



STATE OF VERMONT

Management Letter of
Observations and Recommendations

June 30, 2008



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December 23, 2008

To the Speaker of the House of Representatives,
President Pro-Tempore of the Senate,
and the Governor of the State of Vermont:

We have audited the basic financial statements of the State of Vermont (the State), as of and for the fiscal year ended June 30, 2008, and have issued our report thereon dated December 23, 2008. In planning and performing our audit of the financial statements of the State, in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, we considered the State's internal control over financial reporting 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 State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control. We have not considered internal control since the date of our report.

In accordance with *Government Auditing Standards*, we have issued a report dated December 23, 2008 on our consideration of the State's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. We noted certain matters communicated in that report related to the State's financial reporting process that we consider to be significant deficiencies and material weaknesses in the State's internal control over financial reporting

During our audit we noted certain other 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 and recommendations.

Our audit procedures are designed primarily to enable us to form an opinion 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 State's operations 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 your convenience.

This report is intended solely for the information and use of the Speaker of the House of Representatives, the President Pro-Tempore of the Senate, the Governor, and management of the State of Vermont and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

KPMG LLP

Very truly yours,

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Stimulus Funding under the American Recover and Reinvestment Act of 2009

Observation

On February 17, 2009 President Obama signed into law the American Recovery and Reinvestment Act of 2009 (ARRA), a \$787 billion economic stimulus program, including \$355 billion in funding directly to State, Local and Federal Governments. Funds will be distributed primarily through existing federal programs and recipients of the funding will have responsibility for an unprecedented level of oversight, accountability, transparency, and reporting. Some of the specific responsibilities include monitoring and oversight of funds received, performance measurement and, fraud prevention and detection, project and risk management, and citizen-centric Web sites. It is also expected that these increased responsibilities will be attached to all federal funding in the future.

Specific guidance from the Federal government has identified the following crucial accountability objectives:

- Funds are awarded and distributed in a prompt, fair, and reasonable manner;
- The recipients and uses of all funds are transparent to the public, and the public benefits of these funds are reported clearly, accurately, and in a timely manner;
- Funds are used for authorized purposes and potential for fraud, waste, error, and abuse are mitigated;
- Projects funded under this Act avoid unnecessary delays and cost overruns; and
- Program goals are achieved, including specific program outcomes and improved results on broader economic indicators.

Recommendation

The unprecedented level of responsibility attached to ARRA will present numerous challenges to states. While the State has taken the initial major step of establishing an Office of Economic Stimulus and Recovery, it is imperative that sufficient resources be allocated to create appropriate infrastructure and processes to address the federal objectives, ensure that the State complies with the stringent requirements for this funding and mitigates risks related to the Governor's certifications made prior to the receipt of any Federal funds under ARRA.

Based on our work with other states, we are presenting the following list of actions being taken to help prepare for ARRA. This is not intended to be an all-inclusive list:

- Analyze new compliance requirements to determine how the State will ensure compliance
- Analyze new reporting requirements and development of a process to meet those requirements
- Develop anti-fraud, waste and abuse controls
- Perform agency readiness assessments
- Develop guidelines and policies applicable to agencies receiving ARRA funds
- Develop reporting requirements for entities (sub-recipients) to which the state provides ARRA funds
- Analyze the IT changes needed to support the tracking of ARRA funds
- Analyze IT security/privacy issues that may occur regarding the transparency of data

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- Analyze financial accounting and control procedures
- Establish a compliance monitoring function to ensure the state is complying with applicable regulations before the funds are subject to external audit
- Assess ability of construction systems (manual and automated) to prevent construction overruns
- Analyze how to identify and collect the performance measures required to be reported

Management's Response

The Office of Economic Stimulus and Recovery, working with the Department of Finance and Management have already created interim policies and procedures concerning accounting for, tracking and reporting for ARRA monies. A new Administration Bulletin specifically and wholly about ARRA is currently under development and will be issued prior to June 30, 2009. A new ESR website, containing a link to Recovery.gov and ARRA information specific to Vermont has been launched; the website is updated weekly and new information is posted as it becomes available (example: the VT ARRA Awards list). The interim policies and procedures include separate fund and account codes specific to ARRA, new approval and informational forms, and quarterly reporting forms and instructions for internal use and to be used by Tier 1 Recipients. These interim policies and procedures, plus additional instructions, forms, process flows, etc. will be formalized in the new Administrative Bulletin. The Legislature's Joint Fiscal Office has been involved in the planning from the start.

