



STATE OF NORTH CAROLINA

SPECIAL FINANCIAL REPORT

DEPARTMENT OF STATE TREASURER
BALANCE IN THE TREASURY
AS OF DECEMBER 31, 2000

OFFICE OF THE STATE AUDITOR
RALPH CAMPBELL, JR.
STATE AUDITOR

SPECIAL FINANCIAL REPORT

**DEPARTMENT OF STATE TREASURER
BALANCE IN THE TREASURY
AS OF DECEMBER 31, 2000**

RICHARD H. MOORE, STATE TREASURER

HARLAN E. BOYLES, FORMER STATE TREASURER

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AUDITOR'S SPECIAL FINANCIAL REPORT

The Honorable Michael F. Easley, Governor
The Honorable Richard H. Moore, State Treasurer
The Honorable Harlan E. Boyles, Former State Treasurer
The Members of the North Carolina General Assembly
The Citizens of the State of North Carolina

This Special Financial Report presents the results of our efforts to check the records of the North Carolina Department of State Treasurer pursuant to North Carolina General Statute §147-64.6(c)(8). This statute provides that "the Auditor shall check the treasury records at the time a Treasurer assumes office (not to succeed himself), and therein charge him with the balance in the treasury, and shall check the Treasurer's records at the time he leaves office to determine that the accounts are in order."

Article 3, Section 7 of the North Carolina Constitution provides that the term of office for the treasurer shall be four years and shall commence on the first day of January next after his/her election and continue until his/her successor is elected and qualified. On November 7, 2000, Richard H. Moore was elected Treasurer and began his term on January 2, 2001, succeeding Treasurer Harlan E. Boyles.

We performed the procedures we considered necessary under the circumstances to check the balance in the treasury records as of December 31, 2000, as reported on the schedules included herein, and to determine that the records are in order. The primary procedure used was confirmation with external parties to determine that the reported treasury balance exists. Additional procedures were used to determine that the reported balance in the treasury is properly valued and recorded.

In our opinion, the balance in the treasury as of December 31, 2000 is accurately reported on the schedules included herein, except for the amount reported for fixed assets. The fixed asset amounts are overstated by an amount that is not readily determinable. In addition, we found deficiencies in internal control and instances of noncompliance that are related to authorized investments, fixed assets and escheat property. The preceding matters are not material to the

reported balance in the treasury and are more fully discussed in the Findings and Recommendations Section of this report.

AUDITOR'S SPECIAL FINANCIAL REPORT

In accordance with General Statute §147-64.6.(c)(8), I do hereby charge Treasurer Richard H. Moore with the December 31, 2000 balance in the treasury as reported herein.

North Carolina General Statutes require the State Auditor to make reports available to the public. Copies of reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

Respectfully Submitted,



Ralph Campbell, Jr.
State Auditor

February 15, 2001

North Carolina Department of State Treasurer
Schedule of Assets
As of December 31, 2000

(Dollars in Thousands)

Schedule 1

	Investment Pool	Bond Proceeds	Escheat Property	Fixed Assets	Assets Held in Trust
Investments held by the Investment Pool:					
Short-term Investment Portfolio	\$ 7,181,394	\$ 21,516	\$ 21,314	\$ 0	\$ 0
Long-term Investment Portfolio	25,767,071		267,012		
Equity Investment Portfolio	31,722,506				
Real Estate Investment Portfolio	913,514				
Venture Capital Investment Portfolio	126,334				
Intra-Pool Elimination	(23,173)				
Total Investments held by the Investment Pool	65,687,646	21,516	288,326		
Investments held by a custodian		461,085	14,212		
Cash in bank	136,691				
Cash with custodian			25		
Fixed assets				10,420	
Assets held in trust					77,040
Total	\$ 65,824,337	\$ 482,601	\$ 302,563	\$ 10,420	\$ 77,040

The accompanying Notes to the Financial Schedules are an integral part of this schedule.

