

NO. 2000-0085-3

INDEPENDENT STATE AUDITOR'S  
REPORT ON CERTAIN ACTIVITIES  
OF THE  
DEPARTMENT OF THE STATE TREASURER  
AND RECEIVER-GENERAL

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## INTRODUCTION

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The Treasurer and Receiver-General, an elected constitutional officer of the Commonwealth, has jurisdiction over the Department of the State Treasurer (DST) and the State Board of Retirement. In addition, the Treasurer is the chairman of the State Lottery Commission, and a member of the Emergency Finance Board, which is budgeted under the Treasury Department, and, although not within the Treasurer's purview, the Massachusetts Cultural Council is budgeted under the Department of the State Treasurer. The DST is responsible for variety of financial functions, including receiving and managing all funds paid to the Commonwealth; issuing and managing the state's long-term debt; issuing short-term debt and managing the Commonwealth's cash flow; paying retirees; administering the pension system for state employees and retirees; and processing and paying the Commonwealth's bills, in concert with the Office of the State Comptroller (OSC). The Massachusetts General Laws, Chapters 158 and 200A, also assign to the department the responsibility for receiving, safeguarding, and liquidating property that has been transferred to DST from abandoned-property holders. In addition, the Treasurer is statutorily required to serve on numerous boards and commissions (on several of which the Treasurer ex officio serves as chairman); maintains ex officio appointment power to several Commonwealth boards and commissions, and is statutorily mandated to issue various annual reports regarding state finances to other state officials, including the Commissioner of the Department of Revenue, the General Court, and the Attorney General, and to the municipalities within the Metropolitan Park District.

In accordance with Chapter 11, Section 12, of the General Laws we conducted an audit for the purpose of:

- Determining the extent to which the DST had implemented or developed a plan for implementing our prior audit report recommendations.
- Conducting a Chapter 647 review regarding the Commonwealth's practice and method for payment for banking services.
- Conducting a review regarding alleged fraudulent abandoned property claims filed by or on behalf of G.E. Investments or General Electric.
- Reviewing an underpayment of Commonwealth federal payroll tax obligations of approximately \$35 million.
- Conducting fiscal year end cash cut-off audit procedures to determine compliance with the OSC's year-end closing instructions. (See Audit Report No. 2000-5002-2)

During the course of our audit we met regularly with Senior Treasury Management, including the Deputy Treasurer, the Assistant Treasurer of Abandoned Property, Deputy of Cash Management, Assistant Treasurer of Administration and Finance, General Counsel, Director of Report Processing for the Abandoned Property Division, Director of Management Information Systems and other representatives and discussed in detail the various areas of our review and the issues that are in our report. During these meetings we discussed and received explanations, documentation, feedback on

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corrective measures that have or will be implemented, and other pertinent information regarding internal controls, accounting policies and procedures, compliance with applicable laws, rules, and regulations regarding abandoned property, cash management, and other areas in the scope of the audit over DST accounts, functions and activities. Also, officials accompanied our staff on various observations and reviews during the audit, such as, inventory of physical property and an on-site visit to a bank that was holding abandoned property. We also met with representatives from the Office of the State Comptroller and the Division of Insurance. All the discussions and comments provided by these individuals was considered and where appropriate was incorporated in our final report.

AUDIT RESULTS 8

1. Status of Prior Audit Results: Our prior audit report revealed that the DST needed to improve its internal controls over abandoned property in several areas and to document an internal controls plan in accordance with Chapter 647 of the Acts of 1989. Our follow-up review indicated that, although the DST has taken steps to address these prior issues, further improvements were necessary, as discussed below: 8

a. Abandoned Property Controls 8

(1) Improvements Needed over Abandoned Property Controls: Our prior audit disclosed that DST lacked an adequate internal control environment in the processes by which it receives, records, inventories, monitors, safeguards, and liquidates property that has been transferred to it from abandoned-property holders. In addition, we found that DST did not manage and liquidate physical property in a timely manner consistent with the provisions of Chapter 200A, Section 9, of the General Laws. Moreover, our review and observation of certain abandoned property stored within an DST vault at the State House disclosed that property was maintained inside a vault in a haphazard and disorganized manner. Our follow-up review revealed that the DST has taken some corrective actions. Specifically, the physical tangible property being held at the vault was being inventoried and entered into the abandoned property division's computer, the combination to the vault had been changed and three employees now have the new combination, and additional storage space was being made available in order to accommodate more abandoned property and organize the contents. 8

However, our follow-up review also identified areas that still needed improvement. Specifically, the division has not liquidated physical property in compliance with Chapter 200A, Section 9, of the General Laws; documented an internal control system for abandoned property as required by Chapter 647 of the Acts of 1989; made periodic bank deposits for checks, and currency received from holders; provided supervision of staff members performing the inventorying of the vault; and prepared written procedures for the receiving, recording, inventorying, monitoring, safeguarding, and liquidating of abandoned property. The DST indicated that it was still in the process of developing a comprehensive internal control plan that will include abandoned property division.

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- (2) Abandoned Property Division Operating Procedures Are Not in Accordance with Certain Provisions of the General Laws: Our prior review disclosed that the operating procedures of the Abandoned Property Division did not fully comply with all applicable provisions of Chapter 200A of the General Laws. Specifically, the division did not include the names of owners of tangible abandoned property received from banking institutions and hospitals, as well as the payees of state unclaimed checks, on the annual publication of abandoned-property owners; meet annual statutory mandated publication requirements; improperly entitle the listing of unclaimed property owners for questionable purposes; and publish the listing in all counties of the Commonwealth. In addition, the division had not taken steps to ensure that all holders of abandoned property were aware of statutory reporting and transfer requirements.

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During our follow-up review we determined that the DST was publishing the names of abandoned property holders, except for tangible property holders, state unclaimed checks, and aggregate transfers in newspapers covering every county in which an apparent owner had a last known address. In addition, we found DST had properly entitled the listing of unclaimed property owners. Also, the division is mailing a notice to each person having an address listed therein who appeared to be entitled to property of the value of \$100 or more presumed abandoned under Chapter 200A.

- (3) Improvements Needed in Recovery of Unreported Abandoned Property: Our prior audit disclosed that the DST's decision to expand the number of private accounting firms used in the identification of abandoned property not transferred by holders in accordance with the Massachusetts General Laws was not prudent or cost-effective. Specifically, our prior review indicated that the Request for Responses for such accounting services did not contain the specific number of reviews required to be conducted annually; the performance criteria outlining specific audit procedures and compliance review requirements; the specific content requirements of monthly interim engagement reports, such as the number of reviews started, the status of reviews in progress, and the number of reviews completed; and the minimum standards for potential firms' knowledge of abandoned property laws or experience in conducting abandoned property compliance reviews as an absolute prerequisite of contract issuance.

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During our follow-up review we determined that a new Director of Auditing and Compliance was hired with the responsibility of both selecting potential holders for the private accounting firms to review and monitor the actual progress of the private accounting firms. In addition, on August 8, 2000, Chapter 198 of the Acts of 2000 was signed. This legislation's overriding goal is to boost voluntary business compliance with Chapter 200A by providing a six-month "amnesty period" during which holders of abandoned property would not be penalized for turning over abandoned property that should have been reported to the Commonwealth earlier. Also, in response to our transition audit we were informed that all third-party auditing firms contracts expire on June 30, 2000 and that Requests for Responses will be drafted and published in accordance with our recommendation.

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- (4) Improvements Needed in Fiduciary Controls over Dividends, Stocks, Bonds, and Other Intangible Abandoned Property: Our prior review revealed that the two private banks providing custodian services for cash, dividends, stocks, bonds, and other property in excess of \$210 million were not selected by an open competitive procurement process; no written contract existed between DST and its two private banks; the DST could not provide an accounting of the amount of fees paid to the private banks; and at one point a private bank had not remitted cash dividends totaling in excess of \$3.4 million for up to six years after receipt. Moreover, DST had not liquidated stock in the most timely manner allowed by statute and allowed a private bank to consolidate reporting years, thereby further confusing and delaying the liquidation process. Also, DST did not adequately review and reconcile monthly reports issued by one private bank, as evidenced by the submission to us of an internal report that indicated the portfolio balance to be \$77.6 million and a report generated by the bank for the same period that indicated a portfolio balance of \$43.2 million. Additionally, our prior review noted that DST could not identify all mutual fund companies serving as custodian of property that has become abandoned or determine the present value of funds held by mutual fund companies. Our follow-up review disclosed that some corrective action has been taken. Specifically, there were now written contracts between Investors Bank and Trust Company and DST for custodial services and a second contract between Fleet National Bank and Commonwealth of Massachusetts Office of the State Treasurer. In addition, on June 30, 1999, DST requested its two custodians (Investors Bank and Trust Company and Fleet Bank) to transfer all cash balances accrued in DST's Abandoned Property accounts to the Commonwealth.

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However, our follow-up review also indicated that corrective action and internal control improvements were still needed in DST's fiduciary controls over dividends, stocks, bonds, and other tangible abandoned property. Specifically, the DST does not monitor and reconcile portfolio custodians activities and has no written internal controls, guidelines, or procedures for oversight of custodians and mutual fund companies. In addition, the DST's last sale of stock was in 1990 and last mutual fund sale was in 1997 for the funds being held by the two custodians and mutual fund companies. Had DST established a policy for the reoccurring liquidation of stocks and bonds remitted in previous years, the Commonwealth would have received millions of dollars into its General Fund, and the volume and dollar value of outstanding stocks and bonds held by custodians would be greatly reduced.

- b. Internal Control Plan Not Documented: Our prior report disclosed that DST did not comply with a Chapter 647 of the Acts of 1989 requirement that it have a clearly documented internal control plan, readily available for examination and specific to all operational cycles. The lack of such a plan has resulted in the existence of a control environment that was inadequate to provide the highest level of security over funds appropriated by the Legislature and Commonwealth revenues received by DST from other state agencies and departments.

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Our follow-up audit disclosed that, although the DST has addressed some weaknesses in its internal controls and processes that were previously in place, the DST is in the process of developing an internal control plan as required by Chapter 647 of the Acts of 1989 and the Office of the State Comptroller's Internal Control Guide.	
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2. <u>Reporting of Abandoned Property Deposits from Banks, Insurance Companies, and Other Holders Did Not Include the Owner's Name, Last Known Address, and Other Pertinent Information Required by Chapter 200A:</u> Our review disclosed that the DST accepts aggregate, single-dollar deposit amounts of presumed abandoned property from banks, life insurance companies and other holders of abandoned property without the detailed information as to the owner's name and last known address and a breakdown identifying the dollar amount of the individual's property as required by Chapter 200A, Section 7(b), of the General Laws. As a result of the DST's inability to determine ownership, its Abandoned Property Division's practice has been to rely on holder's verification in issuing payments of claims from aggregate deposits. This was that practice used by the DST when it relied on certifications received from both State Street Bank and Trust and General Electric Investments to authorize the payment of more than \$7 million for alleged fraudulent abandoned property claims (see Subsequent Events). This is also the practice used daily to pay all claims derived from aggregate deposits.	26
3. <u>Improper Reporting and Untimely Payment of over \$35 Million of the Commonwealth's Federal Payroll Tax Liabilities:</u> During the first quarter of calendar year 2000, the DST issued payments totaling approximately \$35 million to the U.S. Department of the Treasury, Internal Revenue Service (IRS) for previously underreported and unpaid federal payroll tax liabilities for 1996-1999. We also found that there was not a system in place for the accounting, reconciling, reporting, recording, and payment of federal payroll taxes to ensure the Commonwealth's timely and accurate payment of federal payroll tax obligations and the timely billing and reimbursement of employer Medicare matching share from state agencies. In addition, the DST did not have written policies and procedures for the payment and reconciliation of Commonwealth federal tax obligations, OSC billings and recovery of employer matching Medicare tax obligations from state agencies, as well as, subsequent reimbursements to the DST were performed in an inconsistent and erratic manner, and procedures were not in place to conduct monthly monitoring to ensure that income taxes withheld and employee and employer Medicare tax obligations were accurately reported and timely paid in full in compliance with IRS regulations. Finally, in excess of \$4.6 million in overpayments due the Commonwealth went unrecovered for a 20-month period after the DST received notification from the IRS of the overpayment.	30
4. <u>Improvements Needed in the Administrative and Accounting Functions of the Float Fund:</u> The DST maintains a cash suspense fund (Float Fund), that functions as the Commonwealth's central disbursement account for the payment of its obligations for debt service, local aid, warranted and non-warranted payments, federal and state payroll tax obligations, vendor invoices, and Department of Revenue state tax refund payments. During fiscal years 1999 and 2000, the annual dollar amount of activity that flowed through the Float Fund exceeded \$55 billion. The Float Fund's	35

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outstanding balance has been used as the funding source for the payment of tens of millions of dollars of the Commonwealth's employer matching Medicare tax obligations and the Department of Correction Inmate Escrow Account expenditures without timely reimbursement by appropriate funding sources. DST annually performs a reconciliation of the Float Fund, however, for several years these reconciliations have included a large number of unreconciled variances. The new administration indicated that it has identified and corrected many variances but given the volume of activity in the fund and numerous past problems, it was still in the process of identifying and correcting them. However, DST has not established formal written policies and procedures for the use of Float Fund's outstanding balance for payment of Inmate Escrow Account expenditures and employer matching Medicare tax payments, the timely reimbursement of the Float Fund, and the reconciliation and monitoring of fund activity.

5. Improper Management of Bank Service Fee Payments: Our review disclosed that as a result of improper cash management by former DST staff and the absence of written contractual banking agreements, the Commonwealth has incurred the loss of more than \$565,000 in unused earned bank credits; improperly stated the cost of bank service fees incurred in both fiscal years 1998 and 1999; and lost the opportunity to earn an undetermined dollar amount of additional interest income revenue. In fiscal year 2000 DST converted the method of paying Commonwealth banking service fees from compensating balances to fee-for-service. To fund this change the DST's fiscal year 2000 and 2001 budget requests for bank service fees was increased from \$900,000 in fiscal year 1999 to \$5.3 million. The DST also converted the Commonwealth's 102 Dynacash accounts to interest bearing municipal NOW accounts. The current DST administration estimated that it could earn approximately \$400,000 in the first year and \$600,000 in future years by restructuring its banking relationships and improving the efficiency of cash-flow management. 37
  
6. Improvements Needed in Cash Management's Maintenance of the Commonwealth Bank Account Listings: Our review disclosed that the DST needed to improve its internal reporting within Cash Management and maintenance of Commonwealth bank account listings. DST has not maintained a single up-to-date master listing of all Commonwealth bank accounts. During the course of our review the DST provided a listing of 2,401 bank accounts of which 1,906 (79%) were listed as active. However, as a result of our inquiries, DST staff reviewed the accuracy of the listing and provided a manually revised copy of the original listing that indicated the number of active accounts to be 849 of the 1,906 originally reported. 42
  
7. Inadequate Internal Controls over Eminent Domain Trust Fund Account: Our review of DST's custodial oversight of the Eminent Domain Trust Fund Account disclosed five separate state agencies make deposits and expenditures from the account without centralized control and monthly reconciliation of the account; interest payments to eligible owners by originating agencies are not verified; and because there is not a detailed accounting or an aging by agency of the amount of funds on deposits in the account there may be funds that should be transferred to the Commonwealth as abandoned property as required by Chapter 200A, Section 2, and Chapter 79, Section 70, of the General Laws. Because of these inadequate custodial controls, the DST cannot be assured the account's existing balance is sufficient to fully fund the Commonwealth's liability to property owners. In addition, because 46

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the accounts balances were not verified to DST investment activity on a routine basis and there were no written control procedures for ensuring proper investment interest income management practices, there were periods when the Eminent Domain Trust Fund Account was not fully invested. Also, account balances were kept in liquid investments instead of earning better yields in other forms of investment due to the absence of a cash management process for forecasting account deposits and withdrawals. The DST indicated that it was in the process of implementing a two-phase approach of corrective actions with regard to identifying agency balances, reconciling account activity and balances with the agencies, closing the existing account, and establishing a new Eminent Domain Trust Fund Account in the Cash Management Division.

8. Improvements Needed in Custodial Controls over Deposit-In-Trust Accounts: Our review of DST's custodial activity revealed that investment bank trade confirmations were not being used as the source document for recording account investment activity; inadequate security over computer password controls and the absence of cross training of staff; inconsistent and untimely recording of investment activity; mainframe computer reporting system limitations; limited segregation of duties between custodial and reconciliation functions; a lack of written supervisory approval for both the DST's monthly reconciliation of its Bond and Trust Report to custodian bank monthly balances and the Division of Insurance account balances; and a lack of written procedures for both the processing of custodial transactions and reconciliation functions required for the Deposit-In-Trust Account. The DST also could not provide documentation verifying that the dollar amount insurance companies deposited was in agreement with required bonding amounts established by the Division of Insurance. Rather, the DST's practice is to rely on insurance company documentation as being accurate. Also, during the period March through July 1999 investment transactions for this \$2 billion account were not recorded to the DST's Bond and Trust Reporting System, reportedly because of computer access problems. In addition, all transaction documents, including daily trade confirmations, insurance company transaction authorization letters, and monthly bank statements, for activity transpiring during this period when the DST was without its Bond and Trust Reporting System, were simply filed in storage without verifying and recording.