ESR is responsible for consolidating the information, reported quarterly by the State of Vermont agencies and departments to their individual federal funding agencies, into a statewide quarterly ARRA Report to OMB. Individual ARRA meetings have been held with each agency and department expected to receive ARRA monies. Once the new Bulletin has been issued, we will hold one or more statewide ARRA meetings for all staff involved with managing, accounting for, tracking, and reporting on ARRA projects, including but not limited to Secretaries, Commissioners, Deputies, Business Managers, Accountants, and the individually ARRA Activity Managers; each identified ARRA Activity will have an ARRA Activity Manager assigned who is fully accountable for compliance with the Act and the successful completion of the project or program. Management believes that it has gotten out in front of ARRA; everything being done is directed at assuring effective and efficient use of ARRA monies, compliance with all monitoring and reporting requirements, sound fiscal and accounting controls, departmental accountability standards, and the prevention of fraud and abuse.

Disproportionate Share Hospital (DSH) Program Payments

Observation

The State has previously and continues to participate in the Medicaid Disproportionate Share Hospital (DSH) Payments Program. The DSH Program was established to assist hospitals that serve a disproportionate number of Medicaid and low-income patients by requiring the state to make DSH payments in addition to the standard Medicaid payments to those eligible hospitals (DSH hospitals).

In December 2008, the Department of Health and Human Services Center for Medicare and Medicaid Services (CMS) issued the final rule related to auditing and reporting of DSH payments under the State's Medicaid program. The final rule is effective January 19, 2009 and requires audits initially be performed for the State's 2005 and 2006 Medicaid State Plans (MSP). The final rule requires that these audits be completed by September 30, 2009 and submitted to the Federal government by December 31, 2009. For the 2007 MSP, the audit reports must be completed by September 30, 2010 and submitted within 90 days after completion.

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Beginning in 2008, the audits must be completed within three years of completion of the related MSP with the 90 day submission requirement. The required audits must be performed for each DSH hospital and separate from the current Medicaid audit performed as part of the annual OMB Circular A-133 audit.

Among the many other provisions of the regulations, key ones include:

- States must report annually 17 items about each hospital that receives DSH payments.
- Uncompensated charge data from self reported data including hospital surveys should not be used for DSH calculations. Charges require independent and separate verification by the auditor.
- Uncompensated costs cannot be based on prior year data updated for inflation.
- In order to receive federal matching of Medicaid DSH payments compliance of DSH final rule is required.

Finally, CMS provides a transition period prior to audit repayment requirements. Beginning 2011, audit findings that show DSH payments exceed hospital-specific limits will require CMS to recoup funds not reallocated to other state hospitals with audit findings that show payments below their limit.

Recommendation

Although the State has indicated that it may seek a waiver for the fiscal year 2005 through fiscal year 2008 DSH audits, based on discussions with officials in other states, it is our understanding that CMS will likely not grant waivers for anything other than the most unique situations.

Unless the State can secure a waiver promptly, it is imperative that the State, given the short timeframe for compliance, devote sufficient resources to ensure compliance and avoid potential risk of losing future federal funding under the Medicaid DSH Program.

Management's Response

Vermont intends to comply with the cited regulation insofar as it is possible given the timing of the adoption of the regulation and the periods to which it applies. The Office of Vermont Health Access has arranged with its DSH consultant to update the DSH procedures that were adopted in October, 2008. As soon as that work is available, OVHA will implement the required additional work.

