KPMG

Commonwealth of Massachusetts

Management Letter

June 30, 2010

KPMG LLP
Two Financial Center
60 South Street
Boston, MA 02111

January 18, 2011

The Comptroller's Advisory Board
Commonwealth of Massachusetts
Boston, Massachusetts

Advisory Board Members:

We have audited the basic financial statements of the Commonwealth of Massachusetts (the Commonwealth) as of and for the year ended June 30, 2010, and have issued our report thereon dated January 18, 2011. In planning and performing our audit of the basic financial statements of the Commonwealth, in accordance with auditing standards generally accepted in the United States of America, we considered the Commonwealth's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Commonwealth's internal control. Accordingly, we do not express an opinion on the effectiveness of the Commonwealth's internal control.

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

The Commonwealth's written responses to our comments and recommendations have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

In addition, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and in accordance with *Government Auditing Standards* communicated them in writing to the Commonwealth in a separate report dated January 18, 2011.

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

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

This communication is intended solely for the information and use of management of the Commonwealth, and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

KPMG LLP

MLC 2010-01

Timeliness of the Closing Process

Observation

The Commonwealth's fiscal year ends on June 30. General Laws requires an accounts payable period ending September 15th. The closing process is such that auditable fund trial balances are not available until early to mid-October, 30 days after the close of the accounts payable period. Changes enacted into law during fiscal year 2009 have alleviated some of the time compression associated with the preparation of the statutory basis financial report. While the efforts made by the Comptroller's office have helped streamline the closing process, additional work remains to be done. The closing process remains highly dependent on the coordination of information from various sources. The time required to assemble and compile that information to allow for sufficient analysis could be improved.

Recommendation

The Comptroller's staff should continue to 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. We continue to suggest that consideration be given as to whether a hard close of the Commonwealth's financial records takes place at interim dates throughout the year such that certain account balances, capital assets for example, are not reconciled on just an annual basis. While it may not be practical to perform a hard close on an entity wide basis, there are many accounts within the control of the Comptroller's office for which an interim hard close would facilitate the closing process at year end. As part of the process described above, management should assess opportunities to streamline the documentation of account balances to expedite the closing process.

Management's Corrective Action Plan

Similar to FY 2010, a late supplemental budget enacted on October 15, 2010 was one of the factors delaying the fund closing process. In addition, we had to allot substantial amount of resources to the MassDOT, a new entity created during the FY 2010. For the FY 2011 close, a proposal is being discussed with the Executive Office for Administration and Finance to shorten the Accounts Payable period which can provide some additional time to complete the closing process.

Responsible Official

B J Trivedi and Howard Merkowitz

MLC 2010-02

Accounting and Financial Reporting of Retainage Related to Capital Projects

Observation

The Commonwealth routinely enters into contracts for the construction of capital assets. When these contracts require payments over a period of time, the contract will often include a "retainage" clause. This allows the Commonwealth to hold back a portion of the payment to ensure a good faith effort is made by the contractor to complete the project.

The accounting and financial reporting policies and procedures, which have been established to record capital assets, were also intended to capture retainage costs. However, it was noted during test work that for several departments retainage was not capitalized until it was ultimately paid as opposed to when the costs were incurred as required by generally accepted accounting principles,

Recommendation

Departments should follow the existing retainage policy and enter balances into MMARS throughout the construction period to properly record the value of assets and payables. Controls should be reviewed to ensure that departments are properly entering retainage into MMARS.

Management's Corrective Action Plan

The Comptroller's Office is reviewing the policies and procedures and will update guidance as necessary. Our Quality Assurance Bureau will contact the departments where KPMG found instances of non-compliance with the policies assess compliance through desk reviews and /or onsite visits.

Responsible Official

Kathy Sheppard, Deputy Comptroller

MLC 2010-03

Accounting for Amortization of Bond Premiums and Discounts

Observation

The Treasurer's Office (TRE) is responsible for the bond issuance details; however, once completed the transaction details are provided to the Office of the Comptroller (CTR) to facilitate appropriate accounting entries. The amount of the premium/discount for serial bonds is provided to the CTR from TRE. The information provided to the CTR also includes the details of the premium/discount related to each maturity within the series bonds if applicable.

