STATE OF NEW HAMPSHIRE

Management Letter

Year Ended June 30, 2013

KPMG LLP
Two Financial Center
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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, 2013, 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 basic 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, significant deficiencies or material weaknesses may exist that were not identified. However, as discussed below, we identified a deficiency in internal control that we consider to be a significant deficiency.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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. The identified significant deficiency listed in Section I is not considered to be a material weakness.

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 the deficiency listed in Section I to be a significant deficiency.

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, and elected officials, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

December 23, 2013

STATE OF NEW HAMPSHIRE

Management Letter

Year Ended June 30, 2013

Table of Contents

SECTION I

SIGNIFICANT DEFICIENCY

Controls over the Processing of Medicaid Claims at the Service Provider

The State of New Hampshire (the State) is responsible for administering the multi-billion dollar Medicaid program. Among its responsibilities related to Medicaid, the State is ultimately responsible for ensuring that Medicaid providers receive compensation for services provided to eligible Medicaid recipients.

The State is responsible for overseeing and paying for the billions of Medicaid claims processed annually. Due to the sheer volume and complexity of Medicaid claims, the State outsources the processing of those Medicaid claims to a third-party service organization. However, although the State outsources the responsibility for processing claims, it is still responsible for ensuring that the service organization has the proper internal controls in place and they are operating effectively to ensure the claims processed that are ultimately accounted for in the State's financial statements are complete and accurate.

To ensure that the service organization has proper internal controls, organizations, including the State, often require service organizations to undergo an audit in accordance with Statement on Standards for Attestation Engagements No. 16 – *Reporting on Controls at a Service Organization*, commonly referred to as a SOC 1 audit. Through fiscal year 2012, the State required its Medicaid service organization to undergo a SOC 1 audit, which the State would then review and rely on as evidence that controls at the service organization are operating effectively.

In March 2013, the State changed Medicaid service providers. The prior service organization last had a SOC 1 audit performed for the period ending June 30, 2012, while the new service organization did not have a SOC 1 audit performed for the period from the transition date through June 30, 2013. As a result, the State had no third-party assurance that the internal controls at either service organization were operating effectively during fiscal year 2013.

We did find that the State performed other procedures and analyses to help ensure that Medicaid-related amounts presented in the financial statements were complete and accurate, which helped mitigate the severity of this finding.

Recommendation:

We understand that the change in service organization precipitated this gap in SOC 1 coverage and the State will be obtaining a SOC 1 report from the new service organization going forward. In the future, should the State find itself in a similar situation with any of its service organizations, we recommend that the State work to ensure there is no gap in SOC 1 coverage during transition.

Management's Response:

We concur. The State has coordinated with the Medicaid service provider to have a SOC 1 audit performed for FY 2014 as required by the contract with the service organization. In addition, the State has taken steps to identify similar service organization arrangements and will monitor that SOC 1 audits and reports are completed and that no gap periods occur in an instances where a change in service organization occurs.

SECTION II

OTHER COMMENTS

Internal Controls over Investment Transactions

During our review of internal controls over investments at Treasury, we tested the internal controls over the purchases and sales of investments. The controls tested included documentation of investment transfer instructions via the "Wire Transfer Form" and documented approval of such transfers by the appropriate personnel.

For two of 25 investment transactions tested, we found that the "Wire Transfer Form" was not completed and approval of the transfer was not documented in each transaction. We noted, however, that there were compensating Treasury controls in place that mitigated the severity of these instances and those controls appeared to be operating effectively.

Recommendation:

We recommend that the Treasury Department review their policies and procedures with appropriate personnel to ensure that all protocols and procedures are being followed when executing investment transactions.

Management's Response:

Treasury concurs. Treasury experienced significant staff turnover during and following fiscal year 2013. In training our new employees, all policies and procedures were reviewed and employees were recently trained on those procedures. Treasury now believes it has a sufficient audit trail and that this finding is fully resolved.

