

TOWN OF NEWMARKET, NEW HAMPSHIRE

Management Letter

For the Year Ended June 30, 2007

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To the Town Council
Town of Newmarket, New Hampshire

In planning and performing our audit of the financial statements of the Town of Newmarket, New Hampshire, as of and for the year ended June 30, 2007, in accordance with auditing standards generally accepted in the United States of America, we considered the Town's internal accounting control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Town's internal control. Accordingly, we do not express an opinion on the effectiveness of the Town's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies and other deficiencies that we consider to be material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. Deficiencies considered to be significant deficiencies in internal control are noted in the table of contents and comment headings.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement

Additional Offices:

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of the financial statements will not be prevented or detected by the entity's internal control. Deficiencies constituting material weaknesses are noted in the table of contents and comment headings.

In addition, during our audit we became aware of several other matters that are opportunities for strengthening internal controls and operating efficiency which are also included in this report.

This communication is intended solely for the information and use of management, the Town Council, and others within the Organization, and is not intended to be and should not be used by anyone other than these specified parties.

After you have had an opportunity to consider our comments and recommendations, we would be pleased to discuss them with you.

Melanson, Heath + Company P.C.

Nashua, New Hampshire
May 9, 2008

CURRENT YEAR RECOMMENDATIONS:

1. Establish Formal General Ledger Reconciliation Procedures (Material Weakness)

As a result of accounting staff turnover during fiscal year 2007, the Town's general ledger was not consistently reconciled. Monthly reconciliations are necessary to assure the accuracy of general ledger records, as well as to provide a means of checks and balances between the financial departments. Specifically, we recommend the following general ledger accounts be reconciled on a monthly basis:

- Cash (see comment 2)
- Receivables
- Due from/to other funds (including the netting of due from and to accounts)
- Overall debits and credits
- Interfund transfers

This will provide additional assurance of the accuracy of the Town's internal financial reports, including monthly departmental budget reports. It will also provide the necessary checks and balances over the Treasurer's and Tax Collector's Office to help assure that errors or irregularities are identified and corrected in a timely manner.

We further recommend the Town incorporate all funds, including trust funds, into the general ledger. This will provide improved oversight and control, and will provide a means to reconcile all interfund accounts.

2. Improve Cash Reconciliation Procedures (Material Weakness)

The Town's monthly reconciliations of the Treasurer's cash to the Town's general ledger were not performed regularly and timely during fiscal year 2007. We also noted that there were two versions of the bank reconciliations at June 30; one prepared by the Treasurer, and the other by the Finance Department. Cash reconciliations are an integral part of ensuring the accuracy of financial reporting, and when not performed, or performed incorrectly, increase the risk of errors or irregularities occurring and going undetected.

We recommend the Town implement formal procedures requiring the monthly reconciliation of cash. To help facilitate this process, we recommend the Town institute the following:

- The Treasurer should prepare a monthly comprehensive cash reconciliation summary report (we can provide an example, if requested).
- Once reconciled, the monthly comprehensive cash reconciliation summary report should be signed by the Finance Director and Treasurer, and provided to the Town Administrator.
- The vendor account should be maintained on an imprest basis (i.e., a fixed reconciled balance).
- The Town should consider contracting out the vendor and payroll reconciliations to a bank.
- A log should be maintained to track check numbers issued and voided.

Implementing formal reconciling procedures will improve oversight and control over the Town's cash balances, and will reduce the likelihood of errors or irregularities occurring and going undetected.

3. Improve Controls Over Town Credit Cards (Material Weakness)

During 2007 the Town provided credit cards for the Town Administrator, Recreation Department, Public Works Department, and Library. We reviewed many credit card transactions and noted several weaknesses, which are discussed in the back of this report. We also noted that the Town recently issued a formal credit card policy.

We recommend the Town reconsider whether most of these credit cards could be closed out. For those remaining, we recommend the new policy be expanded to address the following issues:

- a. Actual vendor invoices should be submitted with the credit card statement for payment to support each charge.
- b. A check request form (which is numbered and cross-referenced to the credit card statement) should be attached to each supporting vendor invoice.

