COMMONWEALTH OF MASSACHUSETTS

Management Letter
Year Ended June 30, 2006

Commonwealth of Massachusetts
Management Letter
For the Year Ended June 30, 2006

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December 21, 2006

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, 2006, on which we have issued our report dated December 21, 2006, 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. Such consideration would not necessarily disclose all matters in the Commonwealth's internal controls that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the Commonwealth's internal controls and their operations that we consider to be material weaknesses as defined above.

We did note 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, 2006. Our comments, arranged by department, are presented on the following pages.

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.

Yours truly,

Deloitte & Touche LLP

STATEWIDE OBSERVATIONS

Information Warehouse and Business Process Assessment

The MMARS financial management system was implemented in the fiscal year 2005. One significant change with the new system is that some information previously provided to departments through standard monthly reports must now be obtained by creating information warehouse queries. The management of the departments of the Commonwealth needs to continue training their staff to ensure proficiency in the use of both the MMARS system and the information data warehouse. Departments need to be staffed with skilled personnel, familiar with the MMARS and capable of writing queries to obtain the needed information from the warehouse. This is noted most significantly in departments that manage federal grants because of the complexity of tracking federal grants in the new system and the additional controls and responsibilities that these departments have in accounting for and managing federal programs.

Along those same lines, management should continually reassess internal business processes and procedures to ensure that they have evolved and continue to evolve with the systems. Management needs to be certain that current business process not only maintain an adequate level of internal control but also support efficiency of workflow. Departments should take the initiative in developing the queries they need such that there is a consistency of data received on a month-to-month basis. The Office of the Comptroller ("OSC") -- should also continue to dedicate resources to assist the departments not only in the use of the new system and writing queries but also in improving business processes and resolving problems.

Reporting on the Commonwealth's Retirement Systems

The Commonwealth is unique among state government in that it does not have separately prepared and audited public employee retirement system financial statements. An independent auditor, as part of a single financial statement, audits only the investments and related investment activity of the Commonwealth's three public employee retirement systems, the State Employees Retirement System, the Teacher's Retirement System, and the State-Boston Retirement System. Accordingly, there is no comprehensive financial statement for the individual plans. Information on the individual systems may be pieced together from the Commonwealth's financial statements. But even then, the presentation combines all three retirement systems, further limiting the ability to assess each plan on an individual basis. This reporting model actually requires the OSC to piece together the components of the financial statements of the plans in order to prepare the statewide financial statements. In that the responsibility for managing the plans does not rest with the OSC, it is not appropriate for the responsibility for financial reporting for those plans to rest with that office.

The Commonwealth should direct PERAC to work with the Retirement Boards to prepare separate stand-alone financial statements for each of the retirement systems that include all of the assets, liabilities, revenues, and expenses of each system.

Other Postemployment Benefits

During the current year, the Commonwealth undertook an evaluation of its obligations for other postemployment benefits ("OPEB"), that review having been undertaken as the Commonwealth prepares to implement the provisions of Governmental Accounting Standards Board ("GASB") Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. While the implementation of the accounting standard does not require the Commonwealth to fund its OPEB obligations, it does create an accounting mechanism whereby by the failure to fund those obligations on an annual basis, including the amortization of prior service costs, creates real financial statement liabilities for those unfunded costs over time. The legislature should review the magnitude of the OPEB liabilities, approximately $13.3 billion at June 30, 2006 (or $7.6 billion should the Commonwealth use an irrevocable trust for benefits), and consider the implications of funding or not funding those costs on an annual basis. That consideration should look at factors including the Commonwealth's ability to pay, the cost of funding against other spending priorities, and the implication on bond ratings if these liabilities are not funded.