North Carolina Department of State Treasurer
Schedule of Assets by Custodian/Manager
As of December 31, 2000
(Dollars in Thousands)

Schedule 2

Holder of the assets	Cash in Bank	Investments Held By the Pool	Bond Proceeds	Escheat Property	Fixed Assets	Assets Held in Trust
Depository Banks						
Branch Banking and Trust Co.	\$ 8,687	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Central Carolina Branch & Trust Co.	9,354	2,500				
Centura Bank	4,165					
First Citizens Bank & Trust Co.	9,167					
First Union National Bank	14,191					
Bank of America	23,728	50,000				
Wachovia Bank of North Carolina	66,070					
Other depositories	1,329	117,446				
Investment Custodian/Manager						
Alliance Management		13,694,600				
Branch Banking and Trust Co.		211,752				
Franklin Street		544,400				
First Citizens Bank & Trust Co.		1,686,749				
First Union National Bank		959,692				
NCM Capital Management		132,362				
TradeStreet Management		2,564,657				
Wachovia		1,733,162				
Wellington		10,195,132				
Various Venture Capital partnerships		49,475				
Various Real Estate investment trusts		913,514				
Various mutual fund entities				1,104		
Custodian						
The Bank of New York		32,832,205	461,085			
Fleet Management				13,133		
At the State Treasurer						
					10,420	77,040
Total	\$ 136,691	\$ 65,687,646	\$ 461,085	\$ 14,237	\$ 10,420	\$ 77,040

The accompanying Notes to the Financial Schedules are an integral part of this schedule.

North Carolina Department of State Treasurer
Schedule of Investment Pool Net Assets by Participant
As of December 31, 2000
(Dollars in Thousands)

Schedule 3

Participants	Participant's Share of the Investment Pool's Net Assets	Percentage Ownership
Pension Trust		
Teachers' and State Employees' Retirement System *	\$ 45,851,475	69.10%
Consolidated Judicial Retirement System *	343,772	0.52%
Legislative Retirement System *	26,976	0.04%
Firemen's and Rescue Squad Workers' Pension Fund *	258,718	0.39%
North Carolina National Guard Pension Fund *	48,764	0.07%
Local Government Employees' Retirement System *	11,628,466	17.53%
Total Pension Trust	58,158,171	87.65%
General Fund	2,452,835	3.70%
Retiree Health Premium *	87,961	0.13%
Highway Fund	210,985	0.32%
Highway Trust Fund	652,087	0.98%
Universities & UNC Hospital	1,300,407	1.96%
Community Colleges	58,108	0.09%
Proprietary Component Units	343,278	0.52%
Disability Income Plan of NC *	220,376	0.33%
Death Benefit Plan of NC *	196,126	0.30%
State Treasurer's Escheat Fund *	288,326	0.43%
Register of Deeds Supplemental Pension Fund *	10,889	0.02%
Investment Trust Fund *	1,015,403	1.53%
Other Funds	1,355,203	2.04%
Total Net Assets of the Investment Pool at December 31, 2000	\$ 66,350,155	100.00%

Reconciliation of Cash in Bank and Investments to Participants' Share of the Investment Pool's Net Assets:

Total Investment Pool Assets from Schedule 1	\$ 65,824,337
Add: Other Assets	
Accrued interest receivable	526,400
Other receivables	21
Less: Liabilities	
Other payables	(603)
Participants' Share of the Investment Pool's Net Assets	\$ 66,350,155

* - The financial records of these participants are maintained by the Department of State Treasurer.

The accompanying Notes to the Financial Schedules are an integral part of this schedule.

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**NORTH CAROLINA DEPARTMENT OF STATE TREASURER
NOTES TO THE FINANCIAL SCHEDULES
DECEMBER 31, 2000**

NOTE 1 - ORGANIZATION AND BASIS OF PRESENTATION

The North Carolina Department of State Treasurer is an organizational unit established by the State to manage the people's money. The State Treasurer, an elected official, serves as the State's Chief Investment Officer. As such, the Treasurer is directed by statute to "establish, maintain, administer, manage and operate" investment programs for all funds on deposit, pursuant to the guidance provided in applicable general statutes. The Treasurer "shall have full power as a fiduciary."

The accompanying financial schedules are intended to present the balance in the treasury as of December 31, 2000. The balance disclosed does not include all the financial assets of the Department. For example, receivable assets such as account receivables, notes receivables, and interest receivables, have been excluded from the financial schedules. In addition, cash and investments of the retirement funds and other employee benefit funds, which are held and under the custody of the Treasurer, are presented as an integral part of the Investment Pool in Schedule 1, and disclosed as participants of the Investment Pool in Schedule 3.

NOTE 2 - INVESTMENT POOL

A. Description of the Investment Pool - The Investment Pool (the Pool) is an external investment pool sponsored by the Department of State Treasurer on the State's behalf. The external portion of the Pool, consisting of funds belonging to entities outside of the State of North Carolina's financial reporting entity, was included as a separate Investment Trust Fund in the State of North Carolina's *Comprehensive Annual Financial Report*. The internal portion, consisting of funds belonging to the State and its component units, was included in the various participating funds and component units in the State of North Carolina's *Comprehensive Annual Financial Report*.