New Pension Standards

In June 2012, the Governmental Accounting Standards Board (GASB) issued Statement No. 68, *Accounting and Financial Reporting for Pensions.* This standard revises and establishes new financial reporting requirements for governments that provide their employees with pension benefits through pension plans that are administered through trusts or equivalent arrangements that meet the following criteria:

- Contributions from employers and non-employer contributing entities, if any, to the pension plan and earnings on those contributions are irrevocable.
- Pension plan assets are dedicated to providing pension benefits to plan members in accordance with the benefit terms.
- Pension plan assets are legally protected from the creditors of employers, non-employer contributing entities, if any, and the pension plan administrator. If the plan is a defined benefit pension plan, plan assets also are legally protected from creditors of the plan members.

Key provisions of Statement No. 68 that will be relevant to the State's participation in the New Hampshire Retirement System (NHRS) and the New Hampshire Judicial Retirement Plan (NHJRP) include the following:

- A requirement to report a net pension liability (asset) in the accrual-basis statement of net position that represents the difference between the total pension liability and plan net assets (essentially representing the unfunded actuarial accrued liability), measured as of a date no earlier than the employer's prior fiscal year-end. Because NHRS is a cost-sharing, multiple-employer plan, the State will report its proportionate share of the collective net pension liability of the plan in its government-wide statement of net position. The employers' proportionate share should be determined in a manner consistent with how contributions to the plan are determined, and will likely be determined for the participating employers by or through NHRS. Because NHJRP is a single-employer plan, the State will report the entire net pension liability (asset) associated with the plan.
- Immediate recognition of most components of the periodic change in total pension liability as pension expense. Certain changes in total pension liability and plan net assets will be reported as deferred outflows of resources or deferred inflows of resources in the statement of net position and will be recognized as pension expense over the average remaining service life of all employees (actives, inactives and retirees). For NHRS, the State will report its proportionate share of collective pension expense and deferred inflows of resources and deferred outflows of resources in the government-wide statement of activities and statement of net position, respectively. The proportion applied will be the same as that applied to allocate the net pension liability described above. Deferred inflows of resources and deferred outflows of resources also will be reported to account for the impact of any changes in the proportion of NHRS attributed to the State from period to period. Because NHJRP is a single-employer plan, the State will report the entire amounts of pension

expense, deferred inflows of resources and deferred outflows of resources associated with the plan.

- Changes to key actuarial methods and assumptions used to determine total pension liability for financial statement reporting, including:

    - Use of a single blended discount rate that applies (a) the expected long-term rate of return on pension plan investments to the extent that plan assets are expected to be available to make projected benefit payments and (b) the interest rate on a tax-exempt 20-year AA-or-higher rated municipal bond index to projected benefit payments for which plan assets are not expected to be available for long-term investment in a qualified trust. Currently, the discount rate is solely based on the expected long-term rate of return on plan investments. Therefore, if municipal bond interest rates continue at their current level, discount rates may decline upon implementation of Statement No. 68, particularly for underfunded pension plans.

    - Required use of a single actuarial cost allocation method—"entry-age normal"—rather than the current choice among six actuarial cost methods. Both NHRS and NHJRP used an entry-age method in its most recent actuarial valuation, therefore, this change will likely have a limited impact on each plan's actuarial accrued liability.

- New note disclosures and required supplementary information, including additional disclosures related to the determination of the discount rate and the expected rate of return on plan investments, and the components of deferred inflows of resources and deferred outflows of resources related to pension benefits.

Statement No. 68 will be effective for the State's fiscal year ending June 30, 2015. To the extent practical, in the first period that Statement No. 68 is applied, changes made to comply with the Statement should be reported as an adjustment of prior periods, and financial statements presented for the periods affected should be restated. Therefore, a measurement of net pension liability under the new standards will require determination as of a date no later than June 30, 2014 to restate the beginning net position of the fiscal year ended June 30, 2015. Additionally, NHRS and NHJRP will be required to implement a related new GASB Standard, GASB Statement No. 67, *Financial Reporting for Pension Plans*, for their fiscal years ended June 30, 2014 and December 31, 2014, respectively, that will impact certain disclosures and required supplementary information provided in the respective NHRS and NHJRP stand-alone financial statements.