Through discussions with the CTR and TRE, it was determined that the details of the premium/discount related to each maturity within the series bonds were being utilized by the CTR as the basis for its amortization schedule. The result of this method is that in certain circumstances the premiums/discounts are not being amortized ratably over the life of the bond but rather are recorded at time of bond maturity.

Recommendation

We recommend that policies, processes, and controls be developed to ensure that when debt is issued by the Commonwealth the appropriate accounting entries are made and that amortization schedules are developed in accordance with Generally Accepted Accounting Principles. Amortization schedules should be reviewed and approved by management at the time they are developed.

Management's Corrective Action Plan

In the absence of any system generated detail, we have developed Excel based calculations to support this analysis. We have reviewed and confirmed the calculations and we found out that the calculation per Excel had an immaterial variance when compared to the ratable amortization -GAAP method.

Responsible Official

B J Trivedi, Financial Reporting Bureau

MLC 2010-04

Compliance with Comptroller Policies and Procedures

Observation

The Office of the Comptroller (CTR) is responsible for the implementation and enforcement of policies and procedures designed to enhance the Commonwealth's internal control over financial reporting. CTR has developed an Internal Control Questionnaire (ICQ) in order to monitor compliance with these policies and procedures and to gain comfort over the departmental control environments.

As part of our audit risk assessment procedures, we analyzed the responses received in 2010 to the ICQ. We noted a few departments failed to update their internal control plans. The current Comptroller policy requires that internal control plans be reviewed and updated on an annual basis.

Recommendation

We recommend that the CTR reinforce the requirement to have accurate and updated internal control plans in place.

Management's Corrective Action Plan

We will continue to review the ICP as part of each site visit we conduct and comment on them in our Quality Assurance reports. The State Auditor also reviews ICPs at each of their site visits, including single audit, and includes their assessments in their blue book reports. We have used the ARRA-related department reviews as another opportunity to review ICPs in total (not just for ARRA updates). This has revealed cases where some departments have not implemented previous recommendations. Thus, we are conducting a desk review that follows up on all of our ICP recommendations in 2010 reports to ensure that they have been, or are being, implemented. Per standard practice, CTR will document and contact each department responding on the annual Internal Control Questionnaire that their plans were not updated and determine next steps. CTR's Department Assistance Bureau offers standard classroom training on Internal Control Plans, as well as department-specific training upon request or recommendation. Finally, the Office of the Comptroller will continue to remind departments of the ICP requirements in its internal control guidance, the Close\Open Handbook, in meetings such as the CFO conference and the annual fiscal year Close\Open meetings, and at each New CFO training session.

Responsible Official

Peter Scavotto, Quality Assurance Bureau Director, Office of the Comptroller

MLC 2010-05

CTR: User Access Control and Internal Control

Observation

Super-user level access via membership in the "Department Fiscal – All Functions" (DFISC) security role in the MMARS application is provided by CTR to individuals after obtaining documented approval by the authorized department security officer. DFISC access provides the user with access rights that result in segregation of duties conflicts as the users can initiate, process, and record transactions without intervention by another user.

Manual approval and monitoring controls designed to prevent and/or detect inappropriate activity via these accounts are the responsibility of department management. The number of users with DFISC level access to MMARS appears excessive as there are approximately 500 DFISC user accounts across all departments.

Lack of adequate enforcement of segregation of duties via logical access restrictions within the MMARS application increases the risk that unauthorized and/or inappropriate transactions are processed. The lack of an effective process for monitoring the activity of users who have this level of access increases the risk that unauthorized and/or inappropriate transactions are not detected timely or at all.

Recommendation

Commonwealth should consider implementing a monitoring control to monitor 100% of transactions or for defined risk thresholds and frequency that can be processed by users with super-user access.

Management's Corrective Action Plan

As part of their departmental reviews, QAB monitors the use of DFISC roles and has not yet found an instance of inappropriate use. Furthermore, the Comptroller's office is in the process of implementing a MMARS transaction monitoring report. This report will detail UAIDs (user IDs), name, the number of transactions created, and the UAIDs of the transaction approvers. The report will also indicate when the approver UAID is the same as the creator.

