**STATE OF NEW HAMPSHIRE**

Management Letter

Year Ended June 30, 2011

**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, 2011, 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, 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.

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 2011 – 01 and 2011 – 02 in the State's internal control to be material weaknesses.

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

February 28, 2012

**STATE OF NEW HAMPSHIRE**

Management Letter

Year Ended June 30, 2011

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# SECTION I

# MATERIAL WEAKNESSES

***2011-01 – 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 2011, similarly to 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.

Our review of NHFIRST in 2010 and 2011 indicated that there were significant weaknesses regarding password authentication. Authentication to the NHFIRST/Lawson financial system is through use of the State's Tivoli system. However, Tivoli only validates the existence of a valid user-Id and associated password and provides no management of password criteria such as password length and change frequency. While users of NHFIRST have been instructed to voluntarily create and use complex passwords, the passwords are not checked and consequently their format may not necessarily be stringent. In an extreme example, users could enter a single character as a NHFIRST password and never be required to change it. To overcome this weakness, the New Hampshire Department of Administrative Services has acquired a 3rd party solution (SecureAuth) that can provide appropriate password control using the State's Active Directory network passwords.

Weak access authentication controls create significant vulnerabilities that can be exploited to gain unauthorized access to systems and functions that could lead to the compromise of key systems, applications and data assets. 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 an effective on-line approval control.

Management's Response:

On October 24, 2011, SecureAuth was implemented for user access to NHFIRST. SecureAuth requires a user to enter their username and password and upon successful authentication the user is automatically logged into NHFIRST. SecureAuth usernames and passwords are maintained in

Active Directory and automatically update the Lawson application LDAP password. Active Directory policies enforce NHFIRST password compliance with the State password policy (criteria below). All users were provided an initial password and were required to change their password upon first logon to NHFIRST through SecureAuth.

| Password Criteria | Policy |
|---|---|
| **Minimum password length** | 10 characters |
| **Password Format** | Passwords must contain three of the following four:<br><br>• Uppercase character(s)<br>• Lowercase character(s)<br>• Number(s)<br>• Non-alphabetic special character(s) such as @, &, %, !<br><br>Passwords must not contain parts of the user name.<br><br>Passwords should not contain dictionary words, keyboard sequences, or any name easily associated with the user such as nickname, family, pets, hobbies, address, etc.<br><br>Strong password example:<br>T@ket!me2sve |
| **Maximum password age** | 90 days |
| **Minimum password age** | 1 day |
| **Enforce password history** | 5 passwords are remembered |
| **Account Lockout Threshold** | 4 invalid attempts |
| **Reset Account Lockout Counter After** | 60 minutes |
| **Account Lockout Duration** | 60 minutes |

## ***2011-02 – Material Weakness***

### *Accounting and Reporting of Capital Assets*

During our audit of the Department of Transportation (the Department), we noted that the Department made a number of adjustments to its capital asset records in 2011 to correct prior period errors related to capital assets associated with the Highway Fund. These errors included:

- Lack of removal of capital assets under development from construction in progress once completed and reported as depreciable capital assets.

- Lack of removal of infrastructure assets that had been disposed or replaced from the capital asset records.

- Misclassification of capital assets between the Highway Fund and the Turnpike Fund.

The identification of these errors is evidence of the Department's continued efforts to review the accuracy of its legacy capital asset records. It is also evidence of the need for continued improvement in the internal controls over accounting and financial reporting for capital assets, particularly in the areas of recording disposals and replacements, the allocation of assets between the Highway and Turnpike Funds, and review controls over the maintenance of capital asset records used to prepare the financial statements.

Recommendation:

We recommend that the Department continue its efforts to ensure the accuracy of its legacy capital asset records. We also recommend that the Department improve its system of internal controls over the maintenance of its capital asset records to ensure that the capital assets reported in the financial statements are complete and accurate.

Management's Response:

NH Department of Transportation concurs.

The Department has policies and procedures in place regarding the removal of capital assets and agrees that effective compliance of this policy needs to be better communicated to both program staff and Finance. The current process in the project "paper trail" makes it difficult for staff members of Finance to ascertain clearly, what part of the project is replaced, maintained, or enhanced for capital recognition purposes. Knowing the difficulties of the current method of recording fixed assets, Department staff performed an additional review of fixed assets at year-end that identified previously recorded assets that should not have been recorded to infrastructure. The results of our findings were disclosed and made known to the auditors.

To address this and other issues, the Department has a plan in place to address the recording of Fixed Assets and have operationally in place by June 30, 2012, an automated fixed assets module. This module will replace the current accounting practice of manually preparing spreadsheets that are subject to error. To meet this timetable, the Department in March of 2012 has incorporated a new fixed assets module and hired an Accountant IV to assist in the implementation of this module.