The State Treasurer operates various investment programs (portfolios) as components of the Pool. The Pool is not registered with the Securities and Exchange Commission (SEC) and is not subject to any formal oversight beyond the legislative controls established through statutes. The portfolios of the Pool are designed to ensure all legal and regulatory limits are met while at the same time investing all cash deposits to generate maximum income consistent with safety of principal. The Pool consists of the following individual investment portfolios:

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

Short-term Investment Portfolio – This portfolio provides the State with a primary cash management program. Invested funds are primarily those of the General and Highway Funds. Other participants include the portfolios listed below and various boards, commissions, community colleges, and school administrative units that make voluntary deposits with the State Treasurer. Net excess balances are invested in short-term securities as authorized by statute and in accordance with the projected future cash flow needs. Because the cash balances are ultimately subject to disbursement upon presentation of valid warrants, the primary considerations in making investments are safety and liquidity while the secondary consideration is income.

Long-term Investment Portfolio – This portfolio provides investments in intermediate and long-term treasury, agency, and corporate bonds. Since the deposits in this portfolio are typically not needed for day-to-day operations, the investment securities used generally have a longer term and higher return than those held in the short-term portfolio. The primary participants of the portfolio are the State's pension trust funds, internal service funds, other special funds and component units.

Equity Investment Portfolio – This portfolio provides investments in equity-based trusts that are administered by third-party professionals. The trusts invest in common stock and other equities. For these investments, the State Treasurer does not own the individual securities but rather has a percentage ownership in the trust. The State's various pension trust funds are the sole participants in the portfolio.

Real Estate Investment Portfolio – This portfolio provides investments in real estate trusts and group annuity contracts administered by third-party professionals. The State's various pension trust funds are the sole participants in the portfolio.

Venture Capital Investment Portfolio – This portfolio provides investments in venture capital limited partnerships, the Long-term Investment Portfolio and equities received in the form of distributions from its limited partnership investments. The State's various pension trust funds are the sole participants in the portfolio.

The *Intra-Pool Elimination* includes the other portfolios' investments in the Short-term and Long-term Investment Portfolios. In Schedule 1, these investments are included in the investments held by the short-term and long-term portfolios, as well as in the other portfolios. In order to present the total investment assets of the Pool, those intra-pool assets must be eliminated.

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

- B. Investment Policy** - The State Treasurer is authorized by North Carolina General Statute 147-69.1 to invest all deposits in obligations of or fully guaranteed by the United States; obligations of certain federal agencies; repurchase agreements; obligations of the State of North Carolina; shares, deposits, savings certificates, and certificates of deposit of specified institutions savings and loan associations; prime quality commercial paper bearing specified ratings; bills of exchange or time drafts drawn on and accepted by specified commercial banks and eligible for use as collateral by member banks in borrowing from a Federal Reserve Bank; asset-backed securities (whether considered debt or equity) bearing specific ratings; and corporate bonds and notes of any company incorporated in the United States bearing specified ratings.

General Statute 147-69.2 authorizes the State Treasurer to invest the deposits of certain “special funds” (including the pension trust, the Escheats Fund, the Disability Income Plan of North Carolina, the Public School Insurance Fund, and trust funds of the University of North Carolina system) in the following: investments authorized by General Statute 147-69.1; general obligations of other states in the United States; general obligations of cities, counties and special districts in North Carolina; notes secured by mortgages insured by the Federal Housing Administration or guaranteed by the Veterans Administration on real estate located within the State of North Carolina; limited partnership interest in a partnership whose primary purpose is to invest in venture capital or corporate buyout transactions, not to exceed \$30 million; obligations or securities of the North Carolina Enterprise Corporation, or a limited partnership in which the North Carolina Enterprise Corporation is the only general partner, not to exceed \$20 million. In addition to all of the above, deposits of the pension trust funds may be invested in certain insurance contracts; group trusts; individual, common or collective trust funds of banks and trust companies; certain real estate funds; certain specified preferred or common stocks; and certain mutual funds.

- C. Cash in bank** – This classification includes deposits received minus warrants cleared as of the date recorded in the books of the depository bank.