## SUBSEQUENT EVENTS

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On December 15, 1999, the Office of the Attorney General served a subpoena on the Department of the State Treasurer concerning allegedly fraudulent abandoned property claims filed by or on behalf of GE Investments, GE, or General Electric. On December 17, 1999, the United States Attorney for the Southern District of New York served a separate subpoena regarding abandoned property claims submitted by or on behalf of General Electric Investments, GE, or General Electric, as well as dealings between the DST and the Global Financial Markets Group, or the Global Securities Industry Group of Electric Data Systems Corporation (EDS).

These subpoenas requested documents, records, and related information on the DST's payment of more than \$7 million for these alleged fraudulent abandoned property claims during the period January – April 1999. In addition, the DST was advised to immediately suspend any actions being taken on claims filed on behalf of General Electric Investments, GE, or General Electric.



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The Treasurer/Receiver General of the Commonwealth underpaid Commonwealth's federal payroll tax net obligations of approximately \$35 million. These obligations, represent previously underreported and unpaid federal payroll tax liabilities for 1996-1999. Approximately \$20.6 million of this Commonwealth liability represented 1999 underpayments by the DST's current administration, with the remaining \$19.1 million representing underreported and nonpayments of federal payroll tax obligations applicable to the 1996-1998. In addition, a 1995 DST tax overpayment of \$4.6 million first reported to the DST's prior administration on August 14, 1998 and subsequently to the current administration on March 9, 1999 was not recovered by the current administration until April 2000, when it was applied against the DST's outstanding liabilities for the 1996-1998.

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## INTRODUCTION

Background

The Treasurer and Receiver-General, an elected constitutional officer of the Commonwealth, has jurisdiction over the Department of the State Treasurer (DST) and the State Board of Retirement. In addition, the Treasurer is the chairman of the State Lottery Commission, and a member of the Emergency Finance Board, which is budgeted under the Treasury Department and, although not within the Treasurer's purview, the Massachusetts Cultural Council is budgeted under the DST. The DST is responsible for variety of financial functions, including receiving and managing all funds paid to the Commonwealth; issuing and managing the state's long-term debt; issuing short-term debt and managing the Commonwealth's cash flow; paying retirees; administering the pension system for state employees and retirees; and processing and paying the Commonwealth's bills, in concert with the Office of the State Comptroller (OSC). The Massachusetts General Laws, Chapters 158 and 200A, also assign to DST the responsibility for receiving, safeguarding, and liquidating property that has been transferred to the department from abandoned-property holders. In addition, the Treasurer is statutorily required to serve on numerous boards and commissions (on several of which the Treasurer ex officio serves as chairman); maintains ex officio appointment power to several Commonwealth boards and commissions, and is statutorily mandated to issue various annual reports regarding state finances to other state officials, including the Commissioner of the Department of Revenue, the General Court, and the Attorney General, and to the municipalities within the Metropolitan Park District.

The specific responsibilities and duties of the Treasurer and DST, as established by Chapter 10, Sections 5 through 61, of the General Laws, are detailed below:

a. Treasurer: The Treasurer, or his designee, serves as chairman ex officio of the following boards and commissions:

- State Lottery Commission
- Investment Advisory Council
- State Board of Retirement

- Pension Reserve Investment Management Board
- Water Pollution Abatement Board

In addition, the Treasurer, or her designee, serves as an ex officio member of the following boards and commissions:

- Unemployment Compensation Fund
- Emergency Finance Board
- Board of Bank Incorporation
- Comptroller's Advisory Board
- Emergency Borrowing Board for Cities and Towns
- Emergency Borrowing Board for Counties
- Finance Advisory Board
- Group Insurance Commission Trust Fund
- Commission on Fireman Relief

The Treasurer has the power to appoint (subject to the approval of the Governor or Governor's Council) or approve appointment to the following boards, commissions, and positions:

- Deferred Compensation Commission
- Horse Racing Authority
- Executive Director of the State Lottery
- Retirement Law Commission

The Treasurer is also statutorily responsible for the preparation and submission of the following annual reports:

- Annual Personnel Report to Senate and House Ways and Means Committee (this reporting function is now accomplished through payroll records within the Massachusetts Management Accounting and Reporting System).
- Certification of Deposits in Trust to the Commissioner of the Department of Revenue
- Report on Accounts, Overdue Bank Notes, and Securities to the Attorney General
- Report to General Court on Unpaid Warrants
- Report to General Court on Cash-Flow Projections
- Reports of Statements of Assessments to Towns within the Metropolitan Park District

Additionally, the Treasurer, per statute, receives a quarterly debt statement from all agencies and bond-issuing Authorities (except the Massachusetts Port Authority and the Massachusetts Turnpike Authority). The Treasurer must also receive from the Commissioner of Revenue an annual report stating the value of land owned by the Commonwealth in each city or town within the Commonwealth.

b. Department of the State Treasurer: Mandated duties and responsibilities of DST include the management and oversight of the:

- Receipt, custody, and disbursement of all funds received and expended by state agencies;
- Sale, recording, and accounting of bonds, notes, and securities;
- Administration of the state employee retirement system;
- Management of the state Abandoned Property Division;
- Administration of the state employee deferred compensation plan;
- Processing of disbursements from the Commonwealth;
- Management of numerous legislatively created trust funds;
- Supervisory management of the State Lottery Commission; and
- Management, of the Water Pollution Abatement Trust, in conjunction with the Department of Environmental Management and the Executive Office for Administration and Finance.

#### Audit Scope, Objectives, and Methodology

In accordance with Chapter 11, Section 12, of the General Laws conducted an audit for the purpose of:

- Determining the extent to which DST had either implemented prior recommendations or developed a plan for implementing them with regards to abandoned property and internal control plan.
- Conducting a review regarding the Commonwealth practice and method for paying for banking services.
- Conducting a Chapter 647 review regarding alleged fraudulent abandoned property claims filed by or on behalf of G.E. Investments or General Electric.
- Reviewing an Underpayment of Commonwealth federal payroll tax obligations of approximately \$35 million.

- Conducting a review of fiscal year end cut-off audit procedures to determine compliance with the OSC's year-end closing instructions. (See Audit Report No. 2000-5002-2)

Our audit was conducted in accordance with applicable generally accepted government auditing standards for performance audits. Our methodology included reviewing applicable laws, rules, and regulations; interviewing selected personnel; testing and reviewing accounting records and transactions; and analyzing administrative documents. Our methodology included the following:

Cash Management: We reviewed the internal controls over cash management to determine their adequacy and evaluate what corrective actions have been implemented or are planned by DST to address prior recommendations. Our audit procedures included observations of and interviews with DST and OSC staff. In addition, we meet with representatives of the Commonwealth's private accounting firm and reviewed selections from its workpapers. Our audit procedures included the following:

- A review of applicable laws, rules, and regulations; financial reports; and information cited in both the OSA's Interim Transaction Audit and the Task Force Review.
- A review of internal controls over the Unclaimed Check Fund and the Eminent Domain Fund Account.
- A review of the internal controls over and maintenance of Commonwealth Bank Accounts and Cash Management financial reporting.
- A review of the Fiscal Year 1999 Comprehensive Annual Financial Audit of the Commonwealth and the independent auditor's management letter.

Abandoned Property: We reviewed the Abandoned Property Division's internal controls to determine that property in the DST's custody is safeguarded and managed in accordance with all applicable laws, rules, and regulations. In addition, we evaluated the corrective actions that have been implemented or planned by the Abandoned Property Division to address prior audit recommendations cited in the OSA's Interim Transition Audit Report. Our audit procedures included:

- Interviews with the Assistant Treasurer of the Abandoned Property Division, OSC representatives, and other senior managers;

- Observation and review of tangible abandoned property both on hand in the DST's vault, as well as the collection and monitoring of holder's transfers;
- Review of the DST's publications of the names of abandoned property holders for compliance with applicable laws, rules, and regulations.
- Review of the DST's authorizing procedures for the payment of cash claims and fiduciary ownership transfer of stocks, bonds, mutual funds, and other intangible property.
- Review of the reporting and reconciling of intangible property held by the Abandoned Property Division's two custodial banks and various mutual funds companies;
- Review of the collection of cash dividends due the Commonwealth from financial institutions;
- Other audit procedures as we determined necessary.

Deposit-in-Trust Account: We reviewed the Cash Management Division's custodial and internal controls to determine whether approximately \$2 billion in investments and cash deposited with DST by insurance companies doing business in the Commonwealth in compliance with the Massachusetts General Laws was adequately safeguarded and properly accounted for. Our audit procedures included interviews with staff of both the DST's Cash Management Division and the Division of Insurance, a review of control procedures for the reporting and reconciliation of investment activity, written confirmation of selected insurance company Deposit-in-Trust balances, and other procedures as we deemed necessary.

During our prior audit, certain questionable activities occurred relating to the Unclaimed Check Fund Account (No. 0660-0611), which has resulted in an ongoing criminal investigation by the Office of the Attorney General. The OSA, in conjunction with OSC and DST, reviewed the adequacy of all major systems that have a material impact on the control environment at the time and that warrant reporting, disclosure, and further corrective action. Any review or disclosure of any matters as they relate to the ongoing criminal investigation is precluded for that reason.

Our follow-up review disclosed the original Unclaimed Check Fund Account (No. 0660-0611) balance of \$13,232,872 had remained unchanged for the period February 1999 to February 2000 due to

the ongoing investigation by the Office of the Attorney General. In addition, in June 1999 DST established a new Unclaimed Check Fund Account (No. 0610-0605) with deposits totaling \$5,558,345. These deposits were funded by the transfer of \$5,443,473 representing outstanding Fleet Bank unpaid checks and a second transfer of \$114,872 from a prior designated court only unclaimed check fund. The new Unclaimed Check Fund Accounts activity through February 23, 2000 was limited to the payment of three claims totaling \$4,260 and eight deposits totaling \$24,066.

Our prior audit of the cash management controls over various DST-controlled check-issuance accounts disclosed that the DST lacked an adequate control environment over its various in-house checking account functions. Specifically, control weaknesses within the Unclaimed Check Fund allowed the DST, without any verification of document validity, to issue checks from this fund to private heir finders and other private citizens who present an executed power of attorney or declaration of agency status to the DST without DST's verification that the confirmation of such was made by a valid and proper party. Also, our review of the control environment over other various in-house checking account functions (Stop and Split Fund, Legislative Per Diem Fund, Replacement Check Fund, Bond Fund, Water Pollution Abatement Trust Fund Administrative Account, Automated Clearing House Fund, and Tax Shelter Annuity Check Fund) disclosed a number of internal control weaknesses, such as no segregation of duties—in all instances one person had all responsibility for various functions of check preparation and issuance without signatory authority, no management level review of activities, unsecured unused check stock, unrestricted access to check preparation hardware and software, uncontrolled signature replication stamps, and responsible parties not being able to provide information as to the reconciliation process for the accounts they administer.

During our follow-up audit of DST's internal controls over cash management, the Deputy Treasurer for Cash Management indicated that DST had implemented the Task Force's recommendations with the following actions: some checking account functions (including abandoned property payments) have been transferred to the OSC through the MMARS accounting system, manual check stock within the DST business office is adequately safeguarded and secured, duties have been segregated for the various

functions of check preparation and issuance, check signatory authority has been revised, the use of signature stamps has been eliminated, and management level reviews are required.

During the course of our audit we met regularly with Senior Treasury Management, including the Deputy Treasurer, the Assistant Treasurer of Abandoned Property, Deputy of Cash Management, Assistant Treasurer of Administration and Finance, General Counsel, Director of Report Processing for the Abandoned Property Division, Director of Management Information Systems and other representatives and discussed in detail the various areas of our review and the issues that are in our report. During these meetings we discussed and received explanations, documentation, feedback on corrective measures that have or will be implemented, and other pertinent information regarding internal controls, accounting policies and procedures, compliance with applicable laws, rules, and regulations regarding abandoned property, cash management, and other areas in the scope of the audit over DST accounts, functions and activities. Also, officials accompanied our staff on various observations and reviews during the audit, such as, inventory of physical property and an on-site visit to a bank that was holding abandoned property. We also met with representatives from the Office of the State Comptroller and the Division of Insurance. All the discussions and comments provided by these individuals was considered and where appropriate was incorporated in our final report.



## AUDIT RESULTS

1. Status of Prior Audit Results

Our prior audit report (No. 99-0085-2) revealed that the Department of the State Treasurer (DST) needed to improve its internal controls over abandoned property in several areas and to document an internal control plan in accordance with Chapter 647 of the Acts of 1989. Our follow-up review indicated that, although the DST has taken steps to address these prior issues, further improvements were necessary, as discussed below:

a. Abandoned Property Controls

(1) Improvements Needed over Abandoned Property Controls: Our prior audit disclosed that DST lacked an adequate internal control environment in the processes by which it receives, records, inventories, monitors, safeguards, and liquidates property that has been transferred to it from abandoned-property holders. Specifically, receipts of abandoned property were not accurately documented, deposited in a timely manner, and thoroughly inventoried and secured. As a result, the rights of property owners were not adequately protected against loss or misappropriation. In addition, we found that the DST did not manage and liquidate physical property in a timely manner consistent with the provisions of Chapter 200A, Section 9, of the Massachusetts General Laws. Our review and observation of certain abandoned property stored within an DST vault at the State House disclosed that property was maintained inside the vault in a haphazard and disorganized manner. Moreover, we were informed that only two individuals had the combination to the vault (one of whom was a former employee) and that the vault's combination was never changed during the last eight years.

Accordingly, our prior audit report recommended that DST should develop and implement an internal control environment for the Abandoned Property Division to ensure that property received is properly inventoried, recorded, safeguarded, and, if necessary, liquidated. Specifically, we recommended that DST initiate the following corrective measures to comply with the Commonwealth finance laws, including Chapter 647 of the Acts of 1989 and the State Comptroller's Internal Control Guide:

- Document an internal control system to ensure that transactions and events are carried out in accordance with management directives; administrative policy; accounting policies; procedures; and applicable rules, regulations, and laws.
- Implement a policy by which the Abandoned Property Holder's Log is reconciled with applicable bank records on a timely, fixed, and recurring basis.
- Establish a policy that all entries to the log are uniformly recorded.
- Maintain all inventoried tangible property in a manner that safeguards it against loss or misappropriation by:
  - a. Establishing a system to control and identify property upon receipt. At a minimum, procedures should be developed to document the date of receipt, the contents, the holder of the property, the manner of shipment, and the name and last known address of apparent owner.
  - b. Immediately inventorying and assigning values to all abandoned tangible property.
  - c. Implementing a liquidation schedule for annual auction in accordance with the General Laws.
  - d. Maintaining all inventoried tangible property in a manner that safeguards against loss or misappropriation.
  - e. Immediately changing and securing the combination to the vault.
  - f. Relocating the storage of tangible property to an area within the McCormack Building, as this is where the Abandoned Property Division personnel are located and property is initially received. The relocation will no longer cause disruptions to the responsibilities and duties of the office of Deputy Treasurer.
  - g. Developing an inventory control system from receipt to disposition to ensure that all property is safeguarded.

During our follow-up review we determined that the DST had taken corrective actions in some areas. Specifically, the physical tangible property being held at the vault was being inventoried and entered into the computer system. This task of inventorying was ongoing, focusing on 1998 and earlier vault contents. In addition, we were informed that the combination to the vault has been changed and that three DST employees have the combination. However, our follow-up review identified the following areas that still required management's attention.

- Liquidation of Physical Property: DST had not liquidated physical property in compliance with Chapter 200A, Section 9, of the General Laws, which states, in part:

The treasurer shall proceed with the liquidation of property not earlier than one year after its delivery to him under the provisions of this chapter except that property presumed abandoned pursuant to subsection (b) of section five B [Dividends, etc. of business associations; presumption of abandonment] shall not be liquidated earlier than three years after it was delivered unless the treasurer shall in his opinion find it is in the best interests of the state to do so.

Our review disclosed that no liquidation of physical property has taken place since May 1998. However, the Assistant Treasurer of the Abandoned Property Division stated that, in compliance with Chapter 200A, Section 9, of the General Laws, the division will have all 1998 tangible property on hand appraised. DST's Abandoned Property Division held an auction in the State House on June 24, 2000. This auction, however, will be limited to only the 1998 and earlier vault contents.