- c. Each check request form should be approved by two employees of the department (one of which is the department head).
- d. The check request form should document the Town business purpose of the expense and specify the general ledger expense account to be charged.
- e. All documentation must be provided to the Finance Department in a timely manner to avoid late penalties and interest charges.
- f. Credit card prepayments are prohibited.
- g. Payments should be for the exact amount of the credit card statement.

This will provide additional controls over the use of Town credit cards, thereby reducing the risk of abuses or irregularities occurring.

4. Develop Departmental Receipt Policies and Procedures (Significant Deficiency)

The Town currently does not have formal written policies and procedures for departments to follow for collecting and remitting departmental receipts. Although we did not detect any errors or irregularities during our audit, the lack of formal policies and procedures increases the risk that such situations could occur and go undetected.

We recommend the Town establish formal written departmental receipt policies and procedures. These policies and procedures should address, at a minimum, the following: the uniform format of receipt records and receipts logs, establishment of audit trails, frequency of remittances to the Collector, and overnight security.

We further recommend that the Finance Director perform periodic internal audits of the various departments to assure compliance with the policies and procedures that are adopted. This should result in improved controls over departmental receipts and reduce the likelihood of irregularities occurring.

We also recommend that a copy of the departmental receipt turnover form be provided by departments directly to the Finance Director whenever turnovers are remitted to the Collector. This will provide a necessary measure of checks and balances between departments.

5. Follow or Revise Purchasing Policy (Material Weakness)

The Town has a formal purchasing policy which specifies procedural requirements and required approvals for petty cash, employee expense reimbursements, purchases under \$ 200, purchases between \$ 200 - \$ 5,000, and purchases over \$ 5,000. In our sample testing of disbursements, we noted that the requirements of the purchasing policy were often not followed or documented, particularly in relation to the required authorizations, and documentation of quotes or bids, and petty cash policies.

We recommend the Town either follow or formally revise the existing purchasing policies. This will improve documented oversight and control over Town disbursements.

6. Comply With IRS Employee vs. Independent Contractor Requirements

The Internal Revenue Service (IRS) regulations specify that certain activities be classified as employer/employee transactions and be subject to related payroll taxes. We identified several employee-related transactions which were processed through the Town's vendor manifest, which probably should have been processed through payroll, including:

- Full-time employees providing other paid ancillary functions for the Town.
- The Finance Director being treated as an independent contractor instead of employee. Her contract stated she would perform the same responsibilities as the previous full-time position, receive health insurance benefits similar to Town employees, receive salary increases equivalent to other full-time employees, and earn 120 hours to take at her leisure.
- Financial incentives paid to employees for not participating in the Town's health insurance program.
- Rewards, including grocery store gift cards, to employees.

We recommend the Town seek legal opinions and research IRS regulations to determine whether these transactions were processed properly, and whether 2007 tax filings require amendment.

7. Formalize Fraud Policy and Periodically Discuss Fraud Prevention With Employees

Recent situations of fraud occurring in large public corporations have resulted in a trickle down effect of increased focus on fraud prevention in many organizations. Part of this process involves periodic discussions by chief executives with all management and staff regarding the importance of ethical behavior and appropriate business practices. This helps create an environment where employees recognize that fraud at any level of the organization will not be tolerated.

We recommend the Town formalize a fraud policy and periodically discuss fraud prevention with all employees, and steps that should be taken when fraud is detected or suspected. This will help maintain an ethical business environment, and ensure that employees are aware of their responsibilities to report abuses to the appropriate parties. We could provide the Town with examples of fraud policies from other communities, if requested.

8. Establish Administrative Regulations

The Town does not maintain formalized regulations to provide departments with documented guidance over certain administrative policies and procedures. As a result, inconsistencies may exist between departments with respect to such issues as:

- Cell phone use
- Travel expense reimbursements, including limits
- Employee incentives/bonus'/rewards
- Use of Town vehicles
- Insurance requirements on personal vehicles used on Town business

We recommend the Town develop formal regulations to provide current guidance over administrative policies and procedures. This should result

in improved Town-wide consistency over many routine administrative procedures.

9. Investigate Cause of Health Fund Deficit

At June 30, 2007 the Town's Health internal service fund reflected a deficit of \$ 625,594. We understand this deficit occurred in fiscal year 2003.