The State Treasurer maintains numerous deposit accounts for collecting and disbursing funds. Unless specifically exempt, every officer and agency of the State is required by North Carolina General Statute 147-77 to deposit daily, moneys received, either with the State Treasurer or in an account with a depository institution in the name of the State Treasurer, with a daily report to the State Treasurer. Expenditures for the primary government and certain component units are made by warrants drawn on the State Treasurer which are issued by the agency receiving the goods and services. The State Treasurer processes these warrants each day when

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

presented through the Federal Reserve Bank. The deposits in the Short-term Investment Portfolio are immediately available to the depositor, subject only to compliance with the State's budgetary laws. These deposits were reported in the North Carolina *Comprehensive Annual Financial Report* as cash and cash equivalents.

Agency deposits and deposits by the State Treasurer may be made in any bank, savings and loan association, or trust company within the State, as approved by the State Treasurer. Depositories are required, in accordance with the rules in the North Carolina Administrative Code, codified as Chapter 20 NCAC 7, to collateralize all balances of the State Treasurer which are not FDIC insured. Basically, the Code requires that the banks maintain collateral in an escrow account established by the State Treasurer with a third-party bank. The security types that may be pledged as collateral are enumerated in the Code. Generally, the securities collateral is required to be governmental in origin (e.g., U.S. Treasury and U.S. agency obligations, or state and local government obligations) or the highest grade commercial paper and bankers' acceptances. Indemnity bonds are also permitted. The Code also requires that the fair value of the collateral not be less than the amount of the time deposits and the average balance of demand deposits for the preceding quarter less the allowable deposit insurance on the deposits.

Financial institutions generally may elect to collateralize State deposits separately (dedicated method) or to include the deposits of the State in the same collateral pool with the deposits of North Carolina local government units (pooling method). Financial institutions are required to report quarterly to the State Treasurer the bank balances and amounts deposited in escrow as collateral. However, under the pooling method, the State maintains no record of the amount of local government deposits that are held by the financial institutions. Therefore, the State's risk of being under collateralized at any given time is increased. Depending upon the institution's financial condition, the State Treasurer may require that particular institution to utilize the dedicated method exclusively for the protection of public deposits.

At December 31, 2000, the deposits maintained by the State Treasurer consisted of (expressed in thousands):

	<u>Carrying Value</u>	<u>Bank Balance</u>
Demand	\$ 136,691	\$ 136,510
Time	169,946	169,946
Total Deposits	<u>\$ 306,637</u>	<u>\$ 306,456</u>

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

As of December 31, 2000, approximately 98% of the balances in financial institutions were deposited under the pooling method. Since institutions are required to comply with the State's collateralization policies and procedures, the State Treasurer considers all of its deposits to be either insured or covered by collateral held by the escrow agent.

D. Investments held by the Investment Pool – This classification includes the investment assets held by the various portfolios of the Pool. Investments in nonparticipating contracts, such as nonnegotiable certificates of deposit, are reported at cost, while other short-term investments are reported at amortized cost, which approximates fair value. Investments held by all other portfolios are reported at fair value, the amount at which a financial instrument could be exchanged in a current transaction between willing parties. The fair values of long-term fixed income securities are determined monthly based on commercial third-party pricing sources that base the value on future principal and interest payments using current yields for similar securities. The third-party professional managers supply the fair values for investments in equity trusts, real estate and venture capital. The equity trust investments are priced monthly, and the real estate and venture capital investments are priced quarterly.

The types of investments held by the State Treasurer's Investment Pool at December 31, 2000 are (expressed in thousands):

<u>Investments by type:</u>	<u>Carrying Amount</u>
U.S. government securities	\$ 22,278,384
Corporate bonds and notes	9,813,856
Repurchase agreements	220,000
International bonds	466,279
Domestic equities	53,686
Certificates of deposit	169,946
Investment in equity trusts	31,722,506
Investments in venture capital partnerships	49,475
Investments in real estate trusts	913,514
Total Pooled Investments	\$ 65,687,646

E. Securities Lending - Based on the authority provided in General Statute 147-69.3(e), the State Treasurer lends securities from its Investment Pool to broker-dealers and other entities (borrowers) for collateral that will be returned for the same securities in the future. The Treasurer's securities custodian manages the securities lending program. The custodian typically lends U.S. government securities and corporate bonds and notes in exchange for collateral. The custodian is permitted to receive cash,

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

U.S. government securities, or irrevocable letters of credit as collateral for the securities lent, as long as the collateral is initially pledged at 102 percent of the market value of the securities lent. There are no restrictions on the amount of loans that can be made. The cash collateral received is invested by the custodian agent and held in a separate account in the name of the State Treasurer.

