STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT ON

THE INVESTMENT POOL OF THE NORTH CAROLINA DEPARTMENT OF STATE TREASURER

RALEIGH, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2002

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

Financial Statement Audit Report on

The Investment Pool of the North Carolina Department of State Treasurer

Raleigh, North Carolina

For the Year Ended June 30, 2002

Richard H. Moore
State Treasurer

J. Michael Barham
Deputy Treasurer, Financial Operations Division

STATE OF NORTH CAROLINA
Office of the State Auditor

Ralph Campbell, Jr.
State Auditor

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AUDITOR'S TRANSMITTAL

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

This report presents the results of our financial statement audit of the Investment Pool of the North Carolina Department of State Treasurer (the Department) for the year ended June 30, 2002. Our audit was made by authority of Article 5A of Chapter 147 of the General Statutes.

The accounts and operations of the Investment Pool are an integral part of the State's reporting entity represented in the State's *Comprehensive Annual Financial Report* (CAFR) and the State's *Single Audit Report*. In those reports the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report,* the State Auditor also presents the audit results 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.

As part of the audit work necessary for the CAFR and the *Single Audit Report*, the accounts and operations of the Investment Pool were subject to audit procedures as we considered necessary. In addition, we performed auditing procedures that we considered necessary for us to report on the accompanying financial statements that relate solely to the Investment Pool. The audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States.

The purpose of this report is to present the results of our audit on the accompanying financial statements. A summary of our reporting objectives and audit results are:

1. **Objective** – To express an opinion on the financial statements that relate solely to the Investment Pool of the North Carolina Department of State Treasurer.

   Results - The financial statements present fairly the amounts and disclosures made in accordance with accounting principles generally accepted in the United States of America. These matters are more fully described in the Independent Auditor's Report on the Financial Statements.

2. **Objective** – To present significant deficiencies, if any, in internal control which could adversely affect the Department's ability to record, process, summarize, and report financial data in the financial statements of the Investment Pool and present instances of noncompliance, if any, with laws, regulations, contracts or grants.

   Results - The following significant deficiencies in internal control over financial reporting and instances of noncompliance were noted as a result of our audit:

   Finding

   1. Internal Control with a Service Organization Needs Improvement
   2. Internal Control Related to Contracted Investment Services Needs Improvement
   3. Membership on the Investment Advisory Committee Does Not Comply with Statutory Requirements
   4. Violation of the North Carolina Administrative Code

   These matters are described in the Independent Auditor's Report on Compliance and on Internal Control over Financial Reporting and the Audit Findings and Recommendations section of this report.

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.

Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

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INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

The Honorable Richard H. Moore, State Treasurer
Raleigh, North Carolina

We have audited the accompanying Statement of Net Assets of the Investment Pool of the North Carolina Department of State Treasurer (the Department), as of June 30, 2002 and the related Statement of Operations and Changes in Net Assets for the year then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Investment Pool as of June 30, 2002, and the results of its operations and changes in net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 31, 2002 on our consideration of the Department's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS (CONCLUDED)

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Schedules 1 and 2 are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

October 31, 2002

The Investment Pool
Statement of Net Assets
at June 30, 2002
(Dollars in Thousands) — ***Exhibit A***

ASSETS		
Investments:		
Cash equivalents	$	424,209
Treasury notes and bonds		12,710,797
Federal agency notes and bonds		3,869,162
GNMA certificates		5,178,829
Corporate bonds and notes		10,179,390
Domestic equities		2,255
Equity trust securities		27,032,435
Investments in real estate trust funds		1,510,996
Venture capital investments		39,978
Investment of cash collateral received for securities lent		15,577,252
Total investments		76,525,303
Cash in bank		83,167
Interest receivable and other assets		491,982
Total assets		77,100,452
LIABILITIES		
Obligations under securities lending transactions		15,577,252
Distributions payable		28,667
Total liabilities		15,605,919
NET ASSETS		
Net assets external participants		532,248
Net assets internal participants		60,962,285
Total net assets	$	61,494,533

The accompanying notes to the financial statements are an integral part of this statement.

