NEW HAMPSHIRE RETIREMENT SYSTEM

Management Letter
and
Auditors' Report On Compliance and
On Internal Control Over Financial Reporting
In Accordance With
Government Auditing Standards

Year Ended June 30, 2002

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MANAGEMENT LETTER

November 8, 2002

The Fiscal Committee of the General Court:

We have audited the financial statements of the New Hampshire Retirement System (the System or NHRS) for the year ended June 30, 2002 and have issued our report thereon dated November 8, 2002. In planning and performing our audit of the financial statements of the System, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. An audit does not include examining the effectiveness of internal control and does not provide assurance on internal control. We have not considered internal control since the date of our report.

A material weakness is a condition in which the design or operation of specific internal control components does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. However, we noted no matters involving internal control and its operation that we consider to be material weaknesses as defined above.

During our audit we noted certain matters involving internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with appropriate members of management, are intended to improve the internal control structure or result in other operating efficiencies and have been summarized below.

Securities Lending

We noted that the System instructs its investment custodian - which also functions as its securities lending broker - to notify the System of any amendments to the master securities lending agreement prior to their implementation. While this process allows the System to determine whether such amendments are acceptable and in compliance with the System's investment policy, the System does not regularly perform other internal due diligence on securities lending information available from the custodian. Such information would include, among other things, the audited financial statements of the collateral investment pool, whose assets must be returned to the borrower upon completion of the lending transaction; the portion of the service auditors' report ("SAS 70") that addresses the custodian's securities lending policies and procedures and the effectiveness of its internal controls; and periodic reports of securities lending activities.

The lack of timely and regular due diligence in monitoring securities lending activities increases the risk that lending terms or activities will not be fully understood or considered, potentially increasing investment risk. Accordingly, we recommend that the System develop policies and procedures to evaluate the information noted above. Such policies and procedures would address, for example:

- Gaining an understanding of the nature of the securities that comprise the collateral investment pool managed by the custodian, as well as reviewing the pool's financial statements to ensure that investments are within the guidelines prescribed by the securities lending agreement.

- Periodically reviewing lending activity to ensure that transaction volume, lending income and borrower rebate and management fees appear reasonable.

Management's Response:
The System agrees with the recommendations made for the enhanced due diligence procedures required related to the security lending activity. The System will develop a policy, and accompanying procedures, that will address the issues raised. The policy will specifically state the due diligence and monitoring procedures that will be implemented for the security lending program. Furthermore, the policy will address how frequently the security lending due diligence procedures will be performed and will assign responsibility to appropriate staff members. Appropriate documentation will be retained evidencing that the due diligence procedures are performed as stated in the policy.

Safeguarding of Assets

The System maintains a safe deposit box at a local bank where a small group of investment securities are held. During our audit, we noted that the System has not completed an inventory of this safe deposit box since March 2001. In addition, we noted that the System also had transferable stock certificates received from the liquidation of a venture capital fund stored in an on-site safe. Management indicated that while these stock certificates were to be transferred to the safe deposit box, the certificates have remained in the on-site safe since their receipt earlier this year.

To reduce the risk of loss or misappropriation, we recommend that the System either (a) consolidate all securities not held by the third-party custodian and safeguard them in a single location (e.g., safe deposit box) or (b) turn them over to the custodian to be treated like all other securities held by the System. If option (a) is elected, the System should:

- Designate individuals who are permitted access to the safe and require documentation of any securities movement in and out of the safe.

- Periodically perform an inventory of the safe.

Management's Response:
The System agrees with the recommendations made. The transferable stock certificates that were stored in the on-site safe have been deposited into the System's safe deposit box. An inventory of the contents of the safe deposit box has been completed and it will be the policy of the System that an inventory of the safe deposit box be completed annually. The designated staff members will conduct the annual inventories of the safe deposit box contents and will prepare and sign an inventory document indicating that the annual inventory was completed.

Termination of Benefits

In order to control and minimize the amount of benefit payments paid subsequent to a members' death (or beneficiary's death), built-in safeguards should be expanded to include:

- Appending the retirement plan document with a statement affirming the legal right to recover disbursements rendered subsequent to the date of death.

- Adding a disclaimer to direct deposit slips and annuity payroll checks stating the right to recover all payments made after the payee's death.

- Developing a disclaimer, or notarized affidavit, requiring members to confirm their understanding of a recipient's responsibility to return any payments rendered subsequent to the date of death. Additionally, the form includes authorization for the payee's estate to return any benefit payments rendered subsequent to the date of death. These forms are maintained in each member's file.

