Commonwealth of Massachusetts

Management Letter
Year Ended June 30, 1999

December 16, 1999

Martin Benison, Comptroller
The Commonwealth of Massachusetts

In planning and performing the Single Audit of the Commonwealth of Massachusetts for the year ended June 30, 1999, we noted certain matters involving the internal control structure and the compliance of management of the Commonwealth of Massachusetts with laws and regulations which we have reported to the management of the Commonwealth of Massachusetts in a document entitled, “Reports on Compliance and Internal Control in Accordance with Government Auditing Standards and the Requirements of OMB Circular A-133 and the Schedule of Expenditures of Federal Awards for the Year Ended June 30, 1999.” The individual reports in that document are dated October 21, 1999 to coincide with the date of the auditors’ report on the statutory basis financial statements.

In addition to the matters discussed in the reports described above, we have developed certain observations and recommendations on other current and future accounting, administrative, operating and financial reporting matters. Our comments, based upon those observations and recommendations, are presented on the attached pages.

This report is intended solely for the information and use of management and federal awarding agencies and should not be used by anyone other than these specified parties.

We will be pleased to discuss these comments and recommendations with you at your convenience.

Yours truly,

STATEWIDE OBSERVATIONS

Need to Analyze and Evaluate the Accounting and Reporting of Certain Funds as Individual Funds

The number of funds required by the Legislature and used by the Commonwealth of Massachusetts (the "Commonwealth") hampers the efficiency of the accounting and financial reporting process. In fiscal year 1999, the Office of the Comptroller ("OSC"), operating under the requirements of State Finance Law and the requirements of the Legislature, as established through the budget and Massachusetts General Laws, was required to use approximately 122 individual funds to account for the operations of the Commonwealth.

This use of 122 individual funds makes it difficult for either internal or external users of the Commonwealth's financial information to obtain a clear understanding of the overall operations and financial position of the Commonwealth. Instead of enhancing accountability, the large number of funds makes it difficult for management to perform both the tasks of analyzing operations and detecting errors in the information in the funds.

While many of the individual funds have been created to monitor and control resources that have been designated by the Legislature for a specific purpose, this function can effectively be met by using "sub-funds" within the General Fund.

The existing structure has resulted in the following reporting issues:

1. Split appropriations require extensive effort on the part of management to properly account for the fiscal year activity and report final operating results. Split appropriations are not a budgetary practice used by other states.

2. The Legislature regularly budgets expenditures in funds without providing corresponding revenue to support the activity. This effectively overstates the General Fund balance, creates deficits in other funds and raises the question of whether, in fact, a balanced budget at all levels has been passed as required by Massachusetts General Laws.

3. When the Commonwealth is required to implement Governmental Accounting Standards Board Statement No. 34 each of the 122 funds will have to be analyzed to determine if it must be reported as a major fund in its report under generally accepted accounting principles.

4. It should also be noted that under generally accepted accounting principles, all fund balance deficits must be reported along with a plan for correcting those deficits. Currently, the number of funds with fund balance deficits is excessive.

The following table lists the funds with a Statutory Fund balance deficit:

Fund	Fund Name	Fund Balance Deficit
Budgeted		
101	Highway	$ 180,586,000
102	Local Aid	2,581,361,000
106	Antitrust Law Enforcement	2,188,000
110	Victim and Witness Assistance	5,653,000
111	Intercity Bus Capital Assistance	7,084,000
113	Mosquito and Greenhead Fly Control	1,848,000
134	Environmental Challenge	4,176,000
149	Toxic Use Reduction	4,608,000
152	Environmental Permitting and Compliance Assurance	26,947,000
156	Environmental Law Enforcement	1,872,000
157	Public Access	298,000
158	Harbors and Inland Waters Maintenance	2,121,000
159	Marine Fisheries	3,814,000
161	Low-Level Radioactive Waste Management	307,000
165	Ponkapoag Recreational	77,000
167	Division of Insurance	651,000
172	Leo J. Martin Recreation	194,000
173	Clean Air Act Compliance	104,000
186	Second Century	4,124,000
193	Social Services Program	269,000
194	Local Consumer Inspection	296,000
		2,828,578,000
Nonbudgeted		
107	Government Land Bank	35,097,000
142	Child Support Enforcement	854,000
		35,951,000
Capital Projects		
203	Boston Convention and Exhibition Center	19,000,000
210	Highway	257,944,000
230	State Recreation Areas	102,000
240	Metropolitan Parks	4,095,000
271	Local Aid	20,779,000
276	Water Pollution Control	5,447,000
278	Government Land Bank	11,000,000
		318,367,000
	Total	$ 3,182,896,000

While the deficits in the Capital Project Funds will be corrected through future capital bond issuances, the Local Aid Fund deficit can not. That deficit, which increased by approximately $642M or 33% during fiscal year 1999, can only be corrected by transferring revenues or fund balances from the General Fund. The current practice, beyond its practical inefficiencies, creates a reporting model that is misleading to the users of these financial statements.

Some funds with minimal activity were repealed during fiscal year 1999 and more are legislated for repeal during fiscal year 2000. While this is a good start, a large number of funds remain, and should be evaluated as to their continued need. The following table shows fund activity as of June 30, 1999 for those funds with minimal or no activity during the year. This list excludes funds that were created or repealed during fiscal 1998 and funds whose repeal has been legislated for fiscal 1999.

Fund Number	Fund Name	Revenues and Other Financing Sources	Expenditures and Other Financing Uses
19	Child Support Penalty Fee	$ 506,000	$ -
106	Antitrust Law Enforcement	-	417,000
107	Government Land Bank	190,000	791,000
108	Natural Heritage and Endangered Species	236,000	291,000
111	Intercity Bus Capital Assistance	1,455,000	2,151,000
118	Federally-Assisted Housing	136,000	126,000
122	Oil Overcharge	1,366,000	3,179,000
132	Motorcycle Safety	211,000	185,000
136	Environmental Trust	1,692,000	1,299,000
138	Children's Trust	32,000	134,000
140	Labor Shortage Fund	90,000	1,142,000
144	Drug Analysis	129,000	1,000
146	Re-Employment and Job Placement	-	2,539,000
153	Massachusetts Aids	232,000	64,000
157	Public Access	844,000	1,098,000
161	Low Level Radioactive Waste Management	158,000	244,000
162	Trust Fund for the Head Injury Treatment Services	497,000	572,000
165	Ponkapoag Recreational	700,000	747,000
168	Board of Registration in Medicine	1,832,000	1,737,000
169	Asbestos Cost Recovery	2,649,000	273,000
172	Leo J. Martin Recreation	450,000	488,000
175	Motor Vehicle Emissions Inspection Compliance	-	-
179	Reggie Lewis Track and Athletic Center	332,000	247,000
180	Assisted Living Administration	463,000	236,000
183	Commonwealth Cost Relief	-	8,224,000
185	Solid Waste Disposal	-	-

Fund Number	Fund Name	Revenues and Other Financing Sources	Expenditures and Other Financing Uses
186	Second Century Fund	1,643,000	2,402,000
187	Safe Drinking Water	2,190,000	2,099,000
189	Diversity Awareness Education Trust	1,000	-
190	Child Care Quality	135,000	-
194	Local Consumer Inspection	-	296,000
195	University of Massachusetts Lowell Wannalancit Complex Building Management	-	-
196	Caseload Increases Mitigation	3,461,000	-
198	Voting Equipment Loan	-	-
203	Boston Convention and Exhibition Center Capital	-	-
230	State Recreation Areas Capital Projects	182,000	267,000
240	Metropolitan Parks Capital Projects	1,802,000	2,781,000
250	Water Pollution Control Capital Projects	1,121,000	661,000
270	Federally-Assisted Housing Capital Projects	-	48,000
272	Lockup Facilities Improvement Capital Projects	-	3,000
273	Suffolk County Jail Facility Capital Projects	18,000	-
275	Local Infrastructure	243,000	243,000
280	Intercity Bus Capital Assistance Capital Projects	1,385,000	1,386,000

To improve accountability, the OSC, working with the Secretary of Administration and Finance and the Legislature, should seek legislation to:

- Combine or eliminate many of the existing funds noted above. Any remaining funds should be specifically identified in the legislation and any "new activities" subsequent to the legislation should be limited to the establishment of sub-funds unless, after consultation with the OSC, a conclusion is reached that individual fund reporting is appropriate.

- If combining or eliminating funds is not accomplished, legislation should be proposed to require funds, other than Capital Project Funds, that have had a deficit in fund balance for three consecutive years be reduced to a zero balance as part of the subsequent year's budget.

- "Sunset" provisions should be enacted to require that every fund and sub-fund other than the General Fund be reviewed every five years to determine whether it should be continued. In the absence of a positive action by the Legislature to continue the fund, the Legislature should require that its balance be transferred to the General Fund and the fund or sub-fund abolished.

Overuse of the Practice of Prior Appropriations Continued in the Legislature

Unexpended appropriations have been carried forward (prior appropriation continued or PAC) for the past seven years. Appropriations continued from fiscal year 1999 to 2000 totaled approximately $212M. The unexpended balance in the General Fund for all appropriations at June 30, 1999 is approximately $95M. Of this amount, none reverted back to the appropriation pool. A review of the activities within the General Fund indicates that additional funds were appropriated to many accounts in fiscal year 1999, even though balances carried forward from fiscal year 1998 were sufficient to cover all 1999 expenditures. This results in an increase in the unspent balances compared to those at June 30, 1998. This trend has continued since 1993.

An example of a balance carryforward is the Legislature's Telecommunication Appropriation, No. 97441000. A balance of $6.5M was carried forward from fiscal year 1995. Only $1.7M of the appropriation was spent during 1996 and the remaining $4.8M was carried to fiscal year 1997. Of this amount, only $1.7M was expended during the year and $3.1M was authorized to be carried forward to fiscal year 1998, of which only $1.5M was expended and the remaining $1.6M was authorized to be carried forward to fiscal 1999. In addition, $1.7M was appropriated for 1999. Of this amount, only $1.6M was expended and the remaining $1.7M was authorized to be carried forward to fiscal 2000.

Under Massachusetts General Law, the Commonwealth has the option of either reverting unexpended funds back to the appropriation pool or carrying the balances forward to the next fiscal year. The current trend indicates that more funds are being carried forward from year-to-year than is necessary, thereby diminishing the value of the budgetary controls that should be an element of the annual appropriation process. As an entity with significant impact on controlling budgets and appropriations, the Legislature should be a leader in lapsing unused appropriations.