We recommend the Town investigate the cause of the fund deficit, and also review current allocations of costs to assure that the contracted employer/employee split of 80%/20% is actually followed. Going forward, we also recommend that actual claim payments be specifically charged to employee withholding and to the Town appropriation according to the contractual allocation percentages. This will provide a clear audit trail to assure costs are allocated in accordance with the contractual split.

10. Prepare Proof of Budget

The Town's budget, as approved by Town Meeting, gets summarized on prescribed state forms for tax rate setting purposes. Once the tax rate is set, the Town's revenue and appropriation reports document the budget by line item. Because of the multiple steps and funds involved, there is a risk that errors could occur and not be detected.

We recommend the Town prepare a spreadsheet to provide a clear trail of the budget approved by Town Meeting, to the tax rate setting forms, and finally to the amounts reported in the revenue and appropriation reports of the various budgeted funds. This will provide additional assurance that the budgets reported in the revenue and appropriation reports are accurate.

11. Re-Sort Trustees of Trust Funds Report

The Trustees of the Trust Funds annual report currently does not sort accounts in a format to correspond to generally accepted accounting

principles (GAAP) fund classifications. This makes it more difficult to generate the Town's year-end financial statements.

We recommend the Trustees re-sort the year-end trust fund reports in a manner consistent with GAAP fund classifications. This will streamline year-end accounting procedures to provide more timely reporting. We could provide an example of a revised automated spreadsheet template, if requested.

12. **Consider Implementing Internal Control Improvements (Significant Deficiency)**

In accordance with a new generally accepted audit standard (SAS 112), which is effective for all fiscal year 2007 audits, independent auditors must now report issues (called "significant deficiencies") to the governing body. The definition of this term is included in the opening letter to this management letter.

SAS 112 specifically requires that certain situations, if present in the municipality, must be reported as a significant deficiency. Although these conditions may not be new to the municipality, and may be very common practices for New Hampshire municipalities, they must now be reported in the management letter. The governing body of the Town should evaluate the cost/benefit of these issues to determine whether corrective action is warranted.

The following summarizes certain of the current and past practices in the Town that meet the new criteria of significant deficiencies:

Establish Internal Controls over the Preparation of Audited Financial Statements

Although the Town maintains its accounting records in accordance with standards established by the State statutes, and is able to prepare reports for internal and State purposes, historically, the annual financial statements have been drafted by the independent auditor. Because the Town must take full responsibility for the accuracy and disclosure of the financial statements, it must, either internally, or through the use of a qualified outside party (other than the independent auditor), review the financial

statements and related footnote disclosures, to assure compliance with generally accepted accounting principles, and to verify that no material misstatements exist. Relying on the independent auditor to perform these functions is considered a control deficiency.

Corrective Action to be Considered:

The Town should consider either providing additional staff training in the area of preparing financial statement prepared under the GASB 34 reporting model, or retain a service provider to prepare, assist in the preparation or review of the statements to ensure material misstatements are not present.

Document Components of Internal Control

In order to establish an effective system of internal controls, the Town should document the policies, procedures and controls over key financial transactions, including cash, tax/utility, receivable activity, departmental receipts, purchasing, vendor disbursements, employee benefit/ payroll disbursements, and general ledger maintenance. This documentation could be used by departments as guidance to help safeguard assets, properly record transactions, and provide a basis for continuing operations when turnover occurs in key financial departments. Although the Town maintains certain policies and procedures, they are not complete, or distributed to all applicable departmental personnel.

Corrective Action to be Considered:

Several years ago, the Committee of Sponsoring Organizations (COSO) of the President's Council on Integrity and Efficiency published comprehensive internal control guidance that has recently been put in place by publicly traded companies as a result of Sarbanes Oxley legislation. The COSO report outlines five components of effective internal control: Control Environment, Risk Assessment, Control Activities, Information & Communication, and Monitoring. The Town should consider implementing a written internal control framework using the COSO model. Software programs are available to assist with this process.

Establish Internal Audit Function

Internal audits are an important control measure to provide some assurance that procedures are actually being performed in accordance with management's assertions, and that assets actually exist and are properly safeguarded. The Town historically has relied on the independent auditor to perform these functions. This reliance, however, increases the risk that errors or irregularities could occur and not be tested or detected by management.

Corrective Action to be Considered:

The Town should consider, as part of its documented internal control procedures, establishing an internal audit function to properly monitor operations and assess risk of misstatement of the financial statement caused by either errors or irregularities.