Securities on loan at December 31 are included in the preceding list of security types. However, the securities purchased with the cash collateral received from those loans are not included, because those collateral assets are offset by a liability for the amounts owed to the borrowers. At December 31, 2000, the Investment Pool had \$15.6 billion of cash collateral invested in government securities and corporate bonds and notes.

At December 31, the State Treasurer has no credit risk exposure to borrowers, because the amounts owed to the borrowers exceed the amounts the borrowers owe on the securities borrowed. The securities custodian is contractually obligated to indemnify the Treasurer for certain conditions, the two most important of which are default on the part of the borrowers and failure to maintain the daily mark-to-market on the loans.

Within the Equity Investment Portfolio, certain third-party professional managers include within their total investments various mutual funds that have been involved in similar securities lending transactions. The State Treasurer has no direct or indirect control over these transactions and therefore has not included them in the report.

NOTE 3 - BOND PROCEEDS FUND

- A. Description of the Bond Proceeds Fund** - The State Treasurer has established separate investment accounts for each State bond issue in order to comply with IRS regulations on bond arbitrage. A private investment company under contract with the State Treasurer manages most of these separate accounts. The investments were valued at amortized cost, which approximates fair value. These assets were reported in the North Carolina *Comprehensive Annual Financial Report* as cash and cash equivalents.
- B. Cash in STIF** - Cash held by the Bond Proceed Fund that is not subject to IRS regulations on bond arbitrage is invested in the Short-term Investment Portfolio. The cash is presented in the financial schedules as a component of the cash and investment assets of the Investment Pool.

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

- C. **Investments held by a custodian** – Investments in the Bond Proceeds investment accounts are reported at cost, which approximates fair value. The investment company supplies the values of the assets held by each bond account monthly.

The types of securities held by the bond proceeds funds at December 31, 2000 are (expressed in thousands):

<u>Investments by type</u>	<u>Carrying Value</u>
US government securities	\$ 29,903
Repurchase agreements	381,249
Commercial paper	<u>49,933</u>
Total Bond Proceeds Investments	<u>\$ 461,085</u>

NOTE 4 - ESCHEAT PROPERTY

- A. **Description of the Escheat and Unclaimed Property Program** - General Statue 116B requires that the State Treasurer administer the State of North Carolina's Escheat and Unclaimed Property Program. The purpose and scope of this program is to recover unclaimed or forgotten property belonging to the citizens of the State, reunite the property with the rightful owner, and distribute income from the invested principal to the State Education Assistance Authority. The term "escheat" means to die without a will and without known heirs. A very small portion of property held is true escheat property. The most common type of property is "unclaimed property" and includes any property that results in a person, who is legally entitled to the property, failing to make a valid claim against the holder. Holders of unclaimed property may include businesses, state and local government agencies, financial institutions, universities, hospitals, public utilities, Clerks of Superior Court, and insurance companies.

General Statue 116B requires the State Treasurer to maintain detailed records of the property that has been escheated to the State. The records must include the following: the name and address of the holder, the name and last known address of the owner, and the amount and description of the property. These records are to be made available to the public for inspection.

All types of unclaimed property are reverted to the State. The State broadly classifies the property into three types of assets: cash, securities, and tangible property. Cash is typically escheated to the State from unclaimed checking and savings accounts or uncashed checks. Securities

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

include all types of unclaimed stocks, bonds, and mutual funds. Tangible property includes a wide variety of items such as coins, jewelry, guns, knives, and a variety of other items.

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

Of the three asset classes, only cash and securities have a current market value that is measurable. As a result, they are presented in Schedule 1 as cash and investments in the State Treasurer's Investment Pool and Investments held by a Custodian. These assets were also reported in the North Carolina *Comprehensive Annual Financial Report* in the Expendable Trust Fund as cash and investments.

At December 31, 2000, the tangible property had not been assigned a current market value, thus it is not included on Schedule 1. However, as required by statute, the State Treasurer maintains a detailed listing of all tangible property. The property is held in the State Treasurer's vault until the owner can be located or the property is sold at public auction. General Statute 116B allows the State Treasurer to sell the property at a public sale within three years after receipt of abandoned property. Before each auction, the State Treasurer has the property appraised to assess its value. Once the property is sold, the State Treasurer has full power to invest the proceeds from the sale in the short-term or long-term portfolios of the Investment Pool.

