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

OFFICIAL AUDIT
REPORT

MARCH 26, 2002

TABLE OF CONTENTS/EXECUTIVE SUMMARY

INTRODUCTION

1

The Treasurer and Receiver-General, an elected constitutional officer of the Commonwealth, has direct jurisdiction over the Department of the Treasurer and Receiver-General and the State Board of Retirement, and budgetary control of the Emergency Finance Board. In addition, the Treasurer is the chairman of the State Lottery Commission, and, although not within the Treasurer's purview, the Massachusetts Cultural Council is budgeted under the Office of the State Treasurer and Receiver-General (OST). The OST is responsible for a 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. The Massachusetts General Laws, Chapters 158 and 200A, also assign to the OST the responsibility for receiving, safeguarding, and liquidating property that has been transferred to the OST from abandoned property holders. In addition, the Treasurer is statutorily required to serve on numerous boards and commissions (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 Office of the State Auditor (OSA) conducted a review of the Investors Bank and Trust Company (IBT) and Fleet Investment Services (FIS) contracts for handling certain abandoned property functions for the OST. The OST has a fiduciary responsibility over dividends, stocks, bonds, and other intangible property received as abandoned property pursuant to the Massachusetts General Laws, Chapter 200A, Section 5. The OST contracts with IBT and FIS to carry out this responsibility. IBT and FIS provide safeguarding of transferred abandoned property, monitoring of current market values, collection of dividends and interest distribution, and a monthly accounting to the OST of portfolio activity and value. The purpose of our audit was to review and analyze the process for controlling abandoned property in the custody of IBT and FIS to determine whether controls were adequate for the safeguarding of abandoned property, including cash dividends, stocks, and bonds. We also reviewed contract compliance between the OST, IBT, and FIS.

AUDIT RESULTS **3**

1. IMPROVEMENTS NEEDED IN FIDUCIARY CONTROLS OVER CUSTODIAL BANKING SERVICES **3**

Our review disclosed that the OST has not issued new, competitively bid contracts for abandoned property custodial banking services. The custodial services, provided by IBT for fiscal year 2001, were authorized by four quarterly amendments that extended its contract that expired on June 30, 2000 and increased fees by \$15,000 (33%) over the maximum obligation established by the original contract. Again in fiscal year 2002 OST issued three amendments to IBT's original contract providing additional funding of \$60,000 for custodial services. As a result of OST's amendments for fiscal years 2001 and 2002 the maximum dollar obligation of the original contract executed June 2, 1999 increased from \$78,750 to \$198,750. FIS is providing services under a contract signed July 15, 1996 that contains no termination date. In addition, the OST has not created separate accounts with its custodian banks to denote the date abandoned property securities were deposited in order to monitor the liquidation of securities in accordance with Chapter 200A, Section 9(b) of the General Laws. Also, contrary to Chapter 11, Section 12, of the General Laws, the FIS contract did not include a clause stipulating that the contract is subject to audit by the OSA.

2. RECONCILIATIONS OF MONTHLY CUSTODIAL BANK STATEMENTS OF ABANDONED PROPERTY SECURITY HOLDINGS NOT PERFORMED **6**

Our prior audit report (No. 2000-0085-3) disclosed that, although both the Investors Bank and Trust Company and Fleet Investment Services provided the OST's Abandoned Property Division monthly statements of income and principal transactions detailing daily transaction activity as well as end-of-the-month investment portfolio balances in compliance with their contract requirements, the OST performed no reconciliations of these statements.

Our follow-up review revealed that no corrective action had been taken by the OST's Abandoned Property Division to implement monthly reconciliations of custodian bank monthly statements. In addition, our review of the monthly statements prepared by IBT disclosed such deficiencies as pricing errors, discrepancies in the different accounting methods utilized by IBT and their subcustodian, and bonds incorrectly classified as stock on IBT's computer system. Moreover, we found that IBT's practice of assigning investments' market values without reporting offsetting book value resulted in its issuing monthly custodian statements to the OST's - Abandoned Property Division that contained incorrect investment book and market values and overstated unrealized gains or losses. In fact, our review of IBT statements for the month of January 2001 and July 2001 disclosed that the market value and unrealized gain were overstated on the January statement by \$233,099,791 and the July statement by \$57,908,573.

Also, our review of monthly statements prepared by FIS disclosed that Affiliated Computer Services (ACS), a firm under contract with the OST to recover abandoned property, occasionally retained and did not deposit recovered securities directly in the

designated Commonwealth's FIS account, thereby reducing FIS and the OST's control over these securities.