Once this report is finalized, the CIW team will release a query that will allow department managers to get the transactional level detail for each UAID requested.

Information from this report can be used by individual departments to compare to the department's internal controls for security roles and segregation of duties to ensure they are in alignment.

Responsible Official

Joan Shea, Deputy Comptroller

MLC 2010-06

Census Data – Teachers' Retirement System

Observation

The Teacher's Retirement Board (TR Board) is responsible for maintaining member information for all active, inactive, and retired employees who contribute to and participate in the Massachusetts Teachers' Retirement System (MTRS). The database of information is gathered from many different sources and in some cases in various different formats. The system that is currently used is significantly aged and in some cases does not provide management with appropriate levels of information and in other cases contain corrupted or incomplete data. In addition to servicing the needs of the MTRS, the information contained in the member system is also utilized by PERAC to calculate a projected pension liability, a significant accounting estimate that is part of the financial reporting process. To compensate for the anomalies in the data, PERAC makes adjustments to its actuarial model before finalizing its results, results that ultimately impact future funding requirements for the Commonwealth. The MTRS is currently in the design stage for Rollout 3 (Benefits Processing and Member Self-Service) and will need to carefully consider the accuracy of the information to be transferred from the legacy system.

Recommendation

We recommend that the TR Board conduct a review to identify inconsistent, inaccurate, or corrupted data within the current member systems. Once the review is complete, we recommend that the data be scrubbed prior to transfer to the new system. We would also recommend that the TR Board enforce strict guidelines on external entities that provide information to the system to reduce the level of inaccurate or inconsistent member data. Finally, as the TR Board continues through the process of system design, we recommend that they consider future information and control needs when designing these new systems.

Management's Corrective Action Plan

Starting in 2007, MTRS established a dedicated Data Cleansing and Conversion team (Team) in preparation of replacing our legacy system with a new line of business application. MTRS also purchased a software package to assist in the profiling and scrubbing of data and documenting validations. Additionally, in order to minimize the merging of inconsistent or inaccurate data to our legacy system,

MTRS tightened edits for all information from the 415 school districts. In June 2008 and still ongoing, the Team has been working closely with our new line of business vendor and members of MTRS's Project Management Office on the data cleansing plan to address issues prior to transferring data to the new line of business application. The new line of business application requirements includes designing and implementing security controls and procedures for both internal and external entities. These controls will reduce the level of inaccurate and inconsistent member data.

Responsible Official

Joan Schloss, MTRS Executive Director

MLC 2010-07

Census Data – State Employee Retirement System

Observation

The State Retirement Board (SR Board) is responsible for maintaining member information for all active, inactive, and retired employees who contribute to and participate in the State Retirement System. The database of information is gathered from several different sources and in some cases in various different formats. The system that is currently used is significantly aged and in some cases does not provide management with appropriate levels of information and in other cases contains incomplete data. In addition to servicing the needs of the State Retirement System, the information is also utilized by two actuarial groups (PERAC and Aon) to calculate a projected pension liability and other post employment benefits liability each of which are significant accounting estimates that are calculated as part of the financial reporting process. To compensate for the anomalies in the data, PERAC makes adjustments to its actuarial model before finalizing its results, results that ultimately impact future funding requirements for the Commonwealth. The SR Board is currently in the process of designing a new system and has undertaken various reviews to ensure that data on the existing system is accurate; however, most comprehensive reviews are not performed until a participant retires.

During the current year, we noted the following anomalies:

- 9 files for active participants included the incorrect number of children
- 2 participants had understated salary information
- 3 participants had the incorrect date of birth

Data errors such as the ones above are not unusual in large systems and do not appear to be of a magnitude that would significantly impact actuarial calculations which are performed by the Commonwealth.