The Legislature should carefully review and evaluate its use of PACs and its procedures for appropriating and carrying forward funds so that the available funds are more fully utilized to operate the various programs sponsored by the Commonwealth.

Issues Relating to Bond Offerings and Bond Holder Relations

Recently the Securities and Exchange Commission ("SEC") Office of Municipal Securities held its first annual "Municipal Market Roundtable." While this program was not intended to reach conclusions on the topics covered, it did serve to raise a number of issues that the SEC may focus on as they continue to develop their agenda relating to the $1.3 trillion municipal bond market and their belief that abuses exist in that market.

A major emphasis of the program, as set forth by SEC Chairman Levitt in his opening comments, is the belief that the market has shifted from one driven by well-informed institutional investors, who readily obtained the information they needed, to a market driven by individual investors who do not have access to similar information. This shift has raised the level of concern on the part of the SEC because they do not believe that the reporting and disclosure practices of municipal issuers have kept pace with the investor shift.

Issues discussed during the program included:

1. The lack of timely, ongoing disclosure that is available to the investor community.

2. The need for continued improvements in price and volume information.

3. The concern as to who has the responsibility and lead in the preparation of documents as well as who has the liability when something is not properly disclosed – the issuer, the underwriter, various counsels or financial advisors.

4. The issue of whether the parties, including the underwriters, have sufficient time to review the disclosure documents and perform due diligence.

5. The issue of auditors' involvement, their independence and the giving of consent.

6. Whether continuing disclosure requirements are being met and whether governments are providing information beyond the minimum requirements set forth as the "deadly sins" in 15c2-12.

7. The role of electronic disclosures in fulfilling the responsibilities and the use of websites in aiding the government in meeting these responsibilities.

8. The need for many issuers to have active investor relations programs, whether investors can obtain the information needed to make informed decisions and whether the information they receive is consistent with that available on the government's various websites and from the press.

While the program did not result in specific recommendations, it would be prudent for the Commonwealth to take an active role in monitoring the SEC's agenda relating to their desire to further regulate the municipal bond market and take a lead position in addressing their concerns. The Commonwealth should also evaluate the current status of programs addressing investor relations and the consistency of information provided with that being covered in the press and "published" on the various Commonwealth websites. This may require an active program to monitor the timeliness of updates to websites as events important to investors occur.

Assessment of Internal Controls and Compliance with Chapter 647, the Internal Control Act, Needs Improvement

Massachusetts General Law, Chapter 647, *State Agencies Internal Control Act of 1989* (Chapter 647) (1) outlines internal control standards, (2) defines the minimum level of internal control systems throughout the various departments of the Commonwealth, (3) establishes the criteria against which internal controls will be evaluated, (4) stipulates the designation of an individual, who should be the equivalent in title or rank to an assistant or deputy to the department head, whose responsibilities include ensuring that the department has written documentation of its accounting and administrative control systems on file and, at least annually, evaluating and implementing any changes necessary to maintain the integrity and effectiveness of the system, and (5) requires the reporting of all unaccounted for variances, losses, shortages or thefts of funds or property to the Office of the State Auditor. Departmental implementation of Chapter 647 has become known throughout the Commonwealth as the "departments' internal control plan."

Chapter 647 also states that "Internal control systems for the various state agencies and departments of the Commonwealth shall be developed in accordance with internal control guidelines established by the Office of the Comptroller." The Office of the Comptroller's Internal Control Guide for Managers released in 1999 recognizes that the definition and description of internal controls changed with the publication of a report entitled *Internal Control-Integrated Framework* by the Committee of Sponsoring Organizations ("COSO Report"). The American Institute of Certified Public Accountants ("AICPA") adopted the COSO Report definition of internal control in its Statement on Auditing Standards Number 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS 55.* These documents define internal control as the following:

> "Internal control is a process--effected by an entity's board of directors, management, and other personnel--designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations."

The definition also states that internal control consists of the following five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring.

The Office of the Comptroller, since the passage of Chapter 647, has been publishing internal control guides; assisting departments, when requested, in developing internal control plans; conducting training sessions on internal controls; and reviewing internal control plans when requested by departments or as part of the statewide Single Audit. The Office of the State Auditor has also been involved in reviewing these plans. The fiscal year 1999 statewide Single Audit was used as a vehicle to educate departments on the new definition of internal control and emphasize the need for internal control plans to adopt the new definition.

The visits to departments and reviews of internal control plans have indicated that there has been incremental progress toward complying with Chapter 647. More specifically, it was noted that departments have:

1. an increased awareness of what the internal controls encompass, i.e., it is the way a department conducts its business and that internal controls involve all departmental operations, not just the financial operations,

2. an increased awareness of the importance of internal controls and the plans, and

3. developed written policies and procedures – the third component of the five that comprise internal controls.

However, it was also noted that:

1. Departments' internal controls will improve further only if senior management gives attention to the subject—departments with internal control units and/or internal audit units tended to have a better understanding of internal controls and better plans.

2. Often, internal controls are still not considered by all departmental management to be part of department operations—establishment of internal controls and plans is extra work to satisfy the Office of the Comptroller and the auditors.

3. Confusion still exists at many departments over the role and function of the internal control plan.

4. Internal control officers are not always at the senior level required by Chapter 647.

5. Departments are still seeking more guidance and training on internal control plans, for example, development of a plan or components of a plan that could be used as a template.

6. Many internal control plans need to be expanded to include (a) programmatic operations, (b) risk assessments and (c) control environment.

7. Frequently, plans do not address how internal control violations should be reported.

To more fully comply with the intent and spirit of Chapter 647 and to develop adequate internal control plans at all departments of the Commonwealth, many departments, groups and individuals must be involved. Educating departments, increasing their awareness of the importance of internal controls and internal control plans, and assisting them in the development of internal control plans should be continued. More specifically:

- At all meetings of department heads, senior managers and internal control officers, the Secretary for Administration and Finance should emphasize the importance of internal controls and internal control plans.

- The executive office and department heads should (1) review the goals and objectives of all of the department's operations, (2) conduct department-wide risk assessments, (3) evaluate existing policies and procedures against the goals, objectives and risks, (4) modify policies, procedures and internal control plans, as necessary, (5) assign responsibility for implementation of the contents of the plan, and (6) distribute the plan to all appropriate managers and staff.

- The Office of the Comptroller should (1) complete the second part of the *Internal Control Guide for Managers,* (2) evaluate the need to amend Chapter 647 to more specifically define internal controls, (3) evaluate the need for new legislation, e.g., a CFO act, and, if needed, prepare such legislation, (4) continue to provide training for managers at various levels, and (5) develop a plan and/or components of a plan that can be used as a template for all departments.

- The Single Audit teams should continue to monitor the progress of departments relating to compliance with Chapter 647 and the development of adequate internal control plans.

Need to Analyze and Evaluate the Vendor Master File

It is the Commonwealth's policy not to eliminate vendors from the vendor master file. Instead, files are "marked for deletion." Once designated as such, a check may not be written against that file but the vendor remains in the system. As a result, the Commonwealth's vendor master file contains approximately 370,000 vendors. Of that total, approximately 170,000 are marked for deletion. The remaining "active" files contain current vendors, one-time payment vendors and old vendors that have not been used but have not as yet been marked for deletion. Due to the sheer volume of vendors, the possibility exists that old vendors could be paid in error.

In addition, the procedures for entering vendors in the master file only add to the problem. Under the current process, when a vendor is added to the master file it is added twice, once with the remittance address and once with the legal address for tax reporting purposes. The vendor entered for tax reporting purposes is immediately marked for deletion so that it cannot be used.

It should also be noted that the Commonwealth's policies require that active vendors have a form W-9 on file before an invoice can be paid. A form W-9 could not be produced for 2 of a sample of 10 selections from the vendor master file.

Currently, there are no procedures in place to review the vendor master file to identify vendors that should be marked for deletion. The Commonwealth should periodically run a query on the vendor master file based on the last day of activity. Vendors not used for a determined period of time (i.e., 3 to 5 years) should be marked for deletion and subsequently removed from the system. The Commonwealth should also attempt to modify the accounts payable system such that duplicate files are not created for each vendor. Implementing such procedures will help to reduce the number of files in the vendor master file.

Once the vendor master file has been updated, the Commonwealth should send a W-9 to all remaining vendors on the system. When information is received it should be compared to the information in the master file.

Financial Information Needed to Cities and Towns for On-Behalf Payments

With the implementation of Government Accounting Standards Board ("GASB") Statement No. 24, "Accounting and Financial Reporting for Certain Grants and Other Financial Assistance" (the "Statement"), the Commonwealth must provide financial information to cities and towns related to on-behalf payments. On-behalf payments for fringe benefits and salaries are direct payments made by one entity (the paying entity or government) to a third-party recipient for the employees of another legally separate entity (the employer entity or government). This Statement establishes accounting and financial reporting standards for on-behalf payments for fringe benefits and salaries. On-behalf payments include pension plan contributions, employee health and life insurance premiums, and salary supplements or stipends.

For example, the Commonwealth makes a contribution to the Massachusetts State Teachers Retirement System (the "Retirement System") on behalf of teachers employed by cities and towns in the Commonwealth who participate in the Retirement System. The Statement requires the cities and towns to recognize these on-behalf payments as revenue and a corresponding expenditure or expense and disclose the amounts recognized for such on behalf payments. The most recent actuarial valuation indicates that the Commonwealth contributed approximately $447 million to the Retirement System, including the pension contribution and the cost of living adjustment ("COLA"). However, the amount contributed to the Retirement System on behalf of each of the individual cities and towns could not be specifically identified. The Commonwealth should work with the Massachusetts Teachers Retirement Board to coordinate and develop the procedures necessary to identify payments to the Retirement System on behalf of the cities and towns. Without such information, individual cities and towns could be subjected to receiving qualified audit opinions on their audit reports because they cannot comply with generally accepted accounting principles ("GAAP").

