



COMMONWEALTH OF MASSACHUSETTS

Management Letter

June 30, 2008



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December 23, 2008

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, 2008, and have issued our report thereon dated December 23, 2008. 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 Company'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 December 23, 2008.

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

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Schedule of Observations

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Compliance with Comptroller's Policies

Observation

The Comptroller is responsible for the implementation and enforcement of policies and procedures designed to enhance the Commonwealth's internal control over financial reporting. Departmental compliance with these policies and procedures is summarized in a mandatory Internal Control Plan which must be updated on an annual basis. Compliance with this requirement is monitored through the annual Internal Control Questionnaire (ICQ) overseen by the Comptroller's Quality Assurance Bureau (QAB).

We noted that several departments did not prepare annual updates to their Internal Control Plans. In addition, these departments did not accurately complete the relevant sections of the ICQ.

Recommendation

We recommend that the Comptroller's office perform a focused review of a sample of departments. This review should focus on the compliance with Comptroller policies related to the completeness and timeliness of Internal Control Plans (ICP). This review should be performed by Quality Assurance Bureau. In addition, we recommend that the Quality Assurance Bureau increase the frequency of their departmental reviews to ensure departments comply with Comptroller policies and procedures.

Management's Corrective Action Plan

The Quality Assurance Bureau has performed departmental reviews of policies and procedures, including ICP's, since its inception in fiscal year 2006. In September 2007 an updated Internal Control Guide was issued that expanded the scope of the ICP's to include non-fiscal objectives, risks and controls. Thus, the release was coordinated with updated and expanded training. Of the 28 departments which answered "NO" on the internal control questionnaire as to having an updated plan, 14 have either attended training, have had a review from QAB or are in the process of updating their plans. Desk reviews will occur on the remaining 14.

Responsible Official:

Peter Scavotto, Bureau Director, Quality Assurance Bureau

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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 the 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.

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

As part of the planning process for FY09, we'll review with our third party actuary the methods used to prepare the accrual and come to a common understanding and agreement on those methods.

Responsible Officials

Brian Hickey, Chief Fiscal Officer, Human Resource Division,
Michael Chandrankunnel, Workers' Compensation Unit

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Accuracy of Information Maintained by the Teachers' Retirement System

Observation

The Teacher's Retirement Board is responsible for maintaining member information for all active, inactive, and retired employees who contribute to and participate in the Teachers' retirement system. The data base of information is gathered from many different sources and in some cases in various different formats. The system that is currently used by the board 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 Teachers' retirement system, 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 Teacher's Retirement Board is well into the design process for their new system and will need to carefully consider the accuracy of the information to be transferred from the legacy system.

Recommendation

We recommend that the Teacher's Retirement 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 retirement 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 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

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. The Team consists of three (3) full-time employees: the Legacy System Administrator and two ORACLE Database Administrators. 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 received from the 415 school districts.

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In June of 2008, the Team began to work closely with our new line of business vendor and members of MTRS's Project Management Office to develop a data cleansing plan to address issues prior to transferring data to the new line 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

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Accuracy of Information Maintained by the State Retirement System

Observation

The State Retirement 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 data base of information is gathered from many different sources and in some cases in various different formats. The system that is currently used by the board is a significantly aged system that in some cases does not provide management with appropriate levels of information and in other cases contain 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 State Retirement Board is currently in the procurement process for a new system and should consider these data anomalies as part of the system conversion requirements.

Recommendation

We recommend that the State Retirement Board conduct a review to identify inconsistent, inaccurate or corrupted data within the current member system. 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 retirement 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 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

We agree that information maintained by the MSERS is used by others to calculate a total liability, which is a significant estimate for the Commonwealth. The Board's understanding from PERAC was that the data provided was sufficient to conduct its valuations and from AON was that the data did not have any objections or deficiencies for purposes of calculating OPEB valuations. However, it appears that for this valuation PERAC and AON made assumptions for all of the public employee retirement systems and applied these assumptions to all systems in a uniform conservative manner. Because the integrity of the data for each of the systems is different, the State Retirement Board will request PERAC and AON participate in all meetings with the auditors to ensure that they have an understanding of the nature and quality of the data provided by the State Retirement System. Additionally, the Board has increased the frequency and detail of the information and communication with PERAC and AON, and will continue to ensure appropriate understanding of the current and future data provide for their calculations.

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The Board does not believe there are significant inaccuracies in the current member system, but agrees that the information system, designed and implemented over 30 years ago, is not sophisticated enough to provide the information needs for the current environment. As a result, a project is underway to replace the legacy system with a new line of business. This will require a focus of resources over a period of years, which includes evaluating the data needs, assessing quality of current data and implementing cleansing initiatives. Procedural changes will also be assessed to improve accuracy and reliability of future data from many different sources. During this time, the current system will remain in place with any inaccuracies being resolved as the need arises, such as at the time of the member's retirement or at the point of other transactions.

Responsible Official

Robert Minue, Deputy Director State Retirement Board

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Summary of Non-GAAP Policies

Observation

The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires the Commonwealth to comply with a wide array of regulations. In certain instances, the Commonwealth has chosen to not apply GAAP but rather take a more practical approach to the accounting. While permissible for immaterial items, the Commonwealth is none-the-less required to monitor these so-called non-GAAP policies and assess their materiality each time financial statements are prepared. If the impact of any individual non-GAAP policy is material to the financial statements, then the Commonwealth would be required to address the matter. During our audit, we noted that the Comptroller does not maintain a listing of the departures from GAAP inherent in their financial statements such as the accounting for bond issuance costs and the related amortization of loss on refunding of debt. Significant effort was required on our part to determine the more significant non-GAAP policies and assess their materiality relative to the financial statements.