Recommendation

We recommend that the SR Board continue to review and identify inconsistent, inaccurate, or corrupted data within the current member system to ensure that when data is transferred to the new system any inaccurate or corrupt data is not included. We would also recommend that the SR Board enforce strict guidelines on external entities that provide information to the system to reduce the level of inaccurate or inconsistent member data. Finally, as the SR Board continues through the process of system design we recommend that they consider future information needs and appropriate levels of control when designing the new system.

Response to the KPMG observations of the current audit year.

In the last management letter response MSRB was in the final stages of hiring a vendor to implement a new line of business ("LOB"). The vendor "Sagitec Solutions" has been onsite for the past year with a "go-live" date for the initial LOB phase for the summer of 2012. This implementation will assure that the goal of maintaining accurate and enhanced data elements is met.

Management's Corrective Action Plan

As part of the new LOB implementation all the data contained in the MSRB's current legacy system is being reviewed in conjunction with an overall data cleansing effort. Corrupt, missing or incomplete data is being identified and a comprehensive data reconciliation strategy is underway. The end result will be more consistent and accurate data for migration to the new LOB. This will have a positive short term impact on the quality of data submitted to actuarial groups.

As part of this implementation external agencies will be required to provide correct and accurate work and demographic data. Inaccurate or inconsistent data submissions will be returned to external agencies and will not be accepted or posted until reviewed and corrected. This control will ensure improved data quality and management and ultimately support improved accuracy of the MSRB's business processes.

Built into the design of the new system is the commitment that data is not only being maintained for the "Board's" requirements but those of outside actuarial groups and management agencies. This commitment will allow for a flexible approach in the diversity and form in which information can be retrieved.

Responsible Official

Robert Minue, Deputy Director, State Retirement Board
Office of the State Treasurer (TRE)

MLC 2010-08

Review of Bank Reconciliations – Department of Revenue

Observation

The Department of Revenue (DOR) performs bank reconciliations for its tax collection and tax refunding accounts on a monthly or, in the case of certain high volume accounts, daily basis. The reconciliations are performed by Revenue Accounting Unit (RAU) staff members. During test work, we noted that two monthly bank reconciliations did not contain evidence of review or approval by someone other than the person preparing the reconciliation.

Recommendation

We recommend that DOR review its processes to ensure all bank reconciliations are reviewed and approved by an employee other than the person preparing the reconciliation. This review should be done in a timely manner and the review should be clearly documented.

Management's Corrective Action Plan

As part of the monthly reconciliation process, management will ensure all bank reconciliations are reviewed and approved by an employee other than the person preparing the reconciliation. This review should be done in a timely manner. The cover sheet for each monthly reconciliation should contain both the reconciler's and approver's signatures.

Responsible Official

Paul Naves, Chief Fiscal Officer
Susan Tribble, Director of Revenue Accounting

MLC 2010-09

Workers' Compensation Accrual

Observation

The Commonwealth self-insures for its workers' compensation insurance coverage. This means that the Commonwealth is responsible for the full cost of paying claims of injured workers. In order to ensure that the full extent of the liability is properly reflected in its financial statements, the Commonwealth engages an actuary to perform an analysis of workers' compensation claims. This analysis is then used to develop an accrual, for financial reporting purposes, to reflect the ultimate cost of insuring its workers from the time of the incident.

In performing the actuarial calculations, the Commonwealth's third-party actuary uses a variety of actuarial methods to arrive at the estimated loss. However, the actuary does not use a case review methodology as part of its estimate. Use of a case review methodology is considered a best practice.

Recommendation

We recommend that the Commonwealth review with their third-party actuary the methods used to prepare the workers' compensation accrual. They should ensure that the best estimate be determined and that all relevant information is available for the actuary to consider in making their assessment.

Management's Corrective Action Plan

In the future HRD will work with the AON and consider using a case review methodology.

