KPMG LLP
Suite 1501
Two Central Park Plaza
Omaha, NE 68102

Telephone 402 348 1450
Fax 402 348 0152
Internet www.us.kpmg.com

Suite 1600
233 South 13th Street
Lincoln, NE 68508-2041

Telephone 402 476 1216
Fax 402 476 1944

December 22, 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, 2004, and have issued our report thereon dated December 22, 2004. We have also audited the State's compliance with requirements applicable to major federal award programs and have issued our report thereon dated December 22, 2004. In planning and performing our audit, 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 audit 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, 2004 are shown on the following pages.

1. Input of Fixed Assets

Some capital expenditures were posted to the system with an incorrect acquisition date which resulted in depreciation being computed incorrectly for the assets. We understand that Agency personnel are now reviewing a NIS report of posted fixed assets on a regular basis in order to detect such errors.

2. 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.

3. 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.

4. Cash Reconciliation

The preparation of reconciliations between the actual bank statements and the accounting records (NIS) 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 is developing a reconciliation process; however, the following areas need to be addressed:

- The unreconciled variance shifts from month to month, which still indicates unknown reconciling items continue to exist. As of June 30, 2004, the unreconciled variance between the bank balances and the State's accounting records was $3,833,239, 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 State Disbursement Unit also has an unreconciled amount in addition to the above of approximately $1.3 million.
- Development of an automated 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 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 accounting system. The implementation of an on-line reconciliation process would further require that the Treasurer's current manual ledger be maintained on-line.

5. 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 and they have been documented by State Accounting. State Accounting has added this to their checklist of items to investigate during agency reviews. We encourage the Agency to review and test each agency's procedures in allocating these costs to ensure the procedures adequately and completely distribute these expenditures.

6. Formalization of Policies and Procedures

In recent years, the State implemented a new financial reporting model as required by Governmental 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 prior year, which also substantially changed the Agency's method for preparing the basic financial statements. As a result, we recommend State Accounting continue to develop a formalized policies and procedures manual for its day-to-day operations to ensure consistency of accounting applications, training of accounting personnel, and ensure all personnel are aware of their respective responsibilities and duties.

7. Accrual Questionnaires

(a) 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.

(b) Agencies include on their accrual questionnaires outstanding accounts payable and other estimated accruals. However, at times the agencies label the amounts paid after year-end relating to amounts included on the questionnaire as "P9" transactions in NIS, which are also recorded by the Agency as payables. As a result, accounts payable at two agencies was double-booked. We recommend that the Agency develop a method of financial reporting to ensure payables are not double-booked in the financial statements.

8. Compensated Absences

(a) The State's compensated absences liability 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.

(b) During testwork over the State's compensated absences accrual, several employees' accrual balances for vacation and sick leave were beyond the limits as required by the Nebraska Classified Personnel Rules and the State's three labor contracts. We recommend that employees' vacation and sick leave accrued balances for reporting purposes be reviewed and the limitations be properly calculated.

9. Estate Taxes Receivable

Currently, the Department of Revenue does not accrue a receivable for estate taxes expected to be received after June 30 related to periods prior to that date. We recommend that the Agency coordinate with the Department of Revenue to help develop a method of estimating an estate tax receivable to be accrued at year-end.

10. 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.

11. New Accounting Standards

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.

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

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.

Statement No. 43, *Financial Reporting for Postemployment Benefit Plans and Other Pension Plans*

This Statement establishes uniform financial reporting standards for OPEB plans and supersedes the interim guidance included in Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans.* The approach followed in this statement generally is consistent with the approach adopted in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,* with modifications to reflect differences between pension plans and OPEB plans.

The standards in this Statement apply for OPEB trust funds included in the financial reports of plan sponsors or employers, as well as for the stand-alone financial reports of OPEB plans or the public employee retirement systems, or other third parties, that administer them. This Statement also provides requirements for reporting of OPEB funds by administrators of multiple-employer OPEB plans, when the fund used to accumulate assets and pay benefits or premiums when due is not a trust fund. *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, addresses standards for the measurement, recognition, and display of employers' OPEB expense/expenditures and related liabilities (assets); note disclosures; and, if applicable, required supplementary information (RSI). The measurement and disclosure requirements of the two Statements are related, and disclosure requirements are coordinated to avoid duplication when an OPEB plan is included as a trust or agency fund in an employer's financial report. In addition, reduced disclosures are acceptable for OPEB trust or agency funds when a stand-alone plan financial report is publicly available and contains all required information.

The requirements of this Statement for OPEB plan reporting are effective *one year prior* to the effective date of related Statement 45 for the employer (single-employer plan) or for the largest participating employer in the plan (multiple-employer plan). The requirements of the related Statement are effective in three phases based on a government's total annual revenues, as defined in that Statement, in the first fiscal year ending after June 15, 1999—the same criterion used to determine a government's phase for implementation of Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.* Plans in which the sole or largest participating employer is a *phase 1 government* (those with total annual revenues of $100 million or more) are required to implement this Statement in financial statements for periods beginning after December 15, 2005. Plans in which the sole or largest participating employer is a *phase 2 government* (total annual revenues of $10 million or more but less than $100 million) are required to implement this Statement in financial statements for periods beginning after December 15, 2006. Plans in which the sole or largest participating employer is a *phase 3 government* (total annual revenues of less than $10 million) are required to implement this Statement in financial statements for periods beginning after December 15, 2007. If comparative financial statements are presented, restatement of the prior year financial statements is required. Early implementation of this Statement is encouraged.