Accounting and Financial Reporting for Derivatives

During the current year, the GASB issued an Exposure Draft, a preliminary policy document, relative to accounting and financial reporting for derivatives. Under current guidance, derivative instruments are not accounted for on the statement of net assets but rather are only disclosed in the footnotes to the financial statements. This Exposure Draft proposes accounting for derivatives in a manner similar to the way in which for-profit companies account for such instruments. Specifically, derivative instruments would be accounted for on the statement of net assets of the Commonwealth and be marked to market with the change in the fair value of those instruments flowing through the statement of changes in net assets. Accounting for and reporting on derivative financial instrument can be a complex task. The Commonwealth is a sophisticated debt issuer with an excess of $17 billion of debt outstanding. The Commonwealth also incorporates a number of higher education institutions and other component units which are de-centralized from the accounting function in the Office of the State Comptroller but which also have the ability to issue bonds. The Office of the State Treasurer has issued a derivatives policy as part of its long-term debt policy which defines how the Commonwealth and its agencies and component units must address the use of derivatives. Though enactment of any formal derivatives standard by the GASB is likely to be several years away, we think it is important for the Office of the State Treasurer and the Office of the State Comptroller in conjunction with the Office of Administration and Finance to begin to look at what has been proposed by the GASB and the implications of that policy on the Commonwealth's financial statements in order to assess whether any modifications to the existing derivatives policy would be appropriate. We further recommend that these parties also begin a campaign to educate the institutions of higher education and the component units about what has been proposed for the purpose of ensuring these institutions understand the potential long-term implications of derivative-type activity on their financial reporting.

Performance Measurement for Decision Making

A key responsibility of state and local governments is to develop and manage programs, services, and their related resources as efficiently and effectively as possible and to communicate the results of these efforts to the stakeholders. Performance measurement 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 and linked to the entity's mission, goals, and objectives, meaningful performance measurements assist government officials and citizens in identifying financial and program results, evaluating past resource decisions, and facilitating qualitative improvements in future decisions regarding resource allocation and service delivery.

We recommend that management consider adopting a plan for program and service performance measures to be used as an important component of long-term strategic planning and decision making. These measures should be linked to governmental budgeting as recommended by the Government Finance Officers Association ("GFOA"). The GFOA encourages all governments to utilize performance measures as an integral part of the budget process. Over time, performance measures should be used to report the outputs and outcomes of each program and be related to the mission, goals, and objectives of each department. In the final analysis, GFOA recognizes that the value of any performance measurement program is derived through positive behavioral change. Stakeholders at all levels must embrace the concept of continuous improvement and be willing to be measured against objective expectations. GFOA urges governments to recognize that establishing a receptive climate for performance measurement is as important as the measurements themselves.

The Commonwealth has taken steps in this area by making information available online about the 50 states for comparison with Commonwealth operations, as previously recommended. The Commonwealth also hired a consultant to assist in the benchmarking of its finance activities. These are positive steps which provide valuable information to the Commonwealth's stakeholder. We encourage the Commonwealth to continue to pursue such activities and look for opportunities to provide additional information which can be used to benchmark the Commonwealth's performance.

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 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 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 as part of its initiative for performance measurement and benchmarking, to 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.

Electronic Signatures

Federal legislation enacted in 2000, the *Electronic Signatures in Global and National Commerce Act* (the E-Sign Law), made electronic signatures and electronic contracts just as legally enforceable as traditional paper contracts signed in ink. Therefore, a digital signature is to an electronic document what a handwritten signature is to a paper document. However, a digital signature can provide additional assurances and security in linking an electronic document with the signer. The recipient of a digitally signed document can verify that both the document originated from the person whose signature is attached and that the document has not been changed since it was signed. Additionally, the signer of the document cannot later claim his digital signature was forged.

The term "electronic signature" is a generic, technologically neutral term that refers to the variety of ways a person can indicate their connection with an electronic document. Examples include:

- a symbol – sound or voice print
- a name typed at the end of an e-mail
- a digitized form of a handwritten signature
- a unique password, code, or PIN
- biometrics (retina scans, fingerprints, etc.)
- a digital signature created using encryption technology

The E-Sign Law does not define what an electronic signature is or what technologies can or should be used to create one. The law establishes only that E-signatures in all their various forms qualify in the legal sense and leaves it up to the free market to determine which methods will be used. Many kinds of E-signatures offer very little security. If someone uses an unsecured method (such as a scanned image of a handwritten signature), it could be stolen and used for fraudulent purposes. Stolen E-signatures have the potential to become as widespread a problem as credit card scams and stolen passwords.