To address certain audit issues related to the actuarial information that will be required by employers participating in cost-sharing multiple-employer pension plans, and likely provided by those plans, the AICPA has issued the following two whitepapers:

- Government Employer Participation in Cost-Sharing Multiple Employer Plans: Issues Related to Information for Employer Reporting

- Single-Employer and Cost-Sharing Multiple Employer Plans: Issues Associated with Testing Census Data

These white papers provide recommended alternatives for the provision of pension information by cost-sharing multiple-employer plans to participating employers to facilitate compliance with the requirements of Statement No. 68. The white papers also provide guidance related to the audit of such amounts by the plan auditor as well as responsibilities to be executed by participating employers and their auditors to be able to rely on the pension information provided by the plan. The white papers also introduce new audit guidance regarding the testing of census data by the auditors of the cost-sharing multiple employer plan and the participating employers. Multiple audit interpretations are expected to be issued by the AICPA to codify the guidance provided in the white papers into existing professional audit standards.

The new GASB pension standards also have garnered attention from the Securities and Exchange Commission (SEC) in the context of their impact on the pension information disclosed by issuers of municipal securities. In a recent speech to the 2013 AICPA Conference on Current SEC and Public Company Accounting Oversight Board (PCAOB) Developments, the SEC Chief Accountant cited the new standards and the SEC's expectation that upon their implementation, a more faithful representation of the full impact of the pension obligations provided by state and local governments will result, along with more informative disclosures regarding the assumptions used to measure the pension obligations. The SEC Chief Accountant also stated that the municipal securities market continues to be an area of focus for SEC staff, with such focus including the risks related to pension liabilities facing municipal issuers.

Lastly, in the wake of the issuance of the new pension standards, the GASB also is currently deliberating a project on postemployment benefits other than pensions (OPEB). The findings of such project could result in changes in the OPEB financial reporting framework similar to those for pension benefits in Statement No. 68. Such changes could have a more dramatic on the State's financial statements than those for pension benefits given the current unfunded status of the State's OPEB plan. An exposure draft of a proposed accounting standard related to OPEB is scheduled to be issued by GASB in April 2014.

<u>Recommendation:</u>

The State should engage in communications with NHRS and other participating entities and NHJRP regarding the impact of the new pension standards on the key financial metrics of the plans and the plans' timetable for developing the financial statement information required by participants upon implementation of the standards. The State also should monitor the progress of GASB's OPEB project and review the related exposure draft upon issuance to preliminarily evaluate the impact of any proposed changes in current standards on the financial reporting of the State's OPEB obligation.

Management's Response

We concur.

The State continues to work with the NHRS and participates in the "NHRS Pilot Group" made up of representatives from NHRS and the NH Municipal Association (NHMA). The group is developing communication plans to educate participating public employers affected as well as implementation plans to meet pension calculation and disclosure requirements by the new standard. Also, a page has been created on NHRS' website for communications and links to various resources. The State has also been in communication with the NHJRP regarding their implementation progress and will continue to monitor the implementation going forward.

Additionally, the State has been participating in educational opportunities provided through KPMG as well as monitoring the activities of the National Association of State Auditors, Comptrollers and Treasurers (NASACT) Pension Standards Implementation Workgroup. As a member of the Governmental Accounting Standards Advisory Council (GASAC), the former State Treasurer had been participating on the Governmental Accounting Standards Board's (GASB) Pension Q&A Advisory Committee.

Management believes that NH will be prepared for implementation in State's fiscal year 2015. The State will also monitor the progress of GASB's OPEB project.

Succession Planning

In our 2012 management letter, we provided the State with a comment on succession planning. The State's 2013 Comprehensive Annual Financial Report (CAFR) reports that as of June 30, 2013 approximately 33% of the State's workforce is eligible for retirement and an additional 21% will be able to retire over the next five years. It is with these statistics in mind that we re-issue our comment from the 2012 management letter.

* * * * *

Many governments, including the State, are facing the challenge of ensuring continuity and consistency of service delivery due to employee turnover. In instances where large numbers of government employees are eligible to retire, there is a concern that not enough qualified or available workers will be prepared to replace them. The Government Finance Officers' Association (GFOA) has issued a Generational Change Task Force Report with a number of recommendations to mitigate the risks of turnover of experienced employees. We have summarized a number of these recommendations in the section below.

