STATE OF NEW HAMPSHIRE

Management Letter

Year Ended June 30, 2010

KPMG LLP
Two Financial Center
60 South Street
Boston, MA 02111

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, 2010, 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 2010 – 01 through 2010 – 05 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 2010 – 06 through 2010 – 10 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 responses to the findings identified in our audit are described in Section I and Section II of the management letter. We did not audit the State's responses 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

December 29, 2010

STATE OF NEW HAMPSHIRE

Management Letter

Year Ended June 30, 2010

Table of Contents

SECTION I

SIGNIFICANT DEFICIENCIES

AND

MATERIAL WEAKNESSES

Fiscal 2010 was a challenging year for the State for many reasons including a move to a new State-wide computer system – NHFIRST. For the State's comptroller personnel as well as the business officers and other financial officials throughout the State, the activation of NHFIRST was the culmination of many months of hard work and long hours as well as the beginning of a new era in accounting and reporting on the State's finances. While the State's personnel encountered many challenges with the operation of the system, it is clear that those challenges, generally, were effectively addressed in a timely fashion which enabled the State to meet its statutory reporting deadline of December 31, 2010. Being able to transition to such a large complex system and still meet its reporting deadline for fiscal 2010 is a tremendous achievement and all personnel involved should be commended.

The following comments reflect areas that we still believe need to be addressed by the State as they continue to work on improving the State's accountability and responsibility for its financial resources.

2010-01 – Material Weakness

Information Technology General Controls Failure

In 2010, the State implemented their new general ledger package, NHFIRST which is designed not only to replace the legacy general ledger, NHIFS, with more up-to-date, user friendly accounting software, but it is also to help the State become more efficient in the way it conducts its day-to-day business.

Common to today's technologically advanced general ledger packages, NHFIRST utilizes on-line approval of transactions as a way of cutting down on paperwork and speeding up the time it takes a transaction to go from initiation, through approval, to ultimate completion. The on-line approval process is meant to replace the antiquated signature process used in NHIFS.

In 2010, the audit of the State was focused on the automated approval control in order to determine the effectiveness of approval controls. However, in order for such controls to be effective, it is imperative that the underlying information technology general controls (ITGC) also be considered effective.

During our review of the State's ITGC structure, we noted the following deficiencies which resulted in an ineffective ITGC structure:

- State policy requires passwords have a minimum of 10 characters, NHFIRST set password at 7 characters. Additionally, passwords are not encrypted.
- Access to the Lawson (NHFIRST software) database requires only limited password criteria
- Lawson application has shared accounts along with shared passwords.
- Lawson user IDs and passwords are authenticated by Tivoli, however, the password criteria defined in Tivoli is not applied to the password, meaning the system will accept 1 character passwords.

Due to these control weaknesses we were unable to rely on the on-line approval control in the application and were required to increase the scope of our testing in certain areas.

Recommendation:

We recommend that the State take immediate steps to rectify the password protection issue to help strengthen its ITGC structure and put the State on the right path for an effective ITGC structure and ultimately and effective on-line approval control.

Management's Response:

We concur, and offer the following discussion of changes in process or planned:

- Password Policy and Authentication:

  The State recognized the need for NHFIRST to conform to the State password policy which defines length, special characters, reuse, lockout, and expiration of passwords. The approach that had been planned for NHFIRST proved to be unsustainable and risked rendering the NHFIRST application inoperable when Lawson foundation software upgrades were implemented, therefore it was decided to implement and find an acceptable and auditable solution post implementation. The State is currently procuring, and will implement before the end of state fiscal year 2011, SecureAuth--an off-the-shelf product that meets all the requirements of the State password policy and provides an even higher level of secure access using two-factor authentication with soft certificates. In addition, SecureAuth enables single sign-on for the NHFIRST financial and budgeting applications and can also be used to manage secure access to any other State web-based applications.