The Commonwealth began the use of electronic signatures a few years ago. At that time, there was some reluctance on the part of some departmental managers to make the switch from handwritten signatures on a paper document. The reluctance is now diminishing and, therefore, the use of electronic signatures is more prevalent. As such, the Commonwealth should revisit its electronic access policies and procedures to ensure that controls are in place to prevent any problems. The GFOA recommends that state and local governments continue to improve electronic access to their services and information by other government entities and the public. When the identity of contact and/or the contents of the information received must be authenticated, the use of a secure form of electronic signatures is encouraged. Governments should look for solutions that accomplish the following:

- There is a permanent attachment of a signature to the related document (for example, via a PDF or similar document that cannot be altered or via appropriate encryption).
- There is a permanent audit trail of the electronic signature.
- If changes are made to the documents, it will automatically alert the reader of those changes.

Additionally, the government should consider the following when setting up their electronic signature policies:

- Assess the risk of fraud, error, or misuse of the various types of electronic signatures.
- Assess the cost-benefit on different alternatives of electronic signatures.
- Consult legal counsel on the implications of using electronic signatures.
- Develop plans for retaining and deleting electronic information and employee access to such information.
- Seek input from technology experts.
- Perform periodic review and reevaluation as appropriate.

Managed Competition as a Service Delivery Option

Governments are continually tasked with providing high-quality services within the constraints of limited financial resources. In order to meet this challenge, many governments have turned to the private sector or other governments as an alternative to in-house service delivery as potential ways to save money or improve services. One choice within potential service delivery options is managed competition, in which governments require in-house service units to compete with external providers.

The GFOA recommends that governments systematically identify and evaluate the major factors in considering a managed competition option. Service level, cost, efficiency, effectiveness, quality, customer service, and the ability to monitor the service provider's work should be essential components of any managed competition decision**.** In addition, governments should clearly define the service parameters in the expected service delivery. When evaluating whether to undertake a managed competition initiative, governments should consider the following key points:

(1) Executive Direction. The heads of government must support a move toward a managed competition service delivery model. Support from the government's executive and legislative leadership is essential. The

governmental leaders should establish clear expectations and standards for such an initiative. It is necessary to have a transparent process.

(2) Environmental Consideration. Consideration must be given to how managed competition is affected by demographics, the economy, geography, citizen sensitivity, and the local political environment. Organizations are encouraged to closely evaluate the strengths and weaknesses of the jurisdiction relative to the managed competition option. Consideration should also be given to an analysis of opportunities and threats on the environment external to the organization. A look at how other communities have fared with managed competition for that particular service may be necessary.

(3) Stakeholders' Support. Stakeholders need to be appropriately involved. Stakeholder groups may include unions, employees, media, advocacy groups, local businesses, and the public. By involving stakeholders in the managed competition process, governments will have a better opportunity to convince stakeholders of the value of a competitive service model.

(4) Legal Ramifications. Issues associated with employment law compliance and existing labor agreements must be considered. If a switch to managed competition affects union employees, options like workshops, meetings, and open forums should be considered to communicate to labor unions the possible benefits of managed competition. Human resource impacts should be a factor when making the determination whether to go ahead with managed competition. As part of the negotiations with potential contractors, thought should be given to hiring the current workforce or retraining current employees for reassignment. It should be noted that shifting a service to a contractor might transfer liability and other risks to the contractor (even though these risks are likely built into the contract price).

(5) Service Availability. The services considered for managed competition should be measured against the availability of the service in the market place. Some services, such as trash collection and building construction, may lend themselves to competition. Fairness of competition should also be analyzed. In addition, consideration should be given to the total investment that the government has made in the current service delivery. A substantial prior investment may preclude the government from entering into a competitive situation.

(6) Cost. The cost decision as to whether to perform a service "in house" or outsource it to an external provider involves four basic steps, as described below. Determining the different cost structures is necessary before proceeding with the request for proposal (RFP). However, cost should not be the only basis in comparing competitive bids. Governments should develop a decision-making process that seeks to account for all relevant factors.

A. Service definition.
B. Calculate the in-house costs that could be avoided by outsourcing the service.
C. Estimate the total costs of outsourcing.
D. Compare the cost savings from outsourcing to the costs incurred.

Employee Recognition Programs

The current state of the world is such that many uncertainties exist about the long-term state of our national economy. As such, it is important for the Commonwealth to be proactive in assessing its current financial condition and the longer- term prospects for the economy. One of the ways to support that is 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, a combination that should combine to increase efficiency, productivity, and "profitability" of the operation of the Commonwealth.