Need for Improvement in the Demographic Data Used in the Calculation of the Net Pension Obligations

While the majority of the demographic data provided by the Teachers Retirement Board, the State Retirement Board and the Boston/State Retirement Board used in the actuarial assumptions to calculate the pension benefit obligation is factual, stronger controls are needed to reduce the number of assumptions that must be made in compiling this data. In the process of performing the actuarial valuation, the Public Employee Retirement Administration Commission ("PERAC") performs a series of edits to reduce the amount of missing or inappropriate data incorporated in the compilation of the underlying data. An examination of the edits used in performing the last actuarial valuation as of December 31, 1997 noted that kick-outs or missing information were substituted for in the following way:

- Filtering – An internally developed program which filters individuals with acceptable census data and identifies those with crucial data missing. The individuals with data missing are investigated. Upon investigation, data, based on assumptions, is inserted in place of the missing data and examined for overall reasonableness.

- Assumption Analysis – For those individuals remaining in the population where no information is available, PERAC has implemented an externally developed assumption application. The assumption file maintenance and generation program will statistically determine the likely value for the missing information. The types of crucial data subject to assumption are job group, salary, sex, age, service and veteran code. The census data from the retirement boards which is available and valid is entered into the assumption program and, based on the laws of probability, will determine the most likely value for invalid or missing data. PERAC will accept the most likely value for the information and will input results to the PERAC valuation program.

While we acknowledge that there has been improvement on behalf of PERAC to obtain the required information, there is still a need for the divisions to provide more accurate information. While these types of editing procedures to complete the valuation are acceptable alternatives under actuarial standards, we recommend that procedures be continued to audit and clean up this data to reduce the need for assumptions used in the actuarial valuation to be completed during fiscal year 2000. This will also serve to reduce the fluctuations that are present as differing assumptions are used.

Funding Program Necessary for Workers' Compensation and Group Health Insurance

The Commonwealth should establish a funding program and/or schedule to accumulate assets and satisfy the current underfunded liability related to the internal service funds. As of June 30, 1999, the underfunded liability for the employee's workers' compensation and employees' group health insurance was $257.8M and $33M, respectively. Of these amounts, $36.4M is considered short-term for workers' compensation and $32.4M for group health insurance. These balances represent accumulated long-term liabilities.

Available options to furnish the necessary funding include a surcharge to the current statutory chargeback to state agencies, an annual appropriation based upon an actuarially calculated funding schedule, a redirection of investment earnings, and other actions. The Office of the Comptroller and the State Legislature should coordinate their efforts to evaluate all options and select the most appropriate one(s) to satisfy the existing debt and fund any future liability as it is incurred.

New Reporting Model

The GASB has issued GASB Statement No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments." This standard dramatically changes the basic financial statements that governments are required to issue and is effective for the Commonwealth for periods beginning after June 15, 2001. This statement establishes new financial reporting standards for state and local governments, and component units. It is designed to make governments' general-purpose external financial reports easier to understand and more useful to the citizenry, legislative and oversight bodies, investors and creditors. The statement includes requirements for a management's discussion and analysis, and dramatically changes the basic format of the financial statements by requiring governments to provide basic financial statements on both an entity-wide perspective and a fund perspective.

The entity-wide financial statements will provide information about the primary government and its component units without displaying funds or fund types. The financial statements will distinguish between the governmental and business-type activities of the primary government and between the total primary government and its discretely presented component units (the entity-wide perspective will not include fiduciary activities). In addition, capital assets and general long-term liabilities, which are currently reported in account groups, will be reported as assets and liabilities of governmental activities. All information in the entity-wide financial statements is to be reported using the economic resources measurement focus and the accrual basis of accounting, similar to the way that Enterprise Funds are currently reported in the general purpose financial statements.

Fund perspective financial statements will provide information about the primary government's fund types, including fiduciary funds and blended component units. Governments will present separate financial statements for each fund category (governmental, proprietary, higher education, and fiduciary) and will no longer present a combined balance sheet. As is currently required, governmental fund financial statements will continue to focus on fiscal accountability and report the flows and balances of current financial resources using the modified accrual basis of accounting. Proprietary and Fiduciary Fund financial statements will continue to report operating results and financial position using the economic resources measurement focus and the accrual basis of accounting. The fund perspective will also include component units that are fiduciary in nature.

One of the most significant changes incorporated in this new statement is a requirement for governmental entities to record the cost of infrastructure. Due to the age of some state's infrastructure, it may be difficult, if not impossible, to obtain information regarding the state's historical cost of infrastructure.

In order to avoid delays in issuing financial statements under the new reporting model, we recommend the State begin the process of assessing its records regarding the historical cost of infrastructure. If such information is not available, a process to estimate the historical value of infrastructure should be established as quickly as possible. We also recommend that the State assess the other potential changes in financial reporting and accounting related to the proposed new reporting model.

Focus on Financial Condition

The changes to the governmental reporting model discussed elsewhere in this letter will also begin to focus attention on the overall financial condition of the government. The display of the overall operations of the government into a limited number of columns with debt and long-term assets, combined with the other assets and liabilities, will begin to place an emphasis on the questions of whether the government as a whole is better or worse off than the previous year. While the concept is commercial in nature, the emphasis will be on the growth or the decline of net assets.

This emphasis on financial condition is similar to the State Comptroller's emphasis on the intergovernmental equity. This focus should be on the development of plans to pay for long-term obligations, both debt related and non-debt related, while also recognizing that financial plans need to exist for the repair or replacement of fixed assets and infrastructure. The focus is not so much on the growth of net assets as it is on the maintenance of a net asset balance that demonstrates a sound and stable financial condition with sufficient resources to offset economic downturns. We suggest that the Commonwealth begin to develop models that include plans for future financing of obligations and assets.

New Recommended Practices for Governmental Entities

At its fall 1999 meeting the Executive Board of the Government Finance Officers Association approved six new recommended practices for governmental entities. These practices contained one recommendation relating to the acceptance of credit cards, two recommendations concerning guidance relating to asset allocations for employee benefit plans and three recommendations relating to budgets. The specific recommendations relating to budgets are as follows:

1. *Relationship Between Budgetary and Financial Statement Information:* Recommends that the budget document clearly define the basis of accounting used for budgetary purposes, whether the budgetary basis and the GAAP basis of accounting are the same, and any disparities between the two.

2. *Use of Financial Status in the Budget Process*: Recommends that a component of the budget process be an overall financial status of the governmental entity and its key funds, with a brief, understandable analysis of the current and immediate future status, as well as long-term trends.

3. *Financial Forecasting in the Budget Preparation Process*: Recommends that governments forecast major revenues and expenditures, and that this information be made available to participants in the budget process.

While the Commonwealth has already incorporated financial forecasting within the budget process, the relationship between budgetary and financial statement information and the use of financial status information have historically only been an emphasis of the year-end financial reporting process instead of an aspect of the budget process.

As the Commonwealth moves forward with the process of adopting GASB Statement No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments," the issue of the budgetary information relationship to financial statements and the use of financial status in the budget process should be evaluated. This evaluation should consider providing a process for the development of a management discussion and analysis in the budget process that would be parallel to that planned for the financial statements.

The Need to Improve Accounting for the Assets and Liabilities of Counties Abolished by the Commonwealth

Prior to fiscal year 1998, there were 14 counties in the Commonwealth. During fiscal year 1998, however, county government was abolished through legislation enacted by the Legislature. Since that legislation was enacted, four counties have been abolished and termination is scheduled in three others. Franklin and Middlesex Counties government were abolished in fiscal year 1998. Hampden and Worcester Counties government were abolished on July 1, 1998. On August 13, 1998, legislation was approved abolishing county government in Hampshire, Essex and Berkshire Counties on January 1, 1999, July 1, 1999 and July 1, 2000, respectively. Under this legislation, virtually all functions, duties and responsibilities of the affected counties are transferred to the Commonwealth. As of the date of abolition of an affected county's government, all valid liabilities and debts of the county which are in force immediately before the date become obligations of the Commonwealth, and all assets and revenues of each county become assets and revenues of the Commonwealth

The fixed assets of the counties, which consist largely of buildings such as courthouses, jails and houses of correction, should be brought onto the Commonwealth's books at historical cost. However, obtaining the historical costs of such assets has proven to be a difficult task. To assess historical cost, the Capital Accounting Bureau ("CAB") has made estimates based upon known historical data, such as acquisition or construction date, current assessment amounts, type of structure, and real estate inflation assumptions to estimate values for each respective fixed asset.

While these estimates appear reasonable and the amounts in the fiscal year 1999 financial statements are not materially misstated, these assets should be recorded at historical cost where it is available. Accordingly, the Commonwealth should develop a plan to obtain actual historical cost documentation for the county assets to be assumed by the Commonwealth subsequent to June 30, 1999. The fixed assets to be assumed may be material and the Commonwealth will need to obtain historical cost documentation in order to report fixed assets in the financial statements in accordance with GAAP.

Accounting for Leases Needs to Be Improved

During fiscal year 1998, the Commonwealth restructured its lease accounting procedures through the issuance of the Comptroller's Massachusetts Management Accounting and Reporting System ("MMARS") Memo #277. These changes have greatly simplified the lease accounting procedures by reducing the number of lease type classifications and bringing those classifications in line with GAAP. There are now only three types of leases (capital, space, and operating) as opposed to more than 15 in previous years.

Under the new procedures, the departments are required to assess and classify each lease based on the three available classifications. Once classified, the appropriate information is entered into MMARS. The Comptroller's office downloads the lease information as entered by the departments into MMARS report 831A. That information is used to calculate the present value of lease payments. The Financial Reporting and Analysis Bureau ("FRAB") reports the value of these leases in footnotes to the Statutory Basis and Comprehensive Annual Financial Reports.

The departments of the Commonwealth are required to report the asset cost related to each lease in departments' MMARS accounts in accordance with MMARS Memo #277. The departments, however, do not always do so. As a result, the Comptroller's office has been forced to make a number of assumptions to estimate capitalized amounts for departmental leases. This results in the calculated fixed asset cost being understated and virtually identical to the calculated present value. The understatement is approximately equal to the present value of payments from the actual start date of the lease to the assumed start date of July 1, 1997. FRAB is not able to reasonably estimate the possible misstatement, though such amounts were ultimately deemed immaterial.

The Procurement Bureau should closely monitor the individual departments' compliance with MMARS Memo #277. This monitoring process will ensure that the information concerning leases (classification, out-year payments, etc.) remains internally consistent and consistent between the MMARS Report 831A and the information submitted to the Comptroller's office. This deficiency will become more important after implementation of GASB 34 when such amounts will be reported within the general fund balance sheet for the Commonwealth.

