NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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To: Governor's office representatives – Chief of Staff, Matt Miltenberger and to the Speaker of the Legislative Council – Jim Scheer

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Nebraska, as of and for the year ended June 30, 2017, which collectively comprise the State of Nebraska's basic financial statements, and have issued our report thereon dated December 15, 2017. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards and *Government Auditing* Standards, as well as the accompanying information related to the conduct of our audit.

A qualified opinion was issued as noted in the *Basis for Qualified Opinions* paragraph within the Independent Auditor's Report. The State of Nebraska contracted with two service organizations, United Healthcare Services, Inc. and OptumRx, Inc. to process its self-funded health insurance and prescription drug claims paid on behalf of State employees. During the fiscal year ended June 30, 2017, the State of Nebraska paid or was liable for a total of $184,052,764 in claims. Neb. Rev. Stat. § 81-1125.01 requires in part, for the Director of Administrative Services to report "at least twenty days before the commencement of each regular session of the Legislature: (2) The Comprehensive Annual Financial Report…" We were unable to obtain sufficient appropriate audit evidence, prior to the statutorily required reporting date, regarding the suitability of the design and operating effectiveness of the service organizations internal controls. The service organization control attestation reports had not yet been released by their auditors.

Our Responsibility Under Professional Standards

We are responsible for forming and expressing an opinion about whether the financial statements, which have been prepared by management, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. We have a responsibility to perform our audit of the financial statements in accordance with professional standards. In carrying out this responsibility, we planned and performed the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, we are to obtain reasonable, not absolute, assurance that material misstatements are detected. We have no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected. Our audit does not relieve management of their responsibilities.

In addition, in planning and performing our audit of the financial statements, we considered internal 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 State of Nebraska's internal control. Accordingly, we do not express an opinion on the effectiveness of the State of Nebraska's internal control.

We also have a responsibility to communicate significant matters related to the financial statement audit that are, in our professional judgment, relevant to the responsibilities of those charge with governance in overseeing the financial reporting process. We are not required to design procedures for the purpose of identifying other matters to communicate to you.

We applied certain limited procedures to the Management's Discussion and Analysis, the Budgetary Comparison Schedule – General Fund, the Information about Infrastructure Assets Reported using the Modified Approach, and the Information about Pension Plans, which are Required Supplementary Information (RSI) that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

We were engaged to report on the Combining Financial Statements and Budgetary Comparison Schedules included as supplementary information which accompany the financial statements but are not RSI. With respect to this supplementary information, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United State of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

We were not engaged to report on the introductory and statistical sections, which accompany the financial statements but are not RSI. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Management Letters

We have communicated to management in separate management letters our comments and recommendations for improvement in procedures and internal controls. We did not identify any material weaknesses but significant deficiencies were identified and communicated to the Department of Administrative Services, the Department of Health and Human Services, the Department of Transportation, and the Game and Parks Commission.

Other Information in Documents Containing Audited Financial Statements

Our responsibility for other information in documents containing the State of Nebraska's financial statements and our auditors' report thereon does not extend beyond the financial information identified in our auditors' report, and we have no obligation to perform any procedures to corroborate other information contained in these documents. We have, however, read the other information included in the State of Nebraska's comprehensive annual financial report, and no matters came to our attention that cause us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements.

Accounting Practices and Alternative Treatments

Unusual Transactions

As disclosed in Note 16 to the financial statements the following restatements to the financial statements were made:

Component Units Net Position – The Nebraska State College System restated prior year net position due to overstatement of some assets and understatement of prepaid expenses. These errors caused the fiscal year 2016 ending net position to be overstated. As a result, the beginning Net Position for Component Units on the Statement of Activities decreased by $220,000.

The net position for fiscal year 2016 for Governmental Activities on the Government Wide Statement of Activities increased by $12,204,000 due to restatement of capital assets beginning balance not reported in prior year.

The General Fund beginning Fund Balance for fiscal year 2016 was decreased by $325,000 due to an overstatement of accounts receivable, an overstatement of liabilities, and an expense adjustment for prior year.

The Highway Fund beginning Fund Balance for fiscal year 2016 was increased by $1,048,000 due to an understatement of accounts receivable that had not been reported in the prior year.

The Economic Development Fund beginning Fund Balance for fiscal year 2016 was increased by $3,369,000 due to an understatement of loans receivable in the prior year.

The Federal Fund beginning Fund Balance for fiscal year 2016 was decreased by $3,381,000 due to an overstatement of accounts receivable and loans receivable in the prior year. The Veteran's Affairs Construction Reimbursement Fund was reclassified from the Capital Project Fund to the Federal Fund to better reflect its function.

The Health and Social Services Fund beginning Fund Balance for fiscal year 2016 was decreased by $3,127,000 due to an overstatement of expenses in the prior year.

The Other Special Revenue Fund beginning Fund Balance for fiscal year 2016 was increased by $1,822,000 due to an understatement of accounts receivable and an overstatement of liabilities in the prior year.