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 luncheon.

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. We recommend that such programs be re-assessed and the value proposition for employees be enhanced to be proportionate with their contributions to the Commonwealth.

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, 2006, the unfunded liability for the workers' compensation and group health insurance funds was $42 million and $76 million, respectively. Under the current financial 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 obligations exacerbate the Commonwealth's negative unrestricted 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 Programs

The Commonwealth is about to experience a change in party in the Governor's Office for the first time in 16 years. As such, the expectation is that there will be significant turnover at the Secretariat level of the government and many new leaders will be coming into government service for the first time. Government financial reporting concepts are unique. For example, 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 government-wide statements are intended to focus attention on the overall financial condition of the government. The display of the overall operations of the government, including all debt and long-term assets, makes it easier to determine whether the government as a whole is better or worse off than the previous year. The fund-perspective reporting focuses on the accumulation and use of current financial resources to support the operations of the government. This dual perspective financial reporting is not a concept that exists anywhere else except for governments.

In the current reporting model, this emphasis on government's overall financial condition is similar to the emphasis on the issue of intergenerational equity, which focuses on the development of plans to not only pay for long-term obligations, both debt related and non-debt related, but also on the need for the repair or replacement of fixed assets and infrastructure. The intergenerational equity 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.

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 non-debt 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. This is particularly important in the Commonwealth because it has a long history of paying for and financially supporting its authorities as well as local government capital projects. The negative unrestricted net asset balance is, in part, reflective of the fact that the Commonwealth is carrying significant long-term debt obligations for assets that are owned by cities, towns, and independent authorities of the Commonwealth. This is a prime example of the type of legislative decisions that are made that have a significant financial statement impact in the new reporting model.

The concepts defined above are commercial in nature and are not concepts on which governments have historically focused. Part of the rationale for the new reporting model was to begin to change those historical perspectives. Given this change in focus and the incoming administration, the OSC should consider developing a training program to educate the administration, the Legislature, and other potential users of the financial statements about these concepts.

Appropriate Level of Fund Balance Reserves in the General Fund

Accountants employ the term "fund balance" to describe the net assets of governmental funds calculated in accordance with generally accepted accounting principles ("GAAP"). Budget professionals commonly use this same term to describe the net assets of governmental funds calculated in a government's budgetary basis. In both cases, "fund balance" is intended to serve as a measure of the financial resources available in a governmental fund.

As has been demonstrated by the recent economic downturn, it is essential that governments maintain adequate levels of fund balance to mitigate current and future risks and to ensure stable tax rates. Fund balance levels are a crucial consideration, too, in long-term financial planning.

Those interested primarily in a government's economic condition are likely to favor increased levels of fund balance. Opposing pressures often come from unions, taxpayers, and citizens' groups, which may view high levels of fund balance as "excessive."

The Commonwealth's mechanism for establishing appropriate levels of fund balance reserves is the Stabilization Fund. That fund, often referred to as a "rainy day fund," is intended to cushion against the effects of an economic downturn. During the period of economic downturn in the early 2000's, the value of Stabilization Fund was clearly demonstrated as the resources accumulated therein were invaluable to the Commonwealth in weathering the economic storm caused by the recession.

Such resources, however, cannot reasonably be accumulated during poor economic periods. The problems in funding such a reserve come from the fact that the "interest parties" outlined above tend to view economic surpluses as bearing an unreasonable burden on the taxpayers during good economic times. In order to counter such arguments, it is incumbent on the legislature to develop well-defined parameters for the Stabilization Fund and to ensure that these parameters are adhered to. These parameters must define the limits of the Stabilization Fund reserves and the intended purposes for its use. The Government Finance Officers Association ("GFOA") has recommended that, at a minimum, governments should maintain fund balance reserves equal to no less than five to fifteen percent of regular general fund operating revenues, or of no less than two months of regular general fund operating expenses, though a government's particular situation may require levels of fund balance reserve significantly in excess of these recommended minimums. Furthermore, the GFOA notes that such measures should be applied in the context of long-term forecasting thereby avoiding too much emphasis upon the level of unreserved fund balance in the general fund at any one time.