- Password Encryption:

  All Oracle database passwords are encrypted, including the Lawson proxy password. DoIT is researching a methodology to encrypt any configuration files containing clear text passwords on the application server. Unix and Windows administrator passwords are stored encrypted by the operating system on the Unix and Windows servers. All logins are logged and audited periodically by system administrators and DoIT management. Lawson and Affinity budgeting application passwords are not encrypted on the application server. The configuration files that contain these Lawson and Affinity application passwords have been secured so that only the System Administrators at DoIT can view the contents of the files. This was done by setting the Unix permissions so that only the Lawson account can view or update the Lawson configuration files. For Affinity, only the Unix Administrators in DoIT have the passwords for the lawson and wasadm userids used to access Lawson and WebSphere, respectively, or they grant a "pseudo" connection to the account to another DoIT user who needs the access. All accesses are logged and reviewed by DoIT management.

- Shared Accounts

  Some shared accounts are required for the software to function. For example, SYS and SYSTEM accounts are standard Oracle database accounts used to administer Oracle databases. They must exist for the database to run and to maintain the databases (patches). However, unique accounts have been created with the same rights as SYS or SYSTEM for DoIT staff responsible for administering the NHFIRST databases on a day to day basis. Activity with these accounts are logged and reviewed by DoIT management.

  The Operator Ids PFUSER and PFAdmin are also system accounts required for ProcessFlow to function. (Process Flow is companion software to Lawson which controls transaction approval.) These accounts are used exclusively by the ProcessFlow application and by the ProcessFlow Administrator and Backup Administrator in Financial Data Management to manage ProcessFlow on a daily basis.

  The Operator Id FDMOPER is used by the Department of Administrative Services, Financial Data Management (FDM) for NHFIRST daily scheduling and job processing. LBI, the Lawson report repository, was implemented to also use FDMOPER to access and publish reports from the daily processing cycle. FDM will implement in the first quarter of calendar year 2011, the processing changes and a password change to eliminate the use of this userid in LBI processing and restrict the use of this userid to the three FDM staff that support the daily job scheduling and processing.

<u>2010 – 02 – Material Weakness</u>

Timely Performance of Bank and Cash Balance Reconciliations

Reconciling bank accounts is a key control for ensuring that cash collected and spent by the State is properly reflected in both the bank's records and the State's general ledger. As such, performing these reconciliations should be done regularly and on a timely basis in order to identify and resolve any errors that may exist.

In fiscal 2010, due largely to the implementation of the State's new general ledger system, NHFIRST, the Treasury Department encountered significant delays in reconciling bank statements to the State's Cash Book (cash subsidiary ledger). These delays related to the time associated with developing the reconciliation methodology, and learning the means of resolving discrepancies in the new system. The lack of timely reconciliations can lead to errors and omissions not being discovered and corrected quickly.

Additionally, the State did not have a clear process in place to agree balances in the Cash Book to the General Ledger cash accounts in NHFIRST, maintained by the Comptroller's Office. While the State's systems for recording cash transactions has numerous affirmative reviews and control, this reconciliation process is a critical part of internal controls over cash and became necessary as a result of implementing NHFIRST.

While the State did ultimately perform this reconciliation at the end of the year noting only minor variances, this reconciliation should be performed monthly throughout the year to ensure that operationally, the State's cash activity is being properly accounted for and reported on.

<u>Recommendation</u>:

We recommend that the State standardize its procedures, and establish a monthly process to ensure that bank statements reconcile to the Cash Book. Further, the State should implement a process to reconcile the Cash Book to NHFIRST General Ledger on a monthly basis.

<u>Management's Response:</u>

Treasury concurs. Treasury fully recognizes the critical importance of timely reconciliations. During the first year of NHFIRST implementation Treasury resources were (and continue to be) spread very thin. Like most users of NHFIRST, we continue to learn more about the capabilities and limitations of the system. As the States' central service agency for the processing of all revenue transactions, it was imperative that Treasury assist agencies with those new system processes when the State went live in July 2009. Additionally, there were many starts and stops as we worked cooperatively with the Division of Financial Data Management (FDM) and the Bureau of Financial Reporting (BFR) to ensure the proper reporting and data was being used in reconciliations.