The Division's Director of Report Processing stated that in February 1999 he had verbally requested both the Fleet Bank and the Bank of Boston to hold tangible property transfers to DST beyond the statute period until it has available space within its vault to safeguard received bank bags. On April 10, 2000, OSA staff and the Assistant Treasurer of the Abandoned Property Division conducted a site visit to the Bank of Boston to document the volume of tangible abandoned property not transferred by the bank in compliance with DST request. As a result of this visit it was determined the Bank of Boston had retained 46 storage boxes of tangible property, 19 of which had been held since 1998 and the remaining 27 of which were for the 1999 period. The Assistant Treasurer also stated that Fleet Bank was retaining an additional 34 large bags of tangible property that he recently requested the bank forward to the DST. Common business practices would advocate that these banks be notified in writing of the division's request to hold abandoned tangible property beyond statute periods.

The Assistant Treasurer of the Abandoned Property Division also stated that the contents of the vault are going to be moved to a safe on the same floor as the division's office, as recommended in our prior audit report.

- Inventory of Physical Property: During the audit, we observed the inventorying of the physical property held in the vault at the State House. We noted that two staff division members are inventorying the physical abandoned property on a part-time basis because of staffing limitations. Further, we were

informed that DST's fiscal year 2001 budget request included no provision for additional staffing for the inventory of physical abandoned property. One staff member opens the bank bags without comparing the bag contents to banks listing of contents. The second staff member removes open bank bag contents from the vault to record on the division's computer located outside the vault. Neither staff member is supervised. When the contents of the bags are inputted into the computer, funds that can be deposited are placed in a file draw in the vault segregated from rare coins and other valuables that will have to be appraised and later auctioned. This process has been ongoing on a part-time basis for several months. However, no bank deposit had been made for the inventoried items from the fall of 1999 to March 2, 2000.

On March 14, 2000, the first bank deposit was made in the amount of \$14,524, and the Assistant Treasurer stated that weekly deposits would be made as needed. In addition, included with the undeposited receipts was a check payable to a private individual (not the Commonwealth) for \$101,250 dated December 24, 1999. Based on our recommendation the original holder (State Street Bank) was contacted and a replacement check was issued payable to the Commonwealth of Massachusetts or the private individual. The Abandoned Property Division deposited the replacement check into the Commonwealth's account on March 29, 2000, 27-days after our observation.

Also, our review disclosed when tangible property is received from holders at either the division's 1 Ashburton Office or the State House vault the receipt is not recorded.

- Internal Control Plan for Abandoned Property: The division did not document an internal control system as required by Chapter 647 of the Acts of 1989. A risk assessment for abandoned property was not conducted and there were no written procedures for the receiving, recording, inventorying, monitoring, safeguarding, and liquidating of the abandoned property.

Chapter 647 of the Acts of 1989 requires the "documentation of the agency's internal control system should include (1) internal control procedures, (2) internal control accountability system, and (3) identification of the operating cycles. Documentation of the agency's internal control systems should

appear in management directories, administrative policy, and accounting policies procedures and manuals.

Without a documented internal control plan the Abandoned Property Division cannot be assured that all tangible abandoned property transferred by holders are properly safeguarded against loss, theft, or misuse.

The Assistant Treasurer for Abandoned Property indicated that a comprehensive Internal Control Plan is being developed by the DST's new staff auditor. Each department head has submitted documentation of current practices, outlining the daily flow of activity in each respective area, along with an organizational chart to identify which employees are responsible for each specific function.

Recommendation: The Abandoned Property Division should:

- Continue to develop and document an internal control system as required by Chapter 647 of the Acts of 1989.
- Continue to develop and document written procedures for receiving, recording, inventorying, monitoring, safeguarding, and liquidating tangible abandoned property.
- Considering hiring additional staff to ensure that tangible abandoned property transferred to the Commonwealth is properly safeguarded and processed in a supervised and controlled environment.
- Make timely bank deposits of inventoried tangible property.
- Implement a schedule for annual auctions of tangible property to minimize the volume of property on hand.
- Continue to address its shortage of secured vault space to allow for the timely acceptance of tangible abandoned property in compliance with Chapter 200A, Section 8(a), of the General Laws.

(2) Abandoned Property Division Operating Procedures Are Not in Accordance with Certain Provisions of the General Laws: Our prior review disclosed that the operating procedures of the Abandoned Property Division did not fully comply with all applicable provisions of Chapter 200A, Section 8, of the General Laws. Specifically, the division did not include the names of owners of tangible abandoned property received from banking institutions and hospitals, as well as the payees of state

unclaimed checks, on the annual publication of abandoned-property owners; did not meet annual statutory mandated publication requirements of Section 8(a); improperly entitled the listing of unclaimed property owners for questionable purposes of Section 8(b); and did not publish the listing in all counties of the Commonwealth. In addition, the division had not taken steps to ensure that all holders of abandoned property as defined by Section 7 were aware of statutory reporting and transfer requirements of Section 7(a).

Accordingly, our prior audit recommended that the DST revise its Abandoned Property Division's operating practices to ensure compliance with all pertinent statutory provisions by ensuring that:

- All mandated publications deadlines are adhered to.
- Annual abandoned-property owners list are properly worded and entitled "Notice of Names of Persons Appearing to Be Owners of Abandoned Property" in compliance with the statute. Also, the office should seek rulings from the Office of Campaign and Political Finance and the State Ethics Commission regarding the propriety of using other descriptive titles and wordings.
- All geographical publication requirements are met.
- The names of tangible abandoned-property owners and payees of state unclaimed checks that have been deemed abandoned are published and listed on the office's Internet web page.

During our follow-up review we determined that the DST was publishing the names of abandoned property holders, except for tangible property holders and state unclaimed checks, and aggregate transfers from holders in newspapers covering every county in which an apparent owner had a last known address. Also, the division was mailing a notice to each person having an address listed therein who appears to be entitled to property of the value of one hundred dollar or more presumed abandoned under Chapter 200A.

In addressing our prior issue of low reporting compliance by abandoned property holders, the Assistant Treasurer of the Abandoned Property Division indicated that the division hired a new Director of Auditing and Compliance and that they are developing a major outreach effort so that the Abandoned Property Division can inform the vast majority of non-complaint holders, who may not know of Chapter 200A, about the reporting requirements of the law and assist them in their reporting efforts in the future. In addition, on August 8, 2000 the Governor signed Chapter 198 of the Acts of 2000, which revised

Abandoned Property Law in the Commonwealth. The major provisions of this legislation was to provide a clear definition of what constitutes abandoned property and provide a six-month “amnesty period” during which holders of abandoned property would not be penalized for turning over abandoned property that should have been reported to the Commonwealth earlier.

- Names of Tangible Property Holders and State Unclaimed Checks Have to Be Published: The Assistant Treasurer stated that the division was unable to publish the names of apparent owners of abandoned property from the Unpaid Check Fund since the data files from the fund were virtually unreadable and had never been completely transferred over to the Abandoned Property Division. The division was in the process of having 18 files worth of Unpaid Check Fund data “scrubbed,” after which it will create a list of names of persons to whom unpaid checks are owed so that such names can be advertised in one of next year’s publications. The Assistant Treasurer also informed us that the names of tangible property holders will be published prior to the auctioning of tangible property.

- Names of Property Holders in the Aggregate Have to Be Published: The Abandoned Property Division receives deposits from holders of abandoned property in the aggregate. (The transfer of a single dollar amount without a breakdown identifying the owners of the property or the dollar of the individual’s property or the number or individuals involved.) However, the division’s acceptance of abandoned property in the aggregate is contrary to Chapter 200A, Section 7(b)(3), of the General Laws, which allows for aggregate reporting only for items of value under \$100. The DST’s General Counsel stated that the DST is considering mandating that abandoned property holders report all deposits in compliance with Chapter 200A, Section 7(b) on a form prescribed by the Treasurer that shall include:

1. Except with respect to traveler’s checks, registered checks and money order, the name, if known, and last address, is any, of each person appearing from the records of the holder to be the owner of any property of the value of one hundred dollars or more presumed abandoned under this chapter.
2. In the case of presumed abandoned funds of life insurance, the full name of the insured or annuitant, and last known address, according to the records of the life insurance company.

3. The nature and identifying number, if any, or description of any intangible property and the amount appearing from the records to be due, except that items of value one hundred dollars each shall be reported in aggregate.
4. Except for any property reported in the aggregate, the date when the property became payable, demandable, or returnable, and the date of the last transaction with the owner with respect to the property.
5. Other information which the Treasurer prescribes by rule as necessary for the administration of this section.

Receiving property in the aggregate precludes the Abandoned Property Division from publishing the property owners names as required by Chapter 200A, Sections 8(a) and 8(e).

- Publications Have To Be More Timely: The DST published the names of abandoned property holders during the weeks of March 12 and March 19, 2000. However, publication would have to be made prior to March 1, 2000 for the DST to be in compliance with Chapter 200A, Section 8 (a), of the General Laws, which states:

The treasurer shall cause a notice to be published, not later than March first or, in the case of life insurance companies, September first of the same year following the report, at least once a week for two consecutive weeks in a newspaper of general circulation which is printed in English in each county in which an apparent owner had a last known address.

On September 3, 2000, DST's Abandoned Property Division met the statutorily mandated publication requirement for life insurance company deposits.

- Holders Reports Have to Be Entered into the Division's Computer More Timely: The Abandoned Property Division receives approximately 10,000 holder reports per year. A holder report is an annual report filed with the division by every person, corporation, or other business association, banking or financial organization, life insurance corporation, utility, court, or public authority who are required to complete the report and submit it together with their abandoned property to the division by November 1 of each year (May 1 for life insurance companies).

Although holder remittances (checks) are entered into the Abandoned Property Division's computer system and deposited at the time of receipt, holder reports that identify the owners of the property that



accompanies the remittances are not entered into the division's computer system until a later date. In addition, our review disclosed that, when remittances are deposited by the Abandoned Property Division, a deposit report (a listing of the payees) is generated by the division's computer system to accompany the remittance received when making a deposit with DST's Cash Management Division. However, because no receipt is provided for the deposit by the Cash Management Division, the Abandoned Property Division has no evidence the deposit was made.

At the time of our review in February 2000, the Division's Director of Report Processing estimated that 5,000 current year holder reports and approximately 200 prior year holder reports had not been entered into the division's computer. Of the 5,000 reports not entered into the computer system, division staff estimated that 3,500 reports are "negative balance" or "zero balance." However, because the division did not maintain a log of holders' reports received vs. reports processed, DST could not verify these estimates.

Without entering these holders' reports into the division's computer, the division would be unaware as to the name of the owner of the abandoned property that the division was holding and would not be able to publish the names of the owners as required by Chapter 200A, Section 8(a), of the General Laws which states:

The treasurer shall cause a notice to be published, not later than March first or, in the case of life insurance companies, September first of the same year following the report, at least once a week for two consecutive weeks in a newspaper of general circulation which is printed in English in each county in which an apparent owner had a last known address.

Also, Chapter 200A, Section 8(e), of the General Laws states:

By March first or September first in the case of life insurance companies, the treasurer shall mail a notice to each person having an address listed therein who appears to be entitled to property of the value of one hundred dollars or more presumed abandoned under this chapter.

The Division's Director of Report Processing stated that the division did not have enough help to enter these reports into the computer when they are received and that some of the holder reports are not in a form that is compatible for entry into the division's computer. The Assistant Treasurer of the Abandoned Property Division stated that, to enhance the holders' reporting of abandoned property the

division will require holders comply with the reporting form prescribed by Chapter 200A, Section 7(b), of the General Laws. We were also informed that the DST's fiscal year 2001 budget request did not contain a provision for additional staffing within the division's report processing area.

Recommendation: The DST should continue its efforts to inform noncompliant holders of Chapter 200A reporting requirements, obtain the names of apparent owners of abandoned property from the Unclaimed Checks Fund, and publish the names of tangible property holders prior to auctioning tangible property.

In addition, the Abandoned Property Division should improve its internal control procedures by obtaining receipts from the Cash Management Division as evidence of division holder deposits and developing a log system for recording all holder reports when received and monitoring their location prior to entry in the division's computer system. The division should also implement corrective action to ensure that all mandated publication deadlines are adhered to and holders' reports are processed in a more timely fashion to enable compliance with the time frames for publishing abandoned property owners' names as set forth in Chapter 200A, Section 8(a), of the General Laws.

(3) Improvements Needed in Recovery of Unreported Abandoned Property: Our prior review indicated that the division's decision to expand the number of private accounting firms used in the identification of abandoned property not transferred by holders in accordance with the Massachusetts General Laws was not prudent or cost-effective. Specifically, the division's Request for Responses for such accounting services did not contain the specific number of reviews required to be conducted annually; the performance criteria outlining specific audit procedures and compliance review requirements; and the specific content requirements of monthly interim engagement reports, such as the number of reviews started, the status of reviews in progress, and the number of reviews completed. In addition, the division had not worked with the contractors to develop a schedule for comprehensive mandatory follow-up reviews to ensure that audit issues are promptly and adequately addressed by abandoned-property holders.

Accordingly, our prior audit recommended the division should review existing procedures and policies to determine what corrective actions should be implemented to enhance the recovery of unreported abandoned property. We recommended that in conducting its review, the division:

- Determine whether to continue the use of outside firms and, if so, specify in future contracts with accounting firms the number of reviews to be conducted annually and require interim reporting to the office on the progress of the engagement. The contract should also include the performance criteria outlining specific audit procedures and compliance review requirements.
- Require that documented prior experience in conducting abandoned property audits and proven familiarity with abandoned property laws be included as minimum criteria in future Requests for Responses for audit contracts.
- Develop and implement procedures that require accounting firms to conduct prompt subsequent follow-up reviews of all abandoned property holders that prior audits have identified as being significantly in noncompliance with the Massachusetts Abandoned Property Law.
- Study and implement the fund-intercept program, if deemed viable.

During our follow-up review we determined that a new Director of Auditing and Compliance was hired with the responsibility of both selecting potential holders for the private accounting firms to review and monitoring the actual progress of the private accounting firms. In addition, on August 8, 2000 the Governor signed Chapter 198 of the Acts of 2000, legislation revising Abandoned Property Law in the Commonwealth. The major provisions of this legislation was to (1) provide a clear definition of what constitutes abandoned property, (2) establish a nine-year period of limitation during which an auditor can “look back” into business’s activity to find abandoned property, and (3) provide a six-month “amnesty period” during which holders of abandoned property would not be penalized for turning over abandoned property that should have been reported to the Commonwealth earlier. The Assistant Treasurer of the Abandoned Property Division also indicated that the division will publicly issue Requests for Responses for auditing services with the goal of having new contracts executed. The Request for Responses scope of services will include the number of reviews required to be conducted annually, performance criteria outlining specific audit procedures, and requirements for interim reporting of progress on any review. In addition, the Assistant Treasurer stated that the Request for Responses will include minimum standards

for potential candidates' knowledge of and experience in abandoned property transactions and that the auditing program will be a prime target for inclusion in the publishing of comprehensive regulations for the Abandoned Property Division.

The Assistant Treasurer further stated that the prior administration's goal in using private accounting firms was to increase the dollar amount of abandoned property transferred to the Commonwealth's General Fund, whereas the objective of the current administration will be to focus its auditing programs on educating abandoned property holders on the reporting requirements of Chapter 200A of the General Laws.

Recommendation: The DST should continue its efforts regarding the proposed auditing service Request for Responses scope of service requirements outlined by the Assistant Treasurer of the Abandoned Property Division and the goal of having executed new contracts.

(4) Improvements Needed in Fiduciary Controls over Dividends, Stocks, Bonds, and Other Intangible Abandoned Property: The division's fiduciary controls over cash dividends, stocks, bonds, and other intangible property valued in excess of \$210 million received as abandoned property pursuant to Chapter 200A, Section 5, of the General Laws are managed by two private banks acting as portfolio custodian, and numerous mutual fund companies also provide custodian services for funds they issued. Our prior review of this relationship revealed that the two private banks were not selected by a open competitive procurement process, no written contract existed between the division and its two private banks, the division could not provide an accounting of the amount of fees paid to the private banks, at one point one private bank had not remitted cash dividends totaling in excess of \$3.4 million for up to six years after their receipt. The division did not liquidate stock in the most timely manner allowed by statute and allowed the private bank to consolidate reporting years, thereby further confusing and delaying the liquidation process. Had the division liquidated stock received as abandoned property in accordance with the most aggressive schedule allowed by statute, the Commonwealth could have received use of millions of dollars without incurring the potential of any unfunded liability. Also, the division did not adequately review and reconcile monthly reports issued by one private bank, as evidenced by the submission to us of

an internal report that indicated the portfolio balance to be \$77.6 million and a report generated by the bank for the same period that indicated a portfolio balance of \$43.2 million. The variance between these reports, which was not detected by the division, was \$34.4 million. Additionally, the division could neither identify all mutual fund companies serving as custodian of property that has become abandoned or determine the present value of funds held by mutual fund companies.

