June 11, 2004

Ms. Lori McClurg, Director of Administrative Services
Department of Administrative Services
State of Nebraska
P.O. Box 94664
Lincoln, Nebraska 68509-4664

Dear Ms. McClurg:

We have audited the basic financial statements of the state of Nebraska (the State) for the year ended June 30, 2003, and have issued our report thereon dated June 11, 2004. We have also audited the State's compliance with requirements applicable to major federal award programs and have issued our report thereon dated June 11, 2004. In planning and performing our audits, we considered the State's internal controls in order to determine our auditing procedures for the purpose of expressing our opinions on the basic financial statements of the State and on the State's compliance with requirements applicable to major programs, and to report on internal control in accordance with Office of Management and Budget (OMB) Circular A-133 and not to provide assurance on internal control. We have not considered internal control since the date of our report.

In connection with our audits described above, we noted certain internal control matters related to the activities of the Department of Administrative Services (the Agency) or other operational matters that are presented below for your consideration. These comments and recommendations, which have been discussed with the appropriate members of Agency management, are intended to improve internal control or result in other operating efficiencies.

Our consideration of internal control included a review of prior year comments and recommendations. To the extent the situations that prompted the recommendations in the prior year still exist, they have been incorporated in the comments presented for the current year. All other prior year comments and recommendations have been satisfactorily resolved.

Our comments and recommendations for the year ended June 30, 2003 are shown on the following pages.

1. Capitalization of Assets

There were several instances in which agency personnel "passed" on capitalizing fixed assets when they were unsure of the accounting policies for proper capitalization of the assets. We recommend that accounting policies for capitalization of fixed assets be included in the NIS training manuals. In addition, we recommend that when agency personnel "pass" on the posting of any fixed asset transaction that they are required to explain their reasoning in a "remark" field that is provided in NIS. In order to assist with the implementation of this requirement, the "remark" field should become a required field in NIS.

2. Input of Fixed Assets

Some capital expenditures were posted to an incorrect asset tag number, which resulted in depreciation being computed incorrectly for the asset. We recommend that agency personnel review a NIS report of posted fixed assets on a regular basis in order to detect such errors, and that this function be performed by personnel other than those responsible for the input of asset information.

3. Cash in Bank Not on the State's Accounting System

At year end, the Agency posts an adjustment to record cash and investments not recorded on the State's accounting system by the Nebraska Brand Committee. Although there are exceptions, State statute requires all cash be processed through the Treasurer's Office. To reduce the risk of error, misappropriation of assets, and to ensure compliance with State statutes, we recommend the State develop procedures to ensure all cash is properly processed by the Treasurer's Office and recorded on the State's accounting system. We encourage both agencies to work together to develop procedures that address this risk; for example, send confirmations to banks to verify all accounts are on the State's accounting system.

4. Federal Fund Balance

A federal fund was established to account for all federal grant activity for various agencies. Appropriately, these agencies had initially funded federal expenditures entirely with general funds; however, no due to or due from accounts were established between the general and federal funds to account for eventual federal reimbursement. We recommend the Agency develop a process to monitor these transactions throughout the year in order to ensure amounts owed back to the general fund ultimately are paid to the general fund. In addition, some of these amounts related to receivables from the federal government for expenditures of fiscal years as old as 1998. We further suggest the Agency identify and investigate such amounts.

5. Cash Reconciliation

The preparation of reconciliations between the actual bank statements and the accounting records (NAS) and the related disposition of reconciling items is an essential element of control in safeguarding cash and providing accurate interim and annual financial information.