3. IMPROVEMENTS NEEDED IN FIDUCIARY CONTROLS OVER DIVIDENDS, STOCKS, BONDS, AND OTHER INTANGIBLE ABANDONED PROPERTY **12**

Our prior audit report disclosed improvements were needed in the OST's fiduciary controls over dividends, stocks, bonds, and other intangible abandoned property and that the OST was not in compliance with Chapter 200A, Section 9(b), of the General Laws, which requires liquidation of abandoned property securities. The last sale of abandoned property securities on deposit with the two custodial banks was in 1990.

Our follow-up review of IBT's January 31, 2000 monthly statements showed the OST's Abandoned Property Division's security deposits for the five accounts created in calendar years 1990-1997 had a consolidated book value of \$36,009,078 and a market value of \$150,272,523. As of July 31, 2001 these same five accounts' consolidated book value was reported to be \$23,723,804 and the market value was shown as \$106,090,873. The book value of these accounts decreased by \$12,285,274 in this 18-month period (January 31, 2000 - July 31, 2001), and the market value declined by \$44,181,650. These net decreases reflect both the return of securities to rightful owners and the downturn in the stock market. Had the OST sold these securities as of January 31, 2000, or in prior years of positive growth, both the Commonwealth's General Fund and those rightful owners located at a future date would have received a greater dollar value. In addition, during this 18-month period of declining security market values and Commonwealth's revenue shortfalls, no instructions were issued by the OST for the liquidation of these five accounts to maximize the receipts due the Commonwealth's General Fund. A similar analysis was not permissible for the OST's Abandoned Property Division securities deposited with FIS because the two accounts maintained for the OST do not denote the year abandoned property securities were originally deposited. A comparison of the market value balances of all OST Abandoned Property security deposits with both IBT and FIS as of January 31, 2000 and July 31, 2001 discloses a net consolidated loss of \$27,484,688, yet no instructions were provided either custodian to liquidate existing security deposits in compliance with Chapter 200A, Section 9 (b), of the General Laws.

APPENDIX I **15**

Comparison of the Dollar Value of OST Abandoned Property Securities Deposited with Custodian Banks, January 31, 2000 and July 31, 2001 **15**

APPENDIX II **16**

Summary of the Dollar Value of OST Abandoned Property Securities Deposited with Investors Bank and Trust Company for Three Years or More **16**

INTRODUCTION

Background

The Treasurer and Receiver-General, an elected constitutional officer of the Commonwealth, has direct jurisdiction over the Office of the State Treasurer and Receiver-General (OST) and the State Board of Retirement, and budgetary control of the Emergency Finance Board. In addition, the Treasurer is the chairman of the State Lottery Commission, and, although not within the Treasurer's purview, the Massachusetts Cultural Council is budgeted under the OST. The OST is responsible for a 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. The Massachusetts General Laws, Chapters 158 and 200A, also assign to the OST the responsibility for receiving, safeguarding, and liquidating property that has been transferred to the OST from abandoned-property holders. In addition, the Treasurer is statutorily required to serve on numerous boards and commissions (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.

Audit Scope, Objectives, and Methodology

In accordance with Chapter 11, Section 12, the Office of the State Auditor (OSA) conducted a review of the Investors Bank and Trust Company (IBT) and Fleet Investment Services (FIS) contracts for the handling of certain abandoned property functions for the OST. The OST's fiduciary responsibility over dividends, stocks, bonds, and other intangible property received as abandoned property pursuant to the Massachusetts General Laws, Chapter 200A, Section 5, has been contracted out to IBT and FIS. The banks provide safeguarding of transferred abandoned property, monitoring of current market values, collection of dividends and interest distribution,

and a monthly accounting to the OST of portfolio activity and value. The purpose of the audit was to follow up on our prior audit and to review and analyze the process for controlling abandoned property in the custody of IBT and FIS to determine whether controls were adequate to safeguard abandoned property, including cash dividends, stocks and bonds. We also reviewed contract compliance between the OST, IBT, and FIS.

To conduct our review, we held a series of meetings with staff of both IBT and FIS, which were attended by representatives of the OST's Abandoned Property Division. During these meetings, we obtained a verbal presentation of the (1) processes for receiving Commonwealth of Massachusetts abandoned property investment and dividend deposits, (2) level of identification documentation provided with deposits, (3) source of these deposits, (4) process for returning investments and dividends held to rightful owners and (5) format of the monthly custodian statements and the frequency they are provided to the OST's Abandoned Property Division. At these meetings we requested a copy of the existing custodial service contract between each bank and the OST, the banks' internal written procedures for the processing and recording of cash and investment deposits, the asset reconciliation process, and copies of monthly custodial bank statements for the months of January 2001 through March 2001 and July 31, 2001 previously provided the OST's Abandoned Property Division. We analyzed the materials provided, held follow-up meetings with each custodian bank, and requested additional explanations and custodial bank statements, as necessary.