Accordingly, our prior audit recommended that the division:

- Commence a competitive procurement of portfolio custodian services utilizing the process outlined in 801 Code of Massachusetts Regulations (CMR) 21.00.
- Enter into a written contract with the successful bidder to document both the office's internal needs and the requirements of the Massachusetts Abandoned Property Law, Chapter 200A, Section 9(b), of the General Laws.
- Implement internal control procedures to increase in-house oversight, require monthly review and reconciliation of portfolio balances reported by the custodian, and adequately protect the abandoned-property stock portfolio from purposeful or accidental misappropriation.
- Require the portfolio custodian to provide detailed reports showing the exact date stock was received. Reporting in this nature will allow the office to adopt the most aggressive liquidation process allowed by Massachusetts Law.
- Identify all mutual fund companies serving as custodians of Massachusetts property, determine the present value of funds held by these companies, and implement controls requiring periodic tracking of these balances.

We further recommended that, if the division does not implement a more aggressive liquidation policy in accordance with the provisions of Chapter 200A, Section 9(b), of the General Laws, the DST should consider filing legislation to amend this statute if it is determined that the protection currently afforded abandoned-property owners is inadequate or unfair.

Our follow-up review disclosed that the DST did take some corrective action. Specifically, there were written contracts dated June 2, 1999 between Investors Bank and Trust Company and the DST for custodial services for the period October 1, 1998 to June 30, 2000 and a second contract dated July 25, 1996 between Fleet National Bank and the DST. In addition the division, on June 30, 1999, requested that its two custodians -- Investors Bank and Trust Company and Fleet Bank transfer all cash balances

accrued in the Division's Abandoned Property accounts to the Commonwealth. In response to the request, the Commonwealth received \$4,784,564, of which Investors Bank and Trust Company transferred \$2,764,248 and Fleet Bank transferred \$2,020,316. These transfers represented cash dividends accrued on stocks, bonds, and the other intangible abandoned property previously transferred by holders to these two custodian banks. In a letter dated June 30, 1999 from Investors Bank and Trust to the DST identified abandoned property accounts created from 1990 through 1999 as the source of these cash transfers.

However, our follow-up review also revealed that corrective action and internal control improvements were still needed in the division's fiduciary controls over dividends, stocks, bonds, and other tangible abandoned property. Specifically, the division does not monitor portfolio custodian activities. The division's custodians -- Investors Bank and Trust Company and Fleet Bank -- reported as of January 31, 2000 holding \$170 million and \$40 million, respectively, for a total of \$210 million in cash dividends, stocks, bonds, and other intangible property. Although the division receives monthly statements from its custodians, it has not performed reviews or reconciliations of these statements to the division's records. Moreover, although the division has in addition to the above two custodians an estimated 50-200 mutual fund companies acting as custodians for the Commonwealth Abandoned Property Division, the division could not provide their exact number or total value of property held by these mutual fund companies, and the division has no written internal controls, guidelines, or procedures for oversight of custodians and mutual fund companies. We were provided monthly statements as of January 31, 2000 for Fidelity Investments and Boston 1784 Funds, which mutual funds reported holding abandoned property funds with market values of \$5,218,994 and \$24,475, respectively. Chapter 647 of the Acts of 1989 requires all state agencies maintain an internal control plan to protect the assets of the Commonwealth from loss, theft, or misuse. Had the division established the required internal control plan, procedures would be in place for identifying and monitoring all mutual fund companies retaining Commonwealth assets.

In addition, our review disclosed that the DST's last sale of stock was in 1990 and last mutual fund sale was in 1997 for the funds being held by the two custodians and mutual fund companies. Had the

DST established a policy for the reoccurring liquidation of stocks and/or bonds remitted in previous years, the Commonwealth would have received millions of dollars in its General Fund and the volume and dollar value of outstanding stocks and bonds held by custodians would be greatly reduced. In this connection, Chapter 200A, Section 9(b) directs the Treasurer on how to liquidate abandoned property.

Chapter 200A, Section 9(b), of the General Laws states, in part:

The treasurer shall proceed with the liquidation of property not earlier than one year after its delivery to him under the provisions of this chapter except that property presumed abandoned pursuant to subsection (b) of section five B shall not be liquidated earlier than three years after it was delivered unless the treasurer shall in his opinion find it is in the best interests of the state to do so. If the treasurer sells any securities delivered pursuant to section five B before the expiration of the three year period, any person making a claim pursuant to this chapter before the end of three year period is entitled to either the proceeds of the sale of the securities or the market value of the securities at the time the claim is made, whichever amount is greater. A person making a claim under this chapter after the expiration of this period is entitled to receive either the securities delivered to the treasurer by the holder, if they still remain in the hands of the treasurer, or the proceeds received from sale, but no person has any claim under this chapter against the commonwealth, the holder, any transfer agent, register, or other person acting for or on behalf of a holder for any appreciation in the value of the property occurring after delivery by the holder to the treasurer.

During our audit, the Assistant Treasurer of the division indicated that the financial institutions which provide custodial services to the Abandoned Property Division--Investors Bank and Trust Company and Fleet Bank--are both operating under contract extensions and that the division's goal is to join with the Cash Management Division to issue an RFP for a joint custodial services contract beginning in fiscal year 2001. As far as Abandoned Property is concerned, the Assistant Treasurer indicated that this contract should provide for detailed monthly reports from the custodian and that the reconciliation of portfolio balances reported by the custodian, in keeping with the transition audit's recommendations, will be among the responsibilities assigned to the new Director of Auditing and Compliance, who was appointed in January 2000. Additionally, the Assistant Treasurer stated that the division will review current practices with regard to potential liquidation of stocks and/or bonds remitted in previous years. However, the Assistant Treasurer stated that the division will continue to pay custodial fees for accounts which held securities from many years ago, which in all likelihood will never be claimed.

Recommendation: DST should continue its initiatives as outlined by the Assistant Treasurer and the same initiatives and controls should also be established for the numerous mutual fund companies presently serving as custodians of Commonwealth abandoned property.

In addition, the Abandoned Property Division should address the existing practice of allowing mutual fund companies to retain abandoned property rather than forwarding this property to the Abandoned Property Division's custodian banks as is the custom for dividends, stocks, bonds, and other intangible property. Also, the division should establish a policy for the recurring liquidation of stocks and bonds remitted in previous years.

b. Internal Control Plan Not Documented: Our prior audit disclosed that the DST did not comply with a Chapter 647 of the Acts of 1989 requirement that it have a clearly documented internal control plan readily available for examination, and specific to all operational cycles. The lack of such a plan has resulted in the existence of a control environment that is inadequate to provide the highest level of security over funds appropriated by the Legislature and Commonwealth revenues received by the department from other state agencies and departments.

Chapter 647 of the Acts of 1989, an Act relative to improving the internal controls within state agencies, established standards for maintaining internal controls over activities to prevent the misuse of Commonwealth funds. Chapter 647 established the minimum level of quality acceptable for internal control systems and specifically outlined the following requirements:

- Internal control systems of the agency are to be clearly documented and readily available for examination, including all operation cycles;
- All transactions and other significant events are to be promptly recorded, clearly documented, and properly classified;
- Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority;
- Key duties and responsibilities are to be assigned in a manner to ensure proper checks and balances;
- Access to resources is to be limited;



- Agencies must appoint an official, equivalent in title or rank to an assistant or deputy, to ensure agency compliance with this act; and
- All unaccounted-for variances, losses, and thefts of funds or property are to be reported immediately to the Office of the State Auditor.

The Act also requires agencies to maintain written documentation of their internal accounting and administrative control systems and to “annually or more often as conditions warrant, evaluate the effectiveness of the agency’s internal control system and establish and implement changes necessary to ensure the continued integrity of the system.” In addition, the Office of the State Comptroller issued an Internal Control Guide to explain key internal control concepts. This guide provides specific objectives and activities to assist agencies in complying with the requirements of Chapter 647 of the Acts of 1989.

Accordingly, our prior audit recommended that the DST take immediate steps to comply with Chapter 647 of the Acts of 1989 and implement the guidelines established by the Office of the State Comptroller’s Internal Control Guide to create proper accountability and safeguard the Commonwealth’s assets. We also recommended that the DST review its plan and document controls for all of its departments and units, including controls within the areas of abandoned property, debt management, cash management, cash receipts and revenue management, property and equipment, and other critical areas. The critical areas that should be included in an internal control plan are as follows:

- Develop policy and procedures for all operating cycles which would include an explanation of the cycle and flow of transactions through the critical internal control points. This should include the initiation or authorization of the transactions or event, all aspects of the transaction while in process, and the final classification is summary record.
- Identify the duties and responsibilities of staff and management positions at key internal control points.
- Identify management directives, administrative policies, and accounting policies and procedures.
- Establish terms and conditions under which authorization are to be made and identify the individuals who have authorization to review and approve transactions and significant events.
- Identify key duties and responsibilities where segregation of duties are employed to ensure that effective checks and balances exist. This would include at a minimum, authorizing, approving, and recording transactions.

- Develop a description of the continuous supervision that is provided to ensure that internal control objectives exist. The descriptions at a minimum should include the duties, responsibilities, and accountabilities assigned to each staff member, and the critical points at which work is approved and where the staff members work is reviewed systematically to ensure work flows as intended.
- Identify individuals who have access to resources and records. Restrictions on access to resources will depend upon the vulnerability of the resource and the perceived risk of loss, both of which shall be periodically assessed.

Also, other key elements of Chapter 647 should be included in the internal control plan, as follows:

- Identification of an official equivalent in title or rank to an assistant or deputy to the department head whose responsibility is to ensure that the agency has written documentation of its internal accounting and administrative control system on file.
- Indication that annual, or more often as the condition warrants, evaluations of the internal control system are conducted and the necessary changes to the system are made to ensure the integrity of the system.
- Indication that the documentation of the system is readily available for review by the Office of the State Comptroller, the Executive Office for Administration and Finance, and the Office of the State Auditor.
- Indication that all unaccounted-for variances, losses, shortages, or thefts of funds or property shall be immediately reported to the Office of the State Auditor, which shall review the matter to determine the amount involved and report to appropriate management and law enforcement officials.

Our follow-up review of the DST's internal controls over cash management, deposits-in-trust custodial functions, and abandoned property disclosed that the DST has made the following changes to address weaknesses in the department's internal controls and processes that were in place in the prior administration: (1) new managers and staff have been hired, including an internal auditor responsible for developing the DST's internal control plan, (2) the recommendations of the special Task Force with regard to checking accounts with manually printed checks at local printers in the department's business office have been implemented, (3) abandoned property payment functions have been transferred to the Office of the State Comptroller's Massachusetts Management Accounting and Reporting System (MMARS), and (4) the Abandoned Property Division's implemented a three-level approval process for claim payments and a new computer system for recording both receipts and claim payments of the

Abandoned Property Fund Account. In addition, the Abandoned Property Division provided copies of executed contracts between the Commonwealth and the two private banks serving as portfolio custodians for stocks, bonds, etc., received as abandoned property. The division, however, could not provide executed contracts between the Commonwealth and numerous mutual fund firms that also serve as custodian of abandoned property.

However, our follow-up review found that the DST is in the process of developing a department wide internal control plan as required by Chapter 647 of the Acts of 1989 and the Office of the State Comptroller's Internal Control Guide.

Recommendation: The DST should continue to develop and complete its internal control plan in compliance with Chapter 647 of the Acts of 1989 and implement the guidelines established by the Office of the State Comptroller's Internal Control Guide to create proper accountability and safeguard the Commonwealth's assets. Moreover, the DST should also identify risk areas and document controls for all of its divisions and units, including controls within the areas of abandoned property, debt management, cash management, cash receipts and revenue management, property and equipment, and other critical areas.

#### CURRENT AUDIT RESULTS

2. Reporting of Abandoned Property Deposits from Banks, Insurance Companies, and Other Holders Did Not Include the Owner's Name, Last Known Address, and Other Pertinent Information Required by Chapter 200A

Our review disclosed that the DST accepts aggregate deposits of presumed abandoned property from banks, insurance companies, and other holders of abandoned property without detailed information on the owner's name and last known address and a breakdown identifying the dollar amount of the individual's property as required by Chapter 200A, Section 7(b), of the General Laws.

During the period October through December 1998, GE Securities, etc. had claims filed by or on their behalf by Global Financial Markets or Global Securities Industry Group of Electronic Data System Corp., (EDS) amounting to approximately \$6.9 million. There were 30 to 40 claims filed during this period against abandoned property previously transferred to the Commonwealth by State Street Bank and Trust

in the aggregate (the transfer of a single dollar amount without a breakdown identifying the owners of the property or the dollar of the individual's property or the number or individuals involved).

The DST's Deputy Treasurer-General Counsel stated that, because the Commonwealth had accepted these deposits from State Street Bank and Trust and other holders in the aggregate (without knowledge of ownership), it has been the Abandoned Property Division's practice to rely on holders' verification in making payments of claims from aggregate deposits. The following steps were presented as the payment process used by the Abandoned Property Division for the payment of these alleged fraudulent abandoned property claims:

- (1) General Electric Investment submitted a claim letter to State Street Bank and Trust.
- (2) The claim letter was certified by a single individual at State Street Bank and Trust as being part of aggregate deposits previously transferred to the Commonwealth by the bank.
- (3) The claim letter was returned by the State Street Bank and Trust to General Electric Investment for their certification of entitlement.
- (4) The claim letter was forwarded to the DST Abandoned Property Division certified by both State Street Bank and Trust and General Electric Investment for payment.
- (5) The Abandoned Property Division approved the payment of the claim with interest.

As a result of this practice, \$6.9 million in fraudulent claims were filed and paid.

On December 15, 1999, the Office of the Attorney General served a subpoena on the DST concerning alleged fraudulent abandoned property claims filed by or on behalf of GE Investments, GE, or General Electric. On December 17, 1999, the United States Attorney for the Southern District of New York served a separate subpoena regarding abandoned property claims submitted by or on behalf of General Electric Investments, GE, or General Electric, as well as dealings between the DST and the Global Financial Markets Group or the Global Securities Industry Group of Electric Data Systems Corporation (EDS).

These subpoenas requested documents, records, and related information and advised the DST to immediately suspend any actions being taken on claims filed on behalf of General Electric Investments, GE, or General Electric. In addition, the DST's General Counsel stated that the U.S. Attorney's Office

instructed the DST to not communicate with State Street Bank and Trust on this matter. State Street Bank and Trust was the former holder that previously submitted aggregate deposits without a breakdown identifying the owners of the property and the bank that certified their prior aggregate abandoned property deposits did include the funds requested by the General Electric Investment claims. In the absence of detailed information on the owners, etc. the Abandoned Property Division relied on the State Street Bank and Trust written certification of the aggregate deposits and paid the claims.

The DST's Deputy Treasurer-General Counsel stated that General Electric Securities and EDS have agreed to repay the Commonwealth for all losses and that presently the DST is not making claim payments submitted against aggregate deposits to the abandoned property account by State Street Bank and Trust. The General Counsel further stated that corrective actions were being considered to address the issue of aggregate deposits by holders, including:

- Mandating that deposit reporting include both the owner's name and last known address as well as the dollar amount of the individual's property, consistent with Chapter 200, Section 7(b) of the General Laws. (We were informed that that DST is presently working with a major insurance company domiciled in Massachusetts to provide this additional information for its prior aggregate deposits.)
- Requesting two or more signatures from authorizing banks or insurance companies.
- Considering hiring consultants to conduct forensic auditing reviews of selected aggregate claims.

In addition, as of February 4, 2000 the DST's Abandoned Property Division stopped making claim payments submitted against prior State Street Bank and Trust aggregate deposits to the abandoned property account.

The Massachusetts General Laws, Chapter 200A, Section 7(a), states that "every person holding property declared by this chapter to be presumed abandoned shall report to the treasurer as provided in this section." In addition, Section 7 (b) requires that the report shall be on a form prescribed by the Treasurer and shall include the following:

- (1) Except with respect to traveler's checks, registered checks and money orders, the name, if known, and last known address, if any, of each person appearing from the records of the

holder to be the owner of any property of the value of one hundred dollars or more presumed abandoned under this chapter.

- (2) In the case of presumed abandoned funds of life insurance companies, the full name of the insured or annuitant, and his last known address, according to the records of the life insurance company.
- (3) The nature and identifying number, if any, or description of any intangible property and the amount appearing from the records to be due, except that items of value under one hundred dollars each shall be reported in aggregate.
- (4) Except for any property reported in the aggregate, the date when the property became payable, demandable, or returnable, and the date of the last transaction with the owner with respect to the property.
- (5) Other information which the treasurer prescribes by rule as necessary for the administration of this section.

Because the DST has accepted these deposits from State Street Bank and Trust and other holders in the aggregate (without knowledge of ownership) DST has not enforced the mandated reporting requirements of MGL's Chapter 200A, Section 7.

As a result of DST's inability to determine ownership, its Abandoned Property Division's practice has been to rely on holder's verification in issuing payments of claims from aggregate deposits. This was the practice used by the DST when it relied on certifications received from both State Street Bank and Trust and General Electric Investments to authorize the payment of more than \$7 million for these alleged fraudulent abandoned property claims during the period January – April 1999. This is also the practice used daily to pay all claims derived from aggregate deposits.

