STATE OF NORTH CAROLINA

AUDIT RESULTS FROM

CAFR AND SINGLE AUDIT PROCEDURES

OFFICE OF THE STATE CONTROLLER

FOR THE YEAR ENDED JUNE 30, 2001

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

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March 8, 2002

The Honorable Michael F. Easley, Governor
Members of the North Carolina General Assembly
Mr. Robert L. Powell, State Controller
Office of the State Controller

We have completed certain audit procedures at the Office of the State Controller related to the State's *Comprehensive Annual Financial Report (CAFR)* and the State's *Single Audit Report,* for the year ended June 30, 2001. Our audit was made by authority of Article 5A of *North Carolina General Statute § 147.*

The results of these procedures, as described below, yielded audit findings and recommendations for the Office of the State Controller related to the State's general-purpose financial statements and the State's federal financial assistance programs which required disclosure in the aforementioned reports. The findings noted above are included in the findings and recommendations section contained herein. Our recommendations for improvement and management's response follow each finding.

> We noted internal control weaknesses and instances of noncompliance with state or federal regulations. These deficiencies included failing to remit matching contributions to the employee pension fund and errors in the federal government interest liability calculation.

The accounts and operations of the Office of the State Controller are an integral part of the State's reporting entity represented in the *CAFR* and the *Single Audit Report*. In the *CAFR*, the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report,* the State Auditor also presents the results of tests on the State's internal control and on the State's compliance with laws, regulations, contracts, and grants applicable to the State's financial statements and to its federal financial assistance programs. The audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget Circular A-133.

As part of the work necessary for issuance of the *CAFR* and the *Single Audit Report*, the following activities were subjected to audit procedures at the Office of the State Controller as we considered necessary:

<u>Funds for the *Comprehensive Annual Financial Report*:</u>

Internal Control Over Statewide Financial Reporting

Preparation of the *Comprehensive Annual Financial Report*

<u>Federal Programs for the *Single Audit Report*:</u>

Compliance with the Federal Cash Management Improvement Act

Compilation of the Schedule of Expenditures of Federal Awards

The activities subjected to audit at the Office of the State Controller are substantially less in scope than would be necessary to report on the general-purpose financial statements that relate solely to the Office of the State Controller or the administration of federal programs by the Office of the State Controller. Therefore, we do not express such conclusions.

North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit 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.

Ralph Campbell, Jr.
State Auditor

AUDIT FINDINGS AND RECOMMENDATIONS

Matters Related to Financial Reporting or Federal Compliance Objectives

Current Year Findings and Recommendations - The following findings and recommendations were identified during the current audit and represent significant deficiencies in internal control or noncompliance with laws, regulations, contracts, or grants.

1. STATE FAILED TO REMIT MATCHING CONTRIBUTIONS TO EMPLOYEE PENSION FUND

During fiscal year 2001 the State of North Carolina used $129.9 million of recorded pension costs to avoid a budget deficit in the State's General Fund. These costs are questioned because the State did not remit the pension contributions to the affected retirement systems and failed to remit to the federal government its equitable share of previously allowed pension costs.

To insure that a deficit was not incurred in the administration of the State's budget for fiscal year 2001, the Governor issued Executive Order Number 3. This Order directed the Office of the State Controller to receive the employer portion of retirement contributions for all State funded retirement systems and to escrow such funds into a special reserve as established by the Office of State Budget, Planning, and Management. Retirement systems affected were the Teachers' and State Employees' Retirement System, the Consolidated Judicial Retirement System, and the Legislative Retirement System.

Records maintained by the Office of the State Controller indicate that from February to June 2001, $212.5 million in contributions were escrowed into the special reserve. (State agencies have identified $10.7 million of this amount as originating from charges to federal programs; however, this amount has not been independently verified.) In December 2001, $82.6 million of the total funds escrowed were forwarded to the Department of State Treasurer where they were allocated to the three affected retirement systems. As of the date of this report, $129.9 million is still owed to the affected retirement systems and represents pension costs recorded in the State's departmental accounting records for fiscal year 2001.

