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May 31, 2017

Byron Diamond, Director
Department of Administrative Services
1526 K Street, Suite 240
Lincoln, NE 68508

Dear Mr. Diamond:

This letter is provided pursuant to AICPA Auditing Standards AU-C Section 265, which permits the early communication of audit findings due to their significance and the need for corrective action. The work addressed herein was performed as part of the fiscal year ended June 30, 2017, Comprehensive Annual Financial Report (CAFR) audit. This communication is based on our audit procedures and related activity through May 5, 2017. Because we have not completed our audit of the fiscal year 2017 CAFR, additional matters may be identified and communicated in our final reports.

In planning and performing our audits of the State's financial statements, the Auditor of Public Accounts (APA) considered the State's internal control over financial reporting (internal control) as a basis for designing the audit procedures. The audit procedures selected were utilized for the purpose of expressing our opinions on the financial statements of the State, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified.

We noted certain internal control or compliance matters related to the activities of the Department of Administrative Services (DAS) or other operational matters, which are presented below for your consideration. The following comments and recommendations, which have been discussed with the appropriate members of DAS and its management, are intended to improve internal control or result in other operating efficiencies.

A deficiency in internal control 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 and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We did not identify any deficiencies in internal control that we consider to be a significant deficiency.

Draft copies of this letter were furnished to DAS to provide its management with an opportunity to review and to respond to the comments and recommendations contained herein. Any formal responses received have been incorporated into this letter. Such responses have been objectively evaluated and recognized, as appropriate, in the letter. A response that indicates corrective action has been taken was not verified at this time, but it will be verified in the next audit.

Background Information

State agencies generally purchase equipment and other significant fixed assets with funding through annual budget appropriations. In May 1993, the Nebraska Legislature amended Neb. Rev. Stat. § 81-1107 (Reissue 2014) through LB 544, authorizing the Department of Administrative Services (DAS) to review and approve financing agreements "for the purposes of protecting the credit of the State, insuring the most advantageous terms, providing for proper accounting of financial transactions, complying with the approved budget, and promoting sound financial management." In conjunction with that legislative mandate, DAS implemented a Master Lease Purchase Program (Program), the purpose of which was to establish a mechanism that would allow agencies to make significant equipment acquisitions through tax-exempt lease financing. Only the financing arrangements for real property acquisitions and capital construction need prior legislative approval. Under this Program, the State maintains ownership of the leased equipment.

There are four parties to the Master Lease:

- The State Accounting Division of DAS (DAS State Accounting) represents all State agencies. For agencies participating in the Program, monthly payments are remitted to DAS State Accounting and deposited into the Master Lease Trust Fund (Fund). Semi-annual interest payments and annual principal payments are then made by DAS State Accounting to the Trustee from the Fund.

- Bond Counsel prepares all legal documents. Bond counsel for the Program is Kutak Rock LLP. Bond Council is paid by the Trustee at the request of DAS State Accounting. Bond Council fees for the 2016B lease totaled $17,190.

- The Underwriter markets and sells the instruments (certificates of participation) with varying maturities – 3 to 5 years for computer hardware, telecommunications equipment, and vehicles. Historically, the Program has also financed computer software, buildings, and real estate with longer maturities. The Underwriter also acts as the lessor. The lessor is Union Bank and Trust Company acting for and on behalf of Ameritas Investment Corp. The Underwriter purchases the certificates of participation at a discount and sells them at a premium (reoffering Premium). The Underwriters discount and reoffering premium for the 2016B lease totaled $354,581.

- The Trustee (a bank) receives the proceeds from the sale of the certificates of participation and pays for the equipment purchased from these proceeds. The Trustee maintains the funds until all leased equipment is finally purchased. The Trustee is Union Bank and Trust Company. The Trustee is paid $1,500 annually plus $24 in wire transfer fees for each active lease issuance. The Trustee was paid $19,812 from July 1, 2016, through May 5, 2017.