The Investment Pool
Statement of Operations and
Changes in Net Assets
For the Year Ended June 30, 2002
(Dollars in Thousands) — ***Exhibit B***

REVENUES		
Income from investments	$	(1,880,765)
Income from securities lending		370,489
Total operating loss		(1,510,276)
LESS OPERATING EXPENSES		
Treasurer's allocated cost		4,336
External managers' fees		34,197
Securities lending expenses		336,466
Other operating expenses		1,156
Total operating expenses		376,155
Net decrease in net assets resulting from operations		(1,886,431)
Distributions to participants:		
Distributions paid and payable		(6,924,026)
Share Transactions:		
Reinvestment of distributions paid		6,927,679
Net redemptions of shares		(1,829,964)
Net increase in net assets resulting from share transactions		5,097,715
Total decrease in net assets		(3,712,742)
NET ASSETS		
Beginning of period		65,207,275
End of period	$	61,494,533

The accompanying notes to the financial statements are an integral part of this statement.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

A. **Organization -** The North Carolina Department of the 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."

In establishing a comprehensive investment management program, the State Treasurer, by utilizing a professional investment staff, has developed an investment strategy for each investment portfolio that recognizes the guidelines of the governing General Statutes while providing diversification as appropriate for its participants. The overall investment objective for the State Treasurer's Investment Pool is to generate maximum income consistent with safety of principal.

B. **Financial Reporting Entity -** The State Treasurer's Investment Pool is an external investment pool sponsored by the Department of the State Treasurer on the State's behalf. The external portion of the Investment Pool, consisting of funds belonging to entities outside of the State of North Carolina's financial reporting entity, has been 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, has been included in the various participating funds in the State of North Carolina's *Comprehensive Annual Financial Report.*

C. **Description of the Investment Pool -** The Investment Pool is composed primarily of the holdings of the various North Carolina retirement systems. Of all Pool assets under management by the State Treasurer, approximately 86% belong to the various retirement systems. The retirement funds by statute may not be used "for any purpose other than retirement system benefits and purposes, administrative expenses, and refunds." Further, such funds "shall not be applied, diverted, loaned to or used by the State, any State agency, State officer, public officer or public employee."

The State Treasurer, pursuant to North Carolina General Statute 147-69.3(a), operates various investment programs (portfolios) as components of the Investment Pool. The State Treasurer's Investment 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. This Pool, a governmental external investment pool, consists of the following individual investment portfolios:

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 retirement funds, other employee benefit funds, other special funds and component units.

Equity Investment Portfolio – This portfolio provides investments in an equity-based trust that is administered by a third-party professional. The trust invests primarily in common stock and other equities. For these investments the State Treasurer does not own the individual securities but rather has ownership of the trust. The State's various retirement 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 retirement 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 retirement funds are the sole participants in the portfolio.

D. **Measurement Focus and Basis of Accounting -** The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB). The Investment Pool follows all applicable GASB pronouncements, as well as applicable private sector pronouncements issued on or before November 30, 1989. The financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting. Under this basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

E. **Cash in Bank –** This classification includes deposits received less warrants cleared as of the date recorded on the bank's depository books.

F. **Cash Equivalents –** This classification includes short-term investments of the Short-term Investment Portfolio. Types of investments are certificates of deposit and saving certificates with a maturity date of six months or less and overnight repurchase agreements.

G. **Obligations Under Securities Lending Transactions –** This liability arises from obligations to return collateral that has been received for securities lent.

H. **Net Assets –** This classification represents the total net ownership of the participants for moneys deposited and invested by the Investment Pool.

I. **Revenues -** Income from Investments is comprised of the gross income recorded on the accrual basis of accounting. Gains and losses as recorded, including the increase in fair value of investments, are included in this classification. It also includes the interest on fixed income securities, which is accrued and recorded daily. Because the investments in the Short-term Investment Portfolio are reported at amortized cost, which approximates fair value, the interest earned by this portfolio is amortized daily using the scientific method. Income from the Equity, Real Estate, and Venture Capital Investment Portfolios is recognized in the period in which it becomes susceptible to accrual.

Income from Securities Lending represents gross income earned from securities lending transactions whereby the Investment Pool's custody bank lends securities to broker-dealers and banks.