- B. Cash in STIF** - Cash held by the Escheat Fund is deposited in the Short-term Investment Portfolio of the State Treasurer's Investment Pool. The Escheat Fund's cash amount is a component of the assets presented for the Investment Pool.
- C. Cash with the custodian** - The cash held by the custodian represents the income that has been earned from the securities that have been escheated to the State. The earnings are collected by the custodial agent and periodically transferred to the State Treasurer, where it is deposited into the Escheat Fund's short-term account.
- D. Investments in the Investment Pool** - The Escheat Fund's investments in the Investment Pool are related to deposits held in the Long-term Investment Portfolio of the Pool. These amounts are a component of the investment assets presented for the Investment Pool.
- E. Investments held by a custodian** - This asset includes the securities and mutual fund holdings that have been escheated to the State. The assets are held by the custodial agent and are reported at fair value, the amount at which a financial instrument could be exchanged in a current transaction between willing parties. The fair values are determined by the custodial agent and supplied to the State Treasurer monthly.

General Statutes require the State Treasurer to hold the escheat securities for three years before the securities may be sold, and the securities must be sold at the prevailing market price at the time of sale. A person making

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

a claim after the security has been sold is entitled to receive the net proceeds from the sale.

The types of escheat securities held at December 31 are (expressed in thousands):

<u>Investments by type:</u>	<u>Carrying Amount</u>
Preferred and common stock	\$ 12,969
Mutual funds	1,182
Government and corporate bonds	21
Miscellaneous	<u>40</u>
Total Escheat Investments	<u>\$ 14,212</u>

NOTE 5 - FIXED ASSETS

Fixed assets are stated at cost at date of acquisition. The Department capitalizes fixed assets that have a value or cost in excess of \$5,000 at the date of acquisition and an expected useful life of one or more years. Since all assets were acquired through and used in General Fund operations, no depreciation is recorded. The assets were presented in the North Carolina *Comprehensive Annual Financial Report* in the General Fixed Assets Account Group.

The types of fixed assets held at December 31, 2000 are (expressed in thousands):

	<u>Book Value</u>
Office furniture and equipment	\$ 980
Data processing equipment	5,000
Software	<u>4,440</u>
Total Fixed Assets	<u>\$ 10,420</u>

NOTE 6 - ASSETS HELD IN TRUST

The State Treasurer provides securities safekeeping services for certain State agencies when required by general statute. At December 31, 2000, the following items were held in the State Treasurer's vault (expressed in thousands):

NOTES TO THE FINANCIAL SCHEDULES (CONTINUED)

<u>Owner</u>	<u>Instrument type</u>	<u>Value</u>
Department of Public Instruction	Literary loan notes	\$ 132
Department of Revenue	Certificates of deposit, surety bonds, deed of trust	681
Secretary of State	Certificates of deposit	50
State of North Carolina	317 shares common stock in the NC Railroad	<u>76,177</u>
Total Assets Held in Trust		<u><u>\$ 77,040</u></u>

NOTES TO THE FINANCIAL SCHEDULES (CONCLUDED)

The values of the assets held in trust are presented at cost, which approximates fair value, except for the common stock in the North Carolina Railroad Company. The railroad stock is not marketable and therefore has no readily determinable market value.

FINDINGS AND RECOMMENDATIONS

Finding and Recommendation from Prior Audits - The following presents the status of a finding and recommendation presented in the June 30, 2000 *Investment Pool Audit Report* that affected the current objectives.

1. CERTAIN INVESTMENTS OF THE NORTH CAROLINA NATIONAL GUARD PENSION FUND ARE NOT EXPRESSLY AUTHORIZED BY GENERAL STATUTE

The North Carolina National Guard Pension Fund invests in the Equity Investment Fund and the Real Estate Investment Fund portfolios administered by the Department of State Treasurer. These portfolios maintain certain investments for which the NC National Guard Pension Fund is not expressly authorized by General Statute to maintain.

General Statute 147-69.2(b)(7) authorizes the retirement systems administered by the Department of State Treasurer to invest cash in group trusts; individual, collective or common trust funds; or real estate investment trusts. The Equity Investment Fund and the Real Estate Investment Fund portfolios include these investment types. However, G.S. 147-69.2(b)(8) does not specifically include the NC National Guard Pension Fund when defining the term 'retirement systems.' The State Treasurer has interpreted the intent of the statute to mean all retirement systems, including the NC National Guard Pension Fund.