AUDIT RESULTS

1. IMPROVEMENTS NEEDED IN FIDUCIARY CONTROLS OVER CUSTODIAL BANKING SERVICES

Our review of the Investors Bank and Trust Company (IBT) and Fleet Investment Services (FIS) contracts with the Office of the State Treasurer (OST) for abandoned property custodial banking services disclosed that improvements are needed in the areas of (a) contract procurements, (b) the consistent use of the Commonwealth's standard contract form regarding the inclusion of the clause that the Office of the State Auditor (OSA) has the authority to audit the books and records of the contractor, and (c) accounting for abandoned property by date of deposit.

a. Custodial Bank Abandoned Property Contracts Should Be Competitively Procured

The OST has not issued new and open competitively bid contracts for abandoned property custodial banking services. IBT's original contract was executed on June 2, 1999 and expired on June 30, 2000. Custodial services provided by IBT for fiscal year 2001 were authorized by four quarterly amendments that have extended this contract. These amendments also authorized the payment of \$60,000 to IBT for fiscal year 2001 custodial services, which represents a \$15,000 (33%) increase over the \$45,000 maximum obligation for fiscal year 2000 established by the original contract. Again in fiscal year 2002 OST issued three amendments to IBT's original contract providing additional funding of \$60,000 for custodial services. As a result of OST's use of amendments for fiscal years 2001 and 2002 the maximum dollar obligation of the original contract executed June 2, 1999 increased from \$78,750 to \$198,750. Moreover, FIS is billing under a contract originally signed on July 15, 1996 that contains no termination date and has not been cancelled or amended by either party.

The Office of the State Comptroller's Internal Control Guide for Commonwealth Departments, Volume II, Chapter III, Procurement and Contracting, states, in part:

The Commonwealth's procurement system empowers departments to procure commodities and services at the "best value" for the department and the Commonwealth. Procurements will be considered in the best interest or the best

value to a department or the Commonwealth when procurement supports and balances the following Procurement Principles:

- *Achievements of required outcomes, generates the best quality economic value*
- *Minimized the burden on administrative resources*
- *Expedites simple or routine purchases*
- *Allows flexibility in developing alternative procurement and business relationships*
- *Encourages competition*
- *Encourages the continuing participation of quality contractors and supports the Commonwealth and department procurement planning and implementation*

Periodic procurement results in positive benefits that are achieved in prices, quality, customer services, and public benefits. Competition among contractors promotes the best commodities and services at the lowest responsible cost.

b. State Auditor's Office Authority to Audit Contractors Books and Records Clause Not Included in FIS Contract for Custodial Services

Our review disclosed that, although the OST's contract for custodial services with IBT has a clause that allows the OSA the right to examine the accounts, books, records, and activities of the contractor as required by Chapter 11, Section 12 of the General Laws, OST's contract with the FIS for the same services contains no such provisions.

Chapter 11, Section 12, of the General Laws states, in part:

The department of the state auditor is hereby authorized to inspect, review or audit, in conformity with generally accepted government auditing standards, the accounts, books, records and activities of vendors contracting, having contracted, or agreeing to provide services or materials of any description, or any other thing of value pursuant to any and all contracts or agreements between the commonwealth, its departments, agencies, bureaus, boards, commissions, institutions, or authorities and said vendors to the extent necessary to determine compliance with the provisions and requirements of such contracts or agreements and the laws of the commonwealth. Any grant or contract entered into between an entity, including vendors, and a state agency shall include a clause providing the state auditor with access as intended by this section.

Moreover, the Commonwealth's new Standard Contract Form and Instructions, effective January 24, 2001, contain a clause referring to the OSA's authority to provide access to

contractor records as required by Chapter 11, Section 12, of the General Laws. The Commonwealth's Standard Contract Form and Instructions contains language and clauses on applicable contract laws in order to protect the Commonwealth and its departments. This clause assists departments in gaining access to books, records, and accounts of contractors in order to conduct an independent audit of goods and services provided and further protects the Commonwealth from fraud, waste and abuse because vendors are put on notice that their contracts are subject to audit.

c. Separate Accounts Not Recorded By Date of Deposit for Abandoned Property

Our review of abandoned property custodial services provided by IBT and FIS on behalf of the OST disclosed that the calendar year in which custodial funds are delivered to the OST is not accounted for properly in order to comply with Chapter 200A, Section 9(b), of the General Laws. This law requires the OST to liquidate property after one year of delivery to the OST except for any intangible interest in a business association shall not be liquidated earlier than three years unless the OST determines it is in the best interest of the Commonwealth to do so. The date that the property is delivered to the custodial banks is important information in order to determine when securities should be liquidated (see Audit Result No. 3). Our review disclosed the following:

- The OST has not created separate accounts to denote when abandoned property securities were originally deposited. The last account the OST created at IBT was established in 1999; therefore the account balance reflects deposits from 1999 through July 31, 2001. (The cut-off date of July 31, 2001 reflects the last set of complete IBT monthly bank statements provided to us.)
- The two accounts the OST maintains at the FIS are used to segregate deposits made by National Abandoned Property Processing Corporation (NAPPCO) and Affiliated Computer Services (ACS) (two firms under contract with the OST to recover Commonwealth of Massachusetts abandoned property) and represent the unremitted balance to rightful owners and the Commonwealth; however, there is no date as to when the property was delivered.
- IBT's monthly statement "Transaction Detail" section indicates the transactions date of receipt and disbursement for the current month activity; however, the "Investment Portfolio" section does not record the date securities are deposited. The date of receipt appears only on the monthly statement on which the transaction is originally recorded and does not appear on any subsequent statement.

Because the OST has not created separate accounts to denote when securities were deposited or required its custodial banks to record this information within the “Investment Portfolio” section of the monthly statements, neither it nor the custodial banks could prepare an aging to disclose how long investments have been held by the OST or monitor the sale of securities and the transfer of sale proceeds to the Commonwealth's General Fund for compliance with Chapter 200A, Section 9(b), of the General Laws.

IBT and FIS staff indicated that they would require an authorizing directive from the OST's Abandoned Property Division in order to create additional abandoned property accounts or expand the existing monthly statement “Investment Portfolio” reporting format to account for the date securities were delivered.

Recommendation

The OST should take the following actions to improve its fiduciary controls over dividends, stocks, bonds, and other intangible abandoned property by:

- Issuing an open competitive Request for Proposals (RFP) for abandoned property custodial banking services. The RFP should specify the informational needs required to be provided in monthly statement reports prepared by custodian banks to ensure that the OST's Abandoned Property Division records can be reconciled to the statements received.
- Awarding contracts for custodial banking services using the Commonwealth's standard contract form, which includes a clause regarding the Office of the State Auditor access to vendors' books and records in accordance with Chapter 11, Section 12, of the General Laws.
- Requiring custodial banks to account for abandoned property securities by the date of deposit. Also, the date that securities are delivered should be recorded in order to monitor compliance with Chapter 200A, Section 9(b), of the General Laws.

2. RECONCILIATIONS OF MONTHLY CUSTODIAL BANK STATEMENTS OF ABANDONED PROPERTY SECURITY HOLDINGS NOT PERFORMED

Our prior audit report of the OST (Audit No. 2000-0085-3) disclosed that, although both IBT and FIS complied with contract requirements by providing the OST's Abandoned Property Division with monthly statements of income and principal transactions detailing daily transaction activity and end-of-the-month investment portfolio balances, the OST

performed no reconciliations of these statements in order to ensure that custodial funds were properly accounted for, deposited, recorded, and reported.

Our follow-up review revealed that no corrective action had been taken by the OST's Abandoned Property Division to implement monthly reconciliation of custodian banks' monthly statements. In addition, rightful owners' names do not appear on the listing or wire transfers of abandoned property deposits made to custodian banks by the OST, NAPPCO, ACS, brokers, etc. Instead, the certificate number, issue name, type of investment, CUSIP number (investment industry assigned number for specified security), number of shares and dividend start dates are provided. The OST maintains the name of the abandoned property owner along with the other pertinent information regarding the securities. The actual number of shares held by the custodian bank is only updated on the division records at the time of a claim. OST officials indicated that there is no ongoing reconciliation process in place to verify the security information in the division's computer system to the monthly statements provided by the custodian bank.

To perform proper management oversight of its custodian banks and to protect rightful owners' securities from loss, theft, or misuse, the OST's Abandoned Property Division should have internal control procedures in place that require that monthly custodial statements be reconciled to the division's records to verify the accuracy of the monthly statements. In addition, Chapter 647 of the Acts of 1989, An Act Relative to Improving the Internal Controls Within State Agencies, requires that periodic comparisons be made between resources and the recorded accountability of the resources in order to reduce the risks of unauthorized use or loss and protect against waste and wrongful acts.

Our review of the monthly statements prepared by IBT disclosed pricing errors, discrepancies in the different accounting methods utilized by IBT and their subcustodian (a Brazilian bank subordinate to IBT that held warrants¹ on IBT's behalf), untimely removal of expired warrants (date of warrant's purchase option had past), bonds incorrectly classified as stock on IBT's computer system, and the practice of assigning investment market values

¹ Warrants are investment instruments issued by corporations that allow the holder to purchase additional stock in the corporation at a future date at a preassigned price.

without reporting offsetting book value have resulted in IBT's issuing monthly custodian statements to the OST's Abandoned Property Division that contained incorrect investment book and market values and overstated unrealized gains or losses.