The process, while not yet perfect, has been significantly improved. Treasury continues to work with the Division of FDM and the BFR to automate the process. We are working toward reorganizing the revenue approval and reconciliation sections of the Treasury with the goal of using NHFIRST and bank data to reconcile all activity electronically and on a daily basis. We have met with the Comptroller and have a plan in place to restructure the cash accounts in the NHFIRST General Ledger to facilitate easier and more meaningful reconciliation from NHFIRST to the subsidiary cash ledger.

Treasury takes this weakness very seriously and is committed to its satisfactory resolution.

2010-03 – Material Weakness

Financial Accounting and Reporting - Turnpike

While there were certain improvements made to the Financial Accounting and Reporting process at the Turnpike System from the prior year, there continue to be weaknesses in the process that need to be addressed for FY 2011.

During the audit, the Turnpike personnel generated numerous drafts of the CAFR containing errors that should have been identified and corrected by Turnpike management through their review of the statements. Additionally, documentation supporting amounts disclosed in the financial statements was not readily available to support those amounts or, when available, did not always agree with those amounts.

Recommendation:

We recommend that the Turnpike management review and improve the process for preparing its financial statements. This may require additional training in financial accounting and reporting requirements and or additional involvement of the Bureau of Financial Reporting (BFR) in the review of the Turnpike financial statements.

Management's Response:

We concur. This was indeed a challenging year working with and implementing a new accounting system. To meet this challenge, the Turnpike Division was very active in partnering with the BFR, FDM and officials of State Treasury to produce year-end financials in a complete and timely manner. During the course of this activity, the Division made great strides in understanding and establishing accompanying financial schedules and reports to support the results of operations for the fiscal year.

The Division continues to strengthen its understanding, and improve accounting practices and its ability to capture and report data. This said, it is important to note that the transition to a new automated system of accounting and financial reporting was perhaps more difficult in practice than originally thought. Transition to a new automated system required much more work of the Division and coordination with others than anticipated. The migration from basically a manual system of subsidiary ledgers to NHFIRST was not exactly "plug & play" and required numerous resources and hours of staff and others to accomplish.

Now implemented, the Division has for several months utilized the "multi-ledger" system available in NHFIRST to capture accounting transactions that ultimately, will allow the Division to automate for the first time, the production of financial statements. It is anticipated that the first financials from NHFIRST will occur at the end of the third quarter in March of this year. This ability to generate automated reports and financials will greatly improve the reporting function of the Division, management and others who rely on these statements.

2010-04 – Material Weakness

Reconciliation of DRA Accounts

During our audit of the Department of Revenue Administration (DRA), we noted that certain accounts are not reconciled and that reconciling items for other accounts are not adequately supported to allow DRA to identify and correct issues timely. As a result, we noted the following:

- During July 2009, after the implementation of NHFIRST, an error was detected in an account that was caused by a coding error in the Tax Information Management System (TIMS). This was noted quickly and corrected timely in the account detected. However, another account affected by the same coding error was not detected timely because this account is not routinely reconciled. The DRA worked to correct the errors as a result of the audit inquiry.

- Due to the lack of follow up on reconciliation variances, DRA did not identify errors in the way in which they processed 're-issued' checks (checks reported as lost, or returned by the tax payer for correction) until prompted to do so as a result of the audit.

- In August 2009, due to a lack of controls, DRA issued $680,000 of duplicate refund checks. Those duplicate checks have since been recovered.

Recommendation:

We recommend that DRA implement policies and procedures to ensure that all accounts are reconciled timely and variances are investigated and resolved timely.

Management's Response:

Management of DRA concurs that the transition to a new accounting system played a part in the reconciling errors that occurred during the beginning of FY 2010. Accounts that had been used for processing certain transactions changed, specifically the use of the "clearing account" changed. This change in status was not clearly communicated or understood, resulting in a period of time where the account was still being treated as a "clearing account" and subject to minimal and periodic reconciliations. The duplicate check issue was also in part due to a change in processing and a communication/training breakdown. The Department is unique in its processing of taxpayer refunds and worked with NHFIRST for a solution to the "one time vendor" checks. The process by which these checks are approved in NHFIRST is substantially different and does not yet include some of the long time automated internal controls that had been in place.