This issue was brought to the State Treasurer's attention in fiscal year 1998. The Department went to the General Assembly which then made revisions to G.S. 147. However, the revisions were not all inclusive, and the definition of retirement systems in G.S. 147-69.2(b)(8) was not updated to include the NC National Guard Pension Fund.

Recommendation: The Department should propose a legislative change in General Statute 147-69.2(b)(8) that will add the NC National Guard Pension Fund to the retirement systems definition.

Agency's Response: We concur with the Auditor's recommendation that the Department should propose a legislative change in General Statute 147-69.2(b)(8) that will add the National Guard Pension Fund to the retirement systems definition. This proposed legislative change has been drafted and will be submitted to the appropriate committee when the 2001 General Assembly convenes.

Current Status: As of February 2001, the Department still intends to introduce a legislative change to the 2001 General Assembly that will correct the noncompliance.

Agency's Response: We concur with the Auditor's recommendation that the Department will propose a legislative change in General Statute 147-69.2(b)(8) to add the National Guard Pension Fund to the retirement systems definition. That proposed legislative change has been drafted and will be submitted to the appropriate committee of the 2001 General Assembly.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

Current Findings and Recommendations - The following presents findings and recommendations, determined from the procedures to check the balance in the treasury, which represent significant deficiencies in internal control. Also presented are findings and recommendations regarding noncompliance with laws, regulations, or State policies and procedures.

2. FIXED ASSET RECORDS AND PHYSICAL INVENTORY ARE NOT CURRENT

The Department of State Treasurer does not perform an annual inspection or physical inventory of all assets recorded in its fixed asset records. In addition, the Department does not maintain, on a current basis, its fixed asset records.

The Department has not designated a person with the responsibility to conduct a physical inventory of its fixed assets. As a result, the last physical inventory conducted on all fixed assets was in May 1997. Since that time, the Information Technology Section has conducted a partial inventory of its computer equipment.

As of December 31, 2000, the Department had not updated its fixed assets records for changes since August 2000, nor had they tagged the new assets or documented the asset locations.

According to the statewide fixed asset policies issued by the Office of the State Controller, state agencies should conduct a physical inventory of their fixed assets annually. The policies also require that the assets be tagged to provide an accurate method of identifying individual assets, aid in the taking of physical inventory, control the location of all physical assets, aid in maintenance of fixed assets, and provide a common ground of communication for both the accounting department and the asset users.

Recommendation: The Department should take the necessary actions to update and maintain the fixed asset records. Permanent tag numbers and asset locations should be assigned as soon as possible. The Department should ensure that an annual physical inventory is conducted by individuals that do not have custody of the assets, nor responsibility for receiving, checking in, tagging, and recording the assets, as required by state policy.

Agency's Response: The process of doing a 100% non-independent verification of capitalized assets was begun in October 2000. This also entailed comparing IT records to NC Accounting System records for their equipment. When completed, an independent inventory will be taken.

3. CERTAIN ASSETS ARE CAPITALIZED CONTRARY TO STATE POLICY

The Department of State Treasurer combines and records individual components of a fixed asset as one asset and also capitalizes assets, such as software, which should not be

FINDINGS AND RECOMMENDATIONS (CONTINUED)

capitalized regardless of its cost. As a result, the fixed asset records of the Department are significantly overstated.

According to the statewide fixed asset policies issued by the Office of the State Controller, fixed assets containing separate physical parts, such as a CPU, monitor and keyboard, are not considered one asset. Each separate physical part is considered to be a separate asset and should be individually evaluated when determining if it should be recorded on the fixed asset system. State policy requires that all software purchased or developed for internal use be expensed and not capitalized for financial reporting purposes.

Recommendation: The Department should comply with the statewide policies for capitalizing fixed assets. Software, and other individual components of fixed assets that do not meet the Office of the State Controller's \$5,000 capitalization threshold, should be removed from the fixed asset inventory.

Agency's Response: The process of correcting these records to conform with the Office of State Controller was begun as soon as the problems were identified.

4. DUTIES IN THE ESCHEAT SECTION ARE NOT ADEQUATELY SEGREGATED

Certain tangible property and cash receipt transactions are not adequately segregated among staff of the Escheat Section. These conditions increase the opportunities for an individual to be in a position to perpetrate and conceal errors or irregularities. Effective separation of duties reduces this risk.