OFFICE OF THE COMPTROLLER

Better Communication with Departments on Fringe Benefits and Indirect Costs Needed

The Office of the Comptroller (the "Office") prepares and negotiates approximately 50 indirect cost rates on behalf of federally reimbursed departments. The rates are oftentimes developed with very little, if any, consultation with departmental personnel. During audits of federal programs over the years, many departments have commented that guidance concerning the Commonwealth's policies and procedures relating to the preparation, negotiation and charging of fringe benefits and indirect costs is not formally communicated. There is confusion as to the rationale for the rate procedures performed, which federal and state laws, regulations, policies and procedures apply and the responsibilities of the Office and the departments in the process. In addition, many departments indicated they needed assistance in understanding the terminology used and the reasons the rates fluctuate.

As a result of this confusion, departments are unable to fully participate in rate development, understand the rationale of costs excluded or included in their rate, determine whether the rates developed for them are appropriate for the programs they administer and monitor charges.

The Office should prepare a narrative which explains the policies, procedures, guidance and responsibilities of all departments concerning the preparation, negotiation and charging of fringe and indirect costs. The document should define all technical terms in layperson's language, wherever possible. Once finalized, this guide should be distributed to all departments and the Office should consider holding an annual training session to educate and update departments on current developments. Also, as recommended last year, consultation with appropriate personnel at the departments for whom the rates are developed is strongly encouraged.

Fixed Assets Acquired Need to Be Recorded Within Seven Days of Acceptance

There is a need for the continued improvement in the recording of various fixed assets. The MMARS Fixed Asset Subsystem User Guide requires "assets valued at $15,000 or more to …be recorded onto the system within seven (7) days of acquisition... to properly account for and record those items owned by the Commonwealth… and to allow them to be incorporated into the Commonwealth's Annual Comprehensive Financial Report ("CAFR")…" The requirement is designed to ensure that fixed assets are recorded in an appropriate and timely manner. Failure to record such assets understates the value of fixed assets owned and reported by the Commonwealth.

In several cases, specifically at the Department of Police and Massasoit Community College, fixed asset additions were not recorded in the appropriate accounting period. Also in the current year, the Metropolitan District Commission failed to record assets within seven days of acquisition. These occurrences represent fixed assets that were acquired in prior years, yet were not reported until fiscal year 1999. These resulted primarily from a lack of knowledge of the "Seven Day Rule" by the department personnel, and lack of inclusion in the department's internal control plan. The effect of not recording assets timely and correctly is to understate the fixed assets on the MMARS System and, consequently, the financial statements.

The Commonwealth should carefully review and evaluate its policies and procedures for reporting fixed assets. Departments and agencies need to be aware of the "Seven Day Rule" and, further, be compelled to comply. The Commonwealth needs to ensure this rule is properly documented in the departmental Internal Control Plans. Proper valuation is a necessity for reliable financial statements.

Need to Monitor Non-GAAP Fixed Assets Entered into the MMARS System

Under the Commonwealth Fixed Asset Subsystem Ledger, fixed assets are reported in accordance with requirements for one of two groups: GAAP fixed assets and Non-GAAP fixed assets. Each of these groups of assets has certain reporting requirements. GAAP fixed assets include all land, regardless of cost, and buildings and other assets with a historical cost of $15,000 or more. These are required to be on the Fixed Asset Subsystem and will be incorporated into the Comprehensive Annual Financial Report ("CAFR"). Non-GAAP fixed assets are comprised of all buildings and equipment (including computer software) with a useful life of more than one year and an original cost of between $1,000 - $14,999. These assets must be recorded on the Fixed Asset Subsystem or in a system housed and maintained within a department.

Subsequent to the fiscal year 1998 financial statement audit, it was determined that the Massachusetts Maritime Authority ("MMA") was unable to state its fixed asset balance as of June 30, 1998. At the beginning of fiscal year 1999, MMA made the decision to enter all fixed assets in the MMARS Fixed Asset System, regardless of category, in order to have MMARS mirror its financial statements. This treatment was implemented to provide assurance that all the fixed assets at the agency are recorded. As a result, in fiscal year 1999, roughly $1.4 million of non-GAAP MMA assets were included in the MMARS Fixed Asset System. These entries made in fiscal year 1999 were considered "catch up" assets, because they related to non-GAAP fixed assets that were acquired in prior years.

The Commonwealth should monitor the agencies and departments that elect to use the Fixed Asset Subsystem as their fixed asset inventory system. The inclusion of non-GAAP assets in the MMARS Subsystem could result in overstating fixed assets in the Commonwealth's CAFR. Consideration should be given to developing uniform guidelines relating to the monitoring of department fixed asset activity.

The Commonwealth Should Consider Service Efforts and Accomplishments Reporting

A major focus in government today is departmental accountability. Service Efforts and Accomplishments Reporting ("SEA"), as summarized in GASB Concepts Statement No. 2, "Service Efforts and Accomplishments Reporting," measures performance through various indicators and attempts to gauge departmental efficiency.

Because the primary purpose of governmental entities is to maintain or improve the well-being of their citizens, information that will assist users in assessing how efficiently and effectively the Commonwealth is using resources to maintain or improve the well-being of its citizens could play an important role in future financial reporting. The assessment of a governmental entity's performance requires information not only about the acquisition and use of resources, but also about the outputs and outcomes of services provided, and the relationship between the use of resources and their outputs and outcomes.

An expanding number of governmental entities are developing and using SEA measures. The Government Accounting Standards Board may ultimately require this reporting as part of the entities' general-purpose financial statements. We suggest that the Commonwealth evaluate the use of SEA reporting as an additional tool to promote accountability and efficiency. As the services provided by the Commonwealth are diverse and often complex in nature, we further recommend that program and budget personnel, elected officials, internal auditors, professional groups, and citizens, in addition to financial management, become active in developing and using SEA measures.

Activity-Based Costing

Governments have historically served its citizens regardless of the costs involved to do so. With the continual growth of alternative ways for governments to do business and the pressures to control the overall cost of government, there is a growing focus on the cost of government. The citizens and their representatives in the Legislature have a heightened interest in what programs cost, the cost of delivery under various alternative models and the cost of the individual items or elements required to deliver a service. Activity-based costing is, in effect, government's approach to the cost accounting model used in the private sector to determine the cost to produce a product.

The Commonwealth would benefit from having activity-based costing models as part of the overall management reporting systems. Such models would allow the Commonwealth to more accurately determine the benefits of electronic benefits transfers, payroll direct deposits or the privatization of an activity. We recommend that the Commonwealth begin pilot projects concerning the cost of activities and services that are currently under review for changes in their processes or in the technology used to deliver the services. These pilots should then be used to develop a process for costing the broad range of Commonwealth activities.

All Departments Need to Submit a "GAAP Package" to the Financial Reporting and Analysis Bureau for Proper Reporting of the Comprehensive Annual Financial Report

The Commonwealth of Massachusetts requires all departments to submit a "GAAP Package" to FRAB in order to properly report the Commonwealth's financial condition in accordance with the regulations promulgated by GASB. OSC distributes instructions to all departments as to the information, which must be reported to FRAB so that the CAFR may be accurately reported. The GAAP Packages include information regarding numerous accruals and receivable balances. This information is necessary for fair presentation in accordance with GAAP.

The Comptroller's Office had set August 13, 1999 as the deadline for GAAP Packages. Five departments failed to meet that deadline. These departments did not submit a GAAP Package for fiscal year 1999, as well as for several years prior. The fact that they did not submit a package forces FRAB to make certain estimates and assumptions (concerning payroll, number of employees, etc.).

The Comptroller's Office should communicate with those departments that did not submit a GAAP Package in order to understand the reasons for nonsubmission. If departments are unwilling or unable to formally submit a GAAP Package, FRAB should assist the department in establishing a system able to produce the necessary information needed. At a minimum, FRAB should have a contact at those departments, which would allow them to confirm that the assumptions employed are reasonable.

Additional Tracking Required for Settled Yet Unpaid Legal Cases

FRAB does not have tracking procedures in place to determine which legal cases have been settled but not yet paid. A number of lawsuits are pending or threatened against the Commonwealth arising from the ordinary course of operations. For those cases in which a probable loss will be incurred and the amount of the potential judgment can be reasonably estimated, the Office of the Attorney General ("AGO") estimates the liability. The current portion of this liability is reported in the appropriate governmental funds and the long-term portion is recorded in the General Long-Term Debt Account Group ("GLTDAG"). This information is communicated to FRAB from the AGO annually during the preparation of the SBFR and the CAFR. In addition, the AGO confirms the cases that were outstanding in the prior year but which have since been settled. The AGO, however, is unable to confirm whether the amount of settlement or judgment has been paid prior to year end.

Procedures do not currently exist to either link the AGO information to the accounting records or to track payments and rebates or abatements made by the Department of Revenue in order to determine whether a liability exists at year end for legal cases settled but not yet paid. In the absence of such tracking procedures, an adjustment equal to $15 million was required to be recorded for fiscal year 1999.

FRAB has developed procedures to improve this system, however, FRAB should continue to develop and document additional procedures for tracking such settled cases to avoid any future possible misstatement of the financial records. FRAB could contact the attorney from each department who is in charge of settling cases (or at least keeping track of those cases which are settled) and develop a method of conferring the information from that attorney's office to FRAB on a regular basis (once a year, once each quarter, etc.), in addition to improved information sharing with the AGO. If implemented, FRAB could compile and update the information based on the department attorneys' best estimate as to the most likely (or most likely range) of monetary damages which will result from said lawsuits. Also, FRAB should determine which major payments have been provided for by legislation; this will serve as corroboration for many of the large-dollar monetary damages suits and FRAB should continue to track all those cases until they are actually paid.

INFORMATION TECHNOLOGY DIVISION

Information Systems Security Policies and Procedures

Management conveys and promotes the importance of a secure computing environment. However, the Information Technology Division does not maintain a formal information protection policy or policy manual. An effective information security policy identifies information as a corporate asset and defines management's requirements for protection of that asset. If these requirements are not defined, information may not receive protection commensurate with its value to the organization. Without specific guidance from management relating to information security and mitigation of risk, it is more likely that the integrity, confidentiality and availability of operational and financial information may be compromised.