The following are examples of incorrect values disclosed by our review that were presented on custodian monthly statements IBT submitted to the OST's Abandoned Property Division and resulted in improper unrealized gains (losses) being reported. The first entry represents the reported value shown on monthly statements submitted by IBT, whereas the second entry reflects the correct dollar value reported by IBT in response to questions raised by OSA staff.

OST Account #020208420087 (1993)

1) Pon Holding Corporation (Pricing Error - Expired Preferred Stock)

	<u>Par/Shares Original Face</u>	<u>Statement Date</u>	<u>Book Value</u>	<u>Unit Price</u>	<u>Market Value</u>	<u>Unrealized Gain/(Loss)</u>
Reported Value	4,490.54	January 2001	\$380,079	-	0	(\$380,079)
Correct Value	4,490.54	July 2001	<u>1</u>	-	<u>0</u>	<u>(1)</u>
Net Dollar Change			(\$380,078)	-	0	(\$380,078)

OST Account #020208420299 (1999)

2a) Olympic Broadcasting Corp. (Bond incorrectly classified as a stock on IBT's Computer system)

	<u>Par/Shares Original Face</u>	<u>Statement Date</u>	<u>Book Value</u>	<u>Unit Price</u>	<u>Market Value</u>	<u>Unrealized Gain/(Loss)</u>
Reported Value	1,950,000	January 2001	-	\$10,000	\$195,000,000	\$195,000,000
Correct Value	1,950,000	March 2001	-	<u>0</u>	<u>0</u>	<u>0</u>
Net Dollar Change			-	(\$10,000)	(\$195,000,000)	(\$195,000,000)

The Olympic bond was incorrectly classified as a stock by the IBT computer system and on the same day the bond was reclassified as being in default. Due to these misclassifications errors occurred on the statements. An incorrect market value of \$195,000,000 was assigned when the value of the bond should have been zero because it was in default. Also, the calculation of the 1,950,000 shares at \$10,000 per share was incorrectly calculated at \$195,000,000. The actual calculation would have been \$19,500,000,000.

2b) Companhia De Bebedowt Warrants (Pricing Error - Decimal Point of Unit Price Improperly Recorded)

	<u>Par/Shares Original Face</u>	<u>Statement Date</u>	<u>Book Value</u>	<u>Unit Price</u>	<u>Market Value</u>	<u>Unrealized Gain/(Loss)</u>
Reported Value	183,667	January 2001	\$132,939	\$207.648	\$38,137,994	\$38,005,055
Correct Value	183,667	January 2001	<u>132,939</u>	<u>.208</u>	<u>38,203</u>	<u>(94,736)</u>
Net Dollar Change			-	<u>(\$207.44)</u>	<u>(\$38,099,791)</u>	<u>(\$38,099,791)</u>
Combined Net Dollar Change of 2a/b above				<u>(\$10,207.44)</u>	<u>(\$233,099,791)</u>	<u>(\$233,099,791)</u>

Our review of the market value calculation by IBT resulted in a market value calculation of \$38,137,994, however, the actual calculation of the \$207.648 unit price for 183,667 shares results in a market value of \$38,138,085 which is \$91 more than what is listed on the statement.

3) Companhia De Bebedowt Warrants (Pricing Error - Decimal Point of Unit Price Improperly Recorded)

	<u>Par/Shares Original Face</u>	<u>Statement Date</u>	<u>Book Value</u>	<u>Unit Price</u>	<u>Market Value</u>	<u>Unrealized Gain/(Loss)</u>
Reported Value	183,667	July 2001	\$132,939	\$315.644	\$57,973,407	\$57,840,468
Correct Value	183,667	August 2001	<u>132,939</u>	<u>.353</u>	<u>64,834</u>	<u>(68,105)</u>
Net Dollar Change			-	<u>(\$315.291)</u>	<u>(\$57,908,573)</u>	<u>(\$57,908,573)</u>

Our review of the market value calculation by IBT resulted in a market value calculation of \$57,973,407, however, the actual calculation of the \$315.644 unit price for 183,667 shares results in a market value of \$57,973,387 which is \$20 less than is listed on the statement.

The market value and unrealized gain for OST Account #020208420299 (1999) for January 2001 was overstated by \$233,099,791 and for July 2001 was overstated by \$57,908,573, as follows.