Recommendation: The DST should inform all holders of abandoned property that the Abandoned Property Division will no longer accept aggregate single-dollar-amount deposits that are inconsistent in form and content with the mandated requirements of the Massachusetts General Laws, Chapter 200A, Section 7(a).

In addition, the DST should continue to expand its efforts with major holders of past aggregate deposits to obtain the additional information required to improve the Abandoned Property Division's ability to determine ownership and reduce the reliance on holders' certifications.

3. Improper Reporting and Untimely Payment of over \$35 Million of the Commonwealth's Federal Payroll Tax Liabilities

Our review disclosed that during the first quarter of calendar year 2000, the DST issued payments totaling approximately \$35 million to the U.S. Department of the Treasury Internal Revenue Service (IRS) for previously underreported and unpaid federal payroll tax liabilities for the 1996-1999. The following is an explanation of the \$35 million of unpaid tax obligations.

1999 Underpayment

Department of the State Treasurer	\$18.2 million
University of Massachusetts (Non appropriated funds)	\$2.4 million

1996-1998 Underreported Liabilities and Non-Payments

1996	8.8 million
1997	3.9 million
1998	6.4 million

1995 Treasury Tax Overpayment	<u>(4.6 million)</u>
	<u>\$35.1 million</u>

We also found that there was not a system in place for the accounting, reconciling, recording, reporting, and payment of federal payroll taxes to ensure the Commonwealth's paid all of its federal payroll tax obligations in a timely manner including the billing and reimbursement of employer Medicare matching share from state agencies. In addition, the DST's Cash Management Float Account (Central Disbursement Account), the account to which the OSC deposited state agencies' employer Medicare match payments and the Payroll Withholding Fund established by the OSC within the Massachusetts Management Accounting and Reporting System (MMARS) have been reconciled only on an annual basis by these two agencies. Further, the OSC's billings and recovery of employer matching Medicare tax obligations from state agencies, as well as subsequent reimbursements to the DST for assumed prior tax payments were performed in an inconsistent and erratic manner. Finally, in excess of \$4.6 million of overpayments due the Commonwealth went unrecovered for a 20-month period after the DST received notification from the IRS of the overpayment.

The Internal Revenue Service's Publication 15 – Circular E, Employer's Tax Guide, states that employers must deposit income tax withheld and both the employer's and employees' Medicare taxes. The circular further explains that, for state and local government employers, employee wages are generally subject to federal income tax withholdings and, with certain exceptions, are also subject to Social Security and Medicare taxes.

Circular E requires an employer who accumulates a tax liability of \$100,000 or more on any day during a deposit period (the period during which tax liabilities are accumulated for each required deposit due date) to deposit the tax by the next banking day, whether the employer is a monthly or semi-weekly schedule depositor. As the Commonwealth's tax liability exceeds \$100,000, it should comply with these Circular E requirements. Further, employers are required to deposit 100% of their tax liability on or before the deposit due date. However, penalties will not be applied for depositing less than 100% if both of the following conditions are met:

- Any deposit shortfall does not exceed the greater of \$100 or 2% of the amount of taxes otherwise required to be deposited, and
- The deposit shortfall is paid or deposited by the shortfall makeup date, as described below.

**Makeup Date for Deposit Shortfall:**

- 1) **Monthly schedule depositor.** Deposit the shortfall or pay it with your return by the due date of the Form 941 for the quarter in which the shortfall occurred. You may pay the shortfall with Form 941 even if the amount is \$1,000 or more.
- 2) **Semiweekly schedule depositor.** Deposit by the earlier of:
  - a) The first Wednesday or Friday that falls on or after the 15<sup>th</sup> of the month following the month in which the shortfall occurred or
  - b) The due date of Form 941 (for the quarter of the tax liability).

Penalties may apply if the employer does not make required deposits on time, makes deposits for less than the required amount, or does not use the Electronic Federal Tax Payment System (EFTPS) when required. The penalties do not apply if any failure to make a proper and timely deposit was due to



reasonable cause and not to willful neglect. For amounts not properly or timely deposited, the penalty rates are:

- 2% - Deposits made 1 to 5 days late.
- 5% - Deposits made 6 to 15 days late.
- 10% - Deposits made 16 or more days late. Also applies to amounts paid within 10 days of the date of the first notice the IRS sent asking for the tax due.
- 10% - Deposits made at an unauthorized financial institution, paid directly to the IRS, or paid with your tax return.
- 10% - Amounts subject to electronic deposit requirements but not deposited using the Electronic Federal Tax Payment System (EFTPS).
- 15% - Amounts still unpaid more than 10 days after the date of the first notice the IRS sent asking for the tax due or the day on which the employer receive notice and demand for immediate payment, whichever is earlier.

The Commonwealth will not incur millions of dollars in late payment penalties and interest for Medicare taxes that were abated under standard Internal Revenue Service provisions pertaining to corrected employment tax filings and remittances initiated by a taxpayer. However, the Commonwealth lost thousands of dollars in interest income by not applying the \$4.6 million of overpayments for a 20-month period after receiving notifications from the IRS. In addition, many hours of both the OSC and DST senior management have been expended to correct the Commonwealth's improper reporting and payment of federal tax liabilities for 1995-1999, and thousands of dollars have been paid by the DST for contracting with a private accounting firm to provide expertise in reconciling the DST's payment and federal tax liability history, developing corrective solutions, and assisting DST senior management in working with the IRS.

The actual payment of Commonwealth federal tax liabilities is the responsibility of DST; however, both the DST and OSC have significant input in the preparation, reporting, and timely payment of these liabilities. OSC-administered payroll systems provide the DST with the dollar amount of income tax withheld and calculates and reimburses the DST for the Commonwealth's employer matching share of Medicare taxes that the OSC invoices and collects from all state agencies.

Our review disclosed that neither the DST nor the OSC conduct monthly monitoring procedures to ensure that income taxes withheld and both the employee and employer matching Medicare tax obligations were accurately reported and timely paid in full in compliance with IRS regulations. In addition, the DST did not have formal written policies and procedures for the payment and reconciliation of Commonwealth federal tax obligations. The DST's Deputy Treasurer for Cash Management stated that, although the DST had previously not performed reconciliations of federal tax obligation payments and reporting to determine their accuracy and timeliness, the DST plans to develop reconciliation procedures similar to those used to resolve the issues for the tax years 1995-1999.

The OSC previously calculated the employer's share of the Medicare Tax liability due by doubling the actual dollar amount shown on the CAPS and PMIS payroll system as employee Medicare withholdings. Under the current HR/CMS payroll system the calculation of employer Medicare Tax liability would be performed in the same manner. The OSC previously generated billings to all state agencies approximately four to six weeks after each quarter closed and then transferred a check with a cover letter to the DST as reimbursement for liabilities previously paid. However, in 1999-2000, the time period of reimbursement was delayed because of late budget approval, the transition to the HR/CMS payroll system, and late billings to agencies because of delays by agencies in setting up encumbrances. Our review disclosed that, on April 13, 2000, the OSC reimbursed the DST in excess of \$14 million for employer Medicare taxes. This payment represented amounts collected from state agencies for the period July 1 through December 31, 1999 and was the only reimbursement to the DST during fiscal year 2000. The remaining employer matching Medicare tax obligation due the DST for the period January 1 through June 30, 2000 of more than \$15.4 million had not been reimbursed as of September 6, 2000. It was the DST's practice to pay all taxes (including the employer's medicare match) and then collect reimbursement for the employer's medicare match via the OSC chargeback to agencies.

When asked if there were any major changes in either the Commonwealth's accounting procedures or federal tax laws that would have had an impact on the reporting and payment of the Commonwealth federal tax obligations for the years 1995-1999, an OSC and DST representative responded that they were not aware of any and could only suggest that significant staffing reduction within the DST may have impacted the operations of the department.

In addressing DST's delay in recovery in excess of \$4.6 million of 1995 federal tax overpayments due the Commonwealth until April 2000, the Deputy Treasurer for Cash Management responded that the DST wanted to resolve the accuracy of 1996 payments and reporting to protect against potential interest charges and that the IRS required an explanation for the overpayments prior to allowing DST to use the overpayment as a credit.

The DST and OSC are working with the new Human Resources Compensation Management System (HR/CMS) to expand the Payroll Withholding Fund to incorporate all withholdings and to not be limited to the present five. Currently, the fund includes five tax withholdings (i.e., federal, state, Medicare, and two bond withholding accounts). However, deferred compensation, union dues, and group insurance are excluded because of system limitations.

In addressing what corrective actions DST has taken, the Deputy Treasurer for Cash Management stated that new practices have been implemented for the payment of Commonwealth federal tax liabilities whereby one individual prepares the wire transfer payment to the IRS based on OSC input documentation and a second staff person reviews and authorizes the payment. In addition, the DST's Deputy Treasurer for Cash Management stated that DST plans to develop reconciliations procedures for withholding payments similar to those presently being performed by an independent accounting firm to ensure accurate and timely reporting on a regular basis; she would like to develop procedures, whereby the Float Account will be reconciled quarterly; and she will be working with the OSC to develop modifications to the HR/CMS and establish separate liability and float accounts for tax obligations. These accounts would allow DST to keep track of all employees withholdings and employer Medicare matching shares (i.e., how much has been deposited) should always equal payments made from the account.

Recommendation: The DST should:

- Establish a separate central tax disbursement account from which all Commonwealth tax liabilities would be paid and state agencies employer matching Medicare tax obligations payments would be deposited. With the establishment of a separate central tax disbursement account the existing practice of combining all Commonwealth disbursements through one central account (Float Account) would stop, thereby isolating tax obligations activity within the new account and providing for proper accountability and monthly reconciliation.
- Work with the OSC to create individual payroll withholding funds within MMARS for all payroll withholding and employer matching Medicare tax obligations.
- Work with the OSC to create a written document establishing the Commonwealth's system for accounting for and the payment of federal payroll tax obligations. This system should include procedures requiring monthly reconciliations of both a segregated central tax disbursement account for all Commonwealth payroll tax liabilities and individual payroll withholding funds to ensure employee payroll withholdings and employer matching Medicare tax obligations are accurately report and timely paid in full in compliance with IRS regulations.
- Develop in-house written tax obligations payment procedures, provide staff training of federal tax regulations, and establish controls to ensure the proper segregation of duties for the preparation and approval of both federal tax wire transfer payments and monthly reconciliations of a new central tax disbursement account.

In addition, the OSC should establish policies and procedures to ensure that its billings and recovery of employer-matching Medicare tax obligations from state agencies are performed immediately following each pay period.

4. Improvements Needed in the Administrative and Accounting Functions of the Float Fund

The DST maintains a cash suspense fund (Float Fund), that functions as the Commonwealth's central disbursement account for the payment of its obligations for debt service, local aid, warranted and non-warranted payments, federal and state payroll tax obligations, vendor invoices, and Department of Revenue state tax refund payments. Our review disclosed the annual dollar amount of activity that was transacted through the Float Fund increased from \$50.2 billion in fiscal year 1998 to more than \$57.4 billion in fiscal year 2000.

When a Commonwealth obligation is authorized for payment a warrant is prepared and cash equal to the total dollar amount of the warrant is transferred from Commonwealth reserves to the Float Fund. The Float Fund is the funding source for reimbursement requests presented by the Commonwealth's two

custodian banks and other banks after vendor's checks and wire transfers have been presented for payment. The fund's daily balance represents the dollar value of outstanding checks and wire transfers that have not been presented for payment.

The DST annually performs a reconciliation of the Float Fund in conjunction with the June 30 closing of the Commonwealth's financial statements. The reconciliation performed is a comparison of the MMARS reported Float Fund Balance to the dollar value of outstanding checks reported by the Commonwealth's custodian banks. For the two fiscal years ending June 30, 1999 the following unreconciled variances were reported.

	<u>1998</u>	<u>1999</u>
MMARS Float Fund Balance	\$342,473,690	\$270,162,275
Outstanding Check Total Reported by Banks	<u>311,197,688</u>	<u>284,883,691</u>
Variances	<u>\$ 31,276,002</u>	<u>(\$14,721,416)</u>

As of October 5, 2000 DST's reconciliation of the Float Fund for fiscal year 2000 was not available.

For several years these reconciliations have included a large number of unreconciled variances including checks identified as outstanding on the reconciliation already having a corresponding check presented for payment. DST's reconciliation of the Float Fund as of June 30, 1999 included a \$9,127,564 reduction of the dollar amount of outstanding checks reported by the banks to correct for the banks duplicate posting of payment warrants. In addition, the Float Fund balance per MMARS was increased by \$9 million to reflect the anticipated reimbursement from the Department of Corrections – Inmate Escrow Account for payments previously processed against the Float Fund's outstanding balance rather than the timely transfer of the required funding from the Inmate Escrow Account. The \$9 million adjustment recorded by DST represented the estimated dollar amount of unfunded Inmate Escrow Account payments for the period January – June 1999. Of this amount actual funding reimbursements credited to the Float Fund consisted of 1) a \$6.9 million reimbursement for the period January – May

1999 credited in February 2000, 2) a \$1.4 million reimbursement for June 1999 credited in June 2000, and 3) with the remaining \$700,000 representing an overstated estimate used by DST.

In addition, our review of fiscal year 2000 Float Fund activity disclosed the following:

- \$15.9 million of Inmate Escrow Account payments for the period June 1, 1999 – April 30, 2000 were also applied against the Float Fund's outstanding balance, with actual funding reimbursements not being credited to the Float Fund until June 2000.
- On April 13, 2000 in excess of \$14 million was deposited in the Float Fund to reimburse the fund for employer matching Medicare tax payments previously applied against the Float Fund's outstanding balance during the period July 1, - December 31, 1999.
- As of September 6, 2000 the Float Fund had not been reimbursed for more than \$15.4 million of employer matching Medicare Tax payments previously applied against the Float Fund's outstanding balance during the period January 1 – June 30, 2000.

The new administration indicated that it has identified and corrected many variances but given the volume of activity in the fund and numerous past problems, it was still in the process of identifying and correcting them. However, DST has not established formal written policies and procedures for the use of Float Fund's outstanding balance for payment of Inmate Escrow Account expenditures and employer matching Medicare tax payments, the timely reimbursement of the Float Fund, and the reconciliation and monitoring of fund activity.

Recommendation: The DST should continue to monitor the fund and develop procedures to identify problems and issues within the fund, review the existing practice of using the Float Fund's outstanding balance as the funding source for payments, consider reconciling the fund on a more routine basis and consider opening a new Float Fund in order to let old activity clear in the old fund and gain control of new activity in the new fund.

##### 5. Improper Management of Bank Service Fee Payments

The prior DST administration maintained excessive deposits in compensating balance bank accounts; did not record the liability for unpaid bank services at fiscal year-end; and, contrary to state finance law, paid for these prior year services from the subsequent fiscal year's appropriation. Pursuant to Chapter 647 of the Acts of 1989, the current DST administration notified the Office of the State Auditor (OSA)

that the prior DST administration's payment practices for banking services may have been contrary to the Massachusetts General Laws, and potentially resulted in the loss of interest income on Commonwealth funds. Also, the methodology used to pay for banking services may have been more costly for the Commonwealth than a fee-for-service methodology. In addition, the prior administration's banking services were conducted without contractual arrangements that outlined a process for the Commonwealth's recovery of unused earned bank credits at fiscal year-end. Moreover, along with the loss of earned bank credits caused by excessive depositing of Commonwealth funds, the Commonwealth also lost the opportunity to earn additional interest income by investing its funds in interest-bearing securities.

The Commonwealth pays for banking services via three methods: compensating balances, fee for service payments, or a combination of the two. The following provides an explanation for each of the three methods of payment:

Compensating Balances: Compensating balances is the practice of offsetting the charge for bank services against credits earned by allowing the custody banks to receive and hold Commonwealth funds interest-free. The Commonwealth earns credits on the "net investable balance," which is the balance on deposit with banks in non-interest-bearing accounts (compensating accounts), reduced by 10% to comply with Federal Reserve requirements. The bank calculates the amount of the credit earned by the Commonwealth by applying its earning credit rate (based on some benchmark such as the rolling average interest rate of 90-day United States Treasury Bills) to the Commonwealth's net investable balance. The actual cost of services incurred by the Commonwealth is offset against its available credit balance. Monthly, the banks customarily send a statement depicting the costs for particular bank services, the monthly balance on deposit in compensating accounts; the amount of earned credits available to offset the costs, whether payment of a fee is required in addition to the application of credits; and the amount required to be deposited in compensating accounts to meet the costs of future services. Earned credits can be carried forward for an agreed-upon period of time within each fiscal year but are usually not carried forward to subsequent fiscal years.

Fee-for-Service: Fee-for-Service methodology is the cash payment for bank services provided to DST based on a unit cost or volume basis as agreed to between the DST and each of the banks providing services. The fees could be based on an amount per transaction or could relate to bundled services for lock boxes, reconciliation, direct deposits, and check transactions. This payment method is similar to the method used for personal checking accounts whereby a fee is charged for each check written.