Master lease interest, issuance fees, and expenses include the following:

- The interest rate is set at the time the lease is finalized, and will not exceed 101% of the market rate of comparable "Aa3" rated annual appropriation lease financings.

- A one-time underwriter fee (discount) of .675% for issues of $3 million or less, and .725% for issues that exceed $3 million;

- Legal fees of .15% of the lease amount;

- Trustee fees of $1,500 at closing and $1,500 annually; and

- Printing fees (amounts vary).

Agencies participating in a master lease must spend all the proceeds, plus any interest earned from unspent proceeds, according to the following schedule:

- Within 6 months – 15% of original funds financed plus interest
- Within 12 months – 60% of original funds financed plus interest
- Within 18 months – 100% of original funds financed plus interest

Financial Information

Original Lease Amounts with Fiscal Year (FY) 2017 Activity

Master Lease Issuance	Original Amount Financed	Net Proceeds	Beginning Principal Balance, July 1, 2016	Principal Paid in Fiscal Year 2017	Interest Paid in Fiscal Year 2017	Total Fiscal Year 2017 Payments	
2010A	$ 1,475,000	$ 1,460,531	$ 60,000	$ 60,000	$ 1,328	$ 61,328	
2010B	8,335,000	8,233,013	2,220,000	1,100,000	33,420	1,133,420	
2011A	2,475,000	2,452,319	130,000	130,000	3,055	133,055	
2011B	1,375,000	1,361,398	230,000	100,000	2,765	102,765	
2012A	3,790,000	3,754,548	55,000	55,000	344	55,344	
2012B	3,940,000	3,903,257	700,000	700,000	8,400	708,400	Note 1
2013A	1,900,000	1,882,077	700,000	410,000	8,193	418,193	
2013B	2,625,000	2,601,096	1,460,000	590,000	18,798	608,798	
2014A	1,160,000	1,148,238	705,000	235,000	6,698	241,698	
2015A	2,270,000	2,249,128	1,835,000	435,000	18,835	453,835	
2015B	1,600,000	1,584,655	1,270,000	330,000	15,023	345,023	
2015C	3,255,000	3,227,632	3,255,000	770,000	32,335	802,335	
2016A	11,165,000	11,288,556	11,165,000	2,555,000	199,191	2,754,191	
2016B	11,060,000	11,235,474	11,060,000	1,840,000	211,983	2,051,983	Note2
2017A	4,490,000	4,450,811	-	-	-	-	Note 3
	$ 60,915,000	$ 60,832,733	$ 34,845,000	$ 9,310,000	$ 560,368	$ 9,870,368	

Source: Master lease payment schedules and the State accounting system – EnterpriseOne

Note 1: The 2012B principal payment of $700,000 and $4,200 in interest had not been paid as of May 5, 2017; amounts are due June 15, 2017.

