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January 13, 2012

The Audit Committee
Knox County, Tennessee

Ladies and Gentlemen:

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 Knox County, Tennessee (the County) as of and for the year ended June 30, 2011, which collectively comprise the County's basic financial statements, and have issued our report thereon dated November 22, 2011. We did not audit the Student Activity Funds agency fund, a discretely presented component unit of the Knox County Board of Education, or The Great Schools Partnership, a component unit of the Knox County Board of Education, of Knox County, Tennessee, as of and for the year ended June 30, 2011. The fund financial statements were audited by other auditors whose reports thereon dated November 18, 2011 and October 20, 2011, respectively, have been furnished to us, and our opinion, insofar as it relates to the amounts included for these entities, is based on the reports of the other auditors. Our report also referred to the adoption of a new accounting standard effective July 1, 2010. Under professional standards, we are providing you with the accompanying information related to the conduct of our audit.

Our consideration of internal control over financial reporting 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 a deficiency in internal control that we consider to be a significant deficiency.

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 deficiencies in the internal control that we consider to be material weaknesses, as defined above.

**Significant Deficiency**

*General Government*

***Financial Reporting at the Trustees Office***

The Trustees Office (Trustees) has oversight responsibility related to the processing of approximately $800 million in transactions annually, and it closely coordinates these efforts with the Finance Department. These transactions are reported on various schedules presented in the County's CAFR. Further, it is responsible for reconciling approximately 30 bank accounts monthly. During fiscal year 2011, we observed the following:

- The Trustees Office was unable to produce the schedules required for the CAFR timely. The final schedules which appropriately balanced were not submitted to the Finance Department until approximately four months after year-end.

- The draft schedules produced by the Trustees Office at various iterations through the closing process did not balance.

- The system generated reports documenting the preparation of the monthly bank statement reconciliations indicates that bank reconciliations were not prepared timely throughout fiscal year 2011.

We recommend that the Trustees Office, in close coordination with the Finance Department, develop detailed procedures documenting the production of the schedules to be provided for CAFR preparation. These procedures should be very specific, including documenting the format and content of the various system generated reports needed to support these schedules. These procedures should further document the system generated information necessary to perform the monthly bank reconciliations within 30 days of year end.

Finally, given that this finding has been recurring in nature as it relates to the Combined Schedule of Assets and Liabilities, Combined Schedule of Cash Receipts, Disbursements and Balances, and Combined Analysis of Fee and Commission Accounts schedules which are provided for CAFR reporting purposes (CAFR schedules), we recommend that the Audit Committee:

- Review and approve the newly developed policies and procedures over the Trustees Office closing process; and

- Require that the Trustees Office provide the Audit Committee with the CAFR schedules at least quarterly during the fiscal year and provide verification that the monthly bank reconciliations have been completed timely to ensure that the newly established policies and procedures are operating effectively.

**Management Response**

- The Trustee's Office agrees that the final balanced CAFR schedules required for the CAFR were not submitted to the Finance Department until approximately four months after year-end. The schedules were, however, submitted within a timeframe that allowed for timely issuance of the Knox County financial statements taken as a whole. While there were agreed upon deadlines for the submission of these schedules between KPMG and the Finance Department, we would point out that the statutory and GFOA deadlines for publication and submission of the County's CAFR without requesting an extension are six months after fiscal year end or December 31st for Knox County.

  FY 2011 was a transition year with the implementation of new financial accounting software by Knox County. During this transition, finalizing all reconciliations and schedules took more time and a lot more effort than anyone anticipated, and given this the Trustee's Office chose to err on the side of accuracy versus internal deadlines. Finally, both the Finance Department and this office were posting necessary changes to multiple accounts until at least the end of October so earlier submission of finalized schedules was not possible.