Combination: This method combines both compensating balance and fee-for-service methods. If earned credits under the compensating balance method are not sufficient to pay for the services, direct fee payment would be required and/or balances would need to be increased.

The prior administration deposited more money than was necessary to pay for banking services provided by banks using the compensating balance method. Earned credits in excess of \$1.1 million for the period July 1, 1995 through March 31, 1999 that would expire unused as of June 30, 1999 were generated with two major banks providing services to the Commonwealth. In both cases, the balance of credits earned to compensate for bank service fees exceeded the Commonwealth's actual needs. These excesses were the result of the prior DST administration's decision to deposit with these banks Commonwealth funds that exceeded the amounts required to earn bank credits for coverage of actual bank service fees.

Our review disclosed that, as of June 30, 1999, of the \$1.1 million in excess credits balance as of March 31, the current DST administration was able to use \$534,600, leaving the Commonwealth with unused earned credits of \$565,494 with only one of its major service providers. The DST shared the first bank's excess credits reported as of March 31 with the Commonwealth's Department of Revenue (DOR). The DST projected that a \$1 million fiscal year 1999 savings would accrue to a DOR appropriation subsidy as the result of sharing the DST's unused earned bank credits. However, the Commonwealth lost the use of \$565,494 of earned bank credits from a second bank during the four fiscal years ended June 30, 1999 because the second bank that processes the Commonwealth's Dynacash accounts (advance checking accounts established for state agencies to use for local disbursements) would not carry forward the earned credits to the next fiscal year (fiscal year 2000).



The counsel for the bank, in responding to the DST's request for reconsideration on this position, stated that under the practice in the banking industry, these credits are short-term and not carried forward beyond defined intervals. The counsel further defined the standard internal in the industry by which such credits must be used as monthly or quarterly depending on the size of the banking relationship and provided the following background on the banks past working relationship with DST:

In 1995 when the Dynacash Accounts were reconstructed from zero balance accounts by the Treasurer's Office so that the Commonwealth could exercise better control over state agency spending, those accounts began to have balances and therefore began to earn credits. The Bank agreed with the Treasurer's Office at that time to allow those credits to accumulate and be used for a full fiscal year, at the end of which they would expire. This arrangement was very much out of the ordinary and is the longest period allowed by the Bank for any of its customers. The Bank has only permitted a handful of its customers to accumulate earned credit balances for more than a three-month period.

Accordingly, on June 30, 1996, the Commonwealth's earnings credits for FY 1996 expired and on June 30, 1997 the earnings credits for FY 1997 expired. In November 1997, the Treasurer's Cash Management Office asked the Bank to reinstate the earnings credits for fiscal years 1996 and 1997. The Bank expressed its discomfort and reluctance, but ultimately agreed to do so on the understanding that this was a one-time exception and that all three years of unused earnings credits would expire on June 30, 1998. That was understood by and agreed to by the Cash Management Office. Accordingly, the credits were reinstated in November 1997, and what remained expired on June 30, 1998. I would note that the earnings credits for FY 1997 and 1998 were not substantial and the Bank determined that it could accommodate, albeit reluctantly, this one time request, without doing harm to the obligations it has to its other customers, its stockholders and bank regulators.

The bank notified the DST monthly of the earned credits balance and expected that the DST would responsibly manage the balance. In December 1998, the DST placed another \$20 million on deposit with the bank in a non-interest-bearing account to have as a contingency balance during a Y2K update of the state accounting system. The bank specifically advised the DST that this deposit would result in excess earned credits; however the balance was not adjusted until the current administration moved the money to an interest-bearing account in March 1999.

There was no indication as to why the prior administration did not reduce its compensating balances or why the payment for banking services was not prudently managed. In addition, no documentation was provided to indicate that the prior DST administration sought bids for banking service and weighed

proposals for paying for the services through compensating balances or on a fee-for-services methodology.

At the time of our review, the DST was conducting negotiations with the bank from which the Commonwealth had incurred the loss of more than \$565,000 in earned bank credits during the four fiscal years ended June 30, 1999. During these negotiations, the DST has withheld payment of bank service fees incurred during the first quarter of fiscal year 2000, which amounted to approximately \$3,500 per month.

The prior administration also did not record a fiscal year 1998 liability of \$625,416 for unpaid bank service fees at fiscal year-end. Rather, these prior-year unpaid banking service fees were paid for with subsequent fiscal year 1999 funding. Because these bills were not paid in fiscal year 1998 when they were incurred, fiscal year 1998 actual cost of banking services was understated and appropriated funding for fiscal year 1999 used to pay fiscal year 1998 bills was not available for fiscal year 1999. In accordance with Chapter 29, Section 9E, of the General Laws, the prior DST administration should have requested a deficiency appropriation to pay for the banking services, as follows:

Whenever it appears to any officer having charge of any office, department or undertaking that any appropriation therefore will be insufficient to meet all of the expenditures required in the current fiscal year by any provisions of law, rule, regulation or order not subject to his control, he shall immediately notify the commissioner and the house and senate committees on ways and means of the estimated amount of such additional requirements.

The prior DST administration should have informed the Office of the State Comptroller of the liability for banking services and filed for a deficiency appropriation to pay off the outstanding charges for banking services as of June 30, 1998. Also, the prior DST administration should not have used the fiscal year 1999 appropriation to pay the fiscal year 1998 bills because the appropriations are only to be used for bills of the fiscal year the funds were appropriated for. Specifically, Chapter 29, Section 12, of the General Laws states that:

Appropriations by the general court, unless specifically designated as special, shall be for the ordinary maintenance of the several departments, offices, commissions and institutions of the commonwealth and shall be made for the fiscal year unless otherwise specifically provided therein.

The DST has identified the excess credits as essentially prepayments to the banks, which reduce the earnings potential for the Commonwealth, and stated that such prepayments may not be consistent with the state payment statutes. A bank official in a letter to the Deputy Treasurer for Cash Management stated that earned credits are not prepayments because they are designed to be used on the short term and are not carried forward beyond defined intervals. The standard interval in the industry is monthly or quarterly, depending on the size of the banking relationship. Although the earned credits do not customarily fit the definition of prepayments, the prior administration's policy of accumulating such large credit balances to be applied to future costs of banking services is evidence of its belief that they were prepayments.

The DST indicated that it has taken the appropriate steps to monitor bank service fees to prevent a replication of these occurrences. Specifically, in fiscal year 2000 the DST converted the method of paying Commonwealth banking service fees from compensating balances to fee for service. To fund this change, the DST's budget request for bank service fees was increased from \$900,000 in fiscal year 1999 to \$5.3 million fiscal year 2000, which was approved and appropriated. The DST also received an authorized appropriation of \$5.3 million for fiscal year 2001. The DST also converted the Commonwealth's 102 Dynacash accounts to interest-bearing municipal NOW accounts. The current DST administration estimated that it could earn approximately \$400,000 in the first year and \$600,000 in future years by restructuring its banking relationships while simultaneously the efficiency of cash flow management.

Recommendation: The DST should continue to monitor its bank service fees so that the Commonwealth receives the most beneficial and economical bank services. Also, the DST should execute written contractual agreements for all banking services incurred.

6. Improvements Needed in Cash Management's Maintenance of the Commonwealth Bank Accounts Listings

Our review disclosed the DST had not maintained a single up-to-date listing of all banks currently doing business with the Commonwealth. DST provided its in-house Cash Management System Account

Master Report as its summary of all Commonwealth bank accounts, exclusive of agency's advance accounts. The report was composed of a listing of 2,401 bank accounts, of which 1,906 (or 79%) were listed as active. However, as a result of our review, DST staff reviewed the accuracy of the original listing provided to us and made manual entries that resulted in the number of active accounts reported being reduced from 1,906 to 849 -- a 55% reduction. In addition, the number of inactive accounts increased from 495 to 1,552 -- a 313% increase, as shown below.

	<u>Active Bank Accounts</u>	<u>Inactive Bank Accounts</u>
CMS Account Master Report (06/29/99)	1,906	495
CMS Account Master Report (08/02/99)	849	1,552

In addition, to its Cash Management System Account Master Report, the DST maintains an AREC - Agency Location Master File by department/agency and bank for active and inactive sweep accounts (accounts established by DST for state agencies from which their deposits are then transferred to the DST) and a Cash Management System Bank Master Listing that provides each bank's identification number and name. However, DST did not provide similar subsystem reporting for the DST's disbursement, investment, and debt activity.

The DST's Director of MIS stated that there is one cash management system within the DST and it is referred to as the Cash Management System (CMS) or "Parent System" with a collection of subsystems that are separated by specific functions and that the subsystems interface together with the Cash Management System, since both systems are generated from the same database.

However, our review of DST's management control over its Cash Management System Account Master Report disclosed the following:

- DST staff use individual subsystem reports (i.e., the AREC - Agency Location Master File and the Cash Management System Bank Master Listing) to conduct their specific job requirements without making update entries to the Cash Management System Account Master Report. As a result of this practice, DST has not maintained a single up-to-date master listing of all Commonwealth bank accounts.

- The master report has not been updated by DST due to missing dates, missing account names, missing contact person, and misclassification of active and inactive.
- There were no written controls and procedures.
- There were five route numbers (route numbers identify an individual bank location) representing 47 bank accounts on the CMS Account Master Report (August 8, 1999) that could not be traced to the CMS Bank Master List. The CMS Bank Master List is a report that represents a listing of individual banks with route numbers, bank name, contact person name and phone number.
- Only 96 out of 395 (24%) bank names shown on the CMS Bank Master List could be traced to the CMS Account Master Report.
- There is no internal subsystem currently being used for disbursements, investments, and debt accounts, therefore the DST cannot verify these accounts against the CMS Account Master Report.
- DST uses verbal confirmation rather than written confirmation to ensure that an initial active account is reported on to each Cash Management System (CMS and AREC).
- DST's new bank account request provides no verification that staff established the account on both the AREC and CMS Account Master Report.
- There is limited segregation of duties between the AREC and CMS. Individuals who have access to subsystems also have access to the CMS Account Master Report System.
- No reconciliation processes exists between the AREC and CMS.

The Deputy Treasurer for Cash Management Division stated that DST's current cash management system, which was developed by division staff and consultants in the early 1990s, and modified over the past years is limited, inflexible, and inadequate to meet current needs. The Deputy Treasurer also stated that DST has requested appropriation funding in both fiscal years 2000 and 2001 to develop a new cash management system and that Cash Management Division staffing has been subject to high turnover.

An example of DST's control weaknesses over the Commonwealth's bank accounts was disclosed by OSA field auditors conducting a review of the abolition of Essex County. During the period August 1998 through June 1999, DST's cash management division on seven separate occasions either wire transferred or issued checks payable to Essex County (earmarked for the Essex County Sheriff's Office) for amounts ranging from \$265,362 to \$6,152,164 and totaling over \$24.3 million to a bank account that was closed by Essex County in July 1990. When Essex County staff initiated an inquiry as to the reason for these

late payments with DST, they were told that the payments had been forwarded. However, further review disclosed that the payments had been made to the former Essex County closed bank account. To correct DST's improper payments, on seven separate occasions the bank that improperly had received these payments was required to either wire transfer or forward checks received on behalf of Essex County to the proper bank. In an eighth occurrence, in response to Essex County's staff inquiry as to the status of a \$3,174,397 payment due, DST indicated that the payment was being processed. However, upon review the payee was again found to be the closed account. The payment was cancelled, a replacement check was issued, and Essex County staff traveled to DST's Boston office to take hand delivery of it.

Both the Assistant County Treasurer and the Sheriff's Assistant Superintendent indicated that, prior to the above-mentioned transactions, state funds were being properly forwarded to the designated county depository bank account. Essex County officials told OSA staff that they did not change any information with the DST for these funds to be sent to this closed bank account.

Recommendation: The DST should:

- Maintain an updated CMS Account Master Report as a control tool for proper verification and identification of bank accounts. For example, an updated CMS Account Master Report would determine the amount of active versus inactive bank accounts at any point in time.
- Determine a cost/benefit analysis for the replacement of the outdated Cash Management System.
- Develop personnel cross-training on job responsibilities and computer access to provide for coverage during staff turnover periods within the Cash Management Division.
- Develop reconciliation procedures between CMS Account Master Report and specific subsystem report (i.e., AREC) to ensure all entries to the individual subsystems are reflected in the CMS Account Master Report and that those individuals maintaining these subsystems are not the same individuals conducting this reconciliation.
- Maintain an updated CMS Bank Master List to identify all banks servicing the Commonwealth.
- Develop adequate documentation and authorization/approval procedures to ensure that all new bank accounts are reported on to the CMS Account Master Report and specific subsystem reports.

#### 7. Inadequate Internal Controls over Eminent Domain Trust Fund Account

Our review of DST's the Eminent Domain Trust Fund (Account No. 0610-0603) revealed the need for internal control improvements. Specifically, we found that an individual accounting for agencies deposits and expenditure of funds is not maintained, reconciliations between the account balance and individual agency records are not performed, and the allocation of investment activity to this fund is not always properly credited to the account. As a result of these inadequate accounting controls, the DST cannot be assured that the fund's existing balance is sufficient to fully fund the Commonwealth eminent domain liabilities to property owners and that the interest payments to respective parties is calculated correctly.

When eminent domain land takings are in dispute, (e.g., where the property owner is unknown or under a legal disability) checks that are unaccepted within 60-days are transferred from the agency's account to the Eminent Domain Fund Account until the dispute is settled. When the dispute is settled, the agency submits a letter to the DST requesting the dollar amount of interest earned by its funds while they were deposited in the Eminent Domain Fund Account. The agency then prepares a payment voucher for the disputed amount, plus the interest earned that should be paid to the owner involved. The DST's role is limited to investing the amounts deposited into the fund and calculating the amounts of interest owed on the deposits.

The Metropolitan District Commission (MDC), the Massachusetts Highway Department (MHD), the Department of Environmental Management (DEM), the Department of Fisheries and Wildlife (DFW), and the Department of Capital Asset Management (DCAM) make deposits and expenditures from the account without a centralized control and monthly reconciliation of the account. Over the past four fiscal years (1996-1999), the Eminent Domain Fund Account has issued an average of \$14,948,946 in payments and account year-end balances have averaged \$29,480,050. (See Exhibit I.)

Our review of the Eminent Domain Fund Account disclosed the following:

- Because the fund is not reconciled on a routine basis, the OSC made a prior-year adjustment of \$634,489 to bring the Eminent Domain Trust Fund Account's fiscal year 1997 appropriation ending balance equal to the dollar value of available funding. The overstated appropriation

balance resulted from improper expenditure classifications for previous years. Moreover, the Department of Environmental Management did not process payment vouchers accurately and improperly charged a balance sheet account rather than charging the appropriation account.

- Because the fund's balances were not verified to DST investment activity on a routine basis and there were no written control procedures for ensuring proper investment interest income of management practices, there were periods in which the Eminent Domain Trust Fund Account was not fully invested. In fact, our review of the Massachusetts Management Accounting and Reporting System (MMARS) Investment Report No. 502A for October 27, 1999 indicated an over investment of \$9.4 million. Also, funds are kept liquid instead of earning better yields in other forms of investments due to the absence of a cash management process for forecasting account deposits and withdrawals. The DST's Deputy Treasurer for Cash Management indicated that, with centralized control the DST would ask the individual agencies to provide notice of anticipated expenditures, thereby improving the cash management process.
- Because there is not a detailed accounting or an aging by agency of the amount of funds on deposits in the account, there may be funds that should be transferred to the Commonwealth as abandoned property as required by Chapter 200A, Section 2 and Chapter 79, Section 70, of the General Laws which state:

Chapter 200A, Section 2, Property; presumption of abandonment:

Property which has been bequeathed to any person, shall be presumed abandoned, if not claimed by that person or his heirs, legatees or distributees within three years after death of the testator unless the will makes provision in case of a lapse, failure or rejection of the bequest for the disposition of the property.

When a person, owning property, is not known for three successive years to be living and neither he nor his heirs or distributees can be located or proved for three successive years to have been living, he shall be presumed to have died without heirs or distributees, and his property shall be presumed abandoned.

Chapter 79, Section 70, Unknown person or persons under legal disability:

Amounts deposited or invested under this section shall be subject to the provisions of chapter two hundred A, relating to abandoned property . . .

Moreover, Chapter 647 of the Acts of 1989 requires all transactions to be properly accounted for and reconciled, as follows:

All transactions and other significant events are to be promptly recorded, clearly documented and properly classified. Documentation of a transaction or event should include the entire process or life cycle of the transaction or event, including (1) the initiation or authorization of the transaction or event, (2) all aspects of the transaction while in process, and (3) the final classification in summary records. . . .

Periodic comparison shall be made between the resources and the recorded accountability of the resources to reduce the risk of unauthorized use or loss and protect against waste and wrongful



acts. The vulnerability and value of the agency resources shall determine the frequency of this comparison.

