Commonwealth of Massachusetts

Management Letter for the
Year Ended June 30, 2003

COMMONWEALTH OF MASSACHUSETTS

TABLE OF CONTENTS

INDEPENDENT AUDITORS' REPORT

Mr. Martin Benison, Comptroller
The Commonwealth of Massachusetts

In planning and performing the Single Audit of the Commonwealth of Massachusetts (the "Commonwealth") for the year ended June 30, 2003, on which we have issued our report dated December 31, 2003, we considered its internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the Commonwealth's internal control. However, we noted certain matters involving the Commonwealth's internal control structure and compliance of management of the Commonwealth with laws and regulations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the Commonwealth's internal control that, in our judgment, could adversely affect the Commonwealth's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such matters have been reported to the management of the Commonwealth in the "Report on Compliance and on Internal Control Over Financial Reporting Based Upon the Audit Performed in Accordance with *Government Auditing Standards,"* dated October 24, 2003, and "Report on Compliance and Internal Control Over Compliance with Requirements Applicable to Each Major Program and the Schedule of Expenditures of Federal Awards," dated December 31, 2003.

Our consideration of the Commonwealth's internal control would not necessarily disclose all matters in the Commonwealth's internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are considered to be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by the error or fraud in amounts that would be material in relation to the financial statements or in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, based on our procedures and the report of other auditors, of the reportable conditions described in the above reports, we consider Finding Number 28 to be a material weakness relating to the controls over the Byrne Formula Grant Program administered by the Executive Office of Public Safety/Committee on Criminal Justice.

We also submit our comments concerning certain observations and recommendations relating to other accounting, administrative, and operating matters. These recommendations resulted from our observations made in connection with our audit of the Commonwealth for the year ended June 30, 2003. Our comments arranged by department, are presented on the following pages. The Office of the Comptroller has determined that certain observations and recommendations regarding a Commonwealth comprehensive disaster recovery plan are not a public record as defined by Clause 26 of Section 7 of Chapter 4 of the Massachusetts General Laws and has asked that this information be excluded from this document. The observation and recommendation, however, have been issued as a separate document maintained by the Massachusetts Office of the Comptroller.

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

December 31, 2003

STATEWIDE OBSERVATIONS

Reporting on the Commonwealth's Retirement Systems

The Commonwealth is unique among state governments in that it does not have separately prepared and audited public employee retirement system financial statements. The investments of the Commonwealth's three public employee retirement systems are audited by an independent auditor. This audit, however, does not cover any aspect of the retirement systems except for the investments and related investment activity. Therefore, many aspects of the retirement systems do not have the same level of audit coverage as would be found in other states.

The Commonwealth should consider preparing separate stand alone financial statements for each of the retirement systems that include all of the assets, liabilities, revenues and expenses of each system.

Higher Education Shared Services Center

The Commonwealth should evaluate whether a higher education shared services center would improve the efficiency and accountability of the accounting and student financial aid operations of the community and small state colleges. A secondary goal would be to use the shared services center to reduce the operating costs of nonacademic functions. Problems encountered in recent years at some of the Commonwealth's colleges combined with the significant turnover experienced by many of these institutions as a result of early retirement incentives offered by the Commonwealth in recent years indicate the need to challenge the current approach to providing the back room operations of the state's higher education system.

The use of a shared services center is one approach to improving the accounting and student financial aid operations of many of the smaller institutions of higher education. A shared services center, whether run by a governmental entity or outsourced to a private entity, could provide the following benefits:

- The ability to keep pace with ever-changing technology
- Flexibility and scalability
- The foundation for Internet based e-Business/e-Government
- The ability to enhance responsiveness and customer satisfaction
- Best business processes and practices
- The ability to attract and retain good people
- Optimizing the allocation of existing resources
- Cost savings and cost control
- Better information for management decision making
- Continuous improvement with new ideas and service offerings

Various governmental entities have begun to use shared services centers or similar concepts. In addition, the Apollo Group (University of Phoenix) has used outsourced providers to service both its accounting and student financial assistance functions.

In considering whether to move to a shared services concept the Commonwealth should perform the following steps:

- Complete a business process diagnostic evaluation at a number of institutions;
- Prepare a requirements definition of core financial functions;
- Obtain buy-in from upper management and user institutions;
- Develop documentation deliverables;
- Perform a best practices review of current operations and new technology;
- Research the cost of communications links to the shared services center.

Early Retirement Programs and Service Continuity Planning

In response to the significant budget deficits experienced in recent fiscal years, the Commonwealth has offered an early retirement incentive program ("ERIP") to its employees in an effort to reduce spending. The program was first offered during fiscal year 2002 and resulted in significant reductions in staffing statewide. In response to continuing budget shortfalls in fiscal 2003, the ERIP was enhanced to reduce the statewide workforce even further. Under the ERIP program, only the most critical of positions vacated were filled. This situation, while not new to the Commonwealth, highlights an issue that the Commonwealth must address-ensuring continuity of service in all of its most critical functions.

In many cases, the employees who have accepted the ERIP incentive take with them a wealth of intellectual capital that is difficult for the Commonwealth to replace in the short-term. These personnel reductions have been a prime contributor to the number of noncompliance and internal control findings resulting from the Single Audit over the past two years (from 49 in 2001 to 81 in 2002 and 68 in 2003).