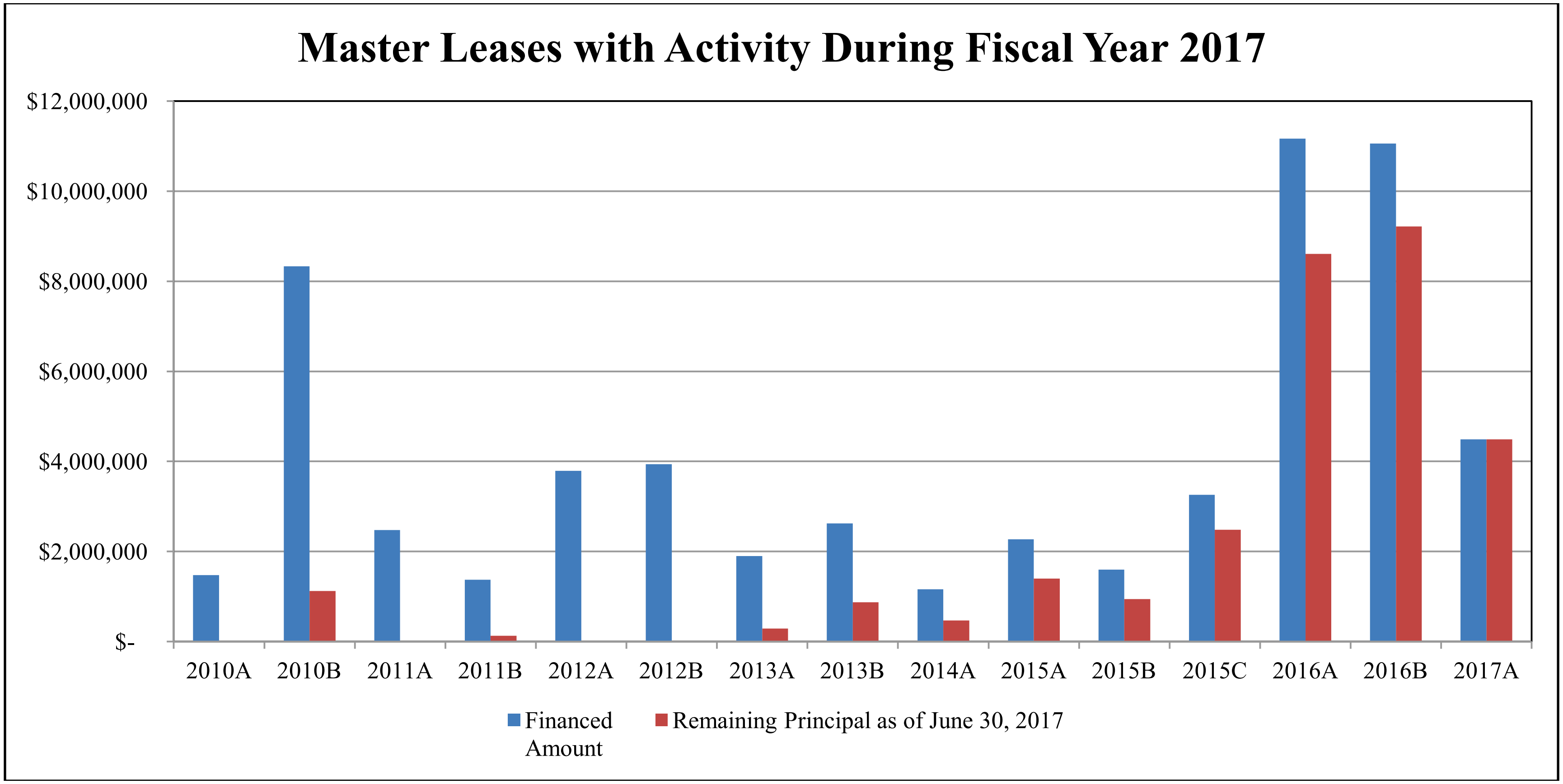
Note 2: The 2016B principal payment of $1,840,000 and $110,600 in interest had not been paid as of May 5, 2017; amounts are due June 15, 2017.

Note 3: The first 2017A interest payment is due on September 15, 2017, and the first principal payment is due on March 15, 2018.

Remaining Master Lease Principal and Interest Amounts as of June 30, 2017

Master Lease Issuance	Remaining Principal as of June 30, 2017	Remaining Interest as of June 30, 2017	Total Payments Remaining as of June 30, 2017
2010B	$ 1,120,000	$ 11,760	$ 1,131,760
2011B	130,000	1,585	131,585
2013A	290,000	5,463	295,463
2013B	870,000	18,363	888,363
2014A	470,000	8,108	478,108
2015A	1,400,000	36,898	1,436,898
2015B	940,000	25,188	965,188
2015C	2,485,000	61,389	2,546,389
2016A	8,610,000	342,985	8,952,985
2016B	9,220,000	555,100	9,775,100
2017A	4,490,000	207,095	4,697,095
TOTAL	$ 30,025,000	$ 1,273,934	$ 31,298,934