The DST was in the process of taking corrective action with regard to the Eminent Domain Trust Fund Account. Specifically, the Deputy Treasurer for Cash Management stated that, on November 23, 1999, a meeting was conducted with agencies utilizing this account to present a draft of new Eminent Domain Trust Fund procedures. The procedures outlined DST's planned two-phase approach for implementing corrective actions, as follows:

Phase I: The establishment of a new Eminent Domain Trust Fund in the Cash Management Division of the DST. Draft procedures for this new fund provided guidelines for centralized depositing to the fund, payments from the fund, administration of the fund and interest income distribution, reporting (which includes certain reconciliation and aging procedures), and the transfer of deposits remaining in the fund for over three years to the DST's Abandoned Property Division.

Phase II: The DST plans to retain the existing Eminent Domain Trust Fund Account (0610-0603) with a November 3, 1999 unexpended balance of \$26 million separate. The Deputy Treasurer for Cash Management stated that a reconciliation with each of the five state agencies presently conducting activity within this account will be required prior to consolidating the existing account with the planned new Eminent Domain Trust Fund Account. To address the reconciliation of the existing Eminent Domain Trust Fund Account, the DST has scheduled meetings with appropriate agencies and requested that each agency provide an accounting of their existing funds on deposit. In addition, the issue of existing deposits within the account being transferred to the Commonwealth's Abandoned Property account will be addressed.

When questioned why the DST had not implemented centralized expenditure control and a monthly reconciliation of the fund, representatives from the DST stated that DST had neither the knowledge of the account activity for each of the individual participating agencies nor the responsibility to conduct these internal control procedures. However, our review with representatives of the Office of the Comptroller verified the individual agency account activity was available to the DST from MMARS. The draft

procedures for the new Eminent Domain Trust Fund Account includes a provision for the reconciliation of the old Eminent Domain Trust Fund Account. In order to reconcile the account, the DST has requested from the agencies that use the account to submit all available data regarding deposits and withdrawals in order to identify the source of the transactions, compute interest, and determine whether any funds should be transferred as abandoned property. Once this reconciliations process is complete, funds will be transferred to the new fund or transferred as abandoned property.

Recommendation: The DST should continue to take corrective action to ensure that all data are accurate, account balances are fully invested, potential state deposits are transferred to the Commonwealth's Abandoned Property Account, and the account is reconciled on a monthly basis prior to its consolidation with the newly created Eminent Domain Trust Fund Account.

#### 8. Improvements Needed in Custodial Controls over Deposit-in-Trust Accounts

Our review of the DST custodian services for Deposit-in-Trust Accounts disclosed that internal control improvements are needed. Specifically, we found investment bank trade confirmations were not used as the source document for recording account investment activity, there was inadequate security over computer password controls, a lack of staff cross-training, inconsistent and untimely recording of investment activity, the absence of written communication establishing the required bonding dollar amount approved by the Division of Insurance, and mainframe computer reporting system limitations. In addition, no reconciliations of the DST's Bonds and Trust Reporting System balances to its two custodian bank statement balances were performed for a period of 3 months, no analysis of reconciliation variance amounts was performed to determine whether they are applicable to the current month or prior periods, there was no supervisory review, and reconciliations comparing the DST's Bonds and Trust Reporting System balances to the Division of Insurance's Deposit-in-Trust Account reported balances were based on different time periods.

Chapter 152, Sections 61 and 62, and Chapter 175, Sections 151 and 185, of the Massachusetts General Laws require all domestic, foreign, and workers' compensation insurance companies conducting business within the Commonwealth of Massachusetts to post bond or other security with the DST. The

Commissioner of the Division of Insurance determines the requisite level of security, and the Treasurer serves as the custodian of funds. Insurance deposits may include various forms of securities or certificates of deposits pledged by insurance companies in accordance with state statutes for protection of citizens doing business with these insurance companies. In addition to the insurance deposits, the Treasurer is also custodian for 10 other custodian accounts in accordance with state statutes for the protection of citizens doing business with individuals and business entities, or to protect the Commonwealth against nonpayment of certain taxes due the Commonwealth. (See Exhibit II) The actual securities for the 11 custodian accounts referred to as Deposits-in-Trust Accounts are held by two local banking institutions.

During the period of our review, the average monthly balance for these accounts were approximately \$2 billion, with over 90% representing deposits required by the Division of Insurance. The DST's custodial duty is to ensure that insurance companies doing business in Massachusetts maintain sufficient deposits (in cash or securities) in accordance with the Massachusetts General Laws. For the four-month period ended June 1999, the average combined month-end balance reported to the DST by its two custodian banks for the Deposit-in-Trust Accounts was \$1,963,509,862.

Reported Month-End Balances

	<u>Bank No. 1</u>	<u>Bank No. 2</u>	<u>Combined Total</u>
March	\$214,558,709	\$1,729,441,708	\$1,944,000,417
April	215,133,700	1,738,893,510	1,954,027,210
May	215,596,700	1,754,713,510	1,970,310,210
June	<u>217,231,700</u>	<u>1,768,469,910</u>	<u>1,985,701,610</u>
Totals	<u>\$862,520,809</u>	<u>\$6,991,518,638</u>	<u>\$7,854,039,447</u>

As stated earlier, the General Laws mandate that insurance companies doing business in the Commonwealth post bond or other securities with the Treasurer to protect the citizens of the Commonwealth. Compliance requires both the Division of Insurance and DST to perform their designated roles. Specifically, the Division of Insurance establishes the required dollar amount the insurance company must deposit, notifies both the insurance company and the DST of the determined

dollar amount, and monitors account balances to ensure determined deposit amounts are maintained. In its role as the custodian of the deposits, the DST receives insurance company instruction letters that contain a description of the security to be deposited, interest wiring instructions (note: interest income earned of securities deposited by the insurance companies are not retained in the account rather the income is transferred back to the companies), a selection of which of DST's two custodian banks the company prefers its deposit be placed, and other related banking information.

To perform its custodian responsibility, the DST has segregated its daily operations into two functions: custodial and reconciliation. The DST custodial function includes the processing of daily trade activity (buy or sell) for Deposit-in-Trust Accounts with the two custodian banks; reporting the daily trade activity into the DST Bonds and Trust Reporting System; and confirming trade activity with the two custodian banks, the Division of Insurance and the insurance company. The DST's monthly reconciliation function includes both a reconciliation of DST Bonds and Trust Reporting System balances to its two custodian bank statements balances, as well as to the Division of Insurance's Deposit-in-Trust Account month-end balances.

Our review disclosed that the DST needed to improve its internal controls over both the custodial and reconciliation functions for these Deposit-in-Trust Accounts. Specifically, our audit disclosed the following:

a. Custodian Functions:

- All daily transactions representing mandated insurance company deposits were not recorded on the DST's main frame Bonds and Trust Reporting System for the period March through July 1999 because of computer access problems. Rather, as a result of this access problem all daily bank trade confirmations, insurance company transaction authorization letters, and monthly bank statements were filed in storage without having their accuracy verified. Our review disclosed that DST's access problem resulted from inadequate control over password security and a lack of staff cross-training. In a letter dated October 28, 1999 DST's Assistant Treasurer of Administration and Finance stated "that from approximately the end of March to July 1999 user access was not available to the "Bond Trust". This situation occurred as a result of staffing transitions which left a void in user accessibility and the knowledge of the system needed to correct the situation."
- Bank trade confirmations (representing supporting documentation provided by custodian banks, as evidence of investment activity) are not the source document used by DST staff for

recording account investment activity to its in-house Bonds and Trust Reporting System. Rather DST's practice is to record all investment activity directly from insurance company instruction letters. Because of this practice:

- a) Amounts recorded by the departments two custodian banks, and amounts recorded on the DST's Bonds and Trust Reporting System do not consistently agree. These variances result from DST recording intended investment activity both buys and sells directly from insurance company instruction letters, whereas, custodian bank balances will only reflect investment activity that has transpired.
  - b) DST does not receive bank trade confirmations once a security is released from the custodian bank. In place of requiring its custodian banks to provide bank confirmations of released securities, DST issues its own internal receipt letter to the insurance company. However, our review disclosed that the DST has no follow-up procedures to ensure the insurance company responded; therefore, DST lacks evidence that the securities were delivered.
- DST's Bonds and Trust reporting system has significant limitations, including an inability to allow posting of transactions after the close of business on the last business day of the month and month-end adjusting entries to correct for improper posting errors disclosed by DST's reconciliation of its Bonds and Trust Report balances to those reported by the custodian banks and the Division of Insurance. (See Comparison Summary on page 54.)
  - DST could not provide documentation verifying the dollar amount insurance companies deposited was in agreement with required bonding amounts established by the Division of Insurance. Rather, DST's practice is to rely on insurance company documentation as being accurate.
  - DST lacked internal control procedures for the monitoring and timely processing of insurance company requested changes or swaps of investments previously deposited in the Deposit-in-Trust Account to comply with Division of Insurance bond requirements. The absence of these control procedures has resulted in duplicate reporting and variances in reported balances between DST and both its custodian banks and the Division of Insurance, as well as the untimely release of investment deposits to the insurance companies.
  - DST could not provide written procedures for its custodian function over Deposit-in-Trust Accounts detailing the process and safeguards staff should follow to ensure the prompt processing and accurate recording of insurance company investment transactions. On January 7, 2000 the DST provided a written set of new procedures for custodial assets. However, our review disclosed that these new procedures did not address the use of bank trade confirmations as the source document for recording investment transactions, detailed procedures and safeguards for the prompt processing and recording of investment transactions, the absence of computer password security and staff cross-training, and DST staff obtaining written notification of required insurance company bonding dollar amounts established by the Division of Insurance.
  - DST could not provide executed copies of contracts with its two custodial banks. The absence of written contractual agreements between DST and its two custodial banks resulted in undefined roles and responsibilities.

b. Reconciliation Functions

DST's monthly reconciliations of its Bonds and Trust Reporting System balances with both its custodian banks and the Division of Insurance reflected inconsistencies in the date investments transactions are recorded, and the absence of uniform end-of-month cut-off statements dates by each of the parties. Specifically, our review disclosed the following:

- No reconciliations of DST's Bonds and Trust Reporting System were performed to its two custodian bank reported balances during the months of February through April 1999. In addition, the May and June 1999 reconciliations were prepared in July 1999 after DST staff regained access to its Bonds and Trust Report System due to computer access problems. This required DST staff to record all trade transactions for the period March through July 1999 and then subtract the July activity. The DST used February 1999 balances reflected on its Bonds and Trust Report as the beginning balance to reconcile both the May and June 1999 reconciliations, however, DST has no supporting documentation of the February 1999 balances being reconciled; therefore, its accuracy cannot be verified. During the period February 1999 through July 1999 DST received monthly bank statements from its two custodian banks which were filed in storage without being verified or recorded.
- The reconciliation process each month reflects variances between DST's Bonds and Trust Report balances and amounts reported by the two custodial banks monthly statements; however, no review is conducted to determine whether these variances are carry-overs from prior months or to age these variances. Therefore, the existing reconciliation process is not a true representation of the variance amount at each month-end.
- Because of the absence of written acknowledgement by the Division of Insurance to variances found by DST's reconciliation of its Bonds and Trust Reporting System balance to the Division of Insurance's monthly Deposit-in-Trust Account balance the DST cannot determine which set of balances is accurate and whether the Division of Insurance has been informed of the existing variances.
- For the period February through June 1999 DST performed no reconciliation of its Bonds and Trust Reporting system balances to the Division of Insurance's monthly Deposit-in-Trust Account balance. DST began a reconciliation process with the Division of Insurance in July 1999; however, there were inconsistencies with reporting dates of balances used for the reconciliations and balance variances in both individual accounts and overall totals. In addition, Division of Insurance staff stated that the division has received only one complete reconciliation package from DST, which was a reconciliation that compared July 27, 1999 Treasury's Bonds and Trust Report to the July 16, 1999 Division of Insurance Deposit-in-Trust Account report. Also, for the period August through December 1999, DST provided the Division of Insurance only selected variance pages rather than a complete reconciled report. Without a complete report the Division of Insurance would be unable to assess the completeness and accuracy of the reconciliation.

- DST does not adjust its Bonds and Trust Report monthly balances to reflect variances found in prior reconciliation with custodian banks before reconciling to Division of Insurance's monthly reports.
- DST's Bonds and Trust Report is not sent to the Division of Insurance in a timely manner. The report has been sent on average one to two months after month-end.
- DST staff responsible for conducting reconciliations of the department's Bonds and Trust Report to both custodian banks reported balances and the Division of Insurance Deposit-in-Trust Account balances rely on custodian staff to resolve disclosed variances. The purpose of conducting these reconciliations is to maintain the accuracy of DST records through independent oversight. By resolving variances with the support of custodian staff responsible for inputting these investment transactions to the Bonds and Trust Reporting System, the independence of the reconciliation process is weakened.
- There was no written supervisory review approval for both DST's monthly reconciliation of its Bonds and Trust Report to custodian bank monthly balances and the Division of Insurance's Deposit-in-Trust Account balances.
- DST could not provide written procedures for its reconciliation function over Deposit-in-Trust Accounts detailing the process staff should follow in performing reconciliations of the DST's Bonds and Trust Report balances to both DST two custodian banks', reported balances and Deposit-in-Trust Account balances reported by the Division of Insurance, as well as, communications that should be conducted to resolve and disclose variances. On January 7, 2000 the Deputy Treasurer of Cash Management provided a written set of new procedures for custodial assets. However, our review disclosed these new procedures did not address the adjusting of DST's Bonds and Trust Report monthly balances to reflect variances found in prior reconciliations of custodian bank balances before reconciling DST's monthly balances of the Division of Insurance's reported Deposit-in-Trust Account, the timely reporting of reconciliation variances with the Division of Insurance, written supervisory approval requirements, and the communication and documentation processes to be followed in resolving disclosed variances with both the custodian banks and the Division of Insurance.

In summary, the following comparison highlights reconciliation variances for five selected insurance companies as of November 30, 1999.

Insurance Company Bank Account Number	November 30, 1999 Balance Per DST Bonds and Trust Report	November 30, 1999 Balance Reported By Custodian Banks	December 8, 1999 Balance Per Division of Insurance
8320300	\$ 100,000	\$ 202,000	\$ 100,000
48002206	5,160,000	3,650,000	150,000
8322640	1,850,000	1,150,000	1,150,000
8321190	1,110,000	2,210,000	1,110,000
48000107	<u>695,000</u>	<u>1,645,000</u>	<u>950,000</u>
Totals	<u>\$8,915,000</u>	<u>\$8,857,000</u>	<u>\$3,460,000</u>

The DST's Deputy Treasurer for Cash Management stated that the prior administration's practice was to send copies of its monthly Bonds and Trust Report to the custodian banks and that if, the banks agreed to the amounts reported by the DST, it was considered a reconciliation. Whereas the current administration has recently implemented controls that require each of the two custodian banks to submit a summary of the securities held in escrow to the DST. The DST then reconciles these reported balances to its in-house Bonds and Trust Report. In addition, the DST has implemented a process whereby the Division of Insurance also submits to the DST its Deposit-Trust Account report for comparison to the DST's Bonds and Trust Report.

Recommendation: Although improvements have been implemented by the current administration, further corrective action should be taken, as follows:

Custody:

- Ensure that the entire process of Deposits-In-Trusts transactions is promptly recorded, properly authorized, and clearly documented (i.e., no timelags of processing transaction from the DST to related parties).
- Improve its password security and provide staff cross-training to ensure system access and that transactions are promptly recorded, authorized and documented.
- Use the bank trade confirmation as the source document for entering all transactions to the DST's Bond and Trust Report, including the establishment of new accounts, replacement collateral transactions, reduction in collateral transactions, and collateral maturities.
- Develop adequate documentation to ensure that new account investment deposits meet the bonding dollar amount established by the Division of Insurance.
- Develop monitoring procedures for the timely processing of insurance companies' requested changes in investment deposits with the Division of Insurance and the custodian banks.
- Obtain custodian bank trade confirmations for securities released to the insurance companies.
- Review the cost of replacing the existing Bond and Trust computerized reporting system to correct the systems inability to allow posting transactions after the close of business on the last day of the month and month-end adjusting entries to correct for improper posting errors disclosed by the DST's monthly reconciliation process.



Reconciliation:

- Develop procedures to ensure that all reconciliations with its custodian banks and the Division of Insurance are prepared using the same cut-off date. In addition, bank reconciliations need to be performed with prior month ending balance being carried forward as opposed to focusing on the current month activity only, and the DST should identify and review variance amounts to determine whether they variance amounts are carry-overs from prior months or to age them.
- Provide written documentation of a supervisory approval review process for all reconciliations.
- Develop new procedures for researching variance amounts and documenting the written analysis of variance amounts. These procedures should address variances disclosed by the DST's monthly reconciliations of its Bond and Trust Report balances to those reported by its two custodian banks and the Division of Insurance's Deposit-in-Trust Account.
- Adjust the Bonds and Trust Report monthly balances to reflect variances found in prior reconciliations with custodial banks before reconciling with Division of Insurance on a month-end basis for a proper reconciliation process.
- Identify of key duties and responsibilities where segregation of duties are employed to ensure that effective checks and balances exist. This would include, at a minimum, authorizing, approving, and recording transactions.