In order to comply with Chapter 647 of Massachusetts General Laws, all departments of the Commonwealth are required to prepare internal controls plans. A significant part of effectively developing an internal control plan is the creation of a department-wide risk assessment. In the current environment, each department-wide risk assessment should address issues related to staff reductions and the loss of intellectual capital to ensure the continued delivery/performance of their most critical functions. Completing the risk assessment and making sure that there are policies and procedures in place to mitigate those risks is critical.

System and Organizational Changes

With a goal of improving the effectiveness, efficiency and economy of Commonwealth operations, the administration is undertaking two major changes—the implementation of a new accounting and reporting system, NewMMARS, and the reorganization of the largest Secretariat, the Executive Office of Health and Human Services ("EOHHS"). The Office of the Comptroller ("OSC") is spearheading the implementation of NewMMARS, while EOHHS, in conjunction with the Executive Office for Administration and Finance, is responsible for implementing the reorganization.

While the goal of such changes is worthwhile, they cannot be undertaken without an assessment of the risks involved. For example, the NewMMARS system which includes within it the PCRS replacement (labor cost management) must be able to continue to interface with other departmental systems, interface with platforms such as the information warehouse and assure that the financial information in MMARS is accurately and correctly converted and carried forward to NewMMARS and that system security and all the appropriate internal controls are also in place. Having controls in place to mitigate such risks is crucial to the financial accounting and reporting and overall operations of the Commonwealth. An independent firm has been preparing for the OSC quarterly risk assessments out of their quality assurance work, which includes staffing change risks. In addition, the vendor, whose software is the basis for MMARS and NewMMARS, on a quarterly basis conducts a second executive quality review of the project's progress including assessing risks and mitigation strategies.

The EOHHS reorganization also has significant risks that must be considered. For example, EOHHS and the 17 departments or divisions under its umbrella are the largest recipient of federal funding. It is estimated that EOHHS and its entities administer more than 100 federal programs totaling approximately $6 billion. Each of these programs comes with its own set of rules, regulations and compliance requirements. Any consolidation or movement of these programs to a new administrative entity must be done so that the specific federal requirements of each grant continue to be complied with or the funding could be jeopardized. Additionally, the reorganization contemplates the consolidation of some administrative functions such as accounting and financial reporting into the Office of the Secretary while the programmatic functions remain with each of the individual departments. The effective coordination of the accounting and financial reporting function with the programmatic function is crucial to the overall operation of all programs but especially for federal programs because many of these federal programs require the Commonwealth to match the federal funds or have a cap on administrative spending. Administrative spending is a significant portion of the costs charged by EOHHS departments to federal programs. Some of these charges are made directly based on actual costs and others are allocated based on indirect cost rates or cost allocation plans prepared in accordance with Office of Management and Budget ("OMB") Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*. As these administrative services are reconfigured, the methodology for billing costs to federal programs must be revisited, revised as appropriate and submitted to the federal government for approval. Organizationally separating these functions makes this coordination more difficult and must be done so that each of the functions understands the others' role with open and frequent communication.

In the Early Retirement Programs and Service Continuity Planning comment above, it was recommended that departments complete a risk assessment to address the reductions in staff and corresponding loss of intellectual capital to respond to budget deficits. The two major changes discussed here must also have a risk assessment completed and it should include the reductions in staff and loss of intellectual capital.

Employee Recognition Programs

As the Commonwealth enters the uncertain economic period of 2003/2004 it is important to look at programs that produce cost savings while at the same time rewarding and retaining the resources needed to run the business of government. The impact of the loss of talented, experienced employees has been evidenced throughout the Commonwealth in the wake of the ERIP program. At this time, it is more important than ever to ensure that the retention of talented employees is a high priority.

The Pride in Performance in Massachusetts program has cut back on the emphasis of employee recognition for excellent performance in recent years. At one time, excellence was rewarded with public recognition at a formal dinner. Currently, such performance is rewarded with a brief reception the attendance at which is strictly limited.

Rewarding and retaining talented employees has always been a challenge for governmental entities. It is always more of a challenge to reward employees in tight economic times which, unfortunately, generally correlate to the periods when these individuals are also being asked to do more with less. In looking at models from other states, several programs are worth noting.

One idea is a “Shared Savings Program” modeled after similar private sector models. This program encourages employees to submit ideas for managing, building or buying something more efficiently. Any actual savings go into a special account and, after a year, half of the savings recognized in the department goes to the department employees.

A second idea is a quality service award, which allows individual employees to earn financial recognition for accomplishments. The program awards up to $10,000 to one person or to a number of people. Massachusetts does have the Carballo award which awards up to $1,000 to one person or group.

While other types of programs exist, the goal for Massachusetts should be to reward talented employees while reducing overall costs and improving operational efficiency.

Workers’ Compensation and Group Health Insurance

The Commonwealth should establish a funding schedule to accumulate assets to satisfy the current under-funded liability related to the internal service funds. As of June 30, 2003, the unfunded liability for the workers’ compensation and group health insurance funds was $287.2 million and $46.9 million, respectively. Under the new reporting model, these balances represent accumulated liabilities and, as such, are reported as liabilities in the governmental fund statements directly reducing the net assets of the Commonwealth. Ultimately, these and other obligations could result in a negative net asset position.