In December 2001, the General Assembly passed legislation expressing its intent to make over a five-year period the pension contribution to the Teachers' and State Employees Retirement System that was not made for fiscal 2001. Section 21 of Session Law 2001-513, An Act to Make Technical Corrections to the Appropriations Act of 2001, provides:

> It is the intent of the General Assembly to appropriate funds to make the contribution to the Teachers' and State Employees' Retirement System ("System") that would have been made for the fiscal period beginning February 28, 2001, and ending June 30, 2001. Further, it is the intent of the General Assembly that the

> payment be made with interest at rates determined by the General Assembly to be consistent with the performance and earnings of the System. Subject to the availability of funds, it is also the intent of the General Assembly to make the payment by appropriations over a five-year period beginning July 1, 2003.

OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments,* Attachment B, Part 11.e.(5) provides that "the Federal Government shall receive an equitable share of any previously allowed pension costs (including earnings thereon) which revert or inure to the governmental unit in the form of a refund, withdrawal, or other credit."

The cost principles, however, provide a reprieve from reverting the federal portion of pension costs in situations similar to what the State found itself, provided certain conditions are met. The conditions require that all pension charges be remitted to the affected retirement plan within six months after the fiscal year end, or for a longer period upon agreement with the federal government. The State, however, failed to seek or obtain such an agreement from the federal government. Attachment B, Part 11.e.(2) of OMB Circular A-87 states:

> Pension Costs calculated using an actuarial cost-based method recognized by GAAP are allowable for a given fiscal year if they are funded for that year within six months after the end of that year. Costs funded after the six month period (or a later period agreed to by the cognizant agency) are allowable in the year funded. The cognizant agency may agree to an extension of the six month period if a appropriate adjustment is made to compensate for the timing of the charges to the Federal Government and related Federal reimbursement and the governmental units contribution to the pension fund. Adjustments may be made by cash refund or other equitable procedures to compensate the Federal Government for the time value of Federal reimbursements in excess of contributions to the pension fund.

Recommendation: The State should make contact with the federal government to seek disposition of the issue of the $129.9 million in pension costs that were not remitted to the affected retirements systems and, as needed, should seek federal agreement to any plan that delays the funding of pension costs after the six-month period established by federal regulation.

Agency Response: The Office of the State Controller (OSC) received the employer share of retirement contributions for the period February through June 30, 2001 as required by Governor Easley's Executive Order Number 3. David McCoy, State Budget Officer, directed $82.6 million be returned to the retirement system and $129.9 million to be used to assist the General Fund in a revenue shortfall for the fiscal year ending June 30, 2001. In December, 2001 the General Assembly enacted legislation (Section 21 of Session Law 2001-513) to appropriate funds over a five year period beginning July 1, 2003 to the

Teachers and State Employees' Retirement System that would have been contributions made between February and June 30, 2001. The funds would be repaid with interest. The OSC has followed all procedures mandated by the Easley Executive Order Number 3, Office of State Budget and Management and the General Assembly through legislative action. The OSC will discuss with the appropriate federal agency the actions of the Executive Order and the intent of the legislation enacted by the General Assembly.

2. CALCULATION OF INTEREST LIABILITY TO THE FEDERAL GOVERNMENT CONTAINED ERRORS

The Office of the State Controller (OSC) did not consistently follow prescribed procedures when performing interest liability calculations. In our sample of eight interest liability calculation spreadsheets for major programs, we noted the following errors:

- Two spreadsheets contained incorrect formulas.
- Four spreadsheets contained incorrect negative balance calculations.

While performing additional test work, we noted that the amount of warrants issued was incorrectly calculated for nine of the twelve monthly Division of Medical Assistance spreadsheets. Consequently, this also resulted in errors in the interest liability calculations. The net effect of these errors was an overstatement of $21,454 of interest owed to the Federal Government.

Recommendation: OSC should exercise more care when making the interest liability calculations. OSC should also place greater emphasis on review procedures necessary to ensure that interest liability calculations are accurate.

Agency Response: Corrective action has been taken. Additional supervisory review procedures were added during the fiscal year to detect errors before the year end interest compilation. The additional review will detect errors at an earlier date to ensure corrections before submission of final reports.

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In accordance with G.S. § 147-64.5 and G.S. § 147-64.6(c)(14), copies of this document 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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April 9, 2002

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