In order to achieve these objectives, the legislature should consider defining specific parameters for the development of a "cap" on Stabilization reserves that are in some way tied to expected financial needs. Once defined, the legislation itself should specifically define the intended use of such reserves to counter the arguments of those "interested parties" who would benefit from the Commonwealth electing not to fund such reserves at appropriate levels. The value of the Stabilization in helping the Commonwealth through the most recent economic downturn should not be forgotten. Those funds should be set aside to protect the longer-term financial interests of the Commonwealth.

Statewide Clearinghouse for City and Town Financial Reporting

The Commonwealth receives significant federal funding, which ultimately is passed through to cities and towns in the Commonwealth. When passed through, the cities and towns in the Commonwealth become subrecipients of these federal grants. In order to comply with federal requirements for subrecipient monitoring, the Commonwealth's grantor agencies are required to perform certain procedures to ensure that the federal funds are being expended consistent with the requirements of the federal government. One of those requirements is ensuring receipt of Single Audit reports prepared for each of these municipalities. Because of the diverse nature of the federal grants passed through to cities and towns, many different Commonwealth agencies are responsible for subrecipient monitoring. In most cases, the municipalities are required to submit their Single Audit reports to multiple Commonwealth agencies. To facilitate the subrecipient monitoring responsibilities for the Commonwealth agencies, the Commonwealth should consider developing a mechanism to centralize the receipt of these reports similar to the Federal Clearinghouse, the federal government's mechanism to ensure receipt of Single Audit reports for federal grantees. Creating such a function will allow the Commonwealth departments to streamline their activities to ensure consistency across the Commonwealth. Currently, the Department of Revenue Division of Local Services requires the receipt of financial statements for all cities and towns in the Commonwealth as part of the procedures in place to certify free cash on an annual basis. The existing processes in place in the DOR could easily be modified to also require the receipt of Single Audit reports, thus creating the clearinghouse mechanism recommended herein. Alternatively, a major grant agency like the Department of Education of the Office of Community Development could create a clearinghouse mechanism within its internal audit function. In either scenario, the overall control processes which the Commonwealth is required to employ could be facilitated.

Departmental Float Fund Reconciliations

In recent years, we have reported a reportable condition, which dealt with the inability of the Office of the State Treasurer and the Office of the State Comptroller to effectively reconcile the Commonwealth's Float Fund. The Float Fund is a systemic control in the accounting system, which provides a complimentary control for the Office of the State Treasurer and the Office of the State Comptroller to reconcile the balance of outstanding checks. Efforts undertaken by these departments over the past several years have improved this process greatly in the current year. As part of that process, it was determined that several departments utilized the Float Fund for checks, which were issued remotely by those departments outside of the normal control processes of the Commonwealth. In order to resolve these issues on a prospective basis, the Treasurer and the Comptroller implemented a policy whereby these departments would no longer process transactions through the Float Fund, but rather would account for these transactions utilizing more traditional controls through the use of advance accounts. Advance accounts require current reconciliation of expenditures against advances. We believe this approach significantly improves the overall control processes of the Commonwealth. It should be noted, however, that these departments are still responsible for reconciling the activity in their float fund sub-accounts for periods prior to the implementation of the advance accounting mechanism. The activity in these accounts still needs to be reconciled, in that there is a 13-month window on checks cut by the Commonwealth. The reconciliation of these accounts should focus on what activity remains outstanding 13 months subsequent to the implementation of the advance accounting processes. As such, these departments should undertake efforts in fiscal year 2007 to ensure that activity in these Float Fund sub-accounts from periods prior to March 2006 are reconciled and zeroed out prior to June 30, 2007.

Individual Funds

The number of funds required by the Legislature and used by the Commonwealth hampers the efficiency of the accounting and financial reporting process. In fiscal year 2006, the OSC operating under the requirements of State Finance Law and the requirements of the Legislature, as established through the budget and Massachusetts General Laws, used approximately 103 individual funds to account for the operations of the Commonwealth.

The use of 103 individual funds makes it difficult for either internal or external users of the Commonwealth's financial information to obtain a clear, concise 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 analysis of operations and the detection of errors.