The State has an established reconciliation process in place; however, the following areas need to be addressed:

- The variance shifts from month to month, which still indicates unknown reconciling items continue to exist. As of June 30, 2003, the unreconciled variance between the bank balances and the State's accounting records was $3,654,783, which indicates that the cash balance per the State's accounting records is overstated.
- No adjustment has been made for the portion of the variance that is due to prior errors.
- No adjustments have been made for the carryover reconciling items related to the Investment Council.
- Although a reconciliation is being performed, some reconciling items are not posted to the general ledger at year end.
- The reconciliations are not being performed or reviewed in a timely manner.
- Monitoring and developing procedures are needed to capture reconciling activity from new systems. The SDU also has an unreconciled amount in addition to the above of approximately $1.9 million.
- Development of an automated daily reconciliation process is needed.

Unknown reconciling items continue to exist, which increases the risk of future variance increases. Interim cash reports produced by NIS and annual financial statements may not accurately reflect the State's cash balance, which may lead to errors in the managerial decision-making process.

We encourage the Agency to continue to investigate the shift in the variance caused by the implementation of a new system at the Agency. In addition, we encourage the Agency to provide other reconciling information in a timely manner to help reduce the amount of time required to complete the reconciliation process. We recommend the State continue to investigate the shift in the variance to determine the cause and establish policies and procedures related to posting adjustments in a timely manner to ensure cash is accurately reported. We also recommend that the reconciliations be prepared in a timely manner and someone other than the preparer review them shortly after completion. Finally, we recommend the State investigate and begin the implementation of a systematic on-line reconciliation process by utilizing the capabilities of the new accounting system. The implementation of an on-line reconciliation process would further require that the Treasurer's current manual ledger be maintained on-line.

6. Leave Time Allocation

The State's payroll system, Nebraska Information System (NIS), does not properly distribute leave time, overtime, and compensation time to separate business unit codes based on employee distributions. In response, each agency has set up procedures to ensure these costs are properly allocated to the correct program. These procedures vary between agencies. We encourage the Agency to monitor each agency's procedures in allocating these costs to ensure the procedures adequately and completely distribute these expenditures.

7. Formalization of Policies and Procedures

In recent years, the State implemented a new financial reporting model as required by Government Accounting Standards Board (GASB) Statement No. 34, which is considered the most comprehensive change in the history of governmental accounting. This statement requires the Agency to perform a significant amount of additional financial reporting procedures. In addition, the State implemented a new accounting system during the current year, which also substantially changed the Agency's method for preparing the basic financial statements. As a result, we recommend the Agency develop a formalized policies and procedures manual to ensure consistency of accounting applications, training of accounting personnel, and ensure all personnel are aware of their respective responsibilities and duties.

8. Schedule of Federal Awards

According to OMB Circular A-133, the State has the responsibility to submit a complete and accurate schedule of expenditures of federal awards (SEFA) and also has the responsibility to ensure compliance with federal requirements through the use of sound internal controls.

In the current year, expenditures listed in the SEFA were not accurately reported and controls were not designed and operating effectively.

The State implemented a new accounting system that was to include a process within the system that would automatically develop the SEFA; however, the process was not working properly as many agencies did not post their federal expenditures to appropriate accounts or funds. Without adequate controls in place, there is an increased risk of misstatement.

We recommend the Agency develop and implement policies and procedures related to the following:

- A process for ensuring all grants are appropriately recorded in the new accounting system,
- A process for ensuring all new grants are properly processed and included on the SEFA,
- Request agencies to submit expenditure information and review for accuracy,
- Reconcile expenditures to the new accounting system,
- Review the SEFA for proper CFDA numbers and program titles, and
- Require separate individuals to prepare and review the SEFA (adequate segregation of duties).

9. Accrual Questionnaires

An essential part of the financial reporting process for the Agency is the completion of accrual questionnaires by each agency. These questionnaires are used to post journal entries to record accrual activity to develop the modified and full-accrual financial statements. During the current year, material errors were noted within the questionnaires and no detailed review is performed by the Agency. We encourage the Agency to implement procedures to ensure that accrual questionnaires submitted by agencies represent all underlying transactions and are complete and accurate. Procedures may include the gathering of supporting documentation from each agency and performing a review of the supporting documentation, and applying analytical procedures over the questionnaires to ensure that all activity is properly presented.