Responsible Official

Brian Hickey

MLC 2010-10

Group Insurance Commission – Review of SAS 70 Reports

Observation

The Group Insurance Commission (GIC) provides health insurance and other benefits to state, housing and certain other authorities' employees, retirees, and their survivors and dependents. The GIC also provides health benefits to participating municipalities' employees, retirees, and their survivors and dependents. GIC contracts with a number of providers to administer these health and dental benefits. In order to enhance the oversight of these providers, GIC obtained SAS 70 reports for each of the providers. These reports, prepared by external auditors, evaluate the internal controls in place at the providers. While progress has been made by GIC in obtaining SAS 70 reports from all of its providers, additional oversight is necessary. Specifically, we did not see evidence of management review of the user control considerations contained in each of the SAS 70 reports. These user control considerations outline those controls and procedures that GIC should consider in order to provide the most value from the SAS 70 reports.

Recommendation

We recommend that GIC formally document its consideration of the key user controls identified in the provider SAS 70 reports. This consideration should be in addition to its other oversight procedures already performed.

Management's Corrective Action Plan

The GIC will continue to conduct its yearly review of SAS70 reports for its self-insured plans. Should any adverse findings and/or pertinent user control considerations be identified, the GIC will request that the plan/s/ provide us with a written corrective action plan, as well as quarterly updates to same, until there is resolution satisfactory to the GIC.

Responsible Official

Kathleen Glynn , Director, Policy & Program Management

MLC 2010-11

Loss Adjustment Expense – Workers' Compensation Accrual

Observation

The Commonwealth self-insures for its workers' compensation insurance coverage. In order to recognize its liability for claims already incurred and amounts to be paid out in the future, the Commonwealth relies on projections prepared by actuaries. These actuarial valuations form the basis upon which amounts are recorded and reported in the Commonwealth's Comprehensive Annual Financial Report.

While the Commonwealth has historically captured the information related to the actual medical claims expense incurred, it has not typically included in its calculation the "claim adjustment expenses" that are an inherent part of the medical claims process. These claim adjustment expenses are the administrative costs incurred to properly administer the incurred claims. A more complete estimate of the liability should include a provision for claim adjustment expenses

Recommendation

We recommend that management discuss with their actuary the implications of including the claim adjustment expense in their calculations. Steps should be taken to ensure the policies, procedures and controls are in place to gather the necessary information and provide it to the actuary in a timely manner for inclusion in the financial statements.

Management's Corrective Action Plan

HRD will follow the recommendation and discuss with AON the steps to be taken to ensure the policies, procedures, and necessary controls are in place in the future.

Responsible Official

Brian Hickey

MLC 2010-12

Loss Adjustment Expense – Medicaid Accrual

Observation

The Commonwealth records an accrual for its share of Medicaid insurance coverage. In order to recognize its liability for claims already incurred and amounts to be paid out in the future, the Commonwealth relies on projections prepared using actuarial models. These actuarial valuations form the basis upon which amounts are recorded and reported in the Commonwealth's Comprehensive Annual Financial Report.

While the Commonwealth has historically captured the information related to the actual medical claims expense incurred, it has not typically included in its calculation the "claim adjustment expenses" that are an inherent part of the medical claims process. These claim adjustment expenses are the administrative costs incurred to properly administer the incurred claims. A more complete estimate of the liability should include a provision for claim adjustment expenses.

Recommendation

We recommend that management consider including an estimate of claim adjustment expenses when computing its estimate of the Medicaid insurance accrual. If management determines that such costs are not significant, those decisions should be documented as part of the formal accrual calculation.

Management's Corrective Action Plan

Management will consider amending the Medicaid accrual policies and procedures to include an estimate of claim adjustment expenses when computing its estimate of the Medicaid accrual. Management will document as part of the formal accrual calculation any decisions that determine such costs are not significant.

Responsible Official

Alda Rego, MassHealth CFO

MLC 2010-13

Executive Office of Health and Human Services

Medicaid Accrual

Observation

Participants in the Medicaid program may submit initial claims up to three months after the initial date of service. For financial reporting purposes, the Commonwealth is required to estimate the claim runout in order to properly accrue a liability for those claims that have been incurred as of June 30 but not yet reported (IBNR). This accrual is based on an analysis of paid claims data as of June 30 and claims paid subsequent to year end with an incurred date prior to year end. Claims paid through September 30 are used to develop the final analysis of IBNR at year end. During the course of our audit, we noted that within the MMIS system, which is the source of all paid claims data, there are adjustments made on a regular basis for items such as recoupments or resubmissions. These adjustments result in variances when comparing the underlying data used develop the IBNR accrual to current live data within the MMIS system. Based on prior year look-back analysis, KPMG notes that these adjustments do not materially impact the total accrual calculation at year-end. However, KPMG noted that the number of adjustments made results in considerable effort to assemble a complete data set in order to support the underlying data used to calculate the Medicaid accrual.