Management's current efforts to provide a secure computing environment are the proper corrective efforts. To help ensure that technology increases business effectiveness while maintaining an appropriate level of integrity and protection, management should develop an information protection policy and policy manual to not only guide decisions regarding the current protection strategy, but also to address future planning and systems design. Policies should be approved by management, and distributed to all users so that they are aware of the policies and procedures regarding the Commonwealth's commitment to the integrity of the environments.

Subjects typically covered in an information security policy include (but are not limited to) the following:

- Policy objectives, scope, and to whom it applies
- Platforms it covers
- The threats to the computing assets
- How computing assets will be secured
- Classification of data/information
- Physical and logical security
- Documented user ID, password, and general use guidelines for both system administrators and users
- Granting, transferring, and terminating user access privileges
- Review of potential security violations
- Periodic review of specific access privileges for continued appropriateness

Physical Security of the Data Center

The door to the data center is physically restricted to key card authorized individuals, however, the doors to the print room and data center are propped open on a regular basis. The primary goal for providing physical security of critical information resources is to minimize or eliminate the threats due to damage or losses to computer assets maintained in a centralized area. When a large number of individuals have access to critical telecommunications equipment, there is an increased risk of corruption or destruction to the equipment.

Adequate physical security should ensure only authorized individuals have access to computer processing hardware in the central processing area. All data center equipment should be stored in a locked room with access granted to only those few individuals who require such access to perform their job responsibilities. More restrictive access controls will help ensure the integrity and continuous use of critical telecommunications equipment.

Information Systems Security

Terminated employees are not removed from system and building resources in an effective, efficient, and timely manner. Two employees, who were data set owners, had not been removed from system resources in a timely manner. Over time, if procedures for assigning, removing and modifying access capabilities are inadequate, unauthorized individuals will have access to system resources and data. This may result in unauthorized individuals exploiting the system and transferred employees accessing additional job functions that may compromise the segregation of duties.

The terminated and transferred employee report should be communicated in a timely manner to all individuals with security administration responsibilities. Agency security administrators should be responsible for effectively communicating the fluctuations in the employee workforce on a daily basis through submission of the employee termination form. To ensure that all terminations have been communicated, human resources should forward a monthly report with a listing of all employee terminations/transfers/ and additions. Additionally, the process to periodically review all system access privileges to ensure their continued appropriateness and usage should be continued.

The Information Technology Division Needs Improved Accounting of Costs and Services

The Information Technology Division (the "Division") is the state's largest data center, network operation center, and business application development facility. The largest entities served by the Division are the Registry of Motor Vehicles, Department of Transitional Assistance, Department of Medical Assistance and the Office of the State Comptroller. The Division's network and data center operations group has doubled in the past few years.

The Division functions from an operating standpoint similar to a private sector fee-for-service business while providing state agencies and their customers computing and networking services at rates which are equal to or below the commercial market rates. The Division does not currently account for operations in a manner similar to commercial enterprises or in a form that would be currently allowed for governmental entities operating as internal service funds. Examples of differences between the current accounting and practices that are found in either private sector or public sector information technology centers that have been set up as internal service funds include: the lack of equipment depreciation and reserves for replacement, the closing of accounts at the end of a fiscal year, the credits that are incorporated into the rate making process, the cap on charge-back revenue, and the single rate for services throughout the year.

Because the current accounting does not provide an accurate measure of the cost of existing operations or allow for the development of balances necessary to fund equipment replacement or expansion, the Division may not have the flexibility to meet the needs of its customers and indirectly the citizens of the State in the world of rapidly changing technology. For example, the Division operates the Department of Social Services ("DSS") system known as Family Net. Since DSS purchased the equipment for this system, they are not charged for its use. Yet, the computer hardware/software system will need future upgrading. But no funds or reserve have been established to deal with these replacements. The Division has been approached by another department about assuming the operations of its systems, yet, without an increase in the current "revenue cap," resources do not exist to provide this service. Other technology services may also be limited due to the current funding mechanism.

The Commonwealth should evaluate its current technology goals and the role of the Division in meeting those goals. In this evaluation, consideration should be given to the alternatives available to fund current and future operations. The evaluation should also consider the current accounting model being followed, the need for an accurate measurement of costs and available resources, and the impact of GASB Statement No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments" on the cost measurement.

Secure Technology Infrastructure and Security Management

As the Commonwealth continues to expand its technology infrastructure, management must ensure that they have a secure infrastructure upon which to build and deploy the Commonwealth's mission-critical applications.

When deploying new applications, evaluating existing applications and developing a next generation technology infrastructure, the eight most critical criteria are:

1. Reliability

2. Performance

3. Security

4. Flexibility

5. Scalability

6. Manageability

7. Ability to Duplicate

8. Long-Term Viability

Secure systems and networks are critical from both infrastructure and corporate confidentiality aspects. A well-designed security architecture is one that has gone through a vigorous vulnerability assessment, meets corporate baseline security standards, has policies and procedures that both support and manage it, has intrusion detection software deployed, and has a methodology to respond to incidents. The access to networks, whether from internal or external sources, should be authenticated and information protected via encryption software, whether it is in transit across the Internet or stored on a server. In many cases, additional integrity and accountability issues, such as nonrepudiation, archiving, access restriction, and digital time stamping, need to be considered. Infrastructure needs may include directory services, secure messaging, intrusion detection, and enterprise systems security management.

The proliferation of e-business and the widespread distribution of systems within the Commonwealth have created a significant challenge for management as they must both manage security and maintain availability on an enterprise-wide basis. Challenges arise from a lack of uniformity and integration in the management of information across heterogeneous systems and point solutions. The use of Internet and web-based technologies compounds the distributed systems challenge because they extend the enterprise systems' management umbrella beyond the boundaries of the organization.

The increasing complexity of distributed information systems, coupled with budgetary pressures, has forced organizations to seek alternative approaches to managing systems. We recommend that you continue to evaluate the available methodologies as you address the challenge of managing information technology in a secure, effective, and efficient manner. Secure enterprise systems management services should address the following areas as an integrated secure systems management process:

- Virtual Private Networks
- Intrusion Detection Systems
- Accountability and Monitoring Systems
- Enterprise Authentication Systems
- Enterprise Authorization Systems
- Remote Access Solutions
- Encryption Systems
- Single and Global Sign-on

Web Site Assessment

The Internet is helping organizations increase productivity, grow revenues, improve customer service and reduce costs. Having a reliable Internet presence is central to an organization's ability to exploit these opportunities. Many organizations are now periodically performing web site assessments. A web site assessment can easily assess the usability and effectiveness of a website with only a small time investment

A web site assessment involves a comprehensive evaluation of an entity's web site, including recommendations for improving the site. An evaluation should addresses five key dimensions of the Commonwealth's web sites:

- Accessibility (e.g., search engine placement)
- Effectiveness (e.g., the ease of navigation)
- Integrity (e.g., valid hyperlinks)
- Business practices disclosure (e.g., Y2K disclosure)
- e-Commerce (e.g., properly configured digital certificate)

The Commonwealth should conduct an overall inventory of its existing web sites and perform a web site assessment to ensure that the key dimensions of the web site are functioning as intended by management.

PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION

Resolution of Differences in the Pension Valuation

On April 28, 1999 a pension valuation report prepared by independent actuarial consultants to the Pension Reserves Investment Management ("PRIM") was released. Using the same data and assumptions employed by the Public Employee Retirement Administration Commission ("PERAC") in its October 1998 valuation report, the independent report found the unfunded actuarial valuation to be approximately $2 billion higher than that calculated by PERAC. PERAC has since changed its actuarial software system from the system that was the basis of the October 1998 report and has rerun the unfunded actuarial liability and noted an acceptable variance from the independent valuation. To date, neither PERAC nor the independent consultant to the PRIM Board have determined the source of the $2 billion difference.

Since the old system was the basis for the previous valuation, PERAC should restore the old actuarial system and perform tests of data to determine the reason for the differences in the valuations. The Commonwealth will be required to perform a new actuarial valuation for Fiscal Year 2000 under GASB 25, which requires that a new valuation be performed biennially, and any differences resulting from the conversion should be identified prior to its issuance.

TEACHERS RETIREMENT BOARD

Overpayment of Teachers Retirement Benefits

During PERAC's review of retired teachers' data for the purposes of performing a new actuarial valuation, it was discovered that a retiree was receiving inflated payments for approximately nine years. The overpayments are estimated to be approximately $800,000. Although the source of the error is unknown and currently under investigation, monthly checks amounting to approximately $8,400 were sent to this individual each month without any notice of error by Board staff or management.

Management at the Teachers Retirement Board should review payments made to retirees periodically for reasonableness. This process could include the generation of exception reports for payments that exceed a certain dollar amount or performing file interrogation analysis on the teachers' retiree data, including payment information. Management can investigate large payments for appropriateness and make any necessary corrections by performing such a review on a periodic basis.

OFFICE OF THE TREASURER

With a newly elected Treasurer taking office in January 1999, the new personnel began the process of evaluating the policies, procedures and systems that had been used under prior administrations. This process, combined with the impact of certain investigations being performed by other officials, resulted in the audit procedures at the Treasurer's office being conducted principally through substantive testing of year-end balances that were material to the Commonwealth's financial statements. Testing of the Treasurer's internal controls was not considered to be effective and, given the changes in process and planned by the current administration, any comments that resulted from such testing would not have provided a true representation of the controls in place at June 30, 1999.

The comments below are those that resulted from the substantive work performed in connection with the audit of the June 30, 1999 year-end balance.

Cash and Investment Management Automated Systems and Associated Reconciling Items

The current cash management system is a program developed by Treasury staff and consultants in 1991. While it has been modified over past years, the system is largely inadequate to meet Treasury needs, especially in the case of the investment sub-system. The current cash management automated systems used by the Office of the State Treasurer ("Office of the Treasurer") does not provide the information needed to reconcile with the Commonwealth's accounting system (MMARS), creates erroneous or unnecessary reconciling items and has serious limitations in the manner in which data can be updated. The limitations in the system hamper the ability of personnel in both the Offices of the Treasurer and the Comptroller to effectively manage the information relating to Treasury operations. The following comments are provided to help illustrate the system limitations.