We recommend that the System consult with its legal advisors as to the effectiveness of adopting such policies in relation to its existing policies to further strengthen controls over termination of benefits.

Management's Response:
The System agrees, pending legal concurrence, to consider an amendment to RSA 100-A and if an opportunity arises to do so, we will submit a housekeeping bill in the matter of termination and recovery of benefits upon recipient death.

In a separate effort to educate the membership base and others regarding the System's authority, the System will incorporate information into its literature, publications, workshops, seminars, and other communication deemed appropriate.

Information Technology (IT)

During our audit, we reviewed existing IT systems and noted that the System's business continuity plan has not been formally approved or tested and that no security policies and procedures manual covering logical access controls and program changes has been developed.

The System is currently in the process of developing and implementing new software and hardware to convert its critical information systems. These new systems will provide opportunities for the System to change the way it does business in the future. We encourage the System to continue to monitor and evaluate the risks involved in the legacy systems until the new systems are fully implemented. In addition, we believe the System should ensure that business continuity planning and documentation of policies and procedures in the new systems are fully developed before the new systems' expected completion in fiscal 2004.

<u>Management's Response:</u>
A business continuity plan has existed for present legacy information systems since the NHRS conducted extensive testing related to Y2K. A soft copy of a business continuity plan is kept at the home of the business administrator seven miles from the office site. The business recovery plan contains contact names and number of key staff members for use in the event that the entire facility was lost. Also included in the plan are contact names and number for mission critical vendors. Although it has never conducted a test of a total facilities lost scenario, it is estimated that the organization could be open for business in a limited capacity within two weeks of a total loss. Going forward, we will develop and conduct periodic testing of the business continuity plan considering these factors. A key assumption which needs to be recognized is that staff is assumed to survive a total facility loss. There is no plan for business continuity should the facility be lost along with the majority of its employees and again, the plan which does exist has never been subjected to a full scale test. By the end of this fiscal year, the NHRS expects to relocate approximately 25% of the staff and 20% of the administration to an alternate site which will help to dilute the risk associated with a loss of facilities.

On a more limited scale, the NHRS has actually demonstrated its ability to cope with circumstances which are capable of disrupting services. Events which resulted in the temporary loss of functionality for a number of reasons were both experienced and dealt with according to plan. In each case, the disruption of services was mitigated as a result of the NHRS response and no meaningful interruption to business processes occurred.

Looking at the business continuity issue beyond the present legacy systems, part of a technology modernization project which has been underway for better than a year, is to create a disaster recovery plan for the new infrastructure. This plan will be updated every six months or more frequently as needed. The project will also be addressing workflow, which will provide procedures on how to complete processes within the new system. By the end of the project will we have a complete business continuity plan which addresses more than simply the technology infrastructure and which will incorporate the necessary components of a disaster recovery plan.

With respect to security policies and practices presently in place, the NHRS has maintained a written policy which is supported by software and hardware infrastructure. User passwords for all operating platforms automatically expired every 30 days and must be renewed in order to gain access to the applications which reside on those platforms. In addition, most applications also employ user passwords for added security. The NHRS does not use any unsecured Internet applications to process confidential information and firewalls and virus protection insulate files and programs from outside tampering. NHRS policies prevent physical and logical access to systems and information whenever staff changes occur and staff access is limited to areas of the operating platform which they need in order to perform their jobs. Platform rights are documented by position and supervisory staff must authorize all new staff and any changes to existing staff with the IT Department in writing. For the older mainframe system operated by Buck/Mellon, the NHRS has the most recent SAS-70 report for the Mellon firm on file and has made a copy available to the KPMG audit team.

In summary, we believe that while the system would presently be vulnerable to acts of terrorism and significant localized disasters, that it is as well postured as can be expected for many of the more routine and mundane threats to business continuity. We are committed to the maintenance of existing plans for the legacy system until it can be replaced and have work-in-progress to ensure a superior level of emergency preparedness with the inception of the new system.

STATUS OF PRIOR YEAR COMMENTS

Following is a summary of the status of corrective actions taken to date on comments and recommendations appearing in our 2001 management letter. For your convenience, we have summarized each comment and recommendation and included management's updated and final responses.

Commercial Real Estate

Valuation Assumptions for Properties Purchased in the Current Fiscal Year
We recommended that the System value all of its commercial real estate properties at fair value.