## SECTION II

## OTHER COMMENTS

***2011-03***

***Liquor Inventory***

In the spring of 2011, the State Liquor Commission (the Commission) performed a full physical inventory at each of the State's liquor stores and its warehouse. The purpose of the inventory is to determine the exact amount of inventory on hand at a point in time and make necessary adjustments to the Commission's perpetual inventory management system.

As part of our audit, we observe the inventory counts performed by Commission personnel at a sample of locations and independently perform a blind recount of a sample of those counts. We compare the quantities per our counts to those per the counts of Commission personnel, and if differences exist, they are investigated and resolved. Finally, once we and the Commission personnel are in agreement on the correct quantity, that quantity is used to update, if necessary, the Commission's inventory figures per their perpetual inventory management system.

During our audit, we noted eight instances out of 180 sampled counts where the Commission's perpetual inventory management system was not updated to reflect the actual quantities counted as part of the physical inventory.

Recommendation:

We recommend that the Commission revisit their policies and procedures related to the performance of the physical inventory and reinforce those policies and procedures with Commission personnel responsible for the performance of the physical inventory to ensure that all actual quantities identified through physical counts are properly updated in the Commission's perpetual inventory management system as appropriate.

Management's Response:

In many instances, initial counts are found to be incorrect, which may result in inappropriate adjustment of the perpetual inventory. In order to mitigate this risk, re-counts are performed to validate isolated variances. In addition, where re-counts may result in continued differences, a complete count of the entire store is performed. These additional control procedures before making adjustments to book inventory balances, can lead to delays in timely adjustment. To assure the timely control over this process, all unadjusted codes will be adjusted in the week following the quarterly inventory date, based on counts that will be performed by the area supervisor.

***2011-04***

***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 one of 25 investment transactions tested, we found that the "Wire Transfer Form" was not completed. Further, for 10 of 25 investment transactions tested, we were unable to verify the transaction approval. We noted, however, that there were other 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 and has added approver initials on documentation (including "Wire Transfer Forms") to indicate review of and approval of every investment transaction.

***<u>2011-05</u>***

***GASB Postemployment Benefit Accounting and Financial Reporting Project***

In June 2011, the Governmental Accounting Standards Board (GASB) issued an exposure draft of a proposed standard, *Accounting and Financial Reporting for Pensions* (the Exposure Draft). This Exposure Draft primarily relates to the financial reporting for pension benefits provided by state and local governments to its employees. The accounting and financial reporting provisions proposed in the Exposure Draft, if adopted in a final standard, would result in significant changes to the manner in which the costs and obligations associated with the pension benefits that governments provide to their employees are calculated and reported. These changes include the following:

- A requirement to report in the statement of financial position a net pension liability, which is the difference between the total pension liability and plan net assets set aside in a qualified trust to pay benefits to current employees, retirees, and their beneficiaries (essentially representing the unfunded actuarial accrued liability), measured as of the employer's fiscal year-end. Governments participating in cost-sharing multiple-employer pension plans would be required to record a liability equal to their proportionate share of any net pension liability for the cost-sharing plan as a whole.

- Immediate recognition of more components of pension expense than is currently required, including the effect on the pension liability of changes in benefit terms, rather than deferral and amortization over as many as 30 years which is common for funding purposes.

- Use of a discount rate that applies (a) the expected long-term rate of return on pension plan investments for which plan assets are expected to be available to make projected benefit payments and (b) the interest rate on a tax-exempt 30-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.

- Required use of a single actuarial cost allocation method—"entry-age normal"—rather than the current choice among six actuarial cost methods.

- More extensive note disclosures and required supplementary information, particularly related to the determination of the discount rate and the expected rate of return on plan investments, and the components of the pension liability and pension expense.

A final standard for the pension phase of the postemployment benefit project is expected to be issued in June 2012. Such standard would likely be effective for the State's fiscal year ended June 30, 2014. A second phase of the postemployment benefit project related to other postemployment benefit (OPEB) financial reporting is expected to be undertaken by GASB upon the issuance of the pension final standard.

Recommendation:

The State should closely monitor the progress of GASB's postemployment benefit project. Once the pension final standard is issued, the State should work with the New Hampshire Retirement System (NHRS) to analyze the impact on the State's current financial reporting practices related to postemployment benefits and identify any changes to the NHRS' financial processes necessary to enable them to provide the State with information needed to comply with the new requirements.

Management's Response:

The State is working with its OPEB actuaries to monitor the proposed changes to GASB pension accounting standards and the probable future application of similar standards for OPEB.