	<u>IBT Original Statements</u>	<u>Revised Values</u>	<u>Overstated Value</u>
<u>January 2001</u>			
Market Value	\$268,835,039	\$35,735,248	\$233,099,791
Unrealized Gain (Loss)	\$234,097,632	\$997,841	\$233,099,791
<u>July 2001</u>			
Market Value	\$93,988,684	\$36,080,111	\$57,908,573
Unrealized Gain (Loss)	\$55,807,575	(\$2,100,998)	\$57,908,573

Note: The August 2001 statement submitted by IBT for OST Account #020208420299 (1999) reported a market value of \$34,186,164 and an unrealized loss of \$4,548,974, which is consistent with the revised July 2001 balances shown above.

In response to the issues raised by our review, IBT senior management stated the following corrective actions have been or will be taken.

- Subcustodians will identify whether an asset is accounted for individually or on a per unit basis, this will allow IBT to implement new procedures to ensure they and their subcustodians utilize the same accounting methods.
- Untimely removal of expired warrants will be corrected by running monthly reports on assets assigned a user CUSIP to identify any impending corporate action.
- IBT is in the process of reviewing the account history to provide an explanation for the discrepancy between market and book value.
- IBT has reduced the market value carried on bonds no longer actively traded to zero and when book value of expired preferred stock is undeterminable, IBT will now assign a book value of \$1 to stop incorrect reporting of unrealized gains or losses.

In addition, IBT's General Counsel stated that we would be provided with a corrected August 31, 2001 statement that will reflect the revisions discussed. Also, IBT's Senior Director of Trust Services stated that the bank will now have its Employee Benefit Reporting Group conduct a full audit prior to releasing monthly statements to the OST's Abandoned Property Division and that revisions to the monthly statement will be made to assist in the monitoring of the available cash balances.

Because IBT did not conduct reviews to ensure the accuracy of its monthly statements prior to releasing them to the OST, and because OST did not conduct reconciliations of monthly statements, errors were not detected that resulted in incorrect security book and market values and overstated unrealized gains or losses. In addition, this practice did not adequately protect the securities of rightful owners from loss, theft, or misuse. Prudent business practices and sound internal controls advocate that IBT have procedures in place requiring a review be conducted to ensure the accuracy of its monthly statements prior to their release to the OST's Abandoned Property Division.

Our review of monthly statements prepared by FIS also disclosed reconciliation and subcontractor issues, as follows:

- FIS complies with the requirements of its custodial service contract by providing the OST's Abandoned Property Division monthly statements of both a detail report of daily transaction activity and the end-of-the-month investment portfolio balances for the two accounts the bank maintains for the division. However, our review disclosed that no monthly reconciliations were performed between the bank and the OST's Abandoned Property Division to ensure their accuracy. Because monthly reconciliations were not prepared, the OST's Abandoned Property Division cannot ensure the accuracy of division records, the accuracy of the monthly statements provided by FIS, and that rightful owners' investments have been adequately protected from loss, theft, or misuse.
- ACS has utilized a Gales and Company account with FIS to occasionally deposit abandoned property instead of directly depositing the abandoned property receipts into the designated Commonwealth's FIS account. FIS indicated that it has made repeated requests for ACS not to use this account but an ACS representative stated that the OST's Abandoned Property Division instructed ACS to do so. However, FIS has never received written documentation confirming this statement. In addition, ACS has given the OST's Abandoned Property Division notification of recovered securities without providing FIS staff the same notice, and there have been instances in which ACS has made untimely deposits of securities after providing OST's Abandoned Property Division notification. Because FIS can only record the receipt of the security when confirmation of proper account credits is received, untimely deposits by ACS create the potential for lost securities and variances between account balances reported by FIS and those recorded by the OST's Abandoned Property Division.

In response to these issues, the FIS Banking Officer who performs the daily custodial services for the OST's ACS account income and principal transactions stated that he will continue to work with the division's staff to resolve these issues.

Recommendation

The OST's Abandoned Property Division should:

- Establish internal controls within the division requiring that a monthly reconciliation be conducted to ensure the accuracy of each OST account's monthly custodial statements of daily transaction activity and end-of-the-month investment portfolio balances provided by its custodian banks.
- Monitor IBT's continued implementation of appropriate improvements to ensure the accuracy of monthly statements submitted to the OST's Abandoned Property Division.

- Work with FIS staff to implement corrective actions to address the existing issues with ACS, including the untimely deposits of recovered securities, the provision of proper FIS notification of deposits, and the improper depositing of securities to accounts other than the Commonwealth's designated account.