Management's Final Response:

- The NHRS is modifying its valuation policy for properties held less than one year. The policy was to value all properties held for less than one year at cost. The NHRS's policy moving forward will be to value all properties held less than one year at fair value in compliance with GASB and NCREIF valuation standards.

Operating Cash

We recommended that the System develop policies and procedures to establish the appropriate amount of excess cash that may be retained by the property managers.

Management's Final Response:

- NHRS's staff has reviewed the current practice of allowing the commercial real estate managers to withhold from the monthly operating cash distributions for anticipated near-term capital improvements and payments of property taxes. That review has included discussions with each of the three commercial real estate managers, as well as, discussions with The Townsend Group, NHRS' real estate consultant.

- Based on the cost/benefit analysis the NHRS's policy moving forward will be to continue to allow the commercial real estate managers to withhold cash from the monthly operating cash distribution if there is a need to pay for capital improvements or property taxes near-term. The real estate managers may withhold distributions for up to two (2) months in order to pay for anticipated capital improvements. The real estate managers may withhold distributions for up to three (3) months in order to pay for anticipated property tax payments. Real estate managers should contact NHRS' Director of Finance to discuss the issue should the anticipated distribution withheld be beyond the stated boundaries of two (2) months for capital improvements and three (3) months for property taxes.

Review of Internal Controls at Property Sites

We recommended that the System establish policies and procedures on the conduct of property manager site visits, including site selection based upon prevailing risk factors, tailored audit programs, formal reporting process and review, and approval process on issues identified.

Management's Final Response:

- The NHRS staff and Townsend Group had presented a proposal for the property audits to the Board in February of this year. After hearing the proposal, the Board tabled the motion for having independent financial audits performed for the real estate investments until the completion of the fiduciary audit that the NHRS has contracted for with Independent Fiduciary Services, Inc. The fiduciary audit is scheduled for completion in in December of 2002 and this audit will recommend best investment practices for the System.

- For the interim, NHRS's real estate managers will continue the current practice of performing periodic site visits and periodic financial property reviews.

Alternative Investments

Review of Activity
We recommended that the System develop various policies and procedures to validate the activity of its alternative investments.

Management's Final Response:

- As recommended, the System has begun documenting its current practice of validating investment activity of alternative investments and monitoring its compliance.

- The System established the position of Investment Analyst within the Finance Department. This new position has the responsibility for developing and implementing the policies, procedures and processes needed to validate the investment activity and to monitor the performance and investment risks associated with the System's marketable investments in equity and fixed income asset classes.

- Likewise, the System has designated another senior-level individual to be responsible for performing similar duties for the private equity investments (alternative investments and commercial real estate investments). This individual is responsible for the development and implementation of policies, procedures and processes that measure investment activity and monitor the risks associated with these investments.

- Furthermore, effective July 1, 2001, the System contracted with an external firm to provide accounting, reporting and compliance services for alternative investments. Outsourcing these responsibilities has freed up internal human resources that can be better utilized for analysis and monitoring of alternative investments. Additionally, effective January 2002, the System started holding comprehensive portfolio reviews with the investment managers on a periodic basis.

Implementation of GASB 34

We recommended that the System review its current disclosures to ensure that they are consistent with the new requirements.

Management's Final Response:
The System is fully cognizant of the new reporting requirements imposed on governmental entities by GASB 34. We implemented the new requirements in the System's Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2002. As required, a new section entitled "Management's Discussion & Analysis" was added and the transmittal letter modified where appropriate.

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Our audit procedures are designed primarily to enable us to form an opinion on the financial statements, and therefore may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the organization gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

This report is intended solely for the information and use of the New Hampshire Retirement System and the Fiscal Committee of the General Court and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

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Auditors' Report On Compliance And On Internal Control Over Financial Reporting In Accordance With *Government Auditing Standards*

The Fiscal Committee of the General Court:

We have audited the financial statements of the New Hampshire Retirement System (the System), as of and for the year ended June 30, 2002, and have issued our report thereon dated November 8, 2002. As discussed in note 2 to the financial statements, the System implemented Governmental Accounting Standards Board Statements No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, and No. 38, *Certain Financial Statement Note Disclosures*, in 2002. We conducted our audit 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.

Compliance

As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving internal control over financial reporting, which we have reported to management of the System in a separate letter dated November 8, 2002.

This report is intended for the information of the management of the New Hampshire Retirement System and the Fiscal Committee of the General Court and is not to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 8, 2002