J. **Operating Expenses -** Treasurer's Allocated Cost covers all indirect expenses, such as salary and fringe benefit costs, of the Investment Pool that are paid from the State's General Fund. Periodically, each investment portfolio reimburses the General Fund for its applicable share of those expenses based on each portfolio's percentage of the Pool's total net assets.

External Managers' Fees are expenses paid directly out of earnings of the Investment Pool to third party professionals for investment management services.

Costs associated with securities lending transactions are paid from the gross income earned and are reported separately as securities lending expenses.

Other expenses include other separately stated expenses paid directly out of earnings of the Real Estate and Venture Capital Investment Portfolios and State Treasurer administrative costs that are directly chargeable to a given portfolio.

K. Method Used to Report Investments and Participant Shares – Investments in nonparticipating contracts, such as nonnegotiable certificates of deposit, are reported at cost. Other investments within the Short-term Investment Portfolio are reported at amortized cost, which approximates fair value. The 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 the Long-term Investment Portfolio are determined daily based on commercial third-party pricing sources. Other third-party professionals supply the fair values of the Equity, Real Estate and Venture Capital portfolios. The Equity Investment Portfolio is priced monthly, and the Real Estate and Venture Capital Investment Portfolios are priced quarterly.

Share prices are determined at the end of the month based on the net asset value of the portfolios divided by the total shares outstanding. Values assigned to individual positions in the Investment Pool are determined by the number of shares owned within the portfolios multiplied by the fair value per share of the portfolios. Participant additions and redemptions are reported at net asset value. Even though the State Treasurer manages and/or monitors the above-mentioned portfolios to protect against losses from credit and market changes, the State Treasurer cannot provide any guarantees or assurances to support the participant share values.

L. Distribution of Income - Net realized income is allocated monthly by the Short-term, Long-term and Equity portfolios and quarterly by the Real Estate and Venture Capital portfolios to Pool participants based on their ownership percentages. Pursuant to North Carolina General Statute 147-69.1(d), moneys received from agency accounts, which are permitted or required to earn interest, must receive allocations of earnings on a pro-rata basis. However, this same statute requires all earnings attributed to agency accounts, which are not permitted or required to earn interest, to be automatically deposited to the State's General Fund. For the fiscal year ended June 30, 2002, $47,684,043 of investment income associated with other Pool participants was credited to the General Fund.

M. Investment Policy - The State Treasurer is authorized by North Carolina General Statutes 147-69.1(c) and 147-69.2(b) to invest in the following:

1. Obligations of or fully guaranteed by the United States and the obligations of certain federal agencies;
2. Repurchase agreements;
3. Obligations of the State of North Carolina;
4. Time deposits of North Carolina financial institutions with a physical presence in the State;
5. Prime quality commercial paper bearing specified ratings;
6. 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;
7. General obligations of other states in the United States;
8. General obligations of cities, counties and special districts in North Carolina;
9. Asset-backed securities (whether considered debt or equity) bearing specific ratings;
10. Obligations of any company incorporated within or outside the United States bearing specified ratings;
11. In addition to all of the above, the Retirement Systems' assets may also be invested in following:

    (a) Insurance contracts that provide for participation in 1) individual or pooled separate accounts of insurance companies, 2) group trusts, 3) individual, common, or collective trust funds of banks and trust companies, 4) real estate investment trusts, and 5) limited partnerships, whether described as limited liability partnerships or limited liability companies; provided such investment assets are managed primarily for the purpose of investing in or owning real estate or related debt financing located within or outside the United States.

(b) Certain mutual funds and specified preferred or common stocks issued by a company created or located within or outside the United States. The assets authorized under this subdivision can be invested through individual, common, or collective trust funds of banks, trust companies, and group trust funds of investment advisory companies.

(c) Limited partnership interests in a partnership or interests in a limited liability company where the primary purpose of the partnership or limited liability company is to invest in public or private debt, public or private equity, or corporate buyout transactions, within or outside the United States.

NOTE 2 - DEPOSITS

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.