In an effort to maximize the return on the Commonwealth's money, the Treasurer invests such funds in overnight accounts each day. The investment management sub-system of the cash management module system used by the Office of the Treasurer to record overnight investments, a sub-system of the cash management module, is not an effective tool in providing accounting information. The transactions are recorded by entry in the system at both the time the purchase is made and when the overnight investment is completed. Amounts recorded by the bank and the amounts recorded on the Office's books do not consistently agree. The variances are due to the fact that, for purposes of effective cash management, amounts recorded by the Treasurer are based on internal estimates of overnight earnings and not on actual amounts paid by the bank. The system does not allow users to update posted security transactions so correction of these estimates within the system is not possible. The Treasurer's Cash Management System compounds the problem by rounding purchases and maturities. The variances are not material, normally within a dollar or two. However, because the amounts do not agree, and there is no facility in the current program to modify posting to reflect rounding differences, the entire balance of the transaction appears as a reconciling item between the Treasurer's books and the bank.

These reconciling items have not been consistently addressed, resolved and removed from the reconciliation over a significant period of time. The end result is a large volume of reconciling items, and a greater likelihood that errors may exist in the population and not be identified by management in a timely manner. It should be noted, however, that under the current administration, significant effort has been made to resolve longstanding reconciling items and all fiscal year 1999 items were resolved before the closing of the books by the Office of the Comptroller.

The Investment System does not allow Office of the Treasurer's personnel to properly record investment activity or correct known errors because it does not allow users to go back and post transactions other than currently. The Treasurer's investment activity includes various short-term vehicles, such as certificates of deposit, commercial paper, and repurchase agreements, in addition to the overnight investments previously discussed. A number of these investments matured on June 30, 1999 but were not recorded by the Office of the Treasurer until subsequent to year end. Because of this system deficiency, this June 30, 1999 activity was posted in July and therefore considered by the system to be fiscal year 2000 activity. This necessitated the recording of a large reconciling adjustment (approximately $15.2M) at year end. That adjustment represented primarily reinvested dividends and purchase/redemption activity. In another case, a significant adjusting entry was recorded in the month of June but did not post correctly. While management identified the error subsequent to the year end system close, the program limitations did not permit it to be manually adjusted in the proper period, resulting in a reconciling item between the Treasurer's books and the MMARS System.

The Investment System does not have the capability to accurately record certain routine transactions. For example, during the fiscal year ended June 30, 1999, investment income was understated by $1 million per month because the MMDT Fidelity system interface to CMS cannot recognize investment income amounts in excess of six digits. Monthly, the Office of the Treasurer performs bank reconciliation by downloading investment information and comparing it to the balances reported in the Investment System. During that process, the bank transmits the amount of investment income earned during the month, which is recorded on the Treasurer's books. The system deficiency identified above results in the Treasurer's MMDT Fidelity system "dropping off" anything in excess of six digits. As a result, for each period in which interest income exceeds $1M, the system automatically understates revenue. Such errors have been identified by management in the course of its reconciliation processes but result in the need to manually record adjusting entries. Preventing the error through modification and/or development of a new cash management systems/investment sub-system would reduce the incidence of reconciling items.

As the Treasurer's Office continues to evaluate procedures and systems, consideration should be given to the automated cash management and investment sub-system's ability to track multiple dates or use "journal entries" as a means of relating transactions to both the posting date and the period it affects. The system should be reviewed and, if possible, modified to allow for postings as of the end of an accounting period. Management should investigate its various system differences and determine whether to fix or update its existing systems. This review should include the assessment of the overall functionality of the current systems and a determination as to whether modifications and/or development of new systems and interfaces represent the most effective long-term solution to this issue.

Any modification or system enhancements should also be accompanied by a review of corresponding business practices. The existing practices, especially for investments, should be examined to determine a means to satisfy the accounting requirements to journal entry the posting of overnight investment purchases with final settlement adjustments and to meet requirements of daily cash position management and cash flow projection. Implementing the system changes and the requisite business practices revisions and associated training will result in less reconciling items, better control over the process and better cash management.

Long-Term Debt Information

The preparation of information relating to long-term debt issuances that have taken place during the year is labor intensive and performed by a single employee in the Office of the Treasurer. As a result of other activities that this employee must perform, information necessary to update the Office of the Comptroller's records and prepare financial statements is often delayed until after the end of the fiscal year.

The Office of the Treasurer should review the methodology used to prepare the long-term debt information and determine if additional employees could be used in preparing the data. When external parties provide information, procedures should be put in place to accumulate the data within a specified time limit after the date of the transaction close.

The Office should consider a transaction-closing checklist to identify for management all the steps that need to be completed before a sale is considered final. The checklist should include information necessary for the preparation of financial reporting systems and be monitored by management so that delays in completion can be explained.

Multiple Bank Accounts

The number of bank accounts maintained by the Commonwealth is excessive and should be challenged in light of the existing emphasis being placed on internal controls. Numerous accounts are maintained for use by departments of the Commonwealth for payments relating to their departmental activity. Other states maintain these accounts in an internally managed pool as a means of improving both controls and the return on the related investments. While such pools may require an improved accounting system for the activity, the reduction in the number of accounts to be reconciled and analyzed often pays for the cost of implementing the systems.

Treasury management should review the entire population of accounts controlled by the Commonwealth and consolidate and centralize as many of those accounts as possible within the constraints of the appropriation process and any prohibition relating to the commingling of funds. This review should include the increased use of lock boxes for those agencies that deposit funds on a regular basis. It should be noted that this process has been started under the current administration, however, the Office of the Treasurer should ensure that it is given top priority and monitored to completion.

Errors on Outstanding Check List

In the spring of 1999, Treasury management began a review of its check issuance practices and reconciliation processes. In the course of that review and year-end reconciliation, the Treasury identified numerous erroneous check entries, including the posting of duplicate checks to the issuance file and the failure to ensure stops and/or deletes were properly posted to the bank record.

The reconciliation of the "Float Fund" has, for several years, included a large volume of unreconciled variances. The new administration has undertaken a process of identifying and correcting these variances. As part of that process, Treasury management has identified that certain checks still listed as outstanding in the "Float Fund" reconciliation have, according to other Treasurer's records and investigations, already had a corresponding check presented for payment. Two problems have been identified which allowed this condition to exist. In some of those cases, checks were issued once in proper form and then again with check numbers which were missing a single digit in the check number. In other cases, completely random check numbers were assigned to duplicate payees and in duplicate amounts. The result of these actions is that the checks that were issued with the correct check numbers properly cleared the account while those with the wrong check numbers continue to remain outstanding in the bank reconciliation. The total amount of such outstanding checks was approximately $9.1 million at June 30, 1999.

Treasury management has researched the issue and concluded that this error stems primarily from an event which occurred in August of 1997. A PPS vendor payment check run was prepared that began with the wrong check number, having excluded one digit. That error was identified by management, the error was corrected, and a second PPS vendor payment check run was immediately prepared. The original file, however, had already been forwarded to the bank. In cases where events like this occur, management is required to forward a request for a "Code 88 Check Delete" to the bank. In this case, such a request was never processed. Given that this event occurred in 1997, the change in administration and the turnover of personnel, management is not able to determine where the breakdown in the correction of these entries occurred.

Treasury management has identified what appears to be the most significant portion of unreconciled variances in the "Float Fund" and is in the process of having these errors corrected. The Office of the Treasurer should continue their efforts and perform a full analysis of all outstanding checks, specifically those that are either significantly aged or those that are transferred to the presently closed unpaid check fund or the abandoned property fund, and compare those checks to its internal records to determine whether similar errors exist. Upon completion of this process, additional corrections should be made to remove these errant checks from the list of those outstanding. Treasury management is actively reviewing accounts and developing procedures to identify and prevent similar transactions should they occur in the future. The Office of the Treasurer should ensure that it is given top priority and monitored to completion.

STATE LOTTERY COMMISSION

Support for Accounts Receivable Transactions

The Lottery was not able to provide documentary support for two "RE" transactions, which were selected for internal control testing during the annual audit. As part of investigating this problem, Lottery personnel acknowledged that an RE transaction has never been prepared for annuity receivables.

Lottery management should review the internal control plan in effect to ensure that all required documentation is retained for the proper period according to guidance provided by the Office of the Comptroller. In addition, management should ensure that RE transactions are properly prepared for all annuity receivable transactions.

Lottery Commission as an Enterprise Fund

The Lottery is not accounted for or controlled in the same manner as other state lotteries. Current accounting literature recommends that lotteries be accounted for as Enterprise Funds so that the full cost of operations are reflected prior to determining the "profits" available for prizes and other uses. Most states follow this accounting model. In addition, because lotteries are separately reported as enterprise funds, most states subject them to a separate audit of operations and separate evaluations of the internal control structures. Currently, the Lottery is reported as part of the major special revenue funds in the financial statements of the Commonwealth. Accordingly, the lottery funds are subjected to the audit procedures that are applied to other funds in order to determine that the financial statements are fairly presented in all material respects but based on levels of materiality which are higher than they otherwise would be had a stand-alone audit of the Lottery been performed.

The Commonwealth should consider accounting for the Lottery as an Enterprise Fund. This would allow the Commonwealth to evaluate the true cost and benefit of its operations while providing additional assurance to the public. Such accounting would require that the Lottery's accounting systems be evaluated and possibly upgraded so that operations could be reported on a full accrual basis.

Need for an Automated General Ledger System

The State Lottery Commission's financial statements are developed using Excel spreadsheets. In addition, reconciliations of financial information in these spreadsheets to MMARS are not performed in a timely manner. Failure to perform such reconciliations may lead to errors going unnoticed for prolonged periods of time, making subsequent corrections more difficult. In fact, under the circumstances, these errors may not be discovered in time to make adjustments to the financial statements which could result in a material misstatement of the financial statements. It also may result in a potential failure to identify manual errors in spreadsheet entries and calculations. Excel spreadsheets do not normally have embedded controls, which are used in a system of internal controls, such as requiring balanced journal entries to make changes to financial information.

The Lottery should adopt a general ledger system. This system could either be based on MMARS downloads or could be an off-the-shelf system which should have requisite embedded controls. The general ledger system would then aid in the development of monthly financial statements that could be easily reconciled to MMARS. Such reconciliations to MMARS should then be performed on a monthly basis with the Comptroller's Accounting Department.

Understatement of Prizes Payable

Prizes payable were understated at June 30, 1999. Approximately one-third of amounts tested were found to be understated. After examination from independent auditors, the Lottery Department completely recalculated its prizes payable schedule as of June 30, 1999. Adjustments were required to prizes payable to correct the errors in the prizes payable balance. The recalculated amounts more accurately disclosed the amount of prizes payable at June 30, 1999.