Recommendation

We recommend that the Comptroller assess the departures from GAAP and develop a process to track the materiality of these departures on at least an annual basis.

Management's Corrective Action Plan

Using the American Institute of Certified Public Accountant's *Checklists and Illustrative Financial Statements for State and Local Governments*, (FSP 13000) we have parsed out sections to the analysts in the Financial Reporting and Analysis Bureau. Each question has either a yes, no, not applicable and a page number reference. We will review each page in the CAFR and note which item is present with page number references. Items that are not present will have memorandums written as to why each should not be included.

Responsible Official

BJ Trivedi Bureau Director, Financial Reporting and Analysis Bureau

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Prior Service Credits

Observation

The Commonwealth administers a variety of health and welfare programs. At the same time, employees of the Commonwealth routinely transfer employment to municipal employers during the course of their careers. The Commonwealth will routinely accept the service credits for employment at another municipality when determining eligibility for one of its own pension, or health and welfare plans. While a process is in place for the transfer of service credits for pension eligibility, there does not appear to be a consistent, documented policy or statute on how eligibility determinations are made for OPEB benefits. In addition, there are no formal agreements between the Commonwealth and the municipal employers with respect to prior service credits. There is a risk that an employee transfers employment late in their career and the ultimate place of employment has not fully accrued the total benefit cost of that employee.

Recommendation

We recommend that the Commonwealth review its policy of accepting prior service credits. We further recommend that formal, written policies and procedures be developed to properly reflect the intent of the transferability of employment. There should be a written agreement upon transfer of employment, and consideration should be given to amounts accrued or accruable for the employees' prior service.

Management's Corrective Action Plan

On January 28, 2009, the Governor filed an emergency recovery plan bill. Section 87 of the proposal proposes to reform the health care benefit system for employees. The current system would be changed to a tiered system based on salary levels. The Governor's FY09 budget proposal also establishes a special commission to propose recommendations to ensure the sustainability of retiree health benefits, accounting for employee needs and fiscal impacts. In terms of pensions, on October 2, 2008, the Governor asked the Treasurer to work with the administration and the Pension Reform Commission to develop a legislative proposal to reform the state pension system and the Massachusetts Bay Transportation Authority (MBTA) pension system. We recognize that a comprehensive review of all post-employment benefits in the Commonwealth is needed as the current system is not sustainable in the long term. Because this issues crosses a number of agencies and a number of branches of government, the office of the Comptroller will coordinate the effort to resolve this problem.

Responsible Official

Eric S. Berman, CPA, Deputy Comptroller

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Standards Supporting the Statutory Basis Financial Reporting Model

Observation

The Commonwealth, in addition to issuing audited financial statements in accordance with generally accepted accounting principles (GAAP), also issues audited statutory basis financial statements (SBFR). The Commonwealth's statutory framework is governed by Section 12 of Chapter 7A as amended by Section 4 of Chapter 88 of the Acts of 1997 of the Massachusetts General Laws (MGL). These MGL sections also require the SBFR financial statements to be audited in accordance with *Government Auditing Standards*. Both the GAAP and SBFR statements are made publicly available.

We believe the SBFR statements provide invaluable information to the executive and legislative branches as well as other interested parties of the Commonwealth. We also believe that requiring such information be audited and moreover audited in accordance with *Government Auditing Standards* subjects the Comptroller's office to unnecessary costs both in terms of real dollars and in terms of lost productivity for the following reasons:

Majority of information in the SBFR statements is included in and subject to the same level of audit effort as in the GAAP statements. Additionally, the GAAP statements are required to be audited in accordance with *Government Auditing Standards*.

Statutory filing deadline of October 31st requires an exceptional effort on the part of the Comptroller's Office to close its books, reconcile departmental activity and process last minute supplemental budget activity. All the while, responding to auditors' inquiries. The amount of paid overtime necessary to issue the fiscal 2007 SBFR statements was approximately 420 hours. The Statutory framework outlined in the MGL's is outdated and inconsistent with many of the current provisions contained in GAAP. The level of effort required to keep MGL's current should be measured against the prolific nature of the GAAP rule setters to issue and amend current standards.

Recommendation

We recommend that the Comptrollers' Office in coordination with the Secretary of Administration and Finance (ANF) seek an amendment(s) to MGL to permit the preparation of unaudited SBFR statements. The Commonwealth should also consider the users of the SBFR and update the MGL to accommodate current accounting standards and or eliminate information that is repeated in the GAAP statements. This will allow the Commonwealth to focus the SBFR on specific information desired by governmental decision makers. A possible model to consider is limiting the SBFR to a report of operational and fund balances in the governmental funds and the reporting of specific budgetary calculations such as transfers to the stabilization fund.

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Management's Corrective Action Plan

As stated previously, to facilitate change, we have submitted legislation downgrading the SBFR from an audit to an attest engagement. That legislation is included in a bill that the Governor submitted on January 28, 2009.

Should the bill not pass, we will work with KPMG to see if we can gain some extra days in the cycle, without jeopardizing audit results

Responsible Official

Eric S. Berman, CPA, Deputy Comptroller

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System Backup and Restoration - DOR

Observation

DOR performs MassTax system restoration from backup tapes on an annual basis. However, business user testing of MassTax application restoration occurs only on a biannual basis.

Recommendation

We recommend that DOR perform system backup and restoration procedures testing on at least an annual basis.

Management's Corrective Action Plan

MassTax database and operating system are restored on an annual basis. Database verification is executed after successful restore to ensure validity. Finding will be taken under advisement.

Responsible Official

Leo Murphy, Project Leader, Tim McCone, Project Leader