Revenue has changed its reconciliation procedures to ensure all accounts are reconciled monthly by the Financial Analyst; the reconciliation is then reviewed and signed off by the Internal Auditor.

Because of the certain limitations of the Lawson application, DRA created an automated solution in TIMS to ensure that, with respect to duplicate checks, the dates, dollar amounts and counts all match. This verification is then reviewed by the Business Administrator who authorizes the release of the file to be sent to Administrative Services for final processing.

<u>2010-05 – Material Weakness</u>

Preparation of Tax Accounts Receivable Estimates

During preparation of the State's Comprehensive Annual Financial Report (CAFR) the Bureau of Financial Reporting (BFR), relying on tax estimates from the Department of Revenue Administration (DRA), records an amount of June 30 tax revenue receivables for business taxes and interest and dividend taxes. While BFR has been responsible for inclusion of the estimates in the CAFR for many years, DRA has been responsible for the basis and accuracy for the past two years. The two agencies collaborate in determination of the appropriate CAFR entries.

This is the third consecutive year that we have identified weaknesses in the State's process for accruing revenues at year end.

During the 2008 audit of 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 estimates were made. Re-estimating the tax receivables using more relevant assumptions resulted in an audit adjustment totaling approximately $31 million. In 2008, we recommended that DRA and BFR revisit the methodology for estimating tax accounts receivable and make appropriate modifications. In 2009 and again in 2010, we noted that our recommendations regarding the State's methodology for estimating accounts receivable were not fully addressed by management. In 2010, we did note that the responsibility for estimating accounts receivable was transferred from the BFR to DRA as previously recommended.

While we did not have any adjustments to the tax accruals in 2010, we did propose other adjustments that resulted from the lack of an effective review by DRA management of other information submitted for inclusion in the State's CAFR. That adjustment resulted in a $6.8 million decrease to the State's fund balance due to a manual error that should have been identified through an effective management review by DRA of the receivable information.

<u>Recommendation:</u>

We reiterate our recommendation from 2008 and 2009 that 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 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 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.

Management's Response:

DRA:

The Department concurs in part. The LBA Auditors have been notified in the last two years (audit cycles) that the Department is in the process of implementing systems that will provide an accurate reporting of the receivables. These systems were not scheduled to be functional until January 2011 in time for year end 2011. Consequently, the Department continued to use the spreadsheets and methodology that had been previously used by Administrative Services.

This year end, the receivable system prototype report is in place and the Department will be able to accurately report receivables by tax type including aging, and count. The Department will work closely with the Comptrollers Office to appropriately account for all receivables for the Department in accordance with the adopted system re-engineering Capital Budget plan.

DAS:

To provide a greater level of analysis and support to the accuracy of DRA's estimated receivables BFR and DRA have agreed to a step whereby they establish a time to collaboratively discuss and review together, the methods of computation and their results. This is intended to add a greater level of scrutiny and validation to the computations.

<u>2010-06 – Significant Deficiency</u>

Accounting for Intergovernmental Payables and Receivables

There are a number of agencies which provide services to other agencies, or owe funds to other agencies for various reasons. A practical example of this relates to payments by the State's primary operating fund as a service to other agencies under the centralized accounts payable system. All amounts paid to vendors are recognized as paid by this operating fund, while the related expenditure/expense may belong to another fund. Therefore, when such an amount is paid by the operating fund, an amount is reflected as due from the other fund ("Due From" account). The corresponding fund records an amount due to the operating fund ("Due To" account). Another example results from the amounts billed by DoIT to other funds which it serves. Cash is not exchanged for these services but rather, upon receiving a bill from DoIT, the billed agency records IT expense and reflects an amount due to DoIT, while DoIT recognizes revenue and reflects the same amount as due from the other fund.