The State Treasurer maintains numerous deposit accounts for collecting and disbursing funds. Expenditures for the primary government and certain component units are made by warrant, both paper and electronic, drawn on the State Treasurer, which are issued by the agency obligated to make the disbursement. On a daily basis, the State Treasurer processes the paper warrants when presented by the Federal Reserve Bank and the electronic warrants when initiated by the issuing agency to fund electronic payments. 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 are reported in the North Carolina *Comprehensive Annual Financial Report* as cash and cash equivalents. Typically, the Short-term Investment Portfolio balances are larger than the cash balances by the amount of warrants issued by the agencies but not yet presented for payment through the banking system.

Agency deposits to the accounts of the State Treasurer and deposits by the State Treasurer may be made in any bank, savings and loan association, or trust company in 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 insured. Basically, these rules require that the bank maintains, as collateral in an escrow account established by the State Treasurer with a third-party bank, securities of a type enumerated in the rules, in an amount whose fair value is not less than the amount of the time deposits and the average balance of demand deposits for the preceding quarter or other approved averaging calculation less the allowable deposit insurance on the deposits. Generally, rules require the securities collateral 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. Surety bonds and letters of credit issued by the Federal Home Loan Bank are also permitted. Financial institutions generally may elect to collateralize State deposits separately (dedicated method) or to include the deposits of North Carolina local government units in the same collateral pool with the State (pooling method). Financial institutions report quarterly on bank balances and amounts deposited in escrow as collateralization of deposits. Financial institutions also report on amounts secured by insurance and amounts protected by securities. The State maintains no records of the amount of local government deposits that are held by the financial institutions and pooled for collateralization purposes with the State deposits. Since the amounts of local government deposits in the pooling method banks are not known, the State's risk of being under collateralized at any given time is increased. An institution's financial condition may cause the State Treasurer to require that a particular institution utilize the dedicated method exclusively for the protection of public deposits.

At June 30, 2002, the deposits maintained by the State Treasurer consisted of (expressed in thousands):

	Carrying Value	Bank Balance
Cash in bank	$ 83,167	$ 87,240
Certificates of deposit	159,746	159,746
Total Deposits	$ 242,913	$ 246,986

As of June 30, 2002, 94% 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 State's agent.

NOTE 3 - INVESTMENTS

The State's investments are categorized to give an indication of the level of risk assumed by the entity at year-end. Category 1 includes investments that are insured or registered or for which the securities are held by the State or its agent in the State's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the selling financial institution's trust department or agent in the State's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by the dealer's trust department or agent, but not in the State's name.

Investments held by the State Treasurer at June 30, 2002 are expressed in thousands:

	Carrying Amount (Fair Value)		
	Category		
	1	3	Total
Investments Categorized:			
U. S. Government and Agency Securities:			
Not on Loan	$ 1,603,620	$ 746,727	$ 2,350,347
On Loan for Securities Collateral	279,484		279,484
Corporate Bonds and Notes Not on Loan	9,252,485	1,234,909	10,487,394
Asset Backed Securities	5,178,829	10,314,880	15,493,709
Repurchase Agreements	264,463	3,280,736	3,545,199
International Bonds Not on Loan	359,706		359,706
Domestic Equities	2,255		2,255
Total Investments Categorized	$ 16,940,842	$ 15,577,252	32,518,094
Investments Not Categorized:			
Equity-based Trust			27,032,435
Venture Capital Investments			39,978
Real Estate Trust Funds			1,510,996
Investments Held by Broker/Dealers under Securities Loans with Cash Collateral:			
U.S. Government and Agency Securities			14,696,855
Corporate Bonds and Notes			528,205
International Bonds			38,994
Total Investments Not Categorized			43,847,463
Total Pooled Investments			$ 76,365,557

Investments at year-end incorporated all material categories and types of investments held during the year. The certificates of deposit, which are presented as a cash equivalent in the Statement of Net Assets, are not listed here but, instead, are a component of the deposit total reported in the deposit section of the notes.

