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October 22, 2009

Major General Joseph C. Carter, Adjutant General
Departments of the Army and the Air Force
Joint Force Headquarters
Massachusetts National Guard
50 Maple Street
Milford, MA 01757-3604

Dear Major General Carter:

On April 30, 2009, your office requested that the Office of the State Auditor examine an account maintained by the State Quartermaster (SQM) of the Massachusetts Military Division of the Commonwealth to determine whether state funds may have been commingled with the account or interest earned on state matching funds may have been improperly maintained by the SQM. In response to that request and as authorized by Chapter 11, Section 12, of the Massachusetts General Laws, we performed an audit of certain SQM activities. Our audit was initiated for the purpose of conducting a review and analysis of state matching funds advanced to the SQM and to determine whether the SQM is complying with applicable laws, rules, and regulations. In addition, we evaluated and reported on applicable internal controls and recommended improvements to certain areas of the SQM's operations that could be strengthened and made more efficient or effective.

Our audit, which covered the period July 1, 2005 through May 31, 2009, was made in accordance with generally accepted government auditing standards for performance audits. We identified and evaluated the policies, procedures, practices, and internal controls utilized by the SQM over its fiscal operations and account management.

Our review consisted of, but was not limited to, the following:

- Reviewing applicable laws, regulations, and policies relating to the SQM's creation and overall operation, including the Master Cooperative Agreement and National Guard Regulation 5-1 National Guard Grants and Cooperative Agreements.
- Meeting with National Guard and SQM officials to gain an understanding of the SQM's accounting system and key areas of concern.
- Examining financial reports, accounting records, and other pertinent documents.
- Reviewing and comparing bank statement information to SQM's accounting records.
- Testing a sample of expenditures of state funds for compliance with the Master Cooperative Agreement and National Guard Regulation 5-1 National Guard Grants and Cooperative Agreements.
- Tracing payments made by the state during the audit period to the SQM's accounting records and bank statements.
- Reviewing the interest earned on state matching funds to ascertain the amount that was retained within the SQM Air National Guard bank account for the audit period.
- Reviewing a Department of Defense, U.S. Army Criminal Investigations Command (CID) report of the SQM's office.

The results of our audit and our recommendations are contained in the Attachment to this letter. I hope this information will be helpful to your agency. Should you have any questions or need further assistance concerning this or any other matter, please feel free to contact me.

Sincerely,

A handwritten signature in black ink, reading "A. Joseph DeNucci". The signature is written in a cursive, flowing style.

A. JOSEPH DeNUCCI

Auditor of the Commonwealth

INTRODUCTION

Background

The Massachusetts Military Division – Massachusetts National Guard (MMD) was established under the provisions of Chapter 33, Section 11, of the Massachusetts General Laws. The MMD's mission is to maintain properly trained and equipped military units available as needed to support the Department of Defense under the direction of the President of the United States and to provide trained and disciplined military forces for emergencies within the Commonwealth of Massachusetts under the direction of the Governor of Massachusetts.

The State Quartermaster (SQM) is a component of the MMD. In accordance with Chapter 33 of the Massachusetts General Laws, the State Quartermaster is charged with the care and control of all land and buildings held for military purposes and all other military property of the Commonwealth. He has the authority to administer the Master Cooperative Agreement (MCA) between the United States Government, National Guard Bureau (NGB), and the Commonwealth of Massachusetts¹. This agreement establishes the terms and conditions applicable to the contribution of NGB funds or in-kind assistance for the operation and training of the State Army and Air National Guard. This agreement also provides environmental, security, firefighter, operations, and maintenance services for approved federal and state facilities located in the Commonwealth of Massachusetts. To facilitate the required services, the SQM employs approximately 200 Cooperative Agreement employees. These employees are located throughout the state wherever approved federal and state facilities are located.

The SQM manages funds from the 14 various operational units called "Appendices" within the MCA. The scope of the MCA includes all activities enumerated in the 14 Appendices. Our audit focused on two of the 14 Appendices (Appendix 21 – Air National Guard Facilities and Operations Maintenance Activities, and Appendix 22 – Air National Guard Environmental Program Management) because state matching funds were used in the operation of these appendices.

Both MMD and the State Quartermaster's office are located in Milford, Massachusetts, at the Joint Force Headquarters for the Army National Guard and Air National Guard.