The time of performance is ongoing.

Centralized Location for Agency Audit Reports

Observation

Throughout each fiscal year, the Federal government performs numerous audits of programs operated by the various State agencies and issues reports on those audits. These reports need to be collected and analyzed as part of the year end financial statement compilation process.

The State does not have policies and procedures to identify and track the results of the Federal government audits in a central location. As a result, the State can not effectively monitor the results of these audits in order to determine whether or not the results of the audit could have a material impact on the year end financial

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statements. In addition, the State is not able to ensure that appropriate and timely corrective action has been taken to address the matters noted as a result of each audit.

Recommendation

We recommend that the State implement procedures to ensure that all audits and reviews are collected and reviewed at a central location within the Department of Finance and Management (the Department) so that the Department can review the results of all Federal audits to determine whether or not the audit results could have a material impact on the financial statements. In addition, the Department can work directly with individual State agencies and departments to ensure that timely and appropriate corrective action has been taken.

Management's Response

The Department of Finance and Management, through its Internal Control Section, is in the process of developing procedures to address these concerns. It is our expectation that these procedures will be in place before October 1, 2009.

Processing of Traffic Tickets

Observation

The Judiciary Department is responsible for processing all traffic tickets issued by law enforcement in the State at its processing center in White River Junction. The Judiciary Department is currently in the process of developing a new computer system to process and track traffic tickets.

The Department of Taxes currently operates a tax collection computer system that has the capability to collect, process and track traffic tickets issued by the Judiciary Department. The use of an already existing system instead of investing in the development of a new system would save the State money and increase efficiencies between the two Departments.

Recommendation

We recommend that the State continue its collaboration effort to review the feasibility of using the current collection computer system operated by the Department of Taxes to process traffic tickets.

Management's Response

From Judiciary: The Judiciary does not agree with this recommendation. If administrative processing and collection of the revenue were the only goals of the Judicial Bureau in adjudicating traffic tickets, we might be more agreeable with this recommendation. However, the money is a small part of the overall process. The Judicial Bureau is the forum for the people to hold individuals accountable for behavior that transgresses the law and for those individuals to hold government accountable for enforcing the laws fairly and properly. Careful consideration must be given to issues involving the exercise of discretion within the powers granted to each branch of government under the constitution.

In a less grand context, the Tax Department will not have a computer system that can accomplish the Judicial Bureau's function within the time frame for which it is needed. It may be able to accomplish some of the revenue functions but not without a substantial investment. The Judiciary would still have to develop the computer software for the case management of the tickets as they proceed through the judicial process. The effort to

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include accounting for the collection of revenue in the system is not significant to the overall system. The Judicial Bureau system will be available in the Spring of 2010. The Tax Department cannot match that date. Frankly, both systems will get the revenue into the State's hands within the same time frame and we suspect the development cost of the judicial computer approach will be less expensive than the Tax Department alternative.

When this idea was first proposed, we gave the Tax Dept. a sample of 250 tickets so they could test their system. Less than 10 tickets scanned with any accuracy. The Tax Dept has represented to the Legislature that it could do this job well if the police would submit ticket data electronically. So could we. However, it would take all law enforcement agencies to computerize the ticketing process from the car to the station. Then it would take data interfaces to push data to the Tax Department and to the Courts. These interfaces and E-Ticketing system have not been a priority for the State or for Local Government. In fact, the State passed up the opportunity to invest in this technology when the stimulus funding became available.

We do endorse the idea of all delinquent accounts receivable being referred to a Department of Revenue for coordinated collection processes with the rest of State Government. There is huge potential for increasing the compliance with judgments by consolidating the collection tools within one department. We have begun meeting with Tax Department officials regarding this idea.

