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NEW HAMPSHIRE RETIREMENT SYSTEM

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

Year Ended June 30, 2005

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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, 2005, and have issued our report thereon dated May 23, 2006. 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.

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 an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the System's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Exhibit I.

A material weakness is a reportable 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 caused by error 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 the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

Compliance and Other Matters

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 and contracts 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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Exhibit I.

We also noted certain additional matters that we reported to management of the System in a separate letter dated May 23, 2006.

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

May 23, 2006

Bingham McCutchen LLP issued a report dated April 28, 2006, to Board of Trustees of the System titled "Independent Investigation Related to the Hermes Proposal" (referred to hereafter as the Bingham Report). We understand that the System is formulating corrective actions to address certain of the observations presented in the Bingham Report. After reviewing the Bingham Report, we noted several internal control and or compliance matters all of which we consider to be reportable conditions as follows:

Consent Agenda Process

The Bingham Report indicates the Board of Trustees routinely utilized a consent agenda process. An item placed on the consent agenda is deemed to be approved, without any discussion or vote by the Board, unless any trustee objects to it being on the consent agenda, in which case the item will be taken off and placed on the agenda for full discussion and vote. The consent agenda was intended to be only for perfunctory, non-controversial clerical actions. The Bingham Report revealed that the consent agenda process was utilized on several occasions for non perfunctory items, including:

- Waiving guidelines establishing an ownership limit of 15% in a single entity for the proposed Hermes investment.
- Reviewing and approving the FY 2004 Annual Code of Ethics Report Card.
- Hiring of the commission broker, Great Lakes Capital Partners, ltd.

We recommend the System review the use of the consent agenda process and consider only using it for perfunctory, non-controversial clerical actions and or suspend the process until such time as the Board can consider an effective alternative.

<u>Management Response</u>

The System agrees with the observation. The System is currently reviewing all existing Board governance policies and is also drafting a complete Board governance policy that will address many of the governance issues raised in the Bingham McCutchen report, including the consent agenda process. The System would anticipate that this new governance policy will specifically restrict the use of the consent agenda to perfunctory administrative or ministerial tasks consistent with best business practice.

Code of Ethics Controls

The System has an established Code of Ethics (the Code) the purpose of which is described in section 401.01(a) of the Code that among other items requires board members, employees and outside service providers be, and give every appearance of being, independent and impartial. Additionally, section 401.04(c)(d) and (f) of the Code expressly prohibits side-by-side investments by trustees and staff.

The System has established a reporting process whereby violations or potential violations of the Code including section 401.04 of the Code are to be self reported. According to the Bingham Report, the System's former board chairman disclosed, to varying degrees, in his fiscal year

2000 through 2004 annual certifications, a potential side-by-side investment in one or more of the System's venture capital investment managers' funds. The System's process for monitoring, reporting and resolving such occurrences did not adequately address these potential violations.

We recommend that the System review its current process for capturing, reporting and resolving potential Code of Ethics violations and make the necessary adjustments to ensure that all Code violations or potential violations are identified and addressed timely and adequately.

Management Response

The System agrees with the observation. We have reviewed and revised the System's current bylaws and shifted oversight responsibility for the Code of Ethics process to the Audit Committee of the Board of Trustees. In addition, the System has established and staffed an internal compliance area that will be responsible for administering the Code of Ethics process and reviewing any substantive Code of Ethics issues. This internal compliance area will report directly to the Audit Committee on the Code of Ethics process on an annual basis or more frequently if circumstances dictate.

Clarify Escalation Requirement

The System's Code of Ethics (Code) in section 401.05(d)(1) provides for the necessary board action if a member of the board of trustees violates the Code such as to constitute a conflict of interest subject to official sanction by the vote of the Board. In such instances, the Board is required to petition the Governor and Executive Council for removal of the offending trustee pursuant to NH RSA 91:3.

According to the Bingham Report, at the July 2005 board meeting, the Board voted that there was a violation of the Code section 401.04(o) by the former board chairman for his failure to disclose a conflict of interest in connection with the Board's consideration of the Hermes proposal.

Rather than petition the Governor and Executive Council as provided for in the Code, the Board voted to postpone petitioning the Governor until the next board meeting to permit the former board chairman an opportunity to consult with his attorney.

We recommend that the System clarify the escalation requirements provided by the Code to ensure that all established protocols are adhered to.

Management Response

We are currently reviewing this issue and we will address the issue appropriately.

Board Governance

The lack of Board level investment expertise was cited both in the Bingham Report and the 2002 report issued by Independent Fiduciary Services, Inc. As an immediate response to this issue, the System began a program of board education that among other items is meant to raise the level of awareness of investment related matters, including conflicts of interest.

As a longer term solution to this lack of investment expertise and extensive reliance on its outside investment consultant, the System should consider studying the governance and committee structure of other large state retirement systems or equivalent entities and seek legislative action, where necessary, to permit the needed changes to increase the investment expertise of the Board.

Management Response

The System agrees with the observation. We are currently working with external consultants to review and examine current Board governance policies and trustee education initiatives in order to determine and implement revised policies that are consistent with industry best practice for Board governance.

Code of Ethics Violations

The Bingham Report cites approximately twenty (20) Code section/subsection violations. Several of the Code violations are described in greater detail above. We recommend that the System evaluate each violation and prepare a corrective action plan to specifically address each violation and the related control enhancements needed to ensure that such violations do not occur in the future.

Management Response

The System agrees with the observation. Under the oversight of the System's Audit Committee, internal compliance staff at the System will review all code violations reported by Bingham McCutchen and they will address each code violation in a manner consistent with sound Board governance practices.

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MANAGEMENT LETTER

May 23, 2006

The Fiscal Committee of the General Court:

We have audited the financial statements of the New Hampshire Retirement System (the System), for the year ended June 30, 2005, and have issued our report thereon dated May 23, 2006. In planning and performing our audit of the financial statements of 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.

During our audit we noted one operational matter that is presented for your consideration. This comment and recommendation, which has been discussed with the appropriate members of management, is intended to result in operating efficiencies and is summarized as follows:

New Financial Reporting for Postretirement Benefits

The Governmental Accounting Standards Board (GASB) issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* and the related Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. Those Statement's establish the standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information in the financial reports of the System and state and local governmental contributing employers.

The measurement of OPEB under the new standards will significantly impact the System's financial statements and those of its contributing employers. This project, including dealing with the ramifications of potential funding decisions, will constitute a significant effort for the System. Accordingly, senior management should begin now to familiarize itself with the available literature and analyze the results to prepare for future implementation. The System will be required to comply with Statement No. 43 as of June 30, 2007. The System's contributing employers most likely will be required to comply with Statement No. 45 as of June 30, 2008.

Management Response:

The System agrees with the observation. The System is aware of the new Governmental Accounting Standards Board (GASB) Statements No. 43 and 45 that require new accounting measurements, reporting and disclosures for post employment benefits other than pensions. We plan to implement the new standards in our annual reporting for the fiscal year ended June 30, 2007. It is our intention to work closely with our actuary and our auditors to insure that the new GASB pronouncements are fully implemented.

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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 System's 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,

KPMG LLP