10. Compensated Absences

The State has a compensated absences liability that is calculated using information obtained from the NIS. The Agency utilized NIS in calculating all compensated absences balances for all agencies except the State Patrol. We encourage the Agency to require the State Patrol to utilize NIS to properly calculate its compensated absences balance.

11. Accounting Environment

During the past few years, there have been significant changes in the accounting environment in response to corporate scandals. New procedures for auditor's responsibility for fraud have been introduced in SAS 99, *Consideration of Fraud in a Financial Statement Audit.* Further, a new accounting monitoring board, the Public Company Accounting Oversight Board, and accounting requirements with respect to public companies have been introduced with the passing of the Sarbanes—Oxley Act in July 2002. This act does not currently apply to governments; however, we encourage the State to review these new rules and look for ways to enhance accountability and responsibility. Establishing an audit committee would be a good starting point. Periodic review of the adequacy and scope of internal accounting controls and procedures, their implementation, and the prompt "follow-up" of auditor recommendations should all be undertaken. The act requires certification by management over the internal accounting control environment and, while this is not required of governments, it is a good standard to judge the current internal control system. We encourage the State to gauge the effects of the act and determine what ways the State could apply sections of the act to enhance accountability and responsibility. In addition, the Government Finance Officers Association (GFOA) makes the following recommendations regarding the establishment of audit committees by state and local governments:

- Every government should establish an audit committee or its equivalent. Reliable audits are essential to the credibility of financial reporting by state and local governments. The audit committee is a practical tool that a government can use to enhance the independence of the external auditor and, hence, the reliability of the financial statement audit.

- The audit committee should be formally established by charter, enabling resolution or other appropriate legal means.

- The members of the audit committee collectively should possess the expertise and experience in accounting, auditing, financial reporting, and finance needed to understand and resolve issues raised by the independent audit of the financial statements. When necessary or otherwise desirable, members of the audit committee should be selected from outside the government to provide the needed expertise and experience.

- A majority of the members of the audit committee should be selected from outside of management. At the same time, the audit committee should include at least one representative each from the executive and legislative branches of the government.

- An audit committee should be sufficiently large to ensure that its members possess all of the skills needed to realize the committee's objectives. At the same time, the audit committee should be small enough to operate efficiently. Therefore, as a general rule, an audit committee should be composed of no less than five and no more than seven members.

- Members of the audit committee should be educated regarding both the role of the audit committee and their person responsibility as members, including their duty to exercise an appropriate degree of professional skepticism.

- The audit committee should oversee the resolution of audit findings.

- The audit committee should present annually to the governing board and management a written report of how it has discharged its duties and met its responsibilities. It is further recommended that this report be made public.

12. New Accounting Standards

Statement No. 39, *Determining Whether Certain Organizations Are Component Units*

An objective of Statement No. 14, *The Financial Reporting Entity*, is that all entities associated with a primary government are potential component units and should be evaluated for inclusion in the financial reporting entity. This statement amends Statement No. 14 to provide additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. Generally, it requires reporting, as a component unit, an organization that raises and holds economic resources for the direct benefit of a governmental unit. Organizations that are legally separate, tax-exempt entities and that meet all of the following criteria should be discretely presented as component units. These criteria are:

1. The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.

2. The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.

3. The economic resources received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

This statement continues the requirement in Statement No. 14 to apply professional judgment in determining whether the relationship between a primary government and other organizations for which the primary government is not financially accountable and that do not meet these criteria is such that exclusion of the organization would render the financial statements of the reporting entity misleading or incomplete. Those component units should be reported based on the existing blending and discrete presentation display requirements of Statement No. 14. The provisions of this statement are effective for the State's 2004 fiscal year.

Statement No. 40, *Deposit and Investment Risk Disclosures*

The deposits and investments of state and local governments are exposed to risks that have the potential to result in losses. This statement addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, this statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Deposit and investment policies related to the risks identified in this statement also should be disclosed.