When escheated tangible property is received, the same person tags the property, records the property to the inventory file, and has easy access to the assets once they are placed in the vault. There is no independent review of the daily tangible property transactions and the controls over access to the vault are weak. The vault keys are stored in an unlocked office drawer, which is accessible to all staff. Further, employees' use of the vault keys is not monitored, and the sign out log is not properly maintained.

When cash is escheated, the same person assigns the receipt number, logs the cash receipt, and deposits the money. The deposit ticket is not independently reviewed before the cash is deposited.

Recommendation: The Department should examine their current procedures for processing escheated property and identify ways to improve the segregation of duties. In addition, physical controls should be enforced to provide adequate safeguards over the assets held in the vault. Consideration should be given to having at least two people enter the vault when assets need to be delivered, removed, or checked.

Agency's Response: We have begun a process to review all procedures in the Escheat Section to determine what changes can be made to make the work flow more smoothly and more accountable. We will expand this process to assure that the procedures include

FINDINGS AND RECOMMENDATIONS (CONTINUED)

a proper segregation of duties, especially where assets are received, handled, stored deposited, or are being returned. We agree that segregation of duties is a significant internal control requirement, and are working to correct this issue.

5. ESCHEAT PROPERTY REPORT DETAILS ARE NOT CURRENT

The owner details from the unclaimed property reports are not recorded on a timely basis to the escheat system (Wagers system). Upon receipt, the report is logged on the system as being received from the holder; however, the Escheat Section is currently three months behind in recording the details about the owner of the property.

Until the Department records the details related to potential owners into the escheat system, neither the Department nor the public can readily identify potential refunds of property.

The Escheat Section is responsible for establishing methods and procedures to record valid transactions on a timely basis. G.S. 116B-6(i) requires that before making a deposit to the Escheat fund or retaining the property, the Treasurer must record the name and address of the holder and the name and last known address of each person entitled to the abandoned property, i.e., the owner(s). The law states that these records shall be available for public inspection at all reasonable business hours.

Recommendation: To ensure compliance with the General Statute requirements, the Department should evaluate their current procedures to identify the most cost efficient and effective way to expedite the processing of unclaimed property reports.

Agency's Response: We agree that we must improve our procedures in recording property reports and reconciling monthly receipts more promptly and more consistently record changes in the assets or the status thereof. It should be noted that this audit began shortly after the November 1 deadline for receiving corporate reports which saw a 227% percent increase in reports filed as result of the statute enacted by the General Assembly in 1999. Steps are already in progress to remedy this problem and to monitor the process in the future.

6. ESCHEAT RECONCILIATIONS AND ESCHEAT SECURITY RECORDS ARE NOT CURRENT

The Escheat Section has established procedures for reconciling monthly receipts per the escheat system to the deposits recorded in the general ledger. When we began our tests in December 2000, the most current cash reconciliation was June 1999, which was eighteen months old. By the end of January 2001, the monthly reconciliation of cash receipts was only three months in arrears, which is the same amount of time by which the unclaimed property reports were behind.

The Escheat Section is behind in updating their escheat security records for all the corporate action filings that have occurred. Because the records are not current, they are unable to reconcile the escheat system to the monthly statements received from the

FINDINGS AND RECOMMENDATIONS (CONTINUED)

custodial bank. In addition, the Section's mutual fund records are incomplete. The Section has not received current statements from all the mutual fund holders. They need the statements to determine the current number of shares owned and to accurately price the securities.

FINDINGS AND RECOMMENDATIONS (CONCLUDED)

A sound internal control provides for independent verification of recorded amounts. Failure to reconcile the transactions on a monthly basis increases the likelihood of errors or the misappropriation of assets occurring and remaining undetected during the normal course of business. The Department's inability to reconcile their security balances to the custodian's statement increases the risk of misstatement. Furthermore, until the escheat system properly reflects all the assets on hand, the escheat securities cannot be refunded to the owner or sold as permitted by law.

Recommendation: The Department should place more emphasis on recording transactions timely, as well as communicating and monitoring the control activities to ensure the escheat records are accurate. The Department should evaluate their current procedures to identify the most cost efficient and effective way to update the escheat system (Wagers system).

Agency's Response: Same as for Finding #5.

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In accordance with G.S. § 147-64.5 and G.S. § 147-64.6(c)(14), copies of this report have been distributed to the public officials listed below. Additional copies are provided to other legislators, state officials, the press, and the general public upon request.

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February 15, 2001

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