## SUBSEQUENT EVENTS

On December 15, 1999, the Office of the Attorney General served a subpoena on the DST concerning allegedly fraudulent abandoned property claims filed by or on behalf of GE Investments, GE, or General Electric. On December 17, 1999, the United States Attorney for the Southern District of New York served a separate subpoena regarding abandoned property claims submitted by or on behalf of General Electric Investments, GE, or General Electric, as well as dealings between DST and the Global Financial Markets Group, or the Global Securities Industry Group of Electric Data Systems Corporation (EDS).

These subpoenas requested documents, records, and related information on DST's payment of more than \$7 million for these alleged fraudulent abandoned property claims during the period January – April 1999. In addition, the DST was advised to immediately suspend any actions being taken on claims filed on behalf of General Electric Investments, GE, or General Electric.

On May 3, 2000 the DST reported that it had underpaid Commonwealth's federal payroll tax net obligations of approximately \$35 million. These obligations represent previously underreported and unpaid federal payroll tax liabilities for 1996-1999. Approximately \$20.6 million of this Commonwealth liability represented 1999 underpayments by the DST's current administration, with the remaining \$19.1 million representing underreported and nonpayments of federal payroll tax obligations applicable to 1996 through 1998. In addition, a 1995 DST tax overpayment of \$4.6 million first reported to DST's prior administration on August 14, 1998 and subsequently to the current administration on March 9, 1999 was not recovered by the current administration until April 2000, when it was applied against DST's outstanding liabilities for 1996 through 1998.

## EXHIBIT I

Department of the State Treasurer  
Summary of Eminent Domain Trust Fund Account Activity

Fiscal Years 1991 – 2000

<u>Fiscal Year</u>	<u>Beginning Balance</u>	<u>Receipt</u>	<u>Expenditure</u>	<u>Ending Balance</u>
2000	\$25,277,070	\$ 4,259,815 <sup>(a)</sup>	\$ 1,619,967 <sup>(a)</sup>	\$27,916,918
1999	30,629,105	5,951,931	11,303,966	25,277,070
1998	31,994,717	14,874,874	16,240,486	30,629,105
1997	30,019,310	21,376,388	19,400,981 <sup>(b)</sup>	31,994,717
1996	28,068,727	15,435,023	13,484,440	30,019,310
1995	30,555,778	6,305,318	8,792,369	28,068,727
1994	28,167,516	5,367,983	2,979,721	30,555,778
1993	7,419,986	41,071,570	20,324,040	28,167,516
1992	13,337,188	26,326,115	32,243,317	7,419,986
1991 (Carry-forward Amount)	<u>11,701,674</u>	<u>2,888,024</u>	<u>1,252,510</u>	<u>13,337,188</u>
Total	<u>\$237,171,071</u>	<u>\$143,857,041</u>	<u>\$127,641,797</u>	<u>\$253,386,315</u>

	<u>Date</u>	<u>Amount</u>	<u>Date</u>	<u>Amount</u>
High	1993	\$41,071,570	1992	\$32,243,317
Low	1991	\$2,888,024	1991	\$1,252,510

Four Year Average  
Fiscal Years 1996-1999

<u>Fiscal Year</u>	<u>Expenditures</u>	<u>Ending Balance</u>
1999	\$11,303,966	\$ 25,277,070
1998	16,240,486	30,629,105
1997	18,766,492	31,994,717
1996	<u>13,484,440</u>	<u>30,019,310</u>
	<u>\$59,795,384</u>	<u>\$117,920,202</u>
Average	<u>\$14,948,846</u>	<u>\$29,480,050</u>

<sup>(a)</sup>As of March 22, 2000

<sup>(b)</sup>The dollar amount reported as fiscal year 1997 expenditures is composed of the account's actual expenditures of \$18,766,492 and a prior-year adjustment of \$634,489 made by the Office of the State Comptroller on March 12, 1998. The OSC's adjustments was required to bring the Eminent Domain Trust Fund Account's fiscal year 1997 ending appropriation balance equal to the dollar value of available funding. The overstated appropriation balance resulted from improper expenditure classifications during fiscal years 1992 through 1996.

## EXHIBIT II

Custodial Accounts  
As of November 30, 1999

	<u>Balance</u>
1. Insurance Deposits	\$1,906,019,000
2. Self-Insurers	29,880,000
3. Inheritance Tax	10,500
4. Excise Tax	-
5. Cigarette Tax	315,000
6. Foreign Bankers	3,199,129
7. Checks or Money Orders	870,000
8. Motor Vehicles	812,424
9. Collateral Banks	210,000
10. Motor Bus	-
11. Alcohol Wholesalers/Manufacturers	<u>71,000</u>
Total	<u>\$1,941,387,053</u>

These accounts may include various forms of securities or certifications of deposits pledged by business entities or individuals in accordance with state statutes for the protection of citizens doing business with these individuals or entities, or to protect the Commonwealth against nonpayment of certain taxes due the Commonwealth. The actual securities are held by two local banking institutions.

Descriptions of the accounts follow:

1. Insurance Deposits: Domestic, foreign, and all workers' compensation insurance companies conducting business within the Commonwealth of Massachusetts must post bond or other security with the DST. The Commissioner of the Division of Insurance determines the requisite level of security, and the Treasurer serves as the custodian of the funds (per Massachusetts General Laws, Chapter 152, Sections 61 and 62, and Chapter 175, Sections 151 and 185).
2. Self-Insurers: Entities that provide self-insurance in accordance with the requirements of the Department of Industrial Accidents (DIA) are required to post bond or security at a level determined by the DIA with the Treasurer (per Massachusetts General Laws, Chapter 152, Section 125A).

## EXHIBIT II (Continued)

Custodial Accounts  
As of November 30, 1999

3. Inheritance Tax: Executors who file for an extension of the due date for inheritance tax with the Department of Revenue (DOR) are required to post a bond deemed sufficient by DOR with the Treasurer (per Massachusetts General Laws, Chapter 65C, Section 10).
4. Excise Tax: Entities that conduct businesses that collect tax revenue on behalf of the Commonwealth must post bond or securities as required by the Department of Revenue with the State Treasurer. The Excise Tax Category consists mostly of companies involved in the sale of oil and gas (per Massachusetts General Laws, Chapter 62C, Section 66).
5. Cigarette Tax: Massachusetts General Laws, Chapter 62C, Section 66, as it is applied to cigarette wholesales companies.
6. Foreign Bankers: The Division of Banks (DOB) requires foreign banks operating in Massachusetts that are involved in the transmittal of funds internationally to post bond or other securities with the Treasurer (per Massachusetts General Laws, Chapter 169, Sections 2 and 3).
7. Checks or Money Orders: The Division of Banks requires certain entities involved with the issuance of checks and money orders to post sufficient bond or other securities with the Treasurer (per Massachusetts General Laws, Chapter 167F, Section 4).
8. Motor Vehicles: Individuals or fleet operators who wish to post bond or security to provide self-insurance of motor vehicles must transfer to the Treasurer's bonds or securities as prescribed by statute (per Massachusetts General Laws, Chapter 90, Sections 34D and 34F, and Chapter 159A, Section 6).
9. Collateral Banks: The DST could not provide a statutory reference with regard to securities held within this category. The former Deputy Treasurer for Cash Management previously stated that he believed these assets were pledged to protect customers of certain "start-up" financial institutions and health care providers against unsecured losses. The Treasurer is holding securities valued at \$200,000 on behalf of the Boston Bank of Commerce and \$10,000 on behalf of the Capital Area Community Health Plan.
10. Motor Bus: The Treasurer currently holds no securities on behalf of self-insured motor bus carriers.
11. Alcohol Wholesalers/Manufacturers: Massachusetts General Laws, Chapter 62C, Section 66, as it is applied to alcohol wholesalers and manufacturers.

EXHIBIT III

Chapter 647, Acts of 1989

An Act Relative to Improving the Internal Controls Within State Agencies

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Chapter 647

THE COMMONWEALTH OF MASSACHUSETTS

*In the Year One Thousand Nine Hundred and Eighty-nine*

AN ACT RELATIVE TO IMPROVING THE INTERNAL CONTROLS WITHIN STATE AGENCIES.

*Be it enacted by the Senate and House of Representatives in General Court assembled, and by the authority of the same, as follows:*

Notwithstanding any general or special law to the contrary, the following internal control standards shall define the minimum level of quality acceptable for internal control systems in operation throughout the various state agencies and departments and shall constitute the criteria against which such internal control systems will be evaluated. Internal control systems for the various state agencies and departments of the commonwealth shall be developed in accordance with internal control guidelines established by the office of the comptroller.

(A) Internal control systems of the agency are to be clearly documented and readily available for examination. Objectives for each of these standards are to be identified or developed for each agency activity and are to be logical, applicable and complete. Documentation of the agency's internal control systems should include (1) internal control procedures, (2) internal control accountability systems and (3), identification of the operating cycles. Documentation of the agency's internal control systems should appear in management directives, administrative policy, and accounting policies, procedures and manuals.

(B) All transactions and other significant events are to be promptly recorded, clearly documented and properly classified. Documentation of a transaction or event should include the entire process or life cycle of the transaction or event, including (1) the initiation or authorization of the transaction or event, (2) all aspects of the transaction while in process and (3), the final classification in summary records.

(C) Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority. Authorizations should be clearly communicated to managers and employees and should

## EXHIBIT III (Continued)

Chapter 647, Acts of 1989An Act Relative to Improving the Internal Controls Within State Agencies

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include the specific conditions and terms under which authorizations are to be made.

(D) Key duties and responsibilities including (1) authorizing, approving, and recording transactions, (2) issuing and receiving assets, (3) making payments and (4), reviewing or auditing transactions, should be assigned systematically to a number of individuals to ensure that effective checks and balances exist.

(E) Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved. The duties of the supervisor in carrying out this responsibility shall include (1) clearly communicating the duties, responsibilities and accountabilities assigned to each staff member, (2) systematically reviewing each member's work to the extent necessary and (3), approving work at critical points to ensure that work flows as intended.

(F) Access to resources and records is to be limited to authorized individuals as determined by the agency head. Restrictions on access to resources will depend upon the vulnerability of the resource and the perceived risk of loss, both of which shall be periodically assessed. The agency head shall be responsible for maintaining accountability for the custody and use of resources and shall assign qualified individuals for that purpose. Periodic comparison shall be made between the resources and the recorded accountability of the resources to reduce the risk of unauthorized use or loss and protect against waste and wrongful acts. The vulnerability and value of the agency resources shall determine the frequency of this comparison.

Within each agency there shall be an official, equivalent in title or rank to an assistant or deputy to the department head, whose responsibility, in addition to his regularly assigned duties, shall be to ensure that the agency has written documentation of its internal accounting and administrative control system on file. Said official shall, annually, or more often as conditions warrant, evaluate the effectiveness of the agency's internal control system and establish and implement changes necessary to ensure the continued integrity of the system. Said official shall in the performance of his duties ensure that: (1) the documentation of all internal control systems is readily available for examination by the comptroller, the secretary of administration and finance and the state auditor, (2) the results of audits and recommendations to improve departmental internal controls are promptly evaluated by the agency management, (3) timely and appropriate corrective actions are effected

EXHIBIT III (Continued)

Chapter 647, Acts of 1989

An Act Relative to Improving the Internal Controls Within State Agencies

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by the agency management in response to an audit and (4), all actions determined by the agency management as necessary to correct or otherwise resolve matters will be addressed by the agency in their budgetary request to the general court.

All unaccounted for variances, losses, shortages or thefts of funds or property shall be immediately reported to the state auditor's office, who shall review the matter to determine the amount involved which shall be reported to appropriate management and law enforcement officials. Said auditor shall also determine the internal control weaknesses that contributed to or caused the condition. Said auditor shall then make recommendations to the agency official overseeing the internal control system and other appropriate management officials. The recommendations of said auditor shall address the correction of the conditions found and the necessary internal control policies and procedures that must be modified. The agency oversight official and the appropriate management officials shall immediately implement policies and procedures necessary to prevent a recurrence of the problems identified.

House of Representatives, December 21, 1989.

Passed to be enacted, *George J. Livanos*, Speaker.

In Senate, December 22, 1989.

Passed to be enacted, *William W. Budge*, President.

January 3, 1990.

Approved, *Richard D. Riordan* Governor.



## EXHIBIT IV

Chapter 647 Awareness Letter  
From the State Auditor and the State Comptroller



## The Commonwealth of Massachusetts

Office of the State Auditor  
 State House  
 Boston, MA 02133

Office of the Comptroller  
 One Ashburton Place  
 Boston, MA 02108

June 9, 1999

Legislative Leadership  
 Judicial Branch Administrators  
 Elected Officials  
 Secretariats  
 Department Heads

The Office of the State Auditor and the Office of the State Comptroller, as with past fiscal years, will continue our efforts regarding internal controls. Chapter 647 of the Acts of 1989, An Act Relative To Improving Internal Controls Within State Agencies, establishes the minimum level of quality acceptable for Internal Control Systems in operation throughout state departments and constitutes the criteria against which Internal Control Structures will be evaluated. With the passage of this law, we began an Internal Control Campaign to educate and make all departments aware of the significant role Internal Controls have on its financial and administrative operations. A good system of Internal Controls coordinates a department's policies and procedures to safeguard its assets, checks the accuracy and reliability of the department's accounting data, promotes operational efficiency, and encourages adherence to prescribed managerial policies.

Departments have made significant progress in the area of Internal Controls. Every department has certified to the existence of documented controls in the form of an Internal Control Plan. In Fiscal Year 1999, we will be broadening the Internal Control Campaign focus. We will be reviewing and testing plans in a broader context that includes all aspects of a Department's business, programmatic operations as well as financial.

The American Institute of Certified Public Accountants defines Internal Controls as a process designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting, effectiveness, and efficiency of operations and compliance with applicable laws and regulations. Internal Controls consist of the following five interrelated components.

**Control Environment** sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of Internal Control, providing discipline and structure.

**Risk Assessment** is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

EXHIBIT IV (Continued)

Chapter 647 Awareness Letter  
From the State Auditor and the State Comptroller

**Control Activities** are the policies and procedures that help ensure that management directives are carried out.

**Information and Communication** are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

**Monitoring** is a process that assesses the quality of internal control performance over time

Chapter 647 requires that an official, equivalent in title or rank to an assistant or deputy to the department head shall be responsible for the evaluation of the effectiveness of the departments internal controls and establish and implement changes necessary to ensure the continued integrity of the system. This should be done annually or more often as conditions warrant. Department officials responsible for internal controls should evaluate whether their departments' Internal Control Plans include the above components.

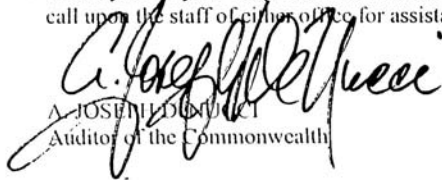
To assist Departments with this effort, we provide the following support activities:

- ◆ The Office of the Comptroller offers departments both ongoing and special internal control training upon request.
- ◆ An Internal Control Guide (due to be updated in early Fiscal Year 2000) is available on the Office of the Comptroller's Web page: <http://www.osc.state.ma.us/>.
- ◆ Upon request, the Office of the Comptroller provides assistance to departments in the process of redefining or reviewing their Internal Control Plans.
- ◆ As part of the Statewide Single Audit, auditors will review and comment upon the Internal Control Plan of any department with audit coverage.
- ◆ Single Audit testing will include increased work: test the transaction compliance with the Internal Control Plan; go beyond the plans to assess and test the plans' implementation within departments.

Chapter 647 requires that all unaccounted for variances, losses, shortages or thefts of funds or property be immediately reported to the Office of the State Auditor (OSA). The OSA is required to determine the amount involved and the internal control weaknesses that contributed to or caused the condition, make recommendations for corrective action, and make referrals to appropriate law enforcement officials. In order to comply with this law instances must be reported on the Report on Unaccounted for Variances, Losses, Shortages, or Thefts of Funds or Property and be submitted to the OSA. Reporting forms can be obtained by contacting the Auditor's office, Room 1819, McCormack State Office Building or Web Site: <http://www.magent.state.ma.us/sao/>.

The Offices of the State Comptroller and the State Auditor are committed to the goal of improving the Internal Control structure of the Commonwealth, department by department.

Thank you for your cooperation and attention on this worthwhile task. Please do not hesitate to call upon the staff of either office for assistance.

  
A. JOSEPH D'AMICO  
Auditor of the Commonwealth

  
MARTIN J. BENISON  
State Comptroller