At June 30, 2010, the State was not able to balance their intergovernmental payables and receivables. In other words, the total of amounts reflected as due from other funds did not equal the total of amounts shown as due to other funds, as would normally be the case. Upon investigation by the State, it appears that administrative agencies would create a billing and record an intergovernmental receivable, while the recipient agency either would not create a payable timely, or would create a vendor payable, and not an intergovernmental payable, thereby causing the Due To and Due From to be 'out of balance'.

Since NHFIRST does not *automatically* create the balanced intergovernmental entry, when an administrative agency initiates an intergovernmental billing, it is the responsibility of the receiving agency to create the intergovernmental payable. The entries are initiated by recording a voucher in the accounts payable system, which initially reflects as a general accounts payable in the general ledger. Normally, that day's close process results in a non-cash 'payment' cycle which properly eliminates the general account payable entry and classifies the amount in a "Due to" account. At year end, many of these vouchers were recorded during the final closing period—that time that is used following year end to record final transactions and adjustments. Logically, receipts and payments are not recorded during this time. As a result, normal daily closeout did not occur, and unknowingly at the time, these intergovernmental liabilities remained in the general Accounts Payable account.

<u>Recommendation:</u>

We recommend that the State review the way in which it records intergovernmental transactions. In the previous accounting system, NHIFS, if an intergovernmental billing (Due From) was created, an intergovernmental payable (Due To) was automatically created in the other agency, thereby ensuring that the transaction was always in balance. During the implementation of NHFIRST, additional restrictions were imposed, as a result of strengthened system security policies, which restrict access to accounts of another agency. This inherently blocks the path of one agency charging directly to another agency's account. This makes it more complex for entries to simultaneously affect different agencies. However, we recommend that the State consider alternatives to automating this transaction similar to the way in which NHIFS processed intergovernmental transactions.

Management's Response:

We concur. The new ERP system introduced many changes in approach to accounting and controlling various aspects of the State's general ledger. The introduction of Accounts Receivable and Accounts Payable system modules, and the ability to maintain balance sheet ledgers for individual funds were probably the two most comprehensive changes, though significant improvements. A great deal of attention was paid at year end to ensuring that agencies recorded all expenses appropriate to accrue for FY 2010, including those owed to other funds. Many of these were captured during the closing period resulting in the classification error described. In the coming year, at the end of the closing period, a cash disbursement cycle will be processed, only for intergovernmental vouchers, thereby correctly classifying liabilities and facilitating tie-out of the inter-agency accounts. In addition, a special search of the general Accounts Payable file will be made to look for intergovernmental items.

2010-07 – Significant Deficiency

Highway Mainframe Reconciliation

In order to facilitate federal and other reporting, the Department of Transportation maintains a general ledger (DOT Mainframe) separate from the State's official books and records (NHFIRST). While the use of accounting sub-systems is a common practice, such an arrangement requires that a control process exists to reconcile NHFIRST data to the DOT Mainframe data.

Prior to the implementation of NHFIRST, the DOT performed a monthly reconciliation between the DOT Mainframe and NHIFS. However, due to challenges encountered during the implementation of NHFIRST, the DOT was unable to reconcile the DOT Mainframe to NHFIRST during FY 2010.

The lack of timely reconciliation can lead to errors and omissions going undetected for an extended period of time. Such reconciliations should be performed timely.

Recommendation:

We recommend that the Department of Transportation implement policies and procedures to ensure that the DOT Mainframe reconciliations are performed timely.

Management's Response:

We concur. Prior to the implementation of NHFIRST, the Division of Finance (Division) would key accounting transactions to the DOT Mainframe first and then upload those transactions to the former statewide accounting system NHIFS. The monthly reconciliation process under this former practice was very much routine and without significant error. The migration from the former accounting system NHIFS to NHFIRST brought unique challenges to the Division as NHFIRST was unable at the time, to accommodate an activity-based (project) means of accounting. The Division must have a project based accounting system in order to properly identify and attribute revenue and expenses to projects. To accomplish this necessary task, the Division double-keyed accounting data both to NHFIRST and the mainframe. This effort was both laborious and prone to errors. To address this issue and to maintain the integrity of data in both systems, the Division hired two part-time accounting technicians to start and complete a reconciliation of all fiscal year entries.