From the Tax Department: *The Tax Department is starting its process for shifting all revenue processes from other state agencies to a Revenue Department. The Judiciary is one of the first Departments that will be included in the transition. The Tax Department already works with the Court Administrator's Office in collections activities for delinquent accounts. During a 12-month period in 2008-2009, the Tax Department offset more than \$1,000,000 in income tax refunds and property tax adjustment payments for 3,729 filers with amounts due to the Judiciary.*

Preliminary meetings with the Acting Court Administrator included discussions on the new computer system status and its future development in relation to future revenue management activities. The Tax Department will review the full work plan for the new computer system with a focus on its integration into current and future revenue collections efforts. The new computer system is more than a revenue tool, it also provides a basis for communicating between local law enforcement officials and the courts. When reviewing the work plan, we will identify the revenue functions of the new system that can be efficiently carried out with Tax Department tools and resources while still meeting the other information objectives of the Judiciary Department.

Judiciary Reconciliation from Ticket Database (VTAD) to the VISION System

Observation

The Vermont Judicial Bureau processes approximately \$5 million a year in traffic tickets and subsequent cash collections through the Traffic Database (VTAD), which is a system separate from the State of Vermont's centralized accounting system, VISION. On a monthly basis, the Court Administration Office performs a reconciliation between VTAD and the VISION system to ensure that the cash collected between the two systems is properly reconciled.

During our test work over the reconciliation between VTAD and the VISION system, we noted that there was a lack of documentation to support that the monthly reconciliation had been performed. In addition, there currently is no supervisory review over the reconciliation to ensure that the reconciliation is complete and accurate. As a result, if there was an error in the reconciliation process, it may not be detected timely.

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Recommendation

We recommend that the Court Administration Office review its procedures over the monthly reconciliation performed between VTAD and the VISION system to ensure that the reconciliation is properly documented and that a supervisory review is performed timely.

Management's Response

Every month the department of Finance & Management receives deposit packets prepared by the Judicial Bureau that include cash/check deposits, credit card activity deposits, and wire transfer deposits from our contracted collection agency. All of these deposits have been reconciled by a clerk and approved by the deputy manager or manager of the Judicial Bureau. These deposit packets consist of a VISION accounting system control sheet, conversion deposit worksheet (VTADS to VISION accounts), deposit bank receipt, and a deposit final report complete with account summary from the case management system. The finance department at the Court Administrator's Office reconciles these monthly packets using Excel query reports from VISION that include data such as deposit ID number, deposit amount, deposit date, and the various revenue accounts where money was deposited. The totals on the VISION report are verified with the information contained on the VTADS "Report of VTTC Collections-Account Summary (report rmo02)." All discrepancies are noted on the Excel spreadsheet with the corresponding correcting journal entry number and referenced back to the original deposit in error. All Judicial Bureau deposits, monthly VTAD reports, VISION Excel queries with reconciliation notes, and correcting journal entries are filed as a completed packet. An additional step can be added to our month-end closing procedures that includes having another accountant approve the reconciliation.

Evaluation of Internal Control

Background

The State's internal control guide indicates that management should establish procedures to monitor the effectiveness of control activities and the use of control overrides. Monitoring activities provides management with the opportunity to identify and correct any control deficiencies or problems and minimize the impact of unfavorable events.

Observation

During our test work, we noted that many of the departments and agencies reviewed do not have a mechanism in place to evaluate their internal controls. At the statewide level, the Department of Finance and Management has the responsibility to ensure that State organizations are functioning within the framework of all policies and procedures set forth by the Department and the Agency of Administration. To fulfill this role, the Department has established an internal control group that has published internal control best practices and has implemented a process whereby departments and agencies are annually required to complete an internal control self-assessment questionnaire, which, in some cases, are validated by the internal control group. While the internal control self-assessment questionnaire is a useful tool, it is very generic and does not address the many varied business activities conducted by the State and does not mitigate the need for organization specific internal control evaluations.