Recommendation

We recommend that the Commonwealth review its policies and procedures for preparing the Medicaid IBNR accrual. Consideration should be given to enhance the management review of the underlying data, and to monitor the nature and extent of adjustments to evaluate the effect, if any, on the IBNR calculation.

Management's Corrective Action Plan

The Executive Office of Health and Human Services', Office of Medicaid will continue to review and enhance as necessary its policies and procedures for preparing the Medicaid IBNR accrual. In addition, management will review the underlying data used to develop the accrual and document the nature and extent of the material adjustments to evaluate the effect, if any, on the IBNR calculation.

Responsible Official

Alda Rego, MassHealth CFO

MLC 2010-14

EOHHS: Documentation of Internal Controls

Observation

As part of the system development process, EOHHS did not document internal controls for the NewMMIS implementation, both IT general controls and specific application and business process controls.

Without a documented internal control plan for NewMMIS implementation, EOHHS management may not be able to determine whether business, IT, and operational risks have been mitigated by internal controls implemented by EOHHS.

While testing was done of the functionality of the NewMMIS that included internal controls, without testing the internal control plan for the NewMMIS implementation, EOHHS is not able to demonstrate whether internal controls were designed and are operating effectively.

Recommendation

We recommend that management document and test internal controls as they relate to IT General Controls and business processes for the NewMMIS and include such procedures as part of new system development activities.

Management's Corrective Action Plan

The NewMMIS implementation was successfully tested for all technical and business functions including internal controls and the results were documented. IT control risks as they relate to the NewMMIS implementation processes were also tracked and managed during the course of the NewMMIS implementation.

EOHHS IT general controls document updates are pending the completion of organizational changes, however, the Internal Control Plan shall be updated on or before 6/30/11.

Responsible Official

Manu Tandon, EOHHS Chief Information Officer

MLC 2010-15

EOHHS: Password Complexity

Observation

During our limited testing of key privileged accounts for a selection of two servers, we noted that last password changes were performed in 2009 and 2010. The password change does not occur on a periodic basis per policy requirement. We were informed that EOHHS is evaluating the possibility of implementing a periodic automated password change solution for privileged accounts.

If passwords to privileged accounts are not changed periodically, passwords may be compromised, enabling unauthorized and unmonitored access to financial and program information.

Recommendation

Passwords to privileged accounts should be changed on a periodic basis and system security configurations should enforce it where possible.

Management's Corrective Action Plan

NewMMIS will schedule the resetting of all privileged system account passwords to recur on a yearly basis, scheduled to occur in the 2nd quarter of this, and subsequent calendar years.

Responsible Officials

Steve Gross, Deputy MMIS Project Manager

MLC 2010-16

ITD: Password – CIW

Observation

Password restrictions are not systematically enforced for end-users accounts used to access CIW.

Without a system-configured password policy, passwords may be compromised, enabling unauthorized and unmonitored access to financial information.

Recommendation

ITD should consider systematically enforcing CIW application password parameters for length, complexity, lockout, expiration, etc.

Management's Corrective Action Plan

CIW is not an application but a data repository which, with Security Officer approval, is accessed via a desktop application such as Microsoft Access. Desktop access requires the user have a valid LAN ID which does systemically enforce a strong password policy. Within the CIW itself, however, there is no way to systemically support or enforce password restrictions without developing a front-end security module. The required funding was not available in FY10 and security development remains as pending.

We are currently assessing the future direction of the CIW and the provision for systemically enforced password parameters for length, complexity, lockout and expiration is recognized as a critical element.

Responsible Official

Maureen Chew, Chief Application Officer, ITD
Lou Angeloni, Chief Financial Officer, ITD