The Capital Projects Fund beginning Fund Balance for fiscal year 2016 was decreased by $402,000 due to the reclassification of the Veteran's Affairs Construction Reimbursement Fund from the Capital Project Fund to the Federal Fund to better reflect its function.

The Permanent School Fund beginning Fund Balance for fiscal year 2016 was increased by $1,311,000 due to an overstatement of liabilities in the prior year.

The restatements of the General Fund, Highway Fund, Economic Development Fund, Federal Fund, Health and Social Services Fund, Other Special Revenue Fund, Capital Projects Fund, and the Permanent School Fund resulted in an increase in the Governmental Activities Net Position – Beginning on the Statement of Activities of $315,000 that had not been reported in the prior year.

The General Services Fund beginning Fund Balance for fiscal year 2016 was increased by $14,000 due to an understatement of capital assets in the prior year.

The Office of the CIO Fund beginning Fund Balance for fiscal year 2016 was increased by $1,669,000 due to an understatement of capital assets in the prior year.

The Transportation Services Fund beginning Fund Balance for fiscal year 2016 was increased by $286,000 due to an understatement of capital assets in the prior year.

The restatements for the General Services Fund, Office of the CIO Fund, and Transportation Services Fund resulted in an increase in the Governmental Activities Net Position – Beginning on the Statement of Activities of $1,969,000 that had not been reported in the prior year.

Qualitative Aspects of Accounting Practices

We have discussed with management our judgments about the quality, not just the acceptability, of the State of Nebraska's accounting principles as applied in its financial reporting. The discussions generally included such matters as the consistency of the State of Nebraska's accounting policies and their application, and the understandability and completeness of the State of Nebraska's financial statements, which include related disclosures.

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the State of Nebraska are described in Note 1 to the financial statements.

Management Judgments and Accounting Estimates

The preparation of the financial statements requires management of the State of Nebraska to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period.

Management uses estimates for instance when calculating the reserve for bad debts; lives of property and equipment; and self-insurance reserves. We evaluated the key factors and assumptions used in these estimates in determining that the estimates were reasonable in relation to the financial statements taken as a whole.

Significant Difficulties Encountered During the Audit

We encountered no significant difficulties in dealing with management in performing our audit other than several delays encountered in obtaining audit documentation required to be provided by the Department of Administrative Services.

Disagreements with Management

There were no disagreements with management on financial accounting and reporting matters that, if not satisfactorily resolved, would have caused a modification of our auditors' reports on the State of Nebraska's financial statements. However, as noted above, a qualified opinion was issued.

Significant Issues Discussed, or Subject to Correspondence, with Management

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management throughout our field work.

Financial Statement Misstatements
In connection with our audit of the State of Nebraska's financial statements, we have discussed with management certain financial statement misstatements that have not been corrected in the State of Nebraska's books and records as of and for the year ended June 30, 2017. We have reported such misstatements to management on a Schedule of Uncorrected Financial Statement Misstatements and have received written representations from management that management believes that the effects of the uncorrected financial statement misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. The attached schedule summarizes uncorrected misstatements of the financial statements.

The following material misstatements detected as a result of audit procedures were corrected by management:

> The entry to eliminate transfer activity within the Highway fund was incorrectly posted causing both transfers-in and transfers-out to be overstated by $413,456,866.
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> The entry to eliminate transfer activity within outside trust funds related to the Omaha School Employee Retirement System was incorrectly posted causing both transfers-in and transfers-out to be overstated by $128,604,975.
>
> Federal funds were received into and paid out of the Airport Development fund instead of the Federal fund. Federal fund revenue and expenditures were understated by $16,456,169 and Airport Development fund (a special revenue fund) revenue and expenditures were overstated by $16,456,169.
>
> Accounts payable related to the Department of Education were recorded twice by the Department of Administrative Services. As a result, Federal fund payables, expenditures, receivables, and revenue were overstated by $26,363,965.
>
> Revenues and expenditures associated with an indirect cost allowance were recorded twice in the Health and Social Services fund. Revenues and expenditures were overstated by $4,246,490.
>
> Activity related to a transfer of funds between the University of Nebraska and the General fund was ran through the Health and Social Services fund and should have netted to $0. An error resulted in Health and Social Services fund revenue and expenditures being overstated by $3,611,420.

Management's Consultation with Other Accountants
In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the State of Nebraska's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Written Representations
We have requested certain representations from management that are included in the management representation letter dated December 14, 2017.

Group Audit Communications:

1. **Instances in which the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work.**
   None

2. **Any limitations on the group audit (for example, when the group engagement team's access to information may have been restricted)**
   We encountered no limitations while performing our audit.

3. **Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls, or others in which a material misstatement of the group financial statements has or may have resulted from fraud.**
   No fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls, or others was identified.