- The Trustee's Office agrees that several of the draft schedules produced by this office were out of balance but these issues were noted and further investigated. This involved a line by line review of several thousands of lines of transactions posted external to this office. As mentioned previously, this was a transition year due to the new financial system implementation and as a result of this implementation this office did not have access to the County fund side of the system until the end of September 2011 and thus investigation of this sort was almost impossible until that access was finally put in place. The majority of eliminations and reclassifications to bring the CAFR schedules into balance related to items posted outside this office that needed to be investigated as described.

- The Trustee's Office agrees that not all bank accounts were reconciled in a timely fashion during fiscal year 2011. While this was not an issue in the previous fiscal year, as mentioned previously the transition to the County's new financial system made the bank reconciliation process substantially more difficult and required significantly more time. During this transition period resulting from implementation, we have had to completely redesign the bank reconciliation process and further implement additional posting process changes for both this office and the County Finance Department. Again, however, the reconciliations were completed within a timeframe that allowed for timely issuance of the Knox County financial statements taken as a whole.

With regard to the recommendations the Trustee's Office will work closely with the Finance Department as indicated to develop appropriate documentation related to the closing process.

We will also work diligently to enhance interoffice communications with the Finance Department.

This office has already drafted CAFR schedules for the quarter ended September 30, 2011 and will present those schedules and the CAFR schedules for the quarter ending December 31, 2011 to the Audit Committee at its January 2012 meeting. Bank reconciliations for the month ended two months prior to the Audit Committee meeting date will offered for inspection if the Committee so requests, as the immediate preceding month's bank reconciliations will still be in process.

Additionally, the Trustee's Office has already assigned an additional staff member to help with monthly reconciliations and is in the process of hiring an additional accountant to allow for a 'Cash Manager' who can oversee and troubleshoot the bank reconciliations and reconciliation process. We are also now working directly with the software vendor support for the County's financial accounting system to identify both system settings and process modifications necessary to eliminate the remaining issues with the bank reconciliations. We anticipate further posting process changes and enhancements that will impact both the Finance Department and this office, but should ultimately reduce the extensive amount of additional time now required in the bank reconciliation process.

Although not considered to be significant deficiencies or material weaknesses, we also noted the following items during our audit which we would like to bring to your attention:

**Other Deficiencies**

*General Government*

***IT Observations***

During our information technology audit procedures, we observed the following:

Management does not perform regular monitoring activities over access to programs and data. User access reviews are performed but are not formal, and evidence of such review is not retained.

Various software features that would enable standardized password criteria, lockout policies, or password expiration have not been placed in operation. User passwords generated by the system are complex in nature; however, users have the ability to change their password to a simple password, which never expires. Based upon discussions with Knox County IT personnel, it was determined that certain system limitations prohibit the requirement of ideal complex password and lockout features.

- The Government periodically installs patches respective to its MUNIS general ledger system. These patches make updates necessary to ensure the system is properly functioning and security threats are addressed, if any. These patches are installed an average of four to six times a year. KPMG noted that patches were installed in fiscal year 2011 in a test environment prior to implementation in the live environment. However, no supporting documentation is maintained to validate this routinely occurs and that no issues are identified prior to implementation in the live environment. As the aforementioned general ledger system is crucial to the Government's ability to record transactions and generate accurate financial reports, a failure of the system as a result of the installation of a new patch would be detrimental to the Government's ability to produce accurate financial reports on a timely basis limiting the decision making ability of the Government's officials.

We recommend that a formal monitoring process over access to programs and data be established and maintained. For all reviews conducted, formal documentation should be maintained to support and justify that a review had taken place. We also recommend that the IT department continue to investigate during fiscal year 2011 if any feasible changes or updates can be made to the system to help strengthen the password functionalities. Finally, we recommend that the IT department put in place formal procedures for testing and documenting review procedures performed over patches prior to their installation in the live system to ensure they are functioning properly and limit the risk of a system failure in the live operating environment.