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 OSC and the legislature should coordinate their efforts to evaluate all options and select the most appropriate steps to satisfy the existing liabilities and fund future liabilities as incurred.

Education Program

The recently implemented governmental reporting model requires governments to provide basic financial statements both at a fund level, similar to what has historically been reported for governmental entities, and at a government-wide level. The latter perspective of reporting is intended 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 inclusive of all debt and long-term assets places a greater emphasis on the question of whether the government as a whole is better or worse off than the previous year.

This emphasis on financial condition is similar to the emphasis on the issue of intergenerational equity. This focus should be on the development of plans to pay for long-term obligations, both debt related and nondebt 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 maintaining of a net asset balance that demonstrates a sound and stable financial condition with sufficient resources to offset economic downturns.

The concepts defined above are commercial in nature and are not consistent with the manner in which governments have historically done business. Part of the rationale for the development of the new reporting model was to begin to change those historical perspectives. Given the change in focus discussed above on the overall financial condition of the Commonwealth and the issues of intergenerational equity that are inherent to the new financial reporting model, the OSC should consider developing a training program focused on educating the administration, the legislature and other potential users of the financial statements about these concepts.

These concepts are all tied to the notion of sustainability. Sustainability is the notion that current economic and consumption patterns should not reduce opportunities for future generations by depleting or impairing resources. Many businesses worldwide have demonstrated that they can operate profitably while employing sustainable practices. Similarly, many governments have adopted and implemented sustainable policies and business practices.

To that end, financial statement models should be developed that demonstrate the implications of the Commonwealth's long-term capital, debt related and nondebt related needs and stress the need for plans to support the future financing of obligations and assets together with the implications of legislative action on financial reporting. This will ensure that decisions made at the legislative level will be consistent with best interests of the taxpayers of the Commonwealth.

Activity-Based Costing

Measuring the cost of government services is useful for a variety of purposes, including performance measurement and benchmarking; setting user fees and charges; privatization; competition initiatives or managed competition; and activity-based costing. Management, 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. While the concepts of effectiveness and efficiency are an essential part of any analysis of the services provided by a government, activity-based costing is an approach used by many governmental entities to determine the true cost to deliver a service.

The Commonwealth benefits from having agencies like the OSC employing activity-based costing models as part of the overall management reporting systems. These models allow the Commonwealth to more accurately determine the benefits of such items as electronic benefits transfers, payroll direct deposits or the privatization of an activity and provide legislators with valuable information to assist in making informed decisions regarding the cost of services provided. We recommend that the Commonwealth consider pilot projects determine the cost of activities and services that are currently under review for changes in their processes. These pilots should then be used to develop a process for calculating the cost of a broad range of Commonwealth activities.

Service Efforts and Accomplishments Reporting

A key responsibility of state and local governments is to develop and manage programs and their related resources as effectively and efficiently as possible and to communicate the results of these efforts to the stakeholders. To that end, a major focus in government today is departmental accountability. Service Efforts and Accomplishments Reporting ("SEA"), as summarized in the Government Accounting Standards Board ("GASB") Concepts Statement No. 2, "Service Efforts and Accomplishments Reporting," measures performance through various indicators and attempts to gauge departmental efficiency. Performance measurements when linked to the budget and strategic planning process can assess accomplishments on an organization-wide basis. When used in the long-term planning and goal setting process, meaningful performance measurements assist government officials and taxpayers in identifying financial and program results, evaluating past resource decisions and facilitating qualitative improvements in future decisions.

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 in achieving its primary purpose 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. These decisions take on an added level of significance as the Commonwealth continues to be asked to provide greater levels of service during a period of diminishing financial resources.

An expanding number of governmental entities presently are developing and using SEA measures. GASB may ultimately require this reporting as part of the entities basic financial statements. In fact, GASB has recently issued a document entitled, "Reporting Performance Information; Suggested Criteria for Effective Communication." This document, dated August 2003, provides GASB's perspectives on the reporting of performance information.

We suggest 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.

Investor Relations Programs and Related Disclosures

The Commonwealth should review its investor relations program. An effective investor relations program that responds to the informational needs of investors, bond insurers, liquidity providers, rating analysts, credit enhancers, counter parties and other constituents interested in obtaining financial and operational information on issuers can reap many benefits to the Commonwealth including the possibility of lowering the Commonwealth's ultimate borrowing costs.

In spite of other events that have occurred over this past year in the securities markets, the Securities and Exchange Commission ("SEC") continues to focus on municipal securities and investor information because of the emerging dominance of individual investors in the municipal market. More than 70% of the outstanding obligations are held by or for individuals either directly or through bond funds and nearly 40% of the total is held by individuals themselves or in their personal trust accounts. Because many investors purchased their bond holdings in the secondary market, the disclosures to that segment of the marketplace are receiving a growing level of attention. The SEC has begun to focus on the information contained on governmental Web sites and whether the information has the potential to mislead investors. Properly used, the Web site is an important element of an investor relations program and an aid in complying with the SEC rules applicable to governmental securities.