Special Testing - Compensation to Previous Town Manager and Finance Director

- Compensation to Melodie Hodgdon was in agreement with the contract, however, as discussed in Comment 6, it remains questionable whether this actually qualified as a contractor relationship, according to IRS regulations.

- Compensation to Al Dixon reflected two overpayment problems:
 1. The contractual salary increase, effective September 22, 2006, was not taken during regular payroll periods, but instead, was accumulated, per his request, until the pay period ending June 2, 2007. The "catch-up" check, was calculated incorrectly, as it reflected 22 pay periods, and should have been only 19. This resulted in an overpayment of \$ 407.

 2. The payment for accumulated sick leave was calculated properly, however, for vacation Mr. Dixon was paid for 72 hours carried forward from the prior year (2006), totaling \$ 3,175, and 188.5 hours for the current year (2007), totaling \$ 8,313. We noted that Mr. Dixon's contract stated that *"One week of vacation may be transferred for use in the following year. No vacation weeks may be cashed in for additional pay."* At a minimum, it appears he should not have been paid for the prior year carryover hours, and it is questionable whether he was entitled to any paid compensation for vacation.

Special Testing - Petty Cash Disbursements

- Petty cash records maintained in the Town Administrator's Office were disorganized and incomplete. Specifically, we noted the following questionable situations:
 - o Supporting invoices were missing for many disbursements.
 - o The business purpose was not documented for several disbursements, including bottles of water, lunches, poison ivy medication, and an excursion on a Florida trip.
 - o Disbursements exceeded the petty cash maximum balance of \$ 500 on three occasions (two for travel and one for expenses), and were in

excess of the purchasing policy limit of \$ 50 per disbursement. These should have been processed on the Town manifest and not petty cash.

- o \$ 120 of car washes charged to petty cash in F/Y 2007.
- o A reimbursement for \$ 655 to the Finance Director was approved only by herself.
- o The Finance Director received a \$ 680 reimbursement for education while acting as a consultant, and not an employee.
- o The petty cash was not operated to maintain a fixed balance of \$ 500 (total of invoices and cash balance).

Special Testing - Expense Reimbursement Disbursements

In our testing of employee expense reimbursements, we noted the following unusual or questionable situations:

- During fiscal year 2007, Al Dixon was reimbursed for four out-of-state conferences, to Philadelphia, twice to Dallas, and to North Carolina, totaling approximately \$ 6,900.
- A reimbursement was made to Al Dixon for disability and life insurance for \$ 1,160, with the only supporting documentation being a check request form prepared and approved by Melodie Hodgdon.
- Many meal reimbursements were supported only by credit card signature slips, therefore, did not provide sufficient detail to determine whether the meals were for only one person.
- Certain expenses were paid by personal credit card and subsequently reimbursed by the Town, instead of paying originally via the Town manifest. Examples include ICMA dues of \$ 818, Prima Risk Management fees of \$ 310, and a conference for four employees in New Castle for \$ 1,140, and monthly cell phone bills.

Special Testing - Town Credit Card Disbursements

In our testing of Town credit card disbursements, we noted the following situations:

- The Town was unable to provide us with the Al Dixon credit card statements, so we did not perform any testing or review.
- Recreation has three separate credit cards, each with \$ 8,000 credit limits, that are very actively used. Risks of abuse are as follows:
 - o Three separate individuals have access to these Town credit cards.
 - o The accounts are used for numerous transactions. In July, 2006 alone there were 101 purchases made with the three cards.
 - o Two of the three cards reflected "prepayments" of approximately \$ 25,000 combined, in an apparent effort to increase the spending limits.
 - o For two of the three cards, the payment to the credit card company rarely equaled the monthly purchase amounts, resulting in fluctuating credit balances being carried forward from month to month.
 - o Because the purpose of most purchases are for recreational activities, travel, related meals, and gasoline, there is an increased risk the cards could be used for personal purposes, which would be difficult to detect.
- The DPW credit card has a \$ 5,000 credit limit and had only 2-6 transactions per month, however, reflected late penalties and other charges for eight of the 12 months, totaling \$ 109.
- The Library credit card has a \$ 6,800 credit limit and had only 2-6 transactions per month, and had two months with late penalties or finance charges, totaling \$ 36.