¹ As of October 22, 2008, the Adjutant General delegated authority to the State Property Officer to administer the Master Cooperative Agreement between the United States Government National Guard Bureau (NGB) and the Commonwealth of Massachusetts.

AUDIT RESULTS

1. IMPROVEMENTS NEEDED IN CONTRACT ADMINISTRATION

Our audit revealed that the State Quartermaster (SQM), contrary to Chapter 7A, Section 7, of the Massachusetts General Laws, does not utilize the Massachusetts Management Accounting and Reporting System (MMARS) to account for over \$30 million of various federal funds advanced annually to the Commonwealth. Rather, all federal money advanced via the Master Cooperative Agreement (MCA) to the Commonwealth through the SQM is deposited into two separate interest-bearing accounts --the Army National Guard (ARNG) bank account and the Air National Guard (ANG) bank account-- both of which are solely maintained and managed by the SQM. Furthermore, since July 2005 state matching funds have increased to over \$1 million annually, and these funds were deposited into the ANG bank account and commingled with federal funds.

As noted in Chapter 7A, Section 7, of the General Laws, the State Comptroller is authorized to prescribe the rules and accounting system used by Commonwealth departments:

The comptroller shall design and install an accounting system for the commonwealth and prescribe the requisite forms and books of account to be used by each department, office, commission and institution of the commonwealth. No form or book of account other than that prescribed as aforesaid shall be used without the approval of the comptroller. He may revise such forms, books or system from time to time. He shall prepare and distribute a book of instructions covering the use and application of said accounting system for the guidance of the various departments, offices, commissions and institutions of the commonwealth. Such instructions will pertain to the financial accounting of assets, liabilities, fund equities, revenues, and expenses of all funds unless specifically exempted by general or special law.

Moreover, the Office of the State Comptroller (OSC) requires Commonwealth departments to use MMARS for all inflows and outflows unless specifically exempted by general or special law.

In addition, the total revenues collected by a Commonwealth department must be deposited into the state treasury and therefore accounted for in the state accounting system (MMARS), as required by Chapter 30, Section 27, of the General Laws, which states, in part:

Except as otherwise expressly provided, all fees or other money received on account of the commonwealth shall be paid daily into the treasury thereof.

The SQM is a component of the Massachusetts Military Division – Massachusetts National Guard (MMD), which is a state agency. Additionally, the MCA is a contract with the state through which

the SQM receives federal funds and state matching funds. Therefore, state guidelines as prescribed by the OSC are applicable to the SQM's office.

According to SQM officials the bank accounts were set up over 20 years ago; however, it was not clear who established the accounts or why they were not brought to the attention of the OSC or the Executive Office for Administration and Finance.

In May 2009, the Department of Defense (DOD) concluded a review of the SQM's records for the period October 1, 2002 through April 30, 2009. This review revealed that the SQM needs to return to the federal government \$1,063,707 in interest earned on federal funds advanced. In accordance with federal agreement regulations, all interest earned on advanced funds, except for \$100 per year, must be returned to the federal government. However, at the time of their audit, the DOD was unaware that commencing in July 2005 state matching funds were commingled with federal funds within the ANG bank account.

The DOD reported that a total of \$1,063,707 of interest earned on federal funds needs to be returned to the federal government. Of this amount, \$187,976 represents interest earned from the ANG bank account, and the remainder represents interest earned from the ARNG bank account, which did not include state funds. Our review focused on the interest earned on state matching funds received, as part of the MCA, and deposited into the ANG bank account. Our review of ANG bank statements and SQM accounting records revealed that a total of \$13,977 in interest was earned on state funds received during the period July 1, 2005 through April 30, 2009. Therefore, \$13,977 should be deducted from the \$187,976 of interest earned from the ANG bank account that needs to be returned to the federal government as calculated by the DOD.

During our review we also tested a sample of expenditures related to state matching funds received in accordance with the MCA and found that all expenditures tested were in compliance with the MCA and National Guard Bureau Regulation 5-1 National Guard Grants and Cooperative Agreements.

Recommendation

The MMD should contact the OSC to initiate the proper process to authorize the OSC to maintain and manage all financial activities (accounting records and bank accounts) of the SQM in compliance with Chapter 7A, Section 7, of the General Laws and determine the final disposition of state funds.