Statement No. 44, *Economic Condition Reporting: The Statistical Section.*

This statement amends the portions of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles,* that guide the preparation of the statistical section. This statement establishes new requirements for presenting the statistical section in a comprehensive annual financial report (CAFR).

The statistical section presents detailed information, typically in ten-year trends, that assists users in utilizing the basic financial statements, notes to basic financial statements, and required supplementary information to assess the economic condition of a government.

Three shortcomings have been identified in the statistical section since NCGA Statement 1 was issued in 1979. First, NCGA Statement 1 presented a list of fifteen required schedules with no additional explanation of the nature of the information they were to contain. As a result, some governments prepared their statistical sections differently from others, thereby diminishing the usefulness and comparability of the information. Second, the statistical section requirements were oriented to general-purpose local governments. Consequently, other types of governments had little guidance on how to adapt the requirements to their circumstances, resulting in incomplete and inconsistent application of the standards and, therefore, additional loss of comparability and usefulness.

Third, the requirements for the statistical section did not encompass the new information that governments are presenting as a result of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.*

The statistical section is a required part of a CAFR, although governments are not required to prepare a statistical section if they do not present their basic financial statements within a CAFR. These circumstances are not altered by this statement. However, this statement does apply to any statistical section that accompanies a government's basic financial statements. The provisions of this Statement are effective for statistical sections prepared for periods beginning after June 15, 2005.

Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.*

This statement establishes standards for the measurement, recognition, and display of other postemployment benefits (OPEB) expense/expenditures and related liabilities (assets), note disclosures and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers.

The approach followed in this Statement generally is consistent with the approach adopted in Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers,* with modifications to reflect differences between pension benefits and OPEB. Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* addresses financial statement and disclosure requirements for reporting by administrators or trustees of OPEB plan assets or by employers or sponsors that include OPEB plan assets as trust or agency funds in their financial reports.

Postemployment benefits (OPEB as well as pensions) are part of an exchange of salaries and benefits for employee services rendered. Of the total benefits offered by employers to attract and retain qualified employees, some benefits, including salaries and active-employee healthcare, are taken while the employees are in active service, whereas other benefits, including postemployment healthcare and other OPEB, are taken after the employees' services have ended. Nevertheless, both types of benefits constitute compensation for employee services.

From an accrual accounting perspective, the cost of OPEB, like the cost of pension benefits, generally should be associated with the periods in which the exchange occurs, rather than with the periods (often many years later) when benefits are paid or provided. However, in current practice, most OPEB plans are financed on a pay-as-you-go basis, and financial statements generally do not report the financial effects of OPEB until the promised benefits are paid. As a result, current financial reporting generally fails to:

- Recognize the cost of benefits in periods when the related services are received by the employer;
- Provide information about the actuarial accrued liabilities for promised benefits associated with past services and whether and to what extent those benefits have been funded; and
- Provide information useful in assessing potential demands on the employer's future cash flows.

This statement improves the relevance and usefulness of financial reporting by (a) requiring systematic, accrual-basis measurement and recognition of OPEB cost (expense) over a period that approximates employees' years of service and (b) providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan.

This statement generally provides for prospective implementation—that is, that employers set the beginning net OPEB obligation at zero as of the beginning of the initial year. Implementation is required in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999. The definitions and cutoff points for that purpose are the same as those in Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This Statement is effective for periods beginning after December 15, 2006, for phase 1 governments (those with total annual revenues of $100 million or more); after December 15, 2007, for phase 2 governments (those with total annual revenues of $10 million or more but less than $100 million); and after December 15, 2008, for phase 3 governments (those with total annual revenues of less than $10 million). Earlier implementation is encouraged.

Statement No. 46, *Net Assets Restricted by Legislation, an amendment of GASB Statement No. 34*

GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets. In the process of applying this provision, some governments have had difficulty interpreting the requirement that those restrictions be "legally enforceable." The confusion over this phrase has resulted in a diversity of practice that has diminished comparability.

This statement clarifies that a legally enforceable enabling legislation restriction is one that a party external to a government—such as citizens, public interest groups, or the judiciary—can compel a government to honor. The Statement states that the legal enforceability of an enabling legislation restriction should be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specified by the enabling legislation or if a government has other cause for reconsideration. Although the determination that a particular restriction is not legally enforceable may cause a government to review the enforceability of other restrictions, it should not necessarily lead a government to the same conclusion for all enabling legislation restrictions.

This statement also specifies the accounting and financial reporting requirements if new enabling legislation replaces existing enabling legislation or if legal enforceability is reevaluated. Finally, this Statement requires governments to disclose the portion of total net assets that is restricted by enabling legislation. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2005.

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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 Agency 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