The Lottery should improve its procedures for reconciling prizes payable and annuity contracts to ensure that the related liabilities are properly stated. Prizes payable are also tracked manually using Excel spreadsheets, which are conducive to potential errors through manual entries.

DEPARTMENT OF REVENUE

Management Review of Revenue Adjustments and Reconciliations Needs Improvement

Management of the Department of Revenue ("DOR" or the "Department") currently does not review the revenue reconciliation process between the "Blue Book" (DOR reports financial information in the "Blue Book" on a monthly basis) and MMARS. Two employees are assigned to print the Blue Book and reconcile the Blue Book to the MMARS system. These employees communicate to each other through the use of memos when adjustments become necessary. When these individuals are not able to determine the most appropriate approach to resolve reconciliation differences, they contact the revenue accounting manager to reach a decision. No other review and monitoring procedures are performed by management to ensure that entries recorded and the reconciliation performed by these employees are accurate and complete.

The revenue accounting manager should review all recorded adjustments and the revenue reconciliation to ensure they are reasonable and valid. This monitoring procedure should also be included in the Department's internal control plan. Ongoing management review of the revenue reconciliation process is necessary for all adjustments and reconciliations to ensure that recording errors are detected and corrected.

Classification of Capital and Operating Leases

The Department's personnel do not appear to be familiar with the criteria for the classification of leases as either operating or capital. In preparing its minimum lease payment schedule to be included in the Commonwealth's GAAP reporting package, the Department staff classified leases for computers as capital leases and other equipment as operating leases, rather than evaluating each lease individually to determine how it should be classified. While our testing did not identify any misclassified leases, each lease should be evaluated individually.

To ensure that leases are properly classified and reported in the Commonwealth's financial statements, Department personnel should become familiar with the criteria for identifying capital leases in accordance with generally accepted accounting principles and classify each lease accordingly.

DIVISION OF EMPLOYMENT AND TRAINING

GAAP Reporting Needs Improvement

The Division of Employment and Training (the "Division") needs to improve the information sent to the Office of the Comptroller for inclusion in the financial statements prepared in accordance with generally accepted accounting principles ("GAAP"). Many of the GAAP reporting schedules, including accounts receivable, leases, fixed assets, as well as materials and supplies, had to be revised a number of times during the audit. There was also no evidence that the reporting package was reviewed by Division management prior to submission to the Office of the Comptroller.

For example, errors were noted in the future minimum lease payment schedule for two leases. For both leases the amounts due in fiscal year year 2001 were reported as due in 2002, while for one of these leases the amount due in fiscal year 2000 was also reported incorrectly. We also noted instances where fixed assets with an acquisition cost greater than $15,000 were not entered into the MMARS Fixed Asset Subsystem in a timely manner or were omitted from the GAAP reporting package.

The Division should have policies and procedures in place to ensure that the GAAP reporting package and supporting schedules are properly prepared and reviewed.

Better Control Over Cash Receipts Is Needed

Checks received by the Division of Employment and Training (the "Division") for quarterly payments and delinquent accounts that are not sent to the lockbox are not received at a central location, are not logged in and are not stamped to prevent unauthorized use. Such checks may also be held until the personnel receiving them identifies the individual responsible for their processing.

Better control of the checks received by the Division would lead to the checks being deposited and recorded in a more timely fashion and provide more assurance against their theft or loss.

The Division's operating procedures should require that all checks not sent to the lockbox be logged in, stamped "for deposit only" and immediately directed to those individuals with authority to process them. The log should also be reconciled on a monthly basis with deposit slips and bank statements.

DEPARTMENT OF PUBLIC HEALTH

Tracking and Reporting of Bad Debt and Contractual Adjustments

The hospitals administered by the Department of Public Health ("DPH") do not separately record allowance for bad debts and estimated contractual adjustments. The hospitals include both allowance for bad debts and estimated contractual adjustments in one account – uncollectible accounts receivable.

Allowance for bad debts is an estimate of patient and third-party accounts that will eventually not be collected as a result of payors or patients not paying their share of the bill. Therefore, the allowance for bad debts provides for revenue earned by the hospitals that may not be collectible. In determining the adequacy of allowance for bad debts, historical collection pattern, aging category, and payer class are generally used by management to determine the level of allowance necessary to reduce patient accounts receivable to their net realizable value. An increase in allowance for bad debts increases operating expenses but does not reduce revenue earned.

In contrast, contractual adjustments represent the portion of gross patient charges that will not be paid by third-party payors as a result of terms prescribed in the reimbursement contracts. Contractual adjustments reduce patient accounts receivable to amounts that will be reimbursed by third-party payors, and patient service revenue to amounts earned, under the contracts. Contractual adjustments are estimated by applying third-party contractual rates against the corresponding outstanding account balances. An increase in estimated contractual adjustments reduces the amount of revenue being recognized.

Allowance for bad debts and contractual adjustments should be tracked and reported separately so they can be easily analyzed and monitored. An analysis of bad debt and amounts written off helps management assess the effectiveness of the hospitals' collection efforts. An analysis of contractual allowance is a tool for management to determine whether a third-party contract is cost beneficial, and can be useful when negotiating future reimbursement contracts. The analysis of both bad debts and contractual rates is becoming more important as the health care industry continues to experience a slow down of payments received from third-party payors and significant reductions in reimbursement rates.

The hospitals should begin tracking allowance for bad debts and estimated contractual adjustments separately and record them under separate accounts. In addition, management should review bad debts, write-offs and contractual and reimbursement rates on a regular basis to maximize revenue and collection.

Timely Billing of Third-Party Payors

The hospitals administered by the DPH enter charges into the billing system when services are provided and medical records are complete, but only generate bills monthly.

As is consistent with industry practice, many third-party payors' reimbursement contracts contain fixed billing windows where any bills received by the payors after the billing window will be denied. Claims cannot be reprocess after they are denied. The billing window applies to both bills sent for the first time and re-bills to correct prior errors, and is determined from the time of patient discharge. By sending bills only on a monthly basis, the hospitals increase their risk of not meeting the billing window and payments being denied.

To maximize revenue and cash flows, as well as to minimize denied claims, the hospitals should implement a policy to send third-party bills as soon as services are provided and the related medical records are completed. Correction of billing errors should be a priority so the hospitals do not miss the time remaining on the billing window.

DIVISION OF MEDICAL ASSISTANCE

Cash Management Information Used to Offset Federal Drawdowns Could Be Improved

During the testing of the Division of Medical Assistance's ("DMA") cash management procedures, it was noted that the estimated refund amount used to offset the daily drawdown amount was, on average, underestimated by approximately $139,000 to $143,000, resulting in a drawdown of federal funds in excess of DMA's needs, and a potential federal interest liability.

Per Section 2.1 of the subagreement between DMA, the State Treasurer, and OSC, "...an adjustment is made to reconcile the difference between average refunds and actual refunds, and the average refund dollar amount is revised, every month. No state or federal interest liability is incurred when this funding technique is properly applied."

DMA had not reassessed the fixed amount by which its drawdowns were reduced for estimated refunds since the prior fiscal year. Accordingly, the fixed amount that DMA utilized was understated, resulting in drawdowns in excess of needs.

Based on discussions with client personnel, this underestimation of refunds is attributable to the increase in the drug rebates in the current year. The fixed amount by which the drawdown was reduced did not incorporate the increase in these rebates and, accordingly, was understated.

However, DMA has developed new, estimated refund amounts using historical data. These estimated refund amounts were expected to be implemented by October 1, 1999.

DMA should comply with the subagreement and revise its estimated refund amount using historical data. Additionally, DMA should ensure that its new estimation methodology is revised every month, thereby complying with Section 2.1 of the subagreement.

Individual Support Plan Response Sheets Not Signed in a Timely Manner by DMR Area Directors

During the tesing of the Medicaid waiver program with the Department of Mental Retardation ("DMR"), it was noted that two out of twenty Individual Support Plan ("ISP") response sheets were not signed by the area director within 30 days after the ISP meeting, as required by 115 CMR 6.23(5)(a). One signature occurred six months after the ISP meeting, while the other was signed more than a year after the meeting, after the ISP had expired.

Per 115 CMR 6.23(5)(a), "Within 30 days following the ISP meeting, the ISP shall be reviewed by the area or facility director or his or her designee, approved or disapproved in part or in whole, and mailed to the individual, family, guardian, designated representative, if any, and providers."

Based on discussions with DMR staff, these errors may have been caused by a backlog in cases for which these particular area directors were responsible. This would have caused delays in the timing of the signatures. However, in both these cases, the delay was excessive, so the lack of signatures on the ISPs were most likely administrative oversights.

115 CMR 6.23(5)(d) allows the ISP to be implemented "prior to completion of the distribution and approval process set forth in 115 CMR 6.23(5)," therefore the recipient most likely will not be inconvenienced by a stop in support services. However, the lack of area director approval could potentially result in exposure for the Division of Medical Assistance and the DMR, especially in the instance where the implemented ISP had never been approved.

DMR should consider implementing a checklist or review procedures for the annual ISP review process. Since the ISPs are in electronic format as of January 1999, DMR should consider utilizing electronic flags, which would highlight any ISPs that are not complete in all respects.

DEPARTMENT OF TRANSITIONAL ASSISTANCE

TANF Time-Limited Benefits Extension Review Policy and Procedures

In November 1995, the Department began the implementation of the Transitional Aid to Families with Dependent Children program ("TAFDC"). This program was the result of Chapter Five of the Acts of 1995, which reformed the Massachusetts welfare system. Chapter Five contained a number of major provisions including Time-Limited Benefits, Work Program, Teen Parent Living and School Attendance. Time-Limited Benefits were implemented in December 1996.

Beginning on October 1, 1996, TAFDC is federally funded through the Transitional Aid for Needy Families ("TANF") block grant. Under the block grant, benefits are provided on a statewide basis in accordance with the requirements of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996. ("PRWORA")

Under TANF, there is a five-year maximum limit on benefits available for recipients. Under the State Welfare Reform Act of 1995, a recipient's benefits are limited to 24 months in a 60-month period. Once the 24 months of benefits have expired, the recipient cannot receive benefits for the remainder of the 60 months, unless an extension for benefits request has been completed. Code of Massachusetts Regulations ("CMR") 203.210: Extension of Benefits Beyond the 24-Month Period, states that the Commissioner or designees may extend benefits to recipients under certain circumstances for a period of up to six months. The first recipients affected by the 24-month clock were slated to have benefit payments stopped in December 1998.