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Recommendation

We recommend that the State expand its current procedures for self-assessments over internal controls and develop guidance to assist individual departments in the development a more comprehensive internal control assessment that is specific for the needs of each department. The use of a more comprehensive tool will allow for an improved monitoring process over the internal controls within each department and will provide a mechanism for each department to evaluate its current internal control structure. This should include setting entity-wide standards for ensuring that each department has documented its existing internal control structure so that it is able to independently monitor whether or not key controls are properly designed as well as subsequently monitoring each key control to ensure that it is operating effectively.

Management's Response

The Department of Finance and Management believes strongly that as a result of our Self Assessment of Internal Controls approach, the State's collective awareness of internal controls has increased significantly. When the control consciousness of an organization is raised, the most logical conclusion is that the system of internal control is strengthened and exposure to risk is minimized. The self assessment process is designed to help managers review the adequacy of internal controls within their areas of responsibility, identify improvement opportunities, and plan for follow-up actions. We continuously stress the importance of management to ensure that responsibilities and expectations are effectively communicated to all levels, and support of the system of internal control must be considered a part of proper workplace performance. Based on the limited resources available to the department, we believe our current process is the most effective and efficient way to proceed.

Fraud Hot Line

Observation

An important element of the risk assessment process is the consideration of fraud risk. One component of the fraud risk assessment process is an anonymous reporting mechanism.

During our test work over the fraud risk assessment process, we noted that there do not appear to be any mechanisms in place to support Nonmanagement personnel in bringing inefficiencies or improprieties to the attention of appropriate officials. While the Office of the State Auditor does maintain a confidential reporting phone line, the majority of the calls received are related to citizen concerns and not the concerns of State employees. It would be more beneficial for the Agency of Administration through the Department of Finance and Management to establish a phone line that all employees are directed to use for anonymous reporting of fraud or other concerns.

Additionally, the American Recovery and Reinvestment Act (ARRA) places a tremendous amount of responsibility on states to ensure that funds received are properly spent by implementing sufficient anti-fraud, waste and abuse controls.

Recommendation

We recommend that the State review all of its existing procedures related to fraud, waste and abuse including those related to anonymous reporting of improprieties, to ensure that federal and state funds are adequately safeguarded and that a mechanism exists to ensure that any unethical or inappropriate activities can be promptly reported to the correct State officials.

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Management's Response

In order to provide a truly independent opportunity to State employees to report fraud without the fear of retribution, it is the position of the Department of Finance and Management that such calls be directed to the State Auditors Confidential Line. The Department of Finance and Management has taken the opportunity on a number of occasions to remind departments and employees of this Confidential Line. Below are some of the efforts undertaken by Finance and Management to increase the level of awareness of the Auditors Confidential Phone Line.

- *The following question has been added to our Annual Self Assessment Survey:*
 - *Does the department periodically inform employees of their responsibility to report suspected fraud to management or to the State Auditor's Office Confidential Line for "reporting suspected waste, fraud, or abuse"?*
- *In a recent Internal Control News Letter we included an article on Occupational Fraud. The following statement was included in that article.*
 - *The VT State Auditor's Office maintains a confidential line at 1-877-290-1400 to report suspected financial fraud, abuse, or corruption in State Government.*
- *The Department of Finance and Management maintains a direct link to the State Auditor's Office Confidential Line on the Finance and Management website.*
- *The Department of Finance and Management has included a statement about reporting fraud to the State Auditor's Office Hot Line in the "to be" published Employee Code of Conduct guide.*

New Accounting Pronouncements

GASB 49

Observation

In November 2006, the Governmental Accounting Standards Board (GASB) issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations* (GASB Statement No. 49). This Statement addresses accounting and financial reporting standards for pollution (including contamination) remediation obligations (PMO), which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. Governments are required to accrue, as a liability, a PMO once any one of five specified obligating events occurs.

This Statement is effective for the State for the fiscal year ending June 30, 2009, and requires that net assets at June 30, 2008 be restated.

Recommendation

The State has already begun the process of creating an inventory of pollution sites, some of which might result in the recognition of a liability. We recommend that this process continue and that a process be established to ensure that the status of the sites in the inventory be adequately monitored to ensure that changes in the status of each site is tracked and properly accounted for.