3. IMPROVEMENTS NEEDED IN FIDUCIARY CONTROLS OVER DIVIDENDS, STOCKS, BONDS, AND OTHER INTANGIBLE ABANDONED PROPERTY

Our prior audit report disclosed that improvements were needed in the OST's fiduciary controls over dividends, stocks, bonds, and other intangible abandoned property. Specifically, the OST's last sale of abandoned property securities on deposit with the two custodial banks was in 1990. OST had no policy for the liquidation of securities in accordance with Chapter 200A, Section 9, of the General Laws and the transfer of the sales proceeds to the Abandoned Property Fund and a subsequent transfer to the General Fund. The law requires the OST to liquidate property after one year of delivery to the OST, except for any intangible interest in a business association shall not be liquidated earlier than three years after delivery to the OST unless the OST determines it is in the best interest of the Commonwealth to do so.

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, registrar, 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.

Our prior report recommended that the OST establish fiduciary controls to ensure custodian bank monthly statements for abandoned property security holdings are monitored and establish a policy for the reoccurring liquidation of securities remitted to OST and deposited

with its custodial banks. In response to our prior audit, the Assistant Treasurer stated that the OST will review current practices with regard to potential liquidation of stocks and/or bonds remitted in previous years.

Our follow-up review indicated that IBT's January 31, 2000 monthly statements showed that the OST's Abandoned Property Division's security deposits for the five accounts created in the years 1990-1997 had a consolidated book value of \$36,009,078 with a market value of \$150,272,523. As of July 31, 2001, these same five accounts' consolidated book value was reported to be \$23,723,804 and their market value was shown as \$106,090,873 (See Appendix II). While the book value of these accounts decreased by \$12,285,274 in this 18-month period, the market value declined by \$44,181,650. These net decreases reflect both the return of securities to rightful owners and the downturn in the stock market. The OST does not have a system in place to distinguish between the increase or decrease in market value and the return of securities to rightful owners.

During this 18-month period of declining security market values and Commonwealth revenue shortfalls, the OST issued no instructions for the liquidation of these five accounts to maximize the receipts due the Commonwealth's General Fund. Had the OST sold these securities as of January 31, 2000 or in prior years of positive growth, in compliance with Chapter 200A, Section 9 (b) of the General Laws, both the Commonwealth's General Fund and the rightful owners located at a future date would have received a greater dollar value.

A similar analysis was not permissible for the OST's Abandoned Property Division securities deposited with FIS because the two accounts maintained for the OST do not denote the year abandoned property securities were originally deposited. (See Audit Result No. 1c). However, a comparison of the market value balances of all OST Abandoned Property security deposits with both IBT and FIS between January 31, 2000 and July 31, 2001 disclosed a consolidated loss of \$27,484,688 (see Appendix I), yet the OST provided neither custodian with instructions to liquidate existing security deposits in compliance with Chapter 200A, Section 9(b), of the General Laws.

Recommendation

The OST should establish policies and procedures for the liquidation of abandoned property securities in compliance with Chapter 200A, Section 9(b), of the General Laws.

During our review, meetings were held with bank representatives in which OST representatives (Assistant Treasurer for Abandoned Property, Assistant Legal Counsel, and Internal Auditor) were present on several occasions. On March 12, 2002, we met with the OST's Assistant Treasurer for Abandoned Property, Assistant Legal Counsel, and Internal Auditor to discuss our review of the ITB and FIS contracts for handling certain abandoned property functions for the OST. Our discussions with OST representatives are as follows:

1. Improvements Needed in Fiduciary Control Over Custodial Banking Services: We were advised that the OST was hopeful of issuing a RFR in the last quarter of fiscal year 2002, with implementation of selected custodian service contracts anticipated for fiscal year 2003. With regard to separate accounts not recorded by date of deposit for abandoned property, OST representatives indicated that the practice is to deposit all abandoned property transferred from ACS and NAPPCO with FIS, with all other transfers to be deposited with IBT. OST's computer system records do not reflect to what custodian bank or account the deposits have been made. OST believes that a monthly reporting system that reflects both the return of investments to rightful owners and the deposit of new abandoned property with the custodian bank by account could be established. However, changes to the OST computer system would be needed. Also, when OST receives electronic information regarding abandoned property (names of owners, specific number of shares, type of investment, etc.) the information is verified and recorded on OST's computer system. OST's computer records reflect the investments that come in and that the same investment is paid out to rightful owners. (The amount paid out to rightful owners recorded on OST's computer system does not reflect the actual name and number of shares paid out, which could exceed the original deposit or be of a different company name because of stock split company mergers, etc.).
2. Reconciliation of Monthly Custodial Bank Statements of Abandoned Property Security Holdings Not Performed: We were advised that OST has recently started to develop reconciliations of mutual fund account statements, and when the process is up and working, OST will focus on custodian bank monthly statement reconciliations. In addition, OST computer records report only the original deposit amounts and not the up-to-date market values.
3. Improvements Needed in Fiduciary Controls Over Dividends, Stocks and Other Intangible Abandoned Property: We were advised that OST has no procedures in place for selling securities in compliance with Chapter 200A, Section 9(b) of the General Laws. The OST stated that the Treasurer's philosophy is to return abandoned property to the rightful owner, and while market conditions change, the abandoned property belongs to rightful owners, not the Commonwealth.