Effective July 1, 2010 (FY 2011), all keying is direct to NHFIRST which then is fed back to the mainframe. This interface contains all expenses incurred by project number thus eliminating the need for double-entry in this regard. As NHFIRST is further developed to meet the full needs and requirements of the Department, we will continue to monitor for variances as a result of the continued use of the two separate systems. This current fiscal year is still a year of transition. Ultimately however, the need for the mainframe will become diminished and eventually phased out for all accounting activity and the need for reconciling will no longer be necessary.

The Division will update written procedures as the full integration of NHFIRST is developed.

2010-08 – Significant Deficiency

Accounting and Reporting of Capital Assets

During our audit of the Department of Transportation we noted various errors in the accounting and financial reporting for infrastructure assets. The errors included the following:

- adding items in FY 2010 that were purchased in prior years;
- adding items twice;
- capitalizing the contracted amount rather than actual costs;
- understatement of additions to buildings
- recording disposal of items not actually disposed
- recording disposals in FY 2010 that were disposed in previous years.

These errors are evidence of a need for improvement in the internal controls over accounting and financial reporting for capital assets.

Recommendation:

We recommend that the State improve its system of internal controls to ensure that capital assets are complete and accurate.

Management's Response:

We concur. The Division has taken on the task of reviewing both process and procedures relative to the accounting and reporting of capital assets. The current process is being addressed and we understand that until a new system of recording assets is in place, the need for manual review needs to be improved. This said, we have also found and reported (properly) during this audit period, errors that culminated over prior periods.

Enhancements to this issue include but are not limited to, working with project managers to better describe on project authorization forms, more detailed descriptions of what project expense qualify as either capital or repair. We are also exploring opportunities with the development of other internal systems to give us better reporting capabilities. Ultimately, the State should expedite the NHFIRST Fixed Asset and Inventory System (available but unimplemented), to provide greater capability to agencies and enable a uniform state-wide system and procedures.

2010-09 – Significant Deficiency

Completeness and Accuracy of the Schedule of Expenditures of Federal Awards

Federal Office of Management and Budget (OMB) Circular A-133 requires the State to prepare a Schedule of Expenditures of Federal Awards (SEFA) that reflects all federal funds expended by the State during its fiscal year ended June 30. It is important that the SEFA be complete and accurate as the Federal expenditures are used as the basis for determining the Federal programs required to be audited. 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.

The Department of Administrative Services (DAS) is responsible for preparing the SEFA based on information provided by the various State agencies and departments and while DAS 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 accurately.

As a result of our audit work, we noted errors on the SEFA including:

- Expenditures reported reflected cumulative program expenditures rather than expenditures for the State's fiscal year;
- Expenditures from two separate Federal programs were reported as a single Federal program resulting in an improper conclusion about the programs required to be audited; and
- Lack of analysis and documentation surrounding the inclusion of program expenditures funded by the Federal Department of Transportation - Federal Aviation Administration

As in prior years, we again noted that the SEFA is prepared by one individual at DAS and that documentation supporting amounts received from individual state departments and agencies is insufficient to enable verification of amounts entered by the agencies. Finally, the SEFA is not adequately reviewed in detail by DAS personnel 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. Further, the Department may want to consider researching the grant and activities module of the Lawson accounting system to determine the cost benefit of being able to centralize the reporting of agency expenditures.

Management's response:

We concur. The SEFA is developed through the accumulation of expenditure data into a web-based application, unrelated to NHFIRST. Analytical procedures to verify the input to this application are necessarily limited by the lack of centralized project/program cost reporting system within the state and of a lack of centrally available contract terms and details. The general ledger is not designed such that expenditures related to federal programs may be captured efficiently, providing an alternative basis for verifying data input into the SEFA report. As compensating controls to provide minimum assurance of SEFA accuracy, Bureau of Financial Reporting (BFR) staff performs year to year comparisons of CFDA information to identify omissions or inconsistency of expenditures. Unfortunately, this does not give a high degree of assurance to its accuracy.