Currently, the Director of the respective Transitional Assistance Office ("TAO") and central office staff review each extension request. As part of our single audit procedures, we noted that, in two cases that involved application for extension of benefits, the approximate time to conclude on each extension request was six months. The review process is very manually intensive with very few efficiencies gained in the area of process automation. During this time, the affected recipients continued to receive benefits. Consequently, recipients can end up receiving significantly more than six months of benefits from the date they were originally scheduled to terminate based on the 24-month clock. Also, in the case of rejected extension requests, the Department does not seek recoupment of the benefits disbursed during the extension review period from recipients.

The Department maintains an automated system which tracks extension applications throughout the approval process. Management should consider ensuring that the automated system is providing satisfactory summary-level information that would be useful in policy decision-making. For example, management may be interested in the total number of extensions applied for and the number that are approved and disapproved. In addition, the Department may want to consider adding additional resources to support individual TAO Directors from large offices with significant recipient populations and central office staff. For example, a separate unit may be created in order to exclusively deal with the timely dispensation of extension claims. Lastly, the Department should consider seeking recoupment from recipients who have been denied extension requests for the period of the extension review.

Equipment and Real Property Management Procedures

Office of Management and Budget ("OMB") A-133 regulations require that equipment purchased with federal funds be properly tracked and inventoried annually. The Department has not completed a physical inventory of all furniture and fixtures purchased. The Department is currently in the process of completing a full inventory. The last physical inventory was completed several years ago, however, the Department does complete an annual inventory of all management information systems hardware and related capital assets. Although the amount of federal funds expended on furniture and fixtures is not significant, the lack of a comprehensive physical inventory can lead to Department assets being misplaced, under-utilized or stolen. The Department's Internal Control unit has addressed this issue in the form of an internal control assessment.

Individuals are permitted to leave the 600 Washington Street location with computer equipment without any intervention from independent security guards located in the building's lobby. The guards perform no verification of ownership. However, the building houses several agencies and this may not always specifically affect the Department. The Department's Internal Control unit has addressed this issue in the form of an internal control assessment.

The Department should ensure that it completes the furniture and fixtures inventory during the next fiscal year. Periodic updates to the inventory listing should also be made whenever assets are purchased, exchanged or disposed of. In addition, policies over property removal should be more thoroughly enforced and augmented. For example, the Department could require that all property being removed be authorized by a unit manager and documented in an approval slip, which could then be presented to the security guard in the lobby.

Direct Deposit Transaction Numbering Methodology

The Department assigns identifying numbers to all transactions that dispense benefits in order to easily track and reconcile individual benefit payments. In the case of direct deposits issued semimonthly, the same check register numbers are used continuously. For example, once the issued numbers in any given year hit the number 90,999,999, the check register numbers are automatically set back to 90,000,000. Consequently, a number could be theoretically used several times in one year. The Department does utilize automated controls over direct deposit payments in order to ensure that all nonsequential payments are properly flagged by the system and approved by management. In addition, the Department currently averages approximately 600,000 individual transactions using semimonthly direct deposits in a given year. Therefore, given historic levels of activity, a number would not be duplicated in any given fiscal year. However, the risk of duplicate payment is not entirely mitigated if activity levels rise significantly.

The Department should explore options to its present numbering system which would allow individual fiscal year transaction numbers to be unique without the current practice of "flipping" the numbering sequence. The system should be evaluated to determine if very old transaction numbers could be purged and reset or an alphanumeric scheme could be implemented.

Contract Execution and Management

The Commonwealth's Procurement Policies and Procedures Handbook (the "Handbook") outlines the procedures for soliciting, obtaining and reviewing commodities and services from vendors and contractors. Specifically, chapter five of the Handbook addresses the issue of contract execution and management. In essence, each contracting department is responsible for developing and implementing procedures to monitor and evaluate contractor performance and compliance. An example of a procedure to comply with the state regulations includes conducting announced or unannounced site visits and record reviews of the contractor. Historically, the Department of Transitional Assistance ("DTA") has completed announced site visits to test and document vendor compliance with contracts. However, during fiscal year 1999, in the Young Parents Program, there were no formal site visits completed due to staffing resource issues. The absence of site visits could lead to diminished supervisory review assurance and relations with contractors.

In order to augment the diminished site review procedures, the Young Parents Program continued its process of completing monthly "desk reviews" of each contractor. Desk reviews ensure that performance targets and contract stipulations as reported in progress reports are being adhered to. In addition, the Department conducted mandatory regional meetings with each contractor twice in fiscal 1999 in order to maintain regular, direct communication. In addition, the Department has recently hired a permanent position to complete site visits. Department management expects that all contractor sites will be visited in fiscal year 2000. While the lack of vendor/contractor site visits does not violate federal or state law, it is an effective control tool to evaluate and review the performance of Department vendors and contractors.

HIGHER EDUCATION

Reporting of the University and College Fund Type Needs Improvement

The Universities and Colleges included in the University and College Fund Type (the "Fund Type") need to continue to improve the procedures relating to financial reporting for the Fund Type. Twenty-four of the twenty-five institutions included in the Fund Type currently produce complete audited stand-alone financial statements, which have varying accounting policies and report disclosures. The remaining institution, Roxbury Community College ("RCC"), did not submit either a GAAP package or an audited stand-alone financial statement for presentation in the Comprehensive Annual Financial Statement ("CAFR").

RCC has recently issued its fiscal year 1998 audited financial statements and is currently in the process of the audit of the 1999 financial statements. Management of RCC expects that it will complete the process of producing the fiscal year 2000 audited financial statements prior to the November 1, 2000 deadline as required for inclusion in the fiscal year 2000 CAFR. The Office of the Comptroller and the Board of Higher Education have requested the Governor to file legislation to extend the statutory requirement for stand-alone financial statement audits in conformity with GAAP to all institutions of higher education. We recommend that the Legislature adopt such reporting requirements.

In addition, we recommend that the University and Colleges follow and adopt policies the Office of the Comptroller establishes and adopt a uniform set of accounting policies and uniform financial statement disclosures that are included as component units of the Commonwealth. Each of the entities should be strongly encouraged to adopt these policies and accounting disclosures to ensure that the Commonwealth is able to produce accurate and complete financial statements on a timely basis.

COMPONENT UNITS

Component Units Need to Be More Responsive in Submitting Their Financial Statement Information

There is a need for continued improvement in the responsiveness of the various component units to financial reporting deadlines. Accurate financial reporting is dependent upon the Office of the Comptroller ("OSC") obtaining from these separate entities the information necessary for the preparation of the Commonwealth's financial statements.

During fiscal year 1999, the OSC provided GAAP reporting requirements and guidelines to representatives from each component unit to facilitate the financial reporting process. Currently, the general purpose financial statements of the Commonwealth include 35 component units. Each of these component units is subjected to an audit and is required to report its financial statements in accordance with GAAP.

Several of the Component Units included in the CAFR did not submit their final audited financial statements prior to the November 1, 1999 deadline established by the OSC, resulting in several late adjustments and reporting disclosures to the CAFR.

Roxbury Community College did not submit final audited financial statements to the OSC prior to the completion of the audit for the CAFR.

The OSC, the department legally responsible for the preparation of the general purpose financial statements, must coordinate the efforts of the component units. In that role, the OSC has already taken many steps to obtain timely and accurate data for inclusion in the Commonwealth's financial statements. If a material component unit did not issue audited financial statements prior to the established deadlines, it could result in a qualification to the Commonwealth's financial statements or denial of the Certificate of Achievement for Excellence in Financial Reporting presented by the Government Finance Officers Association.

The OSC should continue meeting individually with the various component units prior to June 30, 2000 to instill an "ownership interest" in the financial statements and communicate the role they play in the preparation of the Commonwealth's financial statements. The discussion should also focus on the disclosures needed in the component units' financial statements in order to meet their responsibility to comply with the standards established by the Government Accounting Standards Board. The component units should participate in establishing the time lines under which they provide the necessary financial statement information within the broader time lines established by the Comptroller. The component units should also inform their independent auditors of the importance of the established deadline.

In addition, we recommend that the component units adopt the uniform set of accounting policies and financial statement disclosures suggested by the OSC. This will help the OSC organize information for inclusion in the financial statements of the Commonwealth and help ensure that similar accounts across component units are grouped together properly.

Reporting of the Commonwealth and Other Entities

For financial reporting purposes, the Commonwealth includes under the requirements of GASB Statement No. 14, "The Financial Reporting Entity," all funds, organizations, account groups, agencies, boards, commissions and institutions for which it is accountable. The Commonwealth has also considered all potential component units for which it is financially accountable as well as other organizations for which the nature and significance of their relationship with the Commonwealth are such that exclusion would cause the Commonwealth's financial statements to be misleading or incomplete under the requirements of Statement No. 14. Each of these entities should apply the appropriate basis of accounting under GAAP. While various options exist under GAAP for the appropriate measurement focus and basis of accounting to be used by certain component units, there should be consistency for similar entities within the Commonwealth, and agreement on the accounting for transactions and other activities that impact both the primary government and the component units.

One area where there is not uniformity of accounting is the Regional Transit Authorities ("RTAs"). Of the 15 RTAs, 12 follow proprietary accounting and 3, Cape Ann Transportation Authority ("CATA"), Lowell Regional Transit Authority and Merrimack Valley Regional Transit Authority, follow governmental accounting. RTAs are generally considered to be entities that should follow proprietary fund accounting. In 1999, CATA changed from reporting as a Proprietary Fund in 1998 to a Government Fund in 1999.

All discretely presented component units that are proprietary should report using a flow of economic resources measurement focus and the accrual basis of accounting. University and College Fund activities should be reported using the accrual basis of accounting. These entities should adopt uniform accounting standards in accordance with GAAP and in accordance with standards established by the Commonwealth and the GASB. New standards issued by the GASB should be implemented in accordance with the provisions and guidance provided by the Commonwealth and the GASB. Symmetry of adopting accounting standards between the primary government, the component units, and institutions of higher education entities will greatly assist in accurate and timely financial reporting.

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