The board reconsidered the disclosures required by Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*. Portions of that statement are modified or eliminated. The custodial credit risk disclosures of Statement No. 3 are modified to limit required disclosures to:

- Deposits that are not covered by depository insurance and are (a) uncollateralized, (b) collateralized with securities held by the pledging financial institution, or (c) collateralized with securities held by the pledging financial institution's trust department or agent but not in the depositor-government's name; and

- Investment securities that are uninsured, are not registered in the name of the government, and are held by either (a) the counterparty or (b) the counterparty's trust department or agent, but not in the government's name.

Statement No. 3 disclosures generally referred to as category 1 and 2 deposits and investments are eliminated. However, this statement does not change the required disclosure of authorized investments or the requirements for reporting certain repurchase agreements and reverse repurchase agreements, and it maintains, with modification, the level-of-detail disclosure requirements of Statement No. 3.

The provisions of this statement are effective for the State's 2005 fiscal year. Earlier application is encouraged.

<u>Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*</u>

This statement establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This statement also clarifies and establishes accounting requirements for insurance recoveries.

Governments are required to evaluate prominent events or changes in circumstances affecting capital assets to determine whether impairment of a capital asset has occurred. Such events or changes in circumstances that may be indicative of impairment include evidence of physical damage, enactment or approval of laws or regulations or other changes in environmental factors, technological changes or evidence of obsolescence, changes in the manner or duration of use of a capital asset, and construction stoppage. A capital asset generally should be considered impaired if both (a) the decline in service utility of the capital asset is large in magnitude and (b) the event or change in circumstance is outside the normal life cycle of the capital asset.

Impaired capital assets that will no longer be used by the government should be reported at the lower of carrying value or fair value. Impairment losses on capital assets that will continue to be used by the government should be measured using the method that best reflects the diminished service utility of the capital asset. Impairment of capital assets with physical damage generally should be measured using a restoration cost approach, an approach that uses the estimated cost to restore the capital asset to identify the portion of the historical cost of the capital asset that should be written off. Impairment of capital assets that are affected by enactment or approval of laws or regulations or other changes in environmental factors or are subject to technological changes or obsolescence generally should be measured using a service units approach, an approach that compares the service units provided by the capital asset before and after the impairment event or change in circumstance. Impairment of capital assets that are subject to a change in manner or duration of use generally should be measured using a service units approach, as described above, or using deflated depreciated replacement cost, an approach that quantifies the cost of the service currently being provided by the capital asset and converts that cost to historical cost.

Impairment losses should be reported in accordance with the guidance in paragraphs 41 through 46, 55, 56, 101, and 102 of Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and paragraphs 19 through 24 of Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. If not otherwise apparent from the face of the financial statements, the description, amount, and financial statement classification of impairment losses should be disclosed in the notes to the financial statements. If evidence is available to demonstrate that the impairment will be temporary, the capital asset should not be written down.

Impaired capital assets that are idle should be disclosed, regardless of whether the impairment is considered permanent or temporary.

An insurance recovery associated with events or changes in circumstances resulting in impairment of a capital asset should be netted with the impairment loss. Restoration or replacement of the capital asset using the insurance recovery should be reported as a separate transaction. Insurance recoveries should be disclosed if not apparent from the face of the financial statements. Insurance recoveries for circumstances other than impairment of capital assets should be reported in the same manner.

The provisions of this statement are effective for the State's 2006 fiscal year. Earlier application is encouraged.

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Our audit procedures are designed primarily on a test basis and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. Our objective is, however, to use our knowledge of the Department and its interaction with other State agencies and administrative departments 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 report is intended solely for the information and use of the Department of Administrative Services, the Auditor of Public Accounts, the Governor and members of the Legislature, and management of the state of Nebraska, and is not intended to be, and should not be, used by anyone other than these specified parties.

We appreciate and thank all of the Department of Administrative Services employees for the courtesy and cooperation extended to us during our audit.

Very truly yours,

KPMG LLP