**Management Response**

- As a result of KPMG's similar fiscal year 2010 management comment, IT has implemented a program to review user access to systems twice a year in much the same way as we inventory hardware, however, ample supporting documentation illustrating that the reviews took place were not maintained for fiscal year 2011. Although the semiannual user audits help to identify these individuals, the process is not as timely as it could be, and is dependent on the cooperation of various user departments. Also, as part of the new general ledger system that went live at the beginning of fiscal year 2011, users were examined and, where warranted, various levels of access were modified or removed as a result of this review. Finally, changes to user login security have been made that require all users to change their passwords every 90 days, and require complex passwords. After 90 days, users who have not changed their passwords are locked out of the system and have no access to any system.

- Earlier this year, IT implemented a new password policy requiring complex passwords, and requiring password changes every 90 days.

- IT has put into place a policy requiring that all patches be installed and verified in the test environment first and documentation of this process will be maintained as supporting evidence that patches are being installed and evaluated in a test environment prior to their installation in the live system. Patches to the MUNIS test system are applied every Thursday, and notification for testing is sent to users. After a successful two week test period and user signoff, the patches are applied to the production system.

***Home Investment Partnerships Programs***

Per review of the 2011 compliance supplement issued by the Office of Management and Budget, KPMG notes that the HOME program must submit Form HUD 60002, *Section 3 Summary Report, Economic Opportunities for Low- and Very Low-Income Persons* (OMB No. 2529-0043), for each grant over $200,000 that involves housing rehabilitation, housing construction, or other public construction.

During the course of our testwork, KPMG noted that the HOME program had not established an effective control structure to ensure that the required information for Form HUD 60002, *Section 3 Summary Report, Economic Opportunities for Low- and Very Low-Income Persons* (OMB No. 2529-0043), was properly obtained and compiled. Therefore, this report cannot be accurately prepared and submitted for fiscal year 2011.

We recommend that the HOME program establish effective procedures to ensure that adequate information is obtained in order to complete the Section 3 compliance report and submit it on a timely basis in accordance with program requirements stated in the compliance supplement.

**Management Response**

We concur. In February of 2011, the HOME program drafted and approved a specific Section 3 policy and appointed a Section 3 Coordinator to ensure the required reporting requirements are being met under the HOME program on a go-forward basis. The HOME program is now obtaining and compiling the required information in order to begin submission of the Section 3 report on a timely basis starting in fiscal year 2012.

**Other Comment**

*General Government*

***Proposed Statement on Accounting and Financial Reporting for Pensions***

The primary objective of this proposed Statement is to improve accounting and financial reporting by state and local governments whose employees are provided with pensions. It also aims to improve information provided by state and local governments about financial support for pensions that is provided on their behalf by other entities. It is the result of a comprehensive review of the effectiveness of existing standards of accounting and financial reporting for pensions with regard to providing decision-useful information, supporting assessments of accountability and interperiod equity, and creating additional transparency.

Some of the major provisions include the following:

- The net pension liability would equal the employer's total pension liability less the amount of plan net position restricted for pensions (plan net position), as of the end of the employer's reporting period. The total pension liability would be the portion of the present value of projected benefit payments that is attributed to employees' past periods of service. Actuarial valuations of the total pension liability would be required to be conducted at least every two years under the proposed Statement, with more frequent valuation encouraged.

- Projected benefit payments would be discounted to their present value using the single rate that would reflect (1) a long term expected rate of return on plan investments to the extent that plan net position is projected to be sufficient to pay pensions and the net position projected to remain after each benefit payment can be invested long-term and (2) a tax exempt, high-quality municipal bond index rate to the extent that the conditions in (1) are not met.

- A cost-sharing employer whose employees are provided with pensions through a qualified trust would report a net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense based on its proportionate share of the collective net pension liability of all employers in the plan.

The net impact of this proposed Statement will be far reaching and may include:

- Additional liabilities presented in the government wide Statement of Net Assets
- Lower calculated discount rate, resulting in a higher actuarial accrued liabilities for benefits
- Presentation of the County's share of the Tennessee Retirement System liability for future retirement benefits

The County should continue work with its actuaries and the Tennessee Retirement System to evaluate the impact of this proposed standard on the future financial position of the County.

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

Very truly yours,

KPMG LLP