APPENDIX I

Comparison of the Dollar Value of OST Abandoned Property Securities Deposited with Custodian Banks January 31, 2000 and July 31, 2001

<u>Investors Bank and Trust Company</u>		<u>January 31, 2000 Balances</u>		<u>July 31, 2001 Balances</u>		<u>Book Value Increase (Decrease)</u>	<u>Market Value Increase (Decrease)</u>
		<u>Book Value</u>	<u>Market Value</u>	<u>Book Value</u>	<u>Market Value</u>		
<u>Account Number/(Year Created)</u>							
020208054810	(1990)	\$ 999,112	\$ 18,212,050	\$ 413,316	\$ 13,466,475	\$ (585,796)	\$ (4,745,575)
020208420018	(1991)	5,356,065	58,252,972	818,851	39,195,268	(4,537,214)	(19,057,704)
020208420087	(1993)	15,255,806	48,885,146	10,838,007	35,066,848	(4,417,799)	(13,818,298)
020208420112	(1995)	10,488,600	19,841,201	8,807,829	14,994,314	(1,680,771)	(4,846,887)
020208420297	(1997)	3,909,495	5,081,154	2,845,801	3,367,968	(1,063,694)	(1,713,186)
020208420299	(1999)	<u>13,959,325</u> (a)	<u>16,677,110</u>	<u>38,181,109</u> (a)	<u>36,080,111</u> (b)	<u>24,221,784</u>	<u>19,403,001</u>
<u>Total</u>		\$ 49,968,403	\$ 166,949,633	\$ 61,904,913	\$ 142,170,984	\$ 11,936,510	\$ (24,778,649)
<u>Fleet National Bank</u>							
0002802870		\$ 25,983,131	\$ 33,325,406	\$ 35,189,059	\$ 33,485,359		\$ 159,953
0002803670		(c)	<u>6,503,463</u>	<u>4,565,199</u>	<u>3,637,471</u>		<u>(2,865,992)</u>
<u>Total</u>			\$ 39,828,869	\$ 39,754,258	\$ 37,122,830		\$ (2,706,039)
<u>Combined Totals</u>			<u>\$ 206,778,502</u>	<u>\$ 101,659,171</u>	<u>\$ 179,293,814</u>		<u>\$ (27,484,688)</u>

Note: The above balances are exclusive of principal cash. (Income cash summary for dividends and interest receipts.)

(a) The IBT Account Number 020208420299 book value increased by \$24,221,784, which reflects additional deposits to the account created in 1999 after January 31, 2000.

(b) Market value for Deposit Year 1999 was adjusted by OSA staff to reflect a correction made in August 2001 by IBT for a pricing error.

(c) The book value for NAPPCO Account Number 0002803670 January 31, 2000 balance is not available.

APPENDIX II
Summary of the Dollar Value of OST Abandoned Property Securities Deposited with Investors Bank and Trust Company for Three Years or More

		<u>January 31, 2000 Balances</u>		<u>July 31, 2001 Balances</u>		Book Value	Market Value
<u>Investors Bank and Trust Company</u>						Increase	Increase
<u>Account Number/(Year Created)</u>		<u>Book Value</u>	<u>Market Value</u>	<u>Book Value</u>	<u>Market Value</u>	<u>(Decrease)</u>	<u>(Decrease)</u>
020208054810	(1990)	\$ 999,112	\$ 18,212,050	\$ 413,316	\$ 13,466,475	\$ (585,796)	\$ (4,745,575)
020208420018	(1991)	5,356,065	58,252,972	818,851	39,195,268	(4,537,214)	(19,057,704)
020208420087	(1993)	15,255,806	48,885,146	10,838,007	35,066,848	(4,417,799)	(13,818,298)
020208420112	(1995)	10,488,600	19,841,201	8,807,829	14,994,314	(1,680,771)	(4,846,887)
020208420297	(1997)	3,909,495	5,081,154	2,845,801	3,367,968	(1,063,694)	(1,713,186)
	<u>Total</u>	<u>\$ 36,009,078</u>	<u>\$ 150,272,523</u>	<u>\$ 23,723,804</u>	<u>\$ 106,090,873</u>	<u>\$ (12,285,274)</u>	<u>\$ (44,181,650)</u>

Note: The above balances are exclusive of principal cash. (Income cash summary for dividends and interest receipts.)