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

The existing fund structure and number of funds has resulted in the following 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 a budgetary practice that is unique to Massachusetts.
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. GAAP requires all fund balance deficits to be reported in the financial statements along with a plan for correcting those deficits. Currently, 10 funds have fund balance deficits.

The following table lists the budgeted, nonbudgeted special revenue, and capital project funds with a statutory fund balance deficit (amounts in thousands) at June 30, 2006:

Budgeted Fund #	Fund Name	Deficit
0101	Highway	$(1,083,108)
0163	Massachusetts Tourism Fund	(140,911)
0107	Government Land Bank Fund	(35,097)
0176	Motor Vehicle Safety Inspection Fund	(16,432)
0200	General Capital Projects Fund	(311,524)
0204	Capital Improvements and Investment Trust Fund	(3,395)
0210	Highway Capital Projects Fund	(247,376)
0278	Government Land Bank Capital Project Fund	(15,000)
0271	Local Capital Project Fund	(14,425)
	Total:	$(1,867,268)

While the legislature has responded to requests in the past from the State Comptroller to manage this problem and significant actions have been taken in recent years to reduce the number of funds and to address some of the structural deficits inherent in these funds, events in recent years have begun to reverse that positive trend. While some funds with minimal activity were repealed in recent years, a large number of funds remain and should be evaluated as to their continued need.

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 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 or not 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.

OFFICE OF THE STATE COMPTROLLER

GAAP Packages

The OSC requires each department to submit a “GAAP Package” to its Financial Accounting and Reporting Bureau (“FRAB”). The purpose of the GAAP Package is to properly accumulate the information needed to report the Commonwealth’s financial condition under 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. Though GAAP packages are only somewhat effective audit tools, they provide another source of communication of accounting policy to small departments between small departments who may not be audited annually and the OSC.

The OSC set August 15, 2006, as the submission deadline for the GAAP Packages. Thirty nine of the smallest departments in the Commonwealth failed to submit a GAAP Package for fiscal year 2006. 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.

OSC should continue to communicate with departmental Chief Fiscal Officers in upcoming meetings the importance of that information and the need to prepare this package in a timely manner.

Fixed Assets Reporting

Timely reporting of fixed assets continues to be a concern. While in prior years, the decentralized nature of the fixed asset reporting system was a large part of the non-timely completion of fixed assets reporting, the new accounting system placed into service during fiscal 2005 was designed to incorporate a fixed assets module to facilitate fixed asset reporting. Despite the new system, fixed assets continue to be a problem area. In the current year, actions taken by the accounting staff resulted in errors in the reporting of fixed assets and depreciation to the point that five months after the end of the fiscal year, the amounts reported for fixed assets and depreciation were not accurate and required a fix “outside” of the system to ensure that balance reported in the comprehensive annual financial report are accurately reported. While we believe that the new system is fully capable of accurately reporting fixed assets, the Office of the State Comptroller needs to look at its existing policies and procedures to ensure a timely reconciliation of fixed assets during the year such that the matter does not create delays in the financial reporting and audit process.

Timeliness of the Closing Process

The Commonwealth’s fiscal year end is June 30. Currently, the closing process is such that auditable fund trial balances are not received until early to mid-October, mere weeks before the statutory deadline for reporting to the legislature. While the Commonwealth is clearly a very large, complex and decentralized organization, the timing of the closing process is such that the current timelines do not allow for the ability to deal with unexpected difficulties should they arise in the closing, financial reporting and audit process without significant effort by the Comptroller’s staff. This issue will be exacerbated in fiscal 2007 as, for the first time in more than 20 years, the Commonwealth will have new auditors. We recommend that the Comptroller perform a detailed review of the current closing process to assess where estimates may be used to facilitate the closing process. Further, the Comptroller’s staff should review the current organizational structure, including roles and responsibilities, to ensure that there is an appropriate balance of responsibilities and an appropriate level of skills in the respective functions of the Comptroller’s office to expedite the completion of financial reporting. This analysis should consider whether or not procedures for a hard close of the Commonwealth’s financial records take place at interim dates throughout the year such that certain account balances, fixed assets for example, are not reconciled on just an annual basis. In doing so, there will clearly be some difficulties, not the least of which are those entities that roll up into the Commonwealth and which are dependent on the submission of information to the Comptroller's office. While it may not be practical to employ processes to perform a hard close on an entity-wide basis, there are many accounts within the control of the Comptroller's office, like the aforementioned fixed asset reporting and things such as the preparation of the Schedule of Expenditures of Federal Awards, which would facilitate the closing process at year end. Further, the Commonwealth should assess the timelines provided to departments for completion of GAAP packages and period 13 reporting to see if those timelines can be accelerated. The new accounting system should facilitate these processes. Management should assess what tools are available in the new system and assess the implications of those tools to existing practices to see where changes might be appropriate. Similarly, the documentation to support certain account balances, such as statutory receivables, is made up of different reports that must be combined to arrive at the balances reported in the Commonwealth's financial statements. These audit trails often are not clear and require a significant commitment of time to tie out and to support explanations during the audit process. As part of the process described above, management should assess what reporting is available in the MMARS system and assess where that documentation can be cleaned up to facilitate the audit process.