The Government Finance Officers Association ("GFOA") has issued a recommended practice on "Maintaining an Investor Relations Program." The centerpiece of the GFOA program is a commitment to provide annual financial, operating, and other significant information in a timely manner consistent with federal and state laws and SEC rules. Issuers were encouraged to consider addressing the following concerns:

- Identify individuals responsible for speaking on behalf of the issuer.
- Develop procedures for identifying and selecting information, both positive and negative, to be made available to investors.
- Develop procedures for disseminating information so that it gets to all parts of the market simultaneously and not just selected investors.
- Develop procedures to ensure potential investors receive a copy of the preliminary official statement at least one week in advance of a bond sale.
- Identify ways to stay abreast of issues that are likely to be of concern to investors.
- Develop and maintain a good relationship with rating agencies.
- Establish procedures to ensure that financial statements or other information needed for disclosure purposes are completed on a consistent schedule from year-to-year and prior to the date established in any contractual commitments.
- Delineate clearly the roles and disclosure responsibilities in conduit borrowings.
- Engage in marketing activities to alert investors of a pending bond sale.
- Identify investors who hold the issuer's bond to improve communications.
- Be aware that legal issues may exist with respect to securities information provided by electronic means.

Recent industry publications have described examples of investor relations programs and specifically the fact that most investors do not accept the minimal disclosures required by SEC Rule 15c2-12 as sufficient. The following steps, over and above what has been recommended by the GFOA, have been recommended as ways that such programs may be enhanced:

- Conduct research into the legal requirements.

- Examine the information needs of the bond rating agencies, bond insurers and underwriters regarding their requirements to comply with SEC and Municipal Securities Rulemaking Board rules.

- Develop a cover sheet for all filings with the Nationally Recognized Municipal Securities Information Repositories ("NRMSIR") that contained CUSIP numbers. Such a cover sheet is to accompany all filings and is necessary for the NRMSIR to be able to tie disclosure documents to specific bond issues.

- Add an "investor relations site" to the government Web page.

- Develop a quarterly investor newsletter that is posted on the Web site.

In the current environment and in consideration of recent scrutiny that has been given to the Commonwealth by the SEC, the development of such a program can only enhance its relationships with both the investor community and the SEC. In addition, by providing information directly to the investor community and increasing confidence in the marketplace, the Commonwealth may ultimately increase investor interest in the debt with a corresponding lower interest rate.

Use of Comparative Trend Data for Financial Analysis

The Commonwealth's Comprehensive Annual Financial Report ("CAFR") provides a wealth of data that the Commonwealth and other interested users can use to analyze the Commonwealth's financial position. Of course, considering financial data in isolation can lead to inappropriate conclusions—appropriate context is essential for sound interpretation. Accordingly, comparative trend data for the Commonwealth itself may not provide the users of the financial statements with sufficient data to make appropriate decisions.

The Commonwealth should consider providing information about other states on its Web site that would allow users a tool for peer analysis. The decision as to which other states ought to be included should take into consideration population and demographic data, programmatic similarities and other factors that would lead to effective comparison. The rationale for the states included could also be provided. Such information can be obtained from the CAFR published for those states or through industry associations such as the GFOA or the National Association of State Comptrollers.

Compliance with Chapter 647, the Internal Control Act

Massachusetts General Law, Chapter 647, *State Agencies Internal Control Act of 1989* ("Chapter 647"), outlines internal control standards, defines the minimum level of internal control systems and establishes the criteria against which internal controls will be evaluated. Chapter 647 also states, "Internal control systems for the various state departments shall be developed in accordance with guidelines established by the Office of the Comptroller." The OSC has issued written guidance in the form of the Internal Control Guide for Managers and in 2001, the Internal Control Guide for Departments. Departments implement Chapter 647 and these Guides through a document known as the departments' internal control plan.

Since the passage of Chapter 647, the OSC, in addition to publishing the above-mentioned guides, has assisted departments, when requested, in developing internal control plans; conducted training sessions on internal controls and risk assessments; and in conjunction with the Office of the State Auditor ("OSA"), reviewed departmental internal control plans upon request or as part of the statewide Single Audit. The Single Audits starting in 1999 have been used as a vehicle to promote the OSC's internal control campaign and emphasize compliance with Chapter 647 and the guides.

The 2003 Single Audit continued the work of the prior four audits. The team comprised of personnel from the OSC, OSA and the independent audit firm completed reviewing the department-wide risk assessment component of all 157 department's internal control plan.   Feedback letters, jointly signed by the OSC and OSA, were provided to the departments whose risk assessment review was complete. The team found that most departments have made a good faith effort to document their top five to ten department-wide risks. However, improvements are still needed. For example, some departments continue to think only in fiscal terms to the exclusion of programmatic risks, some departments' risks did not align with all of the important goals of the department and some provided risks that were at a level lower than department-wide. Work also began with a few departments whose risk assessments were judged to most fully comply with the guides to show that they have internal control policies and procedures in place to mitigate those risks.

The OSC's internal control campaign has had significant results and is continuing so that the intent and spirit of Chapter 647 and the guides can be more fully realized. To this end:

- The OSC and OSA should continue to have departments show that they have internal control policies and procedures in place to mitigate the risks detailed in their risk assessments;

- The OSC should continue to work with those departments that have developed internal control plans that most closely comply with the guides to be used as a model for other departments to follow;

- The OSC should consider developing a template or model internal control plan or risk assessment component for those departments with common operations, such as the 15 community colleges and the 10 sheriffs' offices; and

- The OSC and the OSA should continue to evaluate the need to amend Chapter 647 to reemphasize and reenergize the internal control focus.