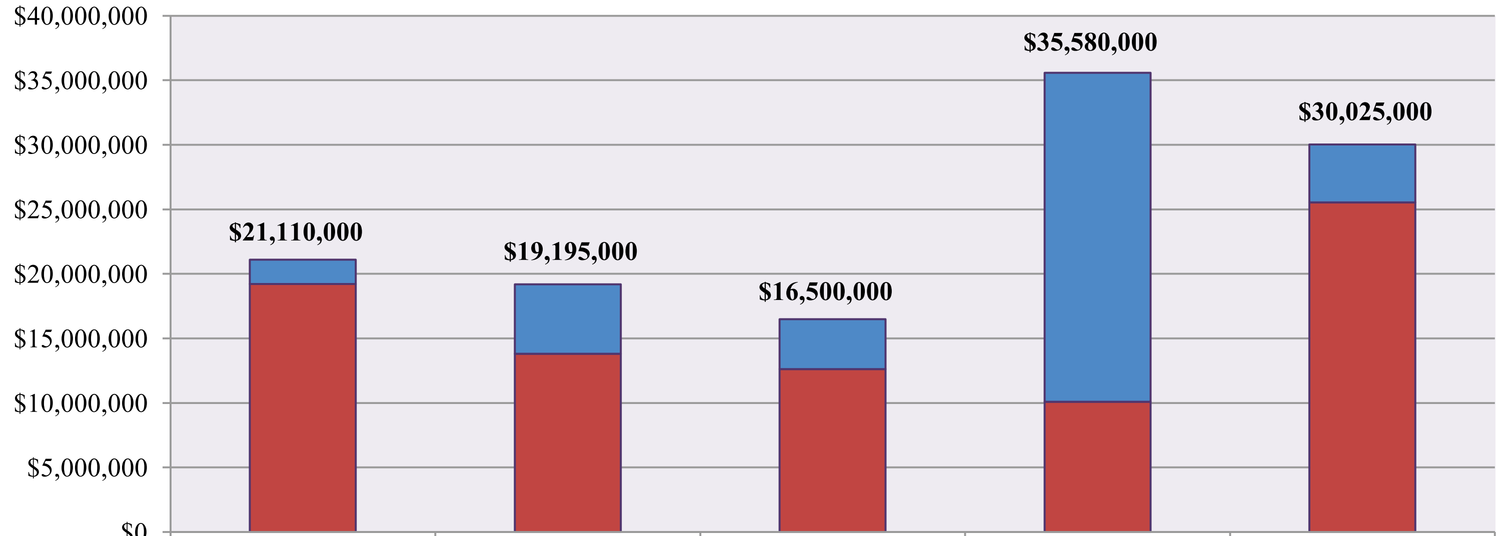
Source: Master lease payment schedules



Source: Tables on pages 3 and 4.

Note: The 2016 Program issuances totaled $22.2 million to provide the Office of the Chief Information Officer (OCIO) with financing to upgrade mainframe computing equipment, communication equipment for the Nebraska State Patrol, the State's voice response equipment, and computer backup hardware. Issuances with no remaining principal as of June 30, 2017, were paid off during the fiscal year.

Total Principal Outstanding at Fiscal Year End June 30, 2013, through June 30, 2017



	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017
New Financing (Principal)	1,900,000	5,390,000	3,870,000	25,480,000	4,490,000
Prior Financing (Principal)	19,210,000	13,805,000	12,630,000	10,100,000	25,535,000
Total	21,110,000	19,195,000	16,500,000	35,580,000	30,025,000

Comments and Recommendations

1. Assets Not Capitalized

During our review of six projects financed by five separate master lease issuances, we noted $6,666,083 of equipment financed through the Master Lease Purchase Program (Program) that was not properly recorded and capitalized in the State accounting system in a timely manner. As of March 28, 2017, the following equipment purchases had not been capitalized within the State's accounting system:

- The Office of the Chief Information Officer (OCIO) financed $2,622,231 of replacement equipment through the Program for the State's interactive voice response system in fiscal year 2016. The assets had not been assigned a dollar amount within the State's accounting system. As such, the fiscal year 2016 CAFR did not properly reflect this equipment as capital assets or the associate depreciation. When the assets are finally assigned costs, they will be capitalized in the incorrect fiscal year, requiring beginning balance adjustments for CAFR reporting.