The Investment Pool has four major investment classifications: U.S. government securities, equity-based trust, corporate bonds and notes, and asset backed securities. At June 30, 2002, these investment classifications had the following attributes (dollars expressed in thousands):

	Carrying Amount (Fair Value)	Principal Amount	Range of Interest Rates	Range of Maturity Dates
U.S. Government and Agency Securities	$ 16,579,959	$ 15,325,162	0 - 9.125%	1 day - 29 years
Corporate Bonds and Notes	9,780,690	9,578,323	5 - 8.875%	4 – 41 years
Asset Backed Securities	5,178,829	5,042,999	6 - 9%	15 – 30 years
Securities Purchased with Cash Collateral Under Securities Lending Program:				
Asset Backed Securities	10,314,880	not applicable	1.88 - 7.15%	15 days – 3 years
Corporate Bonds and Notes	1,234,909	not applicable	1.86 - 2.00%	46 days – 1 year
U.S. Government and Agency Securities	746,727	not applicable	1.77 - 2.08%	122 – 241 days
Equity-based Trust	27,032,435	not applicable	not applicable	not applicable

NOTE 4 - SECURITIES LENDING TRANSACTIONS

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. During the year the custodian lent U.S. government and agency securities and corporate bonds and notes for collateral. The custodian is permitted to receive cash, U.S. government and agency securities, or irrevocable letters of credit as collateral for the securities lent. The collateral is initially pledged at 102 percent of the market value of the securities lent, and additional collateral is required if its value falls to less than 100 percent of the market value of the securities lent. There are no restrictions on the amount of loans that can be made. Substantially all securities loans can be terminated on demand by either the State Treasurer or the borrower. Securities lent at year-end for cash collateral are presented as unclassified in the preceding schedule of custodial credit risk; securities lent for securities collateral are classified according to the category for the collateral. The State Treasurer cannot pledge or sell the collateral securities received unless the borrower defaults.

The cash collateral received is invested by the custodian agent and held in a separate account in the name of the State Treasurer for the benefit of the State Treasurer and/or the borrowers. The average maturities of the cash collateral investments are less than the average maturities of the securities lent. While cash can be invested in securities ranging from overnight up to two years, the custodian agent is not permitted to make investments where the weighted average maturity of all investments exceeds 90 days. At June 30, 2002, the weighted average maturity of unmatched investments was approximately 22 days.

At year-end 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.

The custodian for the equity investment trust has been given the authority to lend the trust's equity securities to broker-dealers for collateral that will be returned to the trust for the same securities in the future. Neither the securities lent nor the collateral received are owned or under the direct control of the State Treasurer.

NOTE 5 - DERIVATIVES AND OTHER SIMILAR TRANSACTIONS

Included in the equity-based trust are stock futures and foreign exchange forward contracts. The trust has entered into these and similar contracts to deliver returns similar to the appropriate industry benchmarks. Derivative positions are accounted for both by the custodian and the investment manger on separate accounting platforms. Both total exposure and realized and unrealized gains and losses are calculated on a daily basis. The positions are reconciled daily with the clearing brokers.

The trust enters into these transactions with industry standard brokerage account forms that are binding by all affected parties. The futures exchanges mediate counterparty credit risk with daily mark-to-market valuations of all futures positions. The money movements are handled by a clearing corporation affiliated with each exchange. Market risks associated with these transactions are the same as the underlying securities.

Third-party professional managers that are used by the various investment portfolios may on occasion invest short-term cash reserves in mutual funds that utilize collateralized mortgage obligations, financial futures, forwards, options, swaps, and other derivative instruments. The State Treasurer does not have direct control over these transactions and does not consider them to be significant transactions in the Investment Pool's operations.

Certain venture capital partnerships in which the State Treasurer invests have the authority to invest in warrants for the purchase of common and preferred stock. These warrants do not imply any requirements for future action and have a minimal value.

Asset backed securities in Note 3, category 1, are mortgage-backed securities issued by an agency of the United States government, the Government National Mortgage Association (GNMA). The State Treasurer invests in these securities to maximize yield while maintaining a high degree of safety. The securities are based on cash flows from payments on underlying mortgages. Therefore, the investment values are sensitive to mortgage prepayments that tend to occur during periods of declining interest rates.

Asset backed securities in Note 3, category 3, include securities purchased with securities lending cash collateral. The State Treasurer's securities lending agent invests in these to maximize yield. The weighted average maturity of these investments is short-term in nature and, as a result, the market risk is reduced.