OFFICE OF THE COMPTROLLER

GAAP Packages

All departments are required by the Commonwealth to submit a "GAAP Package" to the Financial Accounting and Reporting Bureau ("FRAB") of the OSC. The purpose is to properly accumulate the information needed to report the Commonwealth's financial condition under accounting principles generally accepted in the United States of America ("GAAP") in accordance with the standards promulgated by GASB. OSC distributes instructions to all departments detailing the information needed, including accruals for receivables, leases and other balances.

The OSC set August 4, 2003 as the submission deadline for the GAAP Packages. Thirty-two priority III departments failed to submit a GAAP Package for fiscal year 2003. Many of these departments also failed to file GAAP Packages in prior years as well. This forces FRAB to make certain estimates and assumptions (concerning payroll, number of employees, etc.) in order to prepare statements. Although these priority III departments are immaterial individually and in the aggregate, the amounts should be reported to provide an accurate financial picture.

The OSC should continue to communicate with chief fiscal officers in upcoming meetings the need to prepare this package in a timely manner.

Accounting for Fixed Assets

The Commonwealth's fixed assets system is outdated and is not capable of reporting all of the fixed assets information required to be reported in the Commonwealth's financial statements without a significant amount of manual intervention. Specifically, the system is incapable of calculating the annual depreciation charge for the Commonwealth's fixed assets. In addition, inconsistent use of the fixed assets system by the colleges and universities has resulted in significant amounts of data in the fixed assets system that is outdated and inaccurate.

In order for the Commonwealth to effectively report its fixed assets, the data in the fixed assets system must first be sorted to exclude the institutions of higher education. The adjusted data is then reconciled to the MMARS system and downloaded into a series of spreadsheets which are used to calculate depreciation expense and to track cumulative depreciation charges and net book value. Once complete, fixed assets need to be trued up to include fixed asset balances for its institutions of higher education and its component units, as reported by those entities in stand- alone audited financial statements.

While these processes are functional, they are not subject to systematic controls and are highly subject to error. The Commonwealth is in the process of implementing a new financial accounting system that will be capable of managing this data more effectively and will be able to calculate depreciation expense. Until such time as that system becomes operational, however, the OSC should introduce internal controls sufficient to mitigate the risks that are created by the use of these nonsystematic processes. At a minimum, all of the data in the fixed asset spreadsheets should be independently reviewed, spreadsheet formulas should be re-calculated and analytical spot checks should be developed to assist in assessing the integrity of the data.

Submission of Departmental, Higher Education and Component Unit Financial Statements

The OSC requires all separately audited departments, institutions of higher education and component units to submit audited financial statements to them by October 15. This deadline is in place to ensure that all audited financial statements are ready for inclusion in the Commonwealth's GAAP basis financial statements and CAFR. Several of these entities, including the University of Massachusetts Building Authority, the Massachusetts Highway Department's Owner Controlled Insurance Program and Roxbury Community College, did not submit their final audited financial statements to OSC prior to the deadline for completion of the CAFR audit. Currently, the Comptroller has no means by which to enforce compliance.

The failure of separately audited entities to report in a timely manner has always been a concern for the Commonwealth. However, the recent addition of an entity-wide financial statement as a required financial report by GASB raises this issue to a new level. The entity-wide model links the reporting of the Commonwealth's activities as never before. It is now possible for a single department, institution of higher education or component unit of the Commonwealth to put the Comptroller in a position to be unable to comply with the statutory reporting deadline for the Commonwealth's GAAP basis financial report.

The OSC should continue to hold group and individual meetings with the various entities to encourage an ownership interest and better understanding of their importance in the Commonwealth's financial statements. Discussions should continue to focus on the disclosures needed in the entities' financial statements in order to meet their responsibility to comply with standards established by the GASB. The entities should include in their contracts with their independent audit firms the deadlines for their submission to OSC.

In addition to each of these steps, the Comptroller should consider working with the legislature to formalize in statute the requirement to submit audited financial statements in accordance with deadlines established by OSC and to provide some measure of enforcement for failure to comply.

Settled Yet Unpaid Legal Cases

A number of lawsuits, arising from the ordinary course of operations, are pending or threatened against the Commonwealth. The Office of the Attorney General ("AGO") is responsible for tracking and reporting on these lawsuits. The OSC is responsible for maintaining the official books and records of the Commonwealth. Once a case is settled, AGO provides documentation of all cases settled to the Department Assistance Bureau ("DAB") of OSC with judgments against the Commonwealth. The DAB is then responsible for paying the settlement amount to the appropriate party.

The Financial Reporting and Analysis Bureau ("FRAB") in the OSC has been working with AGO, along with the Commonwealth's auditors, to enhance the reporting of information provided by AGO to FRAB for inclusion in the Commonwealth's financial statements.

Annually the AGO estimates a liability for cases in which a probable loss will be incurred and the amount of the potential judgment. The current portion of this liability is reported in the appropriate governmental funds and the long-term portion is recorded as a non-current liability in the statement of net assets within the government-wide financial statements. In addition, the AGO confirms the cases in which the Commonwealth has been successful.

Issues arise, however, in the ability to roll forward activity reported in the prior year. It is often difficult to track down information on cases pending from a prior period that have been settled and the roll forward typically does not take into account any cases that are presented and settled during the same fiscal year.

