Audit Division of the Commission to ensure all fixed asset additions and or deletions are reported properly.

2009 – 13 – MANAGEMENT LETTER COMMENT

Fund Balance Reporting

In February 2009, the Governmental Accounting Standards Board issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions.* The Statement establishes criteria for classifying fund balances into specifically defined classifications and clarifies definitions for governmental types.

The requirements of this proposal would improve financial reporting by establishing fund balance categories and classifications that are easier to understand. The Statement establishes fund balance classifications comprising a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon how it can use amounts reported in governmental fund balances.

The Statement provides for five fund balance classifications based on the relative strength of the constraints that control how specific amounts can be spent:

- The ***nonspendable*** fund balance classification includes amounts that cannot be spent because they are not in spendable form or are legally required to be maintained intact. Items that are not in spendable form include assets not convertible to cash, such as inventories and prepaid items. The corpus of the State's permanent funds is an example of a nonspendable fund balance which is legally required to be maintained intact.

- The ***restricted*** fund balance category includes amounts that can be spent only for the specific purposes stipulated by external resource providers (for example, grant providers), constitutionally, or through enabling legislation (that is, particularly stringent legislation that creates a new revenue source and restricts its use). Amounts included in restricted fund balance would closely resemble the types of balances labeled as restricted net assets on the State's statement of net assets, such as the Revenue Stabilization account.

- The ***committed*** fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of the government's highest level of decision-making authority (for example, a law passed by the legislature). In contrast to restricted fund balance, amounts in committed fund balances may be redeployed for other purposes with appropriate due process.

- Amounts in the ***assigned*** fund balance classification are intended to be used by the government for specific purposes, but do not meet the criteria to be classified as restricted or committed (for instance, the constraint on use is not imposed externally or by a government's highest level of decision-making authority), except for stabilization agreements. In governmental funds other than the general fund, assigned fund balance represents the amount that is not restricted or committed. Further, assignment within the general fund conveys that the intended use of those amounts is for a specific purpose narrower than the general purposes of the government itself.

- ***Unassigned*** fund balance is the residual classification for the government's general fund and includes all amounts not contained in the other classifications or other funds and, therefore, unassigned amounts are available for any purpose.

Governments will be required to disclose more information about amounts reported in fund balance:

- Description of authority and actions that lead to classifying committed and assigned fund balance.

- The government's policy on the order of spending regarding restricted and unrestricted fund balance, and the order of spending from committed, assigned and unassigned fund balances.

- For any stabilization arrangements, the authority for establishing, requirements for additions, and the conditions under which amounts may be used, and if not reported on the face of the financial statements, the balance of the stabilization fund.

- Description of any formally adopted minimum fund balance policies.

- The purpose of each major special revenue fund and which revenues or other sources are reported in each of those funds.

- Encumbrances, if significant, are reported in conjunction with other disclosures of significant commitments.

The requirements of this standard are effective for the State's fiscal year ending June 30, 2011.

Recommendation:

In preparation for the pending implementation of this standard, the State should evaluate its fund balances and determine the appropriate categories and note disclosures. Further, this standard changes the fund balances of governmental funds, which are heavily studied, read, and relied upon by the users of the State's financial statements. In order to educate the users of the State's financial statements, the State should immediately begin to assess the impact and determine their future presentation. Time invested now will prevent future confusion and possible delays in financial reporting.

Management's Response:

Management is aware of this new standard and will begin the process of assessing and developing an implementation strategy, which will include the orientation of key state users to the new fund balance presentation and disclosures required by the standard in preparation for the state's 2011 CAFR.