Accounting for Receivable Transactions

The Comptroller's Office will "roll" or combine monies due from the federal government for a number of departments for a federal automated draw. These monies are combined into an "RE" transaction and represent a receivable on the Comptroller's books. During our FY2006 audit, it was noted that certain receivables that were open as of June 30, 2005 were manually rolled forward in the MMARS system to FY2006. When the money was received related to the receivable, the related transaction had been rolled forward and the receivable could not be closed in the MMARS system. At the time of audit, the Comptroller's office had undertaken actions to identify and remove such receivables from the system. Despite these efforts, however, the receivables remained open in the accounting system as of June 30, 2006, when most should have been closed in July 2005.

The manual rolls of the receivables were a direct result of Comptroller's Office staff misunderstanding of the New MMARS accounting system with the FY2005 implementation. The Comptroller's office should continue to identify and ensure the removal of such receivables. In the future, the Comptroller's office should continue to develop appropriate processes within the MMARS system that will prevent improper manual entries.

OFFICE OF THE STATE TREASURER AND RECEIVER GENERAL

Recording of Interest Income for Investments (Certificate of Deposits)

The Treasury Department accumulates interest on Certificate of Deposits (CDs). The interest accumulated is not recorded until the CD is re-invested at a future point in time and, as such, the interest is not accrued and recorded at year end. When the CD is reinvested, the reinvested amount totals the original investment plus the accrued interest.

In accordance with GASB Statement No. 11 Paragraph 64, *Measurement Focus and Basis of Accounting-Governmental Fund Operating Statements* and GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, investment income (interest and dividends) should be recognized in the period earned. As such, as the reinvestment date for a lot of the investments is after year end, accrued interest income should be booked and the investment should be trued up to reflect the market value of the investment at year end.

The amount of investment income not accrued by the Treasury, as of June 30, 2006, was approximately $4.5 million. This amount was recorded as an adjustment during the audit process.

The Treasury should track and record the amount of accrued interest for investments held based on the original investment date to the period end. In that the Treasury systems are not set up to account for this activity in this way, the Treasury should prepare and request that the Comptroller post a top level entry to the financial statements at least on an annual basis.

Recording Investments at Market Value

The Treasury holds its Short Term Bond fund at cost. The Short Term Bond fund is held with Massachusetts Municipal Depository Trust ("MMDT"), which carries the fund at market value. Treasury has accounted for this fund at the original cost plus reinvested amounts, which are also at cost.

In accordance with GASB 31 Paragraph 7, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, governmental entities, including governmental external investment pools, should report investments at fair value in the balance sheet (or other statement of financial position). Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Since the Treasury is carrying the fund at cost, it is not complying with GASB 31.

The amount between the carrying amount of the investment and the actual market value of the investment is approximately $1 million. As such, investment income and investments were understated. This amount was recorded as an adjustment during the audit process.

The Treasury should carry all investments at fair value consistent with the provisions of GASB 31.

INFORMATION TECHNOLOGY DIVISION

Logical Security Procedures Relating to MMARS Interfaces and Security Roles Should Be Enhanced

A review of the logical security procedures relating to key interfaces with MMARS as well as the current security role setup within MMARS was performed. Logical security procedures identify (1) those users who have the ability to submit batches from the source system into MMARS, and (2) the IDs used by these users to submit batches.