The Investment Pool
Schedule of Net Assets by Portfolio
at June 30, 2002
(Dollars in Thousands) — ***Schedule 1***

	Short-Term Portfolio	Long-Term Portfolio	Equity Portfolio	Real Estate Portfolio	Venture Capital Portfolio	Intrapool Eliminations	Total
ASSETS							
Investments:							
Cash equivalents	$ 423,746	$ 0	$ 463	$ 0	$ 0	$ 0	$ 424,209
Treasury notes and bonds	4,438,875	8,271,922					12,710,797
Federal agency notes and bonds	2,438,243	1,430,919					3,869,162
GNMA certificates		5,178,829					5,178,829
Corporate bonds and notes		10,179,390					10,179,390
Domestic equities					2,255		2,255
Equity trust securities			27,032,435				27,032,435
Investments in real estate trust funds				1,510,996			1,510,996
Venture capital investments					39,978		39,978
Investments in Short-term Portfolio		179,652	371,629	90,309	39,150	(680,740)	
Investment of cash collateral received for securities lent	6,097,839	9,479,413					15,577,252
Total investments	13,398,703	34,720,125	27,404,527	1,601,305	81,383	(680,740)	76,525,303
Cash in bank	83,167						83,167
Interest receivable and other assets	101,527	390,434			21		491,982
Total assets	13,583,397	35,110,559	27,404,527	1,601,305	81,404	(680,740)	77,100,452
LIABILITIES							
Obligations under securities lending transactions	6,097,839	9,479,413					15,577,252
Distributions payable	27,559	1,108					28,667
Total liabilities	6,125,398	9,480,521					15,605,919
NET ASSETS							
Net assets external participants	532,248						532,248
Net assets internal participants	6,925,751	25,630,038	27,404,527	1,601,305	81,404	(680,740)	60,962,285
Total net assets	$ 7,457,999	$ 25,630,038	$ 27,404,527	$ 1,601,305	$ 81,404	$ (680,740)	$ 61,494,533

The Investment Pool Schedule of Operations and Changes in Net Assets by Portfolio for the Year Ended June 30, 2002

(Dollars in Thousands) ***Schedule 2***

	Short-Term Portfolio	Long-Term Portfolio	Equity Portfolio	Real Estate Portfolio	Venture Capital Portfolio	Intrapool Eliminations	Total
REVENUES							
Income (loss) from investments	$ 390,920	$ 2,373,659	$ (4,636,904)	$ 50,872	$ (17,899)	$ (41,413)	$ (1,880,765)
Income from securities lending	146,631	223,858					370,489
Total operating income (loss)	537,551	2,597,517	(4,636,904)	50,872	(17,899)	(41,413)	(1,510,276)
LESS OPERATING EXPENSES							
Treasurer's allocated cost	495	1,724	2,003	108	6		4,336
External managers' fees			24,992	8,323	882		34,197
Securities lending expenses	131,186	205,280					336,466
Other operating expenses	89		61	358	648		1,156
Total operating expenses	131,770	207,004	27,056	8,789	1,536		376,155
Net increase (decrease) in net assets resulting from operations	405,781	2,390,513	(4,663,960)	42,083	(19,435)	(41,413)	(1,886,431)
Distributions to participants:							
Distributions paid and payable	(405,781)	(1,844,516)	(4,624,799)	(82,594)	(6,803)	40,467	(6,924,026)
Share transactions:							
Reinvestment of distributions paid	409,470	1,844,480	4,624,799	82,594	6,803	(40,467)	6,927,679
Net (redemptions) and subscriptions	(780,840)	(1,414,730)		500,000		(134,394)	(1,829,964)
Net increase (decrease) in net assets resulting from share transactions	(371,370)	429,750	4,624,799	582,594	6,803	(174,861)	5,097,715
Total increase (decrease) in net assets	(371,370)	975,747	(4,663,960)	542,083	(19,435)	(175,807)	(3,712,742)
NET ASSETS							
Beginning of period	7,829,369	24,654,291	32,068,487	1,059,222	100,839	(504,933)	65,207,275
End of period	$ 7,457,999	$ 25,630,038	$ 27,404,527	$ 1,601,305	$ 81,404	$ (680,740)	$ 61,494,533

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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

The Honorable Richard H. Moore, State Treasurer
Raleigh, North Carolina

We have audited the financial statements of the Investment Pool of the North Carolina Department of State Treasurer as of and for the year ended June 30, 2002, and have issued our report thereon dated October 31, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Investment Pool's financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests, which are reported in the Audit Findings and Recommendations section of this report, disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards.*

Finding

3. Membership on the Investment Advisory Committee Does Not Comply with Statutory Requirements

4. Violation of the North Carolina Administrative Code

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* (CONCLUDED)

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Department's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. The reportable conditions noted as a result of our audit are described in the Audit Findings and Recommendations section of this report.