The NHFIRST software has a projects reporting module which is not yet fully implemented, as it was not part of the initial design. This module would allow for project reporting, were all agencies to enter activity data with its entry of vouchers. Implementation of this function would enable the state to monitor federal and other programs, providing numerous advantages monitoring operating performance, as well as better control of SEFA data. This is planned to be implemented during FY 2012, thereby enabling greater reliability of assurance as to the accuracy of the SEFA by FY 2012. As with any such effort, resources are limited and our success in this implementation is dependent on maintaining sufficient skill levels of resources which can make the best use of the module. In the meantime, as an additional step, BFR will provide secondary analysis of the SEFA prior to submission as a final document.

2010-10 – Significant Deficiency

Compliance with the Treasury State Agreement

U. S. Department of the Treasury regulations at 31 CFR part 205, which implement the Cash Management Improvement Act of 1990 (CMIA), as amended (Pub. L. No. 101-453; 31 USC 6501 *et seq.*), require State recipients to enter into agreements that prescribe specific methods of drawing down Federal funds (funding techniques) for selected large programs, known as the Treasury State Agreement (TSA). The New Hampshire State Treasury Department (Treasury) is responsible for the implementation and enforcement of policies and procedures designed to enhance the State's internal control over cash management. The Treasury considers the management of cash as having the right amount of cash as needed by the State Agencies to finance the operating and capital budgets on a timely basis and meets this responsibility through a variety of routine tasks including the development and implementation of the CMIA system. The CMIAsystem is a module under NHFIRST. The system was established by Treasury in order to monitor compliance with the TSA, however, the system is underutilized and not established in such a way to ensure relevance to the large programs.

During the past fiscal year, the CMIA system did not include the applicable programs as outlined in the approved TSA and the clearance patterns established in the system are not in agreement with the TSA. The CMIA system includes a lag day which results in cash draw downs to be drawn in an additional day. Additionally, Treasury does not communicate with the State Agencies the importance of the TSA and the relationship between the TSA and the CMIA system. Some State Agencies are not aware of the TSA and the required clearance patterns and have established policies and procedures where the timing is practical for the State Agency but not in accordance with the TSA. Also, during the past fiscal year, some State Agencies have opted out from using the CMIA system as the system does not always identify the total amounts to be drawn.

Recommendation:

We recommend that Treasury ensure that the information included in the CMIA system and the TSA are in agreement and that State Agencies are utilizing the CMIA system effectively.

We also recommend that Treasury formalize policies and procedures to review the TSA, establish clearance patterns with State Agencies to ensure departmental compliance with the TSA and the cash management requirements, and finally to communicate the approved TSA to State Agencies on an annual basis.

Management's Response:

Treasury concurs. Prior to and during the first year of the new financial system, Treasury was incredibly challenged with dedicating sufficient resources to the area of federal cash management. Treasury recognizes the important role communication, policies, and procedures have in ensuring a better understanding of and compliance with cash management requirements including how the customized NHFIRST CMIA module operates and can assist in compliance. At the same time, resources continue to be strained in the Treasury as we recover from, adapt to, and enhance our understanding of the new financial system implemented last year.

With an increased understanding, further process redesign to increase efficiencies throughout the agency and the assistance of Financial Data Management (FDM) in planned NHFIRST development, Treasury will sufficiently address the concerns expressed in this finding. As a first step, Treasury has scheduled an information session and review meeting for mid April to cover the TSA and specific compliance requirements with all agencies covered in the agreement. There will be a specific agenda and directives for the effected agencies. Treasury intends to host similar meetings on an annual basis. Treasury will also develop written policies and procedures with input from the State agencies covered by the TSA after meeting with those agencies in April.

SECTION II

OTHER COMMENTS

<u>2010-11 – Management Letter Comment</u>

Succession Planning

In previous management letters we have presented the issue of succession planning. In the past, delays in the issuance of the State's annual financial statements were 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.