We noted that information was transmitted through the interfaces under generic user IDs. Moreover, employees with Administrator capability have access to conflicting transactions (e.g., the same Administrator could create a vendor and a payment, authorize a transaction, and make it "Go Final").

We recommend use of standard logical security procedures to minimize administration and security risks. In the absence of unique userIDs, it is difficult to establish accountability. Similarly, lack of effective segregation of duties could permit misappropriation of assets. Management should reconsider procedures concerning logical security and promote the use of unique userIDs whenever possible.

DEPARTMENT OF MENTAL RETARDATION

Waiver Choice Forms

Federal regulation 42 CFR 302 (d) states that a recipient must be informed of any feasible alternatives available under the home and community-based services ("HCBS") waiver and given the choice of either institutional or home and community-based services. The form that the Department of Mental Retardation ("DMR") currently uses does not provide a space for the recipient or their legal representative to sign or otherwise confirm that such a communication took place. Rather, the "Verification of Compliance with HCBS Waiver Choice Assurance" only requires that it be signed and dated by a DMR Service Coordinator.

The form referred to above was attached to the waiver application dated September 18, 2003, that Centers for Medicare and Medicaid Services ("CMS") subsequently approved. This waiver will be in effect until July 1, 2007; therefore the choice form currently being used is consistent with the expectations of the cognizant agency. However, it is our recommendation that the form be altered so that it provides a place for the recipient (or their legal guardian) to positively confirm that they were informed of their feasible alternatives. This would provide greater assurance that DMR is in compliance with federal regulations.

Licensure and Certification

One out of 23 of our DMR waiver recipient selections initially did not have evidence of a current license for the recipient's provider. We subsequently learned that a licensure and certification review had been completed for this provider in September 2005; however, the results of the review were not forwarded to DMR's Office of Quality Management, and as a result, the license was never produced and forwarded to the provider.

While we did obtain evidence that the licensing and certification review had been completed, we recommend that DMR improve the communication lines within its Office of Quality Management / Office of Quality Enhancement. This would ensure that the results of their surveys are conveyed to the providers in a timely manner.

HIGHER EDUCATION

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 of a shared services center would be to reduce the operating costs of non-academic 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 and providing some uniformity to the accounting and student financial aid operations of many of the smaller institutions of higher education while still promoting cost savings. A shared services center, whether run by a governmental entity or outsourced to a private entity, could provide the following benefits:

1. Cost savings and cost control
2. Uniformity of functions
3. Flexibility and scalability
4. The foundation for Internet-based e-Business/e-Government
5. The ability to enhance responsiveness and customer satisfaction
6. Best business processes and practices
7. The ability to attract and retain good people
8. Optimizing the allocation of existing resources
9. Better information for management decision making
10. Continuous improvement with new ideas and service offerings
11. The ability to keep pace with ever-changing technology

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 and the Board of Higher Education 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; and
- Research the cost of communications links to the shared services center.

Tuition Retention

The Commonwealth should reconsider expanding its tuition remission program. Under the current system, all funds collected by most of the state colleges and universities are remitted to the Commonwealth. The Commonwealth then finances the operating activities of the colleges and universities. The Commonwealth should consider making all of the colleges and universities pay their own expenses through their own collections. This approach would make the colleges and universities accountable for their activities around collections and spending. The Commonwealth has employed a pilot program with the University of Massachusetts, the Massachusetts College of Liberal Arts, and the Massachusetts College of the Arts with some success. This model should be expanded to ensure greater accountability for the expenditure of funds across the Commonwealth by the college and universities.

Implementing such a policy should be accompanied by further legislative action to eliminate the duplication of efforts that currently exists at the institutions of higher education. Currently, all financial information is entered into the stand-alone systems of the institutions of higher education for purposes of ensuring a complete general ledger. Certain financial information is then re-entered into the statewide accounting system for the purpose of ensuring proper recording of certain information required in that system related to non-appropriated funds. The OSC has proposed legislation that would eliminate the reporting of non-appropriated funds by the institutions of higher education. We support that legislation and believe that the guidance proposed in that legislation relative to how the institutions of higher education would report information to the OSC is a more efficient approach that would eliminate the duplication of efforts at those institutions and eliminate the reconciliation procedures that are required at the OSC.