- The OCIO purchased $4,042,259 of equipment in August 2016 through October 2016. The assets were not capitalized on the State's accounting system as of April 17, 2017. Failing to add the equipment properly to the State's accounting system prior to the fiscal year end will cause errors in CAFR reporting.

- The Department of Health and Human Services financed $207,561 of laboratory equipment in fiscal year 2015. Financed equipment totaling $79,976 was not capitalized in the State's accounting system. The Department subsequently capitalized the equipment in March 2017, resulting in $79,976 being capitalized two fiscal years late. We also noted that $38,511 of financed costs associated with the purchase of the laboratory equipment should have been capitalized instead of being expensed in fiscal year 2015.

- The OCIO financed $1,652,238 to replace outdated networking equipment in fiscal year 2016. Financed equipment totaling $1,593 was not capitalized on the State's accounting system. When the equipment is finally capitalized, it will be capitalized in the incorrect fiscal year.

Good internal controls and good business practices for proper financial reporting require assets to be recorded timely and in the same fiscal year during which they were acquired.

Neb. Rev. Stat. 81-1118.02(1) (Reissue 2014) states, in relevant part, "Each . . . State Agency . . . shall annually make or cause to be made an inventory of all property . . . belonging to the State of Nebraska . . . ." That same subsection requires such inventory to "be completed and filed with the materiel administrator by August 31 of each year."

When assets are not capitalized on the State's accounting system in a timely manner, there is an increased risk of material misstatement of the State's capital assets or expenses on the financial statements. In addition, when assets are not properly recorded on the State's accounting system, an accurate inventory of assets cannot be provided to the Materiel Administrator, as required by State statute.

> We recommend DAS implement procedures to ensure agencies utilizing the Program enter their assets properly and timely into the State accounting system, both for accurate financial reporting and for compliance with § 81-1118.02(1).

DAS Response: DAS-State Accounting will review with agencies using the Program procedures for entering fixed assets into the State Accounting system to ensure accurate and timely reporting.

2. Master Lease Financing Period

We noted two instances where equipment, financed through the Program, was assigned a useful life in the State's accounting system that was shorter than the financing period of the master lease. The OCIO financed $7,920,000 of equipment to replace outdated mainframe computing equipment and assigned the equipment a useful life of three years within the State's accounting system; however, the financing period of the lease was four years. The OCIO also financed $484,077 of equipment to replace outdated networking equipment. The equipment was assigned a three-year useful life within the State's accounting system while the financing period of the lease was five years.

Per the State of Nebraska's Master Lease Purchase Program Policy, "Repayment terms will be negotiated for each equipment group with a term not to exceed the expected life of the equipment being leased." The policy also states, "If the period of the master lease is longer than the default depreciation period" in the State's accounting system, the agency should "contact State Accounting to change the depreciable life for the master leased asset to the period of the master lease."

When assets are financed with a longer lease term than the useful life assigned to them within the State's accounting system, the purchase is not in compliance with Program policy. Likewise, there is an increased risk of the State paying for assets no longer in use.

> We recommend DAS implement procedures to ensure agencies utilizing the Program are properly recording financed assets within the State's accounting system and in accordance with the Program policy.

DAS Response: DAS-State Accounting will review Program policies; and, review procedures with agencies using the Program to ensure fixed assets recorded in the State Accounting system reflect proper useful lives.

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Our audit procedures are designed primarily on a test basis and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. Our objective is, however, to use our knowledge of DAS and its interaction with other State agencies and administrative departments gained during our work to make comments and suggestions that we hope will be useful to DAS.

This interim communication is intended solely for the information and use of DAS, its management, the Governor and the State Legislature, and others within these State agencies. It is not intended to be, and should not be, used by anyone other than the specified parties. However, this letter is a matter of public record, and its distribution is not limited.

If you have any questions regarding the above information, please contact our office.

Sincerely,

Philip J. Olsen, CPA, CISA
Audit Manager