Today, the issue of the pending retirement of the baby boomer generation has come to the forefront as the first of the "boomers" have reached retirement age. Over the next decade, as more state employees reach retirement age, the State will be faced with a tremendous loss of institutional knowledge and possibly significant deficiencies in highly specialized areas and functions.
In order to ensure continuity of service and minimize the loss of institutional knowledge, it is essential that the State develop and execute a succession plan that will address this inevitable challenge.

<u>Recommendation:</u>

We recommend that the State consider adopting a formal succession plan. Such a plan, at a minimum, should include identifying key personnel, retirement timeline and potential replacements.

<u>Management's Response:</u>

We concur in part. In response to prior year comments regarding succession planning, the State has already taken steps to mitigate the impact of personnel loss and otherwise plan for maintaining skill levels in critical agency positions. The Division of Personnel (Division) began a Workforce Development Program in 2008 by hiring a workforce development coordinator, establishing a workforce development committee to oversee initiatives and creating a state-wide workforce development plan. The division has now hosted two annual workforce development summits. These events have been attended by more than one hundred participants in the first year, and approximately two hundred in the second year. The agenda has included presentations by keynote and other speakers accomplished in the area of workforce development, and panel discussions on topical issues. In early 2009, a day-long informational seminar was held for state-wide personnel managers, to share research findings as a part of the "States as Employers-of-choice" project.

Also during the 2009 fiscal year the Division conducted a total of five surveys on different topics specific to workforce development issues to gain an assessment of need and hear a variety of ideas. All survey results are publicly available on the Division website. Management of the state believes that over time the efforts of the Division of Personnel and the various personnel managers across the state will have the desired effect of retaining personnel, planning for the succession of key positions and achieving skill and competence levels of state employees to result in operation of the state with the highest degree of efficiency and effectiveness possible.

2010-12 – Management Letter Comment

One-Time Revenue Sources

Governments around the country have been challenged to close budget gaps without increasing taxes and have responded by, among other things, increasing fees, cutting budgets and reducing services. Governments have also increasingly relied on the use of one-time revenues to close their gaps. While one-time revenue transactions may be a creative way to solve short term budget issues, once used, they are no longer available to be used in the future. Generally the use of a one-time revenue source should be matched with a one-time expense. As such the use of one-time revenues must be critically evaluated to ensure that their use is not simply to fund routine, ongoing activities for which future funding will still be needed.

During FY 2010, the State utilized three one-time revenue sources.

- The State's general fund received a $25 million payment from the University of New Hampshire
- The State's general fund received a $6.5 million payment from the Liquor fund as a result of the 'sale' of land to the Turnpike Commission
- The State's Highway Fund received a $30 million payment from the Turnpike Commission with the commitment for $90 million more in the future

Further, in 2011 the State refinanced $50 million in general obligation bonds, $40 million of which relates to the general fund, with the intention of deferring debt service payments from fiscal year 2011 into future years.

These 2010 transactions are in addition to prior year transactions that allowed for the school building assistance to be bonded rather than be paid for out to the general fund and the use of Federal ARRA dollars to support the State's personnel costs.

The continued use of one-time revenue sources could ultimately have a negative impact on the State's financial condition as such funding sources will ultimately run out.

Recommendation:

We recommend that the State continue to explore funding options other than one-time revenues to balance its books. However, if it becomes necessary to use a one-time source, it should be matched with a one-time expense to help eliminate future budget problems created by using one-time revenues for routine, ongoing costs.

Management's Response:

The State's Executive management is aware of the need and there is continuing effort to achieve balanced budgets based on sustainable revenue sources. These times have been challenging to an unprecedented degree. A great deal of attention is being given to developing efficiencies in government operation and reducing services to serve only those most necessary needs. In fact, the recently submitted Governor's Budget proposes no such one-time revenues, and should any be enacted by future bills, the Governor is directing those to the Rainy Day Fund. It is the expectation of management that the avenue of reducing costs will enable the State to achieve surplus generation through operations, relying only on sustainable revenue sources.