<u>Recommendation</u>

The GFOA encourages governments to address the following key issues and develop strategies concerning succession planning:

- Develop an integrated approach to succession management. Organizations with an integrated, rather than "just-in-time," approach to succession management experience higher retention rates, increased employee morale, and an environment that stimulates innovation and organizational change. There are some positions in an organization that are more critical than others. A successful succession plan should place a high priority on planning for a smooth change in such positions. Key components of an integrated succession management approach include: workforce planning, succession planning, knowledge management practices, and recruitment and retention practices.

- Continually assess potential employee turnover. Making career planning discussions a part of a regular and ongoing performance review process assists in assessing potential turnover. Department heads are a good resource in helping to identify employees that may be planning to leave.

- Provide a formal, written succession plan as a framework for succession initiatives. Without a formal plan, workforce/succession planning tends to take place in a haphazard fashion. A formal plan identifies risks and strategies, thereby providing a guiding framework for specific succession initiatives, including how employees are eligible to participate and what being part of the succession plan means. Plans that have been thoughtfully articulated and communicated to the organization are more likely to be successful. Additionally, having a formal plan indicates organization and leadership commitment to succession management, which is critical for success and for sustaining successful planning across political and leadership transitions. The Budget Department and the Human Resources Department should work together to develop this plan, along with other departments as needed.

- Develop written policies and procedures to facilitate knowledge transfer. Knowledge transfer is a critical component of succession management. There should be written procedures in place to formalize the knowledge transfer. A meeting should be held with departing staff to document job responsibilities.

- Development of leadership skills should be a key component of any succession planning initiative. When leadership development occurs, the organization benefits from developing a leadership pool for other positions. Encouragement of personal professional development activities should be a key part of the succession planning effort. Personal professional development benefits the organization over the long term by helping employees gain the skills they need to assume increased responsibilities.

- Design of better recruitment and retention practices may aid in the succession process. Many organizations will focus more on recruiting the new employee and less on orienting the person to the position and the ongoing development of the employee. Making sure pay levels are competitive with the market place is one means of retaining employees. Providing career advancement opportunities for employees is another means of retention.

- Consideration must be given to collective bargaining agreements and how those agreements fit in with the overall succession plan. The engagement of bargaining units for cross training opportunities is encouraged.

- If early retirement programs are offered, it should be done in conjunction with a succession plan. GFOA strongly recommends that governments use considerable caution when considering the implementation of early retirement plans. If an early retirement program is offered, that might provide a window of opportunity to look at technology, potential to streamline, or rethinking the way services are provided, managed, and/or administered.

- Consider non-traditional hiring strategies. Options such as part-time work, job-sharing, volunteers, and flexible schedules and flexible-place arrangements are providing mechanisms to both meet the needs of the organization and employees.

<u>Management's Response</u>

We concur.

At the end of calendar year 2010, the Workforce Development Coordinator retired from State service and due to budget cuts and fiscal restraints, the Division was not able to fill the vacant position. Over the past several years, the Division has begun to rebuild following the budget cuts of 2010. Several initiatives are now underway in the Division of Personnel's Bureau of Education & Training to address the current and anticipated needs of the workforce. Below is a summary of current initiatives and identified short and long term goals:

<u>In place</u>

1. *Pilot programs allowing open access training in five agencies for a series of core competencies*
2. *An orientation program for new state managers, comprised of a series of briefings by experienced managers in a range of agencies and cross-functional disciplines*
3. *A task force has just begun within the Department of Administrative Services working to update the state's intranet, Sunspot, to document businesses process and facilitate knowledge management and knowledge transfer*
4. *The Division of Personnel Human Resources website maintains a variety of online Workforce Development tools and resources. This toolkit is a continuing resource for agency human resources, management and administrative staff to use and implement in accordance with their individualized agency needs. The following materials can be found on the Human Resources website:*
    - *Self-assessment tools*
    - *Employee Recognition Tool Kit*
    - *Candidate Development Program Model*
    - *How to Measure Customer Satisfaction*
    - *Individual Employee Development Plans*
    - *Knowledge Management Transfer Model*
    - *Mentoring Model*
    - *Organizational Readiness Assessment*
    - *Strategic Planning Model*
    - *Workforce Planning Model*