Auditee's Response

The Major General of the Massachusetts National Guard responded, in part:

I have fully disclosed this matter to the Secretary of the Executive Office of Public Safety and Security. In turn, his staff has briefed the Executive Office and the office of the Secretary of the Executive Office for Administration and Finance. Those offices along with the Massachusetts National Guard (MANG) expect to inform the OSC as soon as reasonably possible to bring MANG into compliance with state law.

2. IMPROVEMENTS NEEDED IN INTERNAL CONTROLS

Our review disclosed that the SQM did not develop policies and procedures specific to their office or the MCA. As a component of the MMD, the policies and procedures of the SQM should be referenced in the Internal Control Plan (ICP) of the MMD. We also found that the SQM did not conduct periodic risk assessments as required by state law and OSC requirements. As a result, the SQM could not adequately ensure the integrity of their records and assets, including over \$30 million in various federal funds advanced annually to the Commonwealth.

Chapter 647 of the Acts of 1989, an Act Relative to Improving the Internal Controls within State Agencies, states in part: "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." Subsequent to the passage of Chapter 647, OSC issued written guidance in the form of the Internal Control Guide for Managers and the Internal Control Guide for Departments. The OSC's most recent Internal Control Guide² continues to stress the importance of internal controls and the need for departments to develop an internal control plan, defined as follows:

A high level department-wide summarization of the department's risks and the controls used to mitigate those risks. This high level summary must be supported by lower level detail, i.e. departmental policies and procedures.

Since the SQM is a component of the MMD, the SQM should have departmental policies and procedures that are referenced in the ICP of the MMD.

Also, the new OSC Internal Control Guide continues to put emphasis on a department-wide risk assessment, which is defined as "the identification and analysis of the risks that could prevent the

² The OSC issued its seventh edition of their Internal Control Guide on September 13, 2007 that streamlines the contents of existing manuals and incorporates the principles of Enterprise Risk Management that tie risk to strategic planning. Accordingly, the new guide replaced both the *Internal Control Guide for Managers, Volume I*, and *Internal Control Guide for Departments, Volume II*.

department from attaining its goals and objectives.” For this reason, the risk assessment is an integral part of an internal control plan because it assists management in prioritizing those activities where controls are most needed. To comply with Chapter 647, management is responsible for evaluating and implementing, at least annually, any changes necessary to promote efficiency, reduce the risk of asset loss, help ensure the reliability of financial activity and compliance with laws and regulations, and maintain the integrity and effectiveness of the internal control system.

Our review of the SQM’s office revealed that there was a lack of segregation of duties and management oversight. Specifically, the financial manager for the MCA has the authority to receive funds, deposit funds, update accounting records, sign checks, and reconcile monthly bank statements. Prudent business practices advocate that separation of duties exist between the individual receiving funds, the individual updating the accounting records, the individual making the deposits, and the individual reconciling the monthly bank statements. In a small office environment where segregation of duties may be difficult to achieve, additional management oversight is necessary. Management should review monthly bank reconciliations and other accounting reports used for internal control purposes and should document their authorizing signature and the date of their review.

It is important for the SQM to develop specific policies and procedures in order to ensure the integrity and effectiveness of its internal control structure and to enhance its ability to respond to changes while maintaining its effectiveness. With adequate internal controls in place, it is more likely that the SQM will respond appropriately and rapidly to major changes in events affecting its overall internal environment, including the implementation of new systems or a major change of key personnel, including the transition that is necessary in changes of administration or necessary re-organization due to fiscal crisis or similar emergencies.

Recommendation

The SQM should develop policies and procedures documenting the internal controls in place (segregation of duties, management oversight, authorizing signatures, etc.) to address the risks and internal control requirements specific to its operations. Moreover, these policies and procedures should be referenced in the ICP of the MMD. Additionally, the SQM should conduct an annual risk assessment and update its control procedures and the ICP of the MMD, based on the results of the risk assessment, as necessary.

Auditee's Response

The Major General of the Massachusetts National Guard responded, in part:

MANG will adopt internal controls for the management of the monies historically managed by the SQM that reflect the accepted best practices for state agencies. Further, the MMD will implement yearly risk assessments and adjust its policies and procedures based upon the results of the risk assessment.