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Management's Response

The spring 2008 Self Assessment of Internal Controls survey included an addendum on GASB Statement No. 49, which asked about the existence of any pollution sites. In the spring of 2008, Department of Finance and Management met with the Department of Environmental Conservation (DEC). The DEC's Waste Management Division's Site Management Section maintains a database inventory of the pollution sites in the State (<http://www.anr.state.vt.us/dec/wmd.htm>). This database includes private underground storage tank and chemical contamination sites for which the State is not the responsible party, as well as sites for which the State is responsible for the clean up. The DEC uses VISION project ids to track costs incurred for each site. The DEC prepared an estimated pollution remediation obligation for June 30, 2008, for sites that the State is obligated to clean up. The Department of Finance and Management has found that the database includes sites that other State departments own, and agrees with the US EPA listing of Vermont Superfund sites. Therefore, Management is working with and relying on the DEC staff for estimating the pollution remediation obligation amounts and information needed for the footnote disclosures.

GASB 51

Observation

In July 2007, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets* (GASB Statement No. 51). This Statement establishes accounting and financial reporting requirements for intangible assets including easements, water rights, timber rights, patents, trademarks, and internally generated computer software.

The requirements of Statement No. 51 are effective for the State for fiscal year ending June 30, 2010.

Recommendation

Identifying the population of intangible assets that the State may have is a time consuming process that will require the involvement of many agencies and departments around the State. We recommend that the State begin the analysis needed to assess the extent to which the State has intangible assets. Creating such an inventory of will enable State officials to determine those items that need to be recognized as assets on the State's balance sheet.

Management's Response

Several months ago the Department of Finance and Management established a GASB 51 Team. Since then the Team has surveyed departments to assess the types and extent of intangible assets that we will be reporting on. We are currently working on amending our current Asset Management Procedure to include more extensive guidance on intangible assets. We are in the process of reconfiguring our VISION accounting system to accommodate additional asset profiles to account for the intangible assets. We are also updating our training materials to provide better guidance to departments. We are working with the Department of Information and Innovation to assure that all IT projects resulting in an intangible asset have provisions in place to capture the appropriate cost through out the life of the project.

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GASB 54

Observation

In March 2009 the GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. This Statement is designed to improve financial reporting by establishing fund balance classifications that are easier to understand and apply. In essence, it establishes a hierarchy based largely on the extent to which a government is bound to observe spending constraints that govern how it can use amounts reported in the governmental funds balance sheet.

The Statement establishes several new classifications based on a government's control over how specific amounts can be spent including:

- ***Nonspendable*** – amounts that are not in a spendable form (inventory) or are required to be maintained intact (the principal of an endowment fund).
- ***Restricted*** – amounts that can be spent only for the specific purposes stipulated by external resource providers, constitutionally, or through enabling legislation.
- ***Committed*** – amounts that can be spent only for the specific purposes determined by a formal action of the government's highest level of decision-making authority.
- ***Assigned*** – amounts intended to be spent by the government for specific purposes. In governmental funds other than the general fund, assigned fund balance represents the amount that is not restricted or committed.
- ***Unassigned*** – the residual classification for the general fund for all amounts not contained in the other classifications.

The State is required to implement the Statement for the fiscal year ending June 30, 2011 with a retroactive restatement as of July 1, 2010.

Recommendation

We recommend that the State begin the analysis needed to assess the extent to which the State's fund balance presentation will change under the new Statement and begin to educate its financial constituents about the impact of these changes on the State's financial statements.

Management's Response

The Department of Finance and Management is sending staff to training on the new GASB Statements. Over the next fiscal year, the Department will review the existing governmental funds and fund balance classifications. During the 2010 legislative session, the Department will recommend changes to statutory language where necessary to change the current classifications to the new classifications. During Fiscal Year 2011, the Department will implement GASB Statement No. 54 by restating the beginning modified accrual fund balance classifications for the governmental funds.