<u>Short term goals</u>

1. *Enhance current training and workforce development programs across state agencies. Training programs will include:*
    a. *Leadership*
    b. *Strategic Planning*
    c. *Knowledge Management*
    d. *Lean Process Improvement*
    e. *Change Management*
2. *Encourage communities of practice to promote the communication of best practices across agencies and to break down silos.*
3. *Increased standardize processes across agencies to include terminology. Initial focus will be on hiring using an onboarding approach and the transition of employees out of the workforce.*
4. *Enhance cross agency communication with a systematic blog and reporting process located on Sunspot.*

<u>Long term goals</u>

1. *Establish communities of excellence using Baldrige criteria or similar criteria.*
2. *Track turnover numbers and new/current employees trained at each agency along with when the training occurred in the employee life cycle.*

Employer Group Waiver Plans

With the passage of the Patient Protection and Affordable Care Act (PPACA), a new type of Medicare prescription drug benefit plan—an Employer Group Waiver Plan (EGWP)—has evolved that has resulted in cost reductions for certain governmental entities when compared to the receipt of the retiree drug subsidy through Medicare Part D. An EGWP is a Medicare Part D prescription drug plan in which an employer partners with a pharmacy benefit manager (PBM) that has contracted directly with Medicare to be a part D provider. The EGWP provides the standard Medicare Part D prescription drug coverage only to Medicare-eligible retirees and covered Medicare-eligible dependents of the sponsoring employers. Much of the savings provided under EGWPs as compared to the rebate drug subsidy program occurs in the "donut hole" of drug expenses not currently covered by Medicare. Under PPACA, pharmaceutical companies will be covering 50% of the beneficiary's share of the cost of brand-name drugs occurring in this donut hole coverage gap (referred to as the Coverage Gap Discount Program). Employer plans that receive a rebate drug subsidy cannot access the Coverage Gap Discount Program.

In addition to the benefit of the potential cost savings, use of an EGWP allows governmental entities to consider EGWP savings in the calculation of the OPEB actuarial accrued liability. Under current GASB standards, the Medicare Part D retiree drug subsidy is considered a grant transaction and is not allowed to be considered in the calculation of the OPEB actuarial accrued liability. Therefore, use of an EGWP could result in a reduction of the accrual basis annual OPEB cost for purposes of GAAP financial statement reporting.

Recommendation

There are many other points of comparison between a retiree drug subsidy program and an EGWP in addition to what is discussed above. However, we suggest that the State research the various terms and conditions of an EGWP and evaluate whether such a plan would be an advantageous alternative for the State.

Management's Response

We concur.

The State is aware of Employer Group Waiver Plans (EGWP). In 2012, the state explored implementing EGWP with its PBM vendor at the time, CVS/Caremark, and identified the need to collect required Medicare data from retirees in order to implement EGWP. This data collection by the State requires significant effort and resources and is ongoing. Additionally, because the CVS/Caremark PBM contract expired on 12/31/13, the State focused its attention of the PBM procurement process, including therein the requirement to implement EGWP.

Effective January 1, 2014, the State entered into a contract with a new PBM vendor, Express Scripts. Express Scripts is performing a fiscal analysis to determine the financial savings that EGWP implementation would produce based on current federal reimbursement levels. Express

Scripts is also working with the state to analyze other issues relevant the State's ability to implement EGWP.

The possibility of implementing EGWP is relevant because of cuts to the retiree health budget. The FY14 and FY15 budgets were funded at 97%/100% of FY 13. As required by law, the Department of Administrative Services presented the Joint Fiscal Committee with a budget spending plan for retiree health benefits for FY 14 and 15 that includes EGWP reimbursements as a possible revenue source to offset the budget cuts.

Finally, the State is also sensitive to the retirees who would experience yet another change in pharmacy administration on the heels of the state's vendor change from Caremark to Express Scripts. There are approximately 4,800 retirees who are over the age of 70 and 1,800 of those retirees are over the age of 80. Changes in how benefits are administered are extremely unsettling, stressful for our older retirees, and hard to afford. Any such implementation requires a substantial amount of communication and education to retirees and even then the state often experiences heavy customer call volume.