AGO, DAB and FRAB under the direction of the Comptroller should work together to develop roll-forward procedures and develop controls to ensure the tracking of all cases, including dismissed cases, on a quarterly or semi-annual basis.

Cash Management Improvement Act ("CMIA")—Record Maintenance

The Commonwealth is required by the provisions of CMIA to re-confirm its clearance patterns with the federal government at least once every five years. The newest agreement relating to clearance patterns took effect on July 1, 2002. In our testing of these clearance patterns in the current year, inconsistencies were noted between payroll clearance patterns noted in the agreement and those calculated as a result of our testing. While this matter was ultimately resolved and the Commonwealth deemed to be in compliance, it became apparent that as a result of turnover in the Office of the State Treasurer ("Treasury") and in the OSC, no one had maintained responsibility for retaining documentation in support of the clearance patterns agreement.

The Commonwealth receives several billion dollars of federal funds on an annual basis. The CMIA agreement and all related ancillary agreements are a critical matter of compliance for the Commonwealth. We recommend that the OSC and the Treasury each identify a point person to oversee the management of compliance with this agreement. Those individuals should be responsible for maintaining all documents that support the CMIA agreement and for demonstrating compliance.

Clarification Needed Concerning the Degree of Responsibility the Office of the Comptroller Assumes for Section II Costs

The OSC is responsible for preparing the Statewide Cost Allocation Plan ("Plan") for Section I costs, which identifies and allocates the allowable costs of Central Service Agencies ("CSAs") to benefiting departments. When the Plan is approved by the U.S. Department of Health and Humans Services, Division of Cost Allocation ("DCA"), an agreement ("Agreement") is signed by the Comptroller and DCA, which cover both Section I and Section II costs. Section II costs are those fringe benefits and other services that are directly billed from seller to user departments.

There appears to be some confusion as to the degree of responsibility OSC assumes for the rates developed and billed by other agencies when the Comptroller signs the Agreement. For instance, in fiscal year 2000, as a result of resolving a 1999 Single Audit finding for the Information Technology Division ("ITD"), DCA indicated that an individual within ITD did not have to certify that their rates were prepared in accordance with OMB Circular A-87, or other federal requirements as the Comptroller did so by signing the Agreement. A review of ITD's rates is not performed by OSC. It is uncertain what other Section II rates have not been certified by seller departments.

The OSC should identify those rates that are not certified by the seller departments and either review them or have the seller departments certify them.

Simplification in Handling Terminal Leave Should Be Considered

Currently, indirect cost rate agreements are negotiated to assess overhead based on all object codes within state employee compensation. Under an agreement with the U.S. Department of Health and Human Services, DCA, terminal leave, which is accounted for as compensation, must be treated as a fringe benefit cost and cannot be assessed indirect costs.

In accordance with Comptroller Policy Memo No. 316, terminal leave charges are initially recorded as compensation in the federal grant appropriation accounts from which they are paid. In order to ensure that indirect costs are not ultimately charged to federal awards, departments are first required to request a change in the Position Account Assignment Rule and, upon approval, immediately transfer terminal leave costs to the Central Terminal Leave Reserve Account managed by the OSC. The OSC does monitor charges to federal accounts and contact departments that have not completed the request for approval and transfer of costs on a timely basis. This multi-step process to ensure terminal leave is not directly charged to a federal program or assessed indirect costs does not appear to be as efficient as possible.

The OSC should consider streamlining the process by immediately transferring terminal leave directly to the central account. This would by pass the need for departments to request a Position Account Assignment Rule change, and eliminate the need for the OSC to approve all requests for the transfer of terminal leave yet still allow the OSC to monitor compliance with federal and state regulations through review of the Central Account.

OFFICE OF THE STATE TREASURER AND RECEIVER GENERAL

Long-Term Debt Management—Operational Review

The Treasury is responsible for managing the Commonwealth's long-term debt activity. Managing the Commonwealth's $15.9 billion debt portfolio is a very complex process that involves, among other things, working with departments and agencies from across the Commonwealth to estimate cash needs for capital spending, managing and paying obligations currently outstanding, ensuring compliance with federal arbitrage regulations, reading market conditions to identify potential refunding opportunities, working with underwriters and bond counsel and taking Commonwealth bonds to market. In recent years, this process has been further complicated by the complexity of transactions that the Commonwealth has entered into, including innovative refunding transactions and variable rate bonds that involve imbedded derivatives. The costs of managing this program are significant and the risks are great.

During the fiscal year ended June 30, 2003, the Commonwealth sold approximately $5 billion in general obligation bonds and notes through competitive and negotiated sales. The costs for legal counsel and underwriting fees were approximately $667,000 and $22.3 million, respectively. In addition, the Commonwealth paid approximately $166,000 for disclosure counsel purposes.

From a risk perspective, accounting and disclosure associated with complex debt instruments is of high concern. In recent years, the Commonwealth has been the subject of an investigation by the SEC. Though that matter was recently settled by the SEC with no sanctions being brought against the Commonwealth, it helps to highlight a growing interest by the SEC into the area of municipal securities. Over the last several years, the SEC has made it abundantly clear through public speeches that the municipal securities market needs to be looked at with greater focus.