Other Items

<u>New Applicable Accounting Standards by the Governmental Accounting Standards Board (GASB)</u>

Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions.* The scope of this Statement addresses accounting and financial reporting for OPEB that is provided to the employees of state and local governmental employers. This Statement establishes standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, and expense/expenditures. For defined benefit OPEB, this Statement identifies the methods and assumptions that are required to be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service. Note disclosure and required supplementary information requirements about defined benefit OPEB also are addressed. In addition, this Statement details the recognition and disclosure requirements for employers with payables to defined benefit OPEB plans that are administered through trusts that meet the specified criteria and for employers whose employees are provided with defined contribution OPEB. This Statement also addresses certain circumstances in which a nonemployer entity provides financial support for OPEB of employees of another entity. The requirements of this Statement are effective for fiscal years beginning after June 15, 2017.

Statement No. 81, *Irrevocable Split-Interest Agreements*. This Statement requires that a government that receives resources pursuant to an irrevocable split-interest agreement recognize assets, liabilities, and deferred inflows of resources at the inception of the agreement. Furthermore, this Statement requires that a government recognize assets representing its beneficial interests in irrevocable split-interest agreements that are administered by a third party, if the government controls the present service capacity of the beneficial interests. This Statement requires that a government recognize revenue when the resources become applicable to the reporting period. The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2016, and should be applied retroactively.

Statement No. 82, *Pension Issues an amendment of GASB Statements No. 67, No. 68, and No. 73*. The objective of this Statement is to address certain issues that have been raised with respect to Statements No. 67, Financial Reporting for Pension Plans, No. 68, Accounting and Financial Reporting for Pensions, and No. 73, Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68. Specifically, this Statement addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. The requirements of this Statement were effective for reporting periods beginning after June 15, 2016, except for the requirements of this Statement for the selection of assumptions in a circumstance in which an employer's pension liability is measured as of a date other than the employer's most recent fiscal year-end. In that circumstance, the requirements for the selection of assumptions are effective for that employer in the first reporting period in which the measurement date of the pension liability is on or after June 15, 2017.

Statement No. 83, *Certain Asset Retirement Obligations*. This Statement addresses accounting and financial reporting for certain asset retirement obligations (AROs). An ARO is a legally enforceable liability associated with the retirement of a tangible capital asset. A government that has legal obligations to perform future asset retirement activities related to its tangible capital assets should recognize a liability based on the guidance in this Statement. The requirements of this Statement are effective for reporting periods beginning after June 15, 2018.

Statement No. 84, *Fiduciary Activities*. The objective of this Statement is to improve guidance regarding the identification of fiduciary activities for accounting and financial reporting purposes and how those activities should be reported. This Statement establishes criteria for identifying fiduciary activities of all state and local governments. The focus of the criteria generally is on (1) whether a government is controlling the assets of the fiduciary activity and (2) the beneficiaries with whom a fiduciary relationship exists. Separate criteria are included to identify fiduciary component units and postemployment benefit arrangements that are fiduciary activities. An activity meeting the criteria should be reported in a fiduciary fund in the basic financial statements. Governments with activities meeting the criteria should present a statement of fiduciary net position and a statement of changes in fiduciary net position. An exception to that requirement is provided for a business-type activity that normally expects to hold custodial assets for three months or less. This Statement describes four fiduciary funds that should be reported, if applicable: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds generally should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria. A fiduciary component unit, when reported in the fiduciary fund financial statements of a primary government, should combine its information with its component units that are fiduciary component units and aggregate that combined information with the primary government's fiduciary funds. This Statement also provides for recognition of a liability to the beneficiaries in a fiduciary fund when an event has occurred that compels the government to disburse fiduciary resources. Events that compel a government to disburse fiduciary resources occur when a demand for the resources has been made or when no further action, approval, or condition is required to be taken or met by the beneficiary to release the assets. The requirements of this Statement are effective for reporting periods beginning after December 15, 2018.

Statement No. 85, *Omnibus 2017*. The objective of this Statement is to address practice issues that have been identified during implementation and application of certain GASB Statements. This Statement addresses a variety of topics including issues related to blending component units, goodwill, fair value measurement and application, and postemployment benefits (pensions and other postemployment benefits [OPEB]). The requirements of this Statement are effective for reporting periods beginning after June 15, 2017.

Statement No. 86, *Certain Debt Extinguishment Issues*. The primary objective of this Statement is to improve consistency in accounting and financial reporting for in-substance defeasance of debt by providing guidance for transactions in which cash and other monetary assets acquired with only existing resources—resources other than the proceeds of refunding debt—are placed in an irrevocable trust for the sole purpose of extinguishing debt. This Statement also improves accounting and financial reporting for prepaid insurance on debt that is extinguished and notes to financial statements for debt that is defeased in substance. The requirements of this Statement are effective for reporting periods beginning after June 15, 2017.

Statement No. 87, *Leases*. The objective of this Statement is to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments. This Statement increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under this Statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources, thereby enhancing the relevance and consistency of information about governments' leasing activities. The requirements of this Statement are effective for reporting periods beginning after December 15, 2019.

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

Sincerely,

Philip J. Olsen

Philip J. Olsen, CPA, CISA
Audit Manager