The debt management operations of the Commonwealth represent one of the highest cost, highest risk functions of the government. The recent change in administration makes this an opportune time to undertake a project to perform a top to bottom review of its debt management function. That process should focus on controls, organizational structure and responsibilities, procurement, risk management, cost/benefit/risk assessment of the structure of deals and overall cost savings. As an example, management may want to assess the efficiency of the processes that are currently in use by comparing the Commonwealth's processes to best practices in place in other state and local governmental entities.

Float Fund

The Treasury's Float Fund has not been effectively reconciled for several years. At June 30, 2003, the Float Fund variance is approximately $30 million. While the variance appears to ultimately inure to the benefit of the Commonwealth, the inability to reconcile this account on a monthly basis is an internal control deficiency that needs to be addressed.

The Float Fund is a clearing account for all disbursements made by the Commonwealth. In addition to serving as a clearing account for the primary operating accounts maintained by the Treasury, however, the Float Fund also includes the activity from several accounts that are maintained at remote locations throughout the Commonwealth, such as the Department of Corrections. Treasury does not receive information supporting any of the transactions processed by the remote accounts making a complete reconciliation almost impossible to perform.

As part of the banking transition that is scheduled to take place in fiscal year 2004, Treasury should consider implementing rotating clearing accounts. All activity in the current clearing account should be frozen effective as of the date of the transition. Once frozen, multiple clearing accounts should be created. One account should be set up to account for the clearing activities of the primary operating accounts and a second should be established to account for the activity in the remote accounts. On an annual basis, those accounts should be closed and new accounts opened to handle clearing activity for the current year. Once closed, the activity in these clearing accounts should be allowed to "run out" for a reasonable period of months after year end. All unresolved matters after that period should be assessed to determine whether or not the remaining items need to be transferred over to the abandoned property accounts or whether residual balances should be returned to the Commonwealth's accounts.

In addition to these controls, policies should be implemented to ensure that the Assistant Treasurer for cash management receives documentation for these remote accounts sufficient to allow the Treasury to reconcile the second clearing account on a monthly basis.

As for the existing clearing account, once frozen, that account should also be allowed to run out for a reasonable period of months. As our past experiences with this account would suggest, much of the $30 million variance is likely the result of prior uncorrected errors and other unreconciled variances in this account. At this time, all known items have already been transferred to abandoned property. Any matters that are not addressed after the six month settling period should be transferred into the Commonwealth's abandoned property accounts and remit back to the General Fund once the statutorily mandated period of time has passed.

Deposits in Trust—Safeguarding of Assets

The Deposits in Trust balance includes $1.4 million of certificates of deposit ("CDs") for which the Treasury currently has physical custody. This is a temporary condition that resulted from a change in banking practice by one of the Commonwealth's vendors, but until such time as those assets are transferred to another banking institution the safeguarding of these assets must be considered.

During the period of the audit, the actual certificates were being stored in an unlocked cabinet in an employee's office. A listing of the CDs and their respective values was being maintained by the same employee that has physical custody of the certificates.

We recommend that the Treasury open of an account at a custodial bank as soon as possible to hold these CDs. Until such time as an account can be opened, the certificates should be locked in a file cabinet and a copy of the listing should be maintained by someone other than the employee who has physical access and custody.

Abandoned Property—Independent Review and Oversight

Notification of the contents of deliveries remitted to the Abandoned Property Division in Chelsea is not provided to individuals independent of the receiving function. Although a general listing of the contents is faxed immediately to the Treasury in Boston, a detailed listing of the items to be remitted is not submitted to anyone else in the Treasury.

Detailed records of assets remitted to the Abandoned Property Division should be submitted to an independent party within the Treasury. In addition, periodic audits should be performed by the internal audit function to ensure that assets listed in the abandoned property log actually exist in the physical inventory.

INFORMATION TECHNOLOGY DIVISION

System Development Methodologies Are Not Followed Consistently

The ITD is not consistently following its own application change control procedures. ITD has developed and implemented a comprehensive Systems Development Methodology ("SDM") to be followed when making changes to all application production environments. A SDM if followed properly, ensures that all changes being made to the production environment follow a controlled, approved process that is in accordance with management's intentions. This methodology is not being followed consistently for all changes being made to the MMARS and Information Warehouse ("Warehouse") production environments. Specifically, it was noted that:

- All changes to the MMARS production environment are not governed by consistent documentation requirements;

- The Warehouse is a repository of historical financial information that is updated on a periodic basis to mirror the MMARS production environment. The development methodology utilized by programmers making changes to the Information Warehouse is not the same as the MMARS development process.

When the SDM is not followed consistently for all changes, there is an increased risk that an unauthorized change can be made or that the change does not match the specifications of the user. Of paramount importance is documenting the reason for modifying a program (i.e. service request, problem ticket, etc.) and obtaining user signoff prior to implementation into production, ensuring that overall accountability lies with the user. In addition, if the process utilized for making changes to the Warehouse environment is not the same as that for production, there is an increased risk that the Warehouse will not match production, possibly resulting in critical data loss or misrepresentation of data.

We recommend that ITD management review and amend the current SDM to ensure consistent standards are applied to all changes, including the Warehouse. Once updated, the SDM should be redistributed to all programmers for both MMARS and the Warehouse. Management should stress the importance of following the methodology for all changes being made to the production environment. It is only by increased awareness of all change management requirements and communication of the importance of compliance that it will be followed. Finally, management should consider periodic reminders in the form of memos and emails reinforcing this as well.

Service Levels With Agencies Are Not Documented

The Operations Group currently does not have documented Service Level Agreements ("SLA") with the agencies that ITD services. ITD is responsible for the day-to-day administration, maintenance and upkeep of the servers of approximately 170 agencies that use the ITD Data Center. While the following improvements have occurred, a formalized SLA for the upkeep and maintenance of other agencies' servers does not exist:

- There is an SLA for MassMail, which includes all the agencies using this product;

- A generic SLA is in use with the Division of Medical Assistance ("DMA"), which will be reviewed and finalized in the near future;

- Operational Services Bureau ("OSB") has developed a draft SLA to be used for certain upcoming applications; and

- OSB intends to purchase products and services from an external vendor within the next fiscal year for metric analysis, an SLA template and plans to build an SLA process within ITD.

Service level agreements are essential to outline users' responsibilities and to clearly define expectations. Informal agreements may result in complaints and user dissatisfaction and more importantly, where service levels have not been defined there may not be a reliable basis for assessment of the quality of services rendered and no effective control in terms of responsibility, accountability, measurement, and feedback.

We recommend that ITD develop and finalize an SLA with the agencies it supports. The scope and the depth of this agreement will depend on the nature of the services provided. However, at a minimum, the SLA should include the following information:

- Purpose of the SLA
- Parties included in the agreement
- Details on definitions of key terminology used
- Services/software/hardware supported
- Responsibilities and priority levels
- Escalation charts

Once developed, compliance with the SLA should be monitored. Any changes to the SLA should be updated in the agreement.

MASSACHUSETTS HIGHWAY DEPARTMENT

Need to Centralize the Receipt and Review Process for All Subrecipient Audit Reports

Several sections within the Massachusetts Highway Department ("Department") have agreements with subrecipients. Currently, there is no uniform procedure in place for all sections to receive and review single audit reports for compliance with the provisions of OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. While all the reports selected for testing were found, it was difficult to locate some reports the Department received and one package received did not contain the certified financial statements, which are required under OMB Circular A-133. Upon request, the certified financial statements were subsequently obtained.

Audit operations has been the unit responsible for receiving and reviewing single audits of planning agencies. That unit should be notified when other sections have entered into subrecipient agreements and directed to ensure single audits are received on a timely basis and are compliant with OMB Circular A-133.

Compliance with the CMIA Subagreement

The Department has a subagreement with the OSC relative to the Commonwealth's agreement with the Treasury concerning the CMIA. The subagreement indicates that federal funds should be requested on the fourth day after payments are issued for receipt on the fifth day. During draw down testing at the Department, it was noted that only three days elapsed between payments and the receipt of federal funds. The Treasury-State Agreement requires a three-day clearance pattern. A Department official indicated that the items tested were all electronic funds transfers.

The Department should alert the OSC that it is drawing funds in accordance with the Treasury-State Agreement and not the subagreement.

MASSACHUSETTS TEACHERS' RETIREMENT BOARD

Need for Increased Controls Over Submission of Teacher Retirement Data as Reported to the Teachers' Retirement Board ("TRB" or the "Board")

In order to accurately track Teacher Retirements, the TRB collects data from every school district in the Commonwealth. Chapter 32 of the Massachusetts General Laws requires that the data must be submitted to the TRB within 10 days after the end of the month. This data includes demographic information (name, address, date of birth, etc.), information regarding the individual teachers' retirements (contribution rate, contribution amounts, date of hire, years of service, etc.), teachers' contribution information (percentage of salary withheld, total dollars withheld for the pay period, etc) and the actual amount collected from employee contributions.

In the past, this information was difficult to obtain, because there was no common system for receiving this data. However, in 1997, the TRB developed a uniform reporting format, which is compatible with major commercial payroll-reporting software packages (such as ADP, Munis, etc.). The TRB also developed and provided a reporting software package, currently used by over eighty districts and charter schools. Every year, the TRB holds several regional employer training seminars for school payroll and business officials. The TRB staff also provide on-site training for newly hired school payroll officials and districts having reporting difficulties. Despite the efforts of TRB, certain school districts within the Commonwealth do not submit the data on a timely basis and TRB is required to pursue the data that is not provided by the school districts. At the time teachers within these districts are ready to retire, TRB is unable to process the retirement paperwork because the records are incomplete. This results in retired teachers not being able to receive their retirement benefits in a timely manner. In addition, when the districts do not submit retirement contributions on time, the teacher's overall benefits will suffer since the TRB is unable to earn investment income on contributions that they have not yet received. Moreover, several schools have not yet adopted compatible payroll software packages causing errors when TRB compiles information. TRB has controls in place to notify a change from previous periods so the errors are detected. However, as a result of the errors further delays are occurring while TRB corrects all errors.

Chapter 32, Section 18, Paragraph 1A, states: "If the Board. …determines that there has been an unreasonable delay in filing of any.…required information, the board,…shall so notify in writing such treasurer or other disbursing officer. If within thirty days thereafter, the board…has not received such required information, the board ….may petition the superior court to compel compliance with this section and enforce the penalty there under."

In order to remedy the current situation, the Board should continue to notify the members responsible for reporting the districts' information and remitting the appropriate contributions. If all else fails, the TRB should use the option of petitioning the superior court to enforce compliance.

The Board has submitted legislation that would require local school districts to submit monthly data and contributions on a timelier basis or be subject to an interest penalty.