Finding

1. Internal Control with a Service Organization Needs Improvement
2. Internal Control Related to Contracted Investment Services Needs Improvement

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider Finding 2 to be a material weakness.

This report is intended solely for the information and use of the management of the Department, the Governor, the Office of State Budget and Management, the Office of the State Controller, and the General Assembly and is not intended to be, and should not be, used by anyone other than these specified parties.

Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

October 31, 2002

AUDIT FINDINGS AND RECOMMENDATIONS

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. INTERNAL CONTROL WITH A SERVICE ORGANIZATION NEEDS IMPROVEMENT

   The Department placed reliance on the internal control of an investment banking company without adequate evidence that controls were suitably designed, placed in operation, and operating with sufficient effectiveness. This investment banking company provides critical investment accounting and custody services to the Department. Without evidence of the controls related to such services, the Department increased the risk of significant deficiencies in its ability to initiate, record, process and report financial data that is subject to the internal control of this service organization.

   - Audit reports necessary for the Department to determine whether the service organization's internal control is adequate are not required by the contract between the Department and the service organization. However, in absence of the contract provision, the service organization contracted with a public accounting firm to prepare these reports semi-annually.

   - Some controls of the service organization upon which the Department relies were not included within the scope of these audit reports.

   - These audit reports indicate a number of expected user controls that the Department had not yet implemented.

   - Evidence was not available to indicate that the Department had reviewed these audit reports to identify relevant risks, and as necessary, to establish compensating Departmental controls.

   Recommendation: Contracts between the Department and any service organization should include the requirement for a *report on controls placed in operation and tests of operating effectiveness* as described in Statement on Auditing Standards No. 70, *Service Organizations,* promulgated by the American Institute of Certified Public Accountants. The Department should review these reports in detail for the purposes of assessing control risks, monitoring the effectiveness of current controls, and designing any additional procedures that are needed.

   Agency's Response: The State Treasurer's staff takes very seriously its responsibility for the adequacy of internal control, including the internal control of contracted service organizations. Prior to contracting with the current equity master custodian the Financial Operations Division staff and the Investment Division staff spent several months assessing the operations of the bank and the internal control provided over the processing and recording of investment transactions. As a result of our change in internal procedures and the efforts of the master custodian, it is the opinion of our staff that the internal control over investment transactions in this Department is stronger than it has been at any time in the history of this agency. Nonetheless, we will continue ongoing efforts to determine ways we can make it even better. We agree with your recommendation that contracts between the Department and a service agency, such as our equity master custodian, should include the requirement for a report on controls as described in the Statement on Auditing Standards No. 70, *Service Organizations,* promulgated by the American Institute of Certified Public Accountants, and we have already taken steps toward that end. We also agree that the Department should review these reports in detail for the purposes of assessing control risks and monitoring the effectiveness of current controls, and this is now also a standard operational procedure for our staff. These steps, as much as our limited resources will allow us to apply them, certainly put us in position to improve even more on the internal controls that are necessary in this area.

2. INTERNAL CONTROL RELATED TO CONTRACTED INVESTMENT SERVICES NEEDS IMPROVEMENT

The Department had internal control weaknesses related to investment buy and sell activities made by investment managers on contract with the Department. Without adequate control, there is an increased risk that the Department may have significant deficiencies in its ability to properly initiate, record, process and report certain financial data.

- Prior to the creation of a single equity trust, the Department had accepted financial information reported by investment managers without reviewing the underlying supporting details. Consequently, when numerous equity trusts were recently transferred to a single trust, the Department discovered a $4.4 billion error in prior year reporting of realized gains/losses. While this error did not affect the net earnings of the Investment Pool, it did impact the timing of distributions made to participants of the State Treasurer's Investment Pool.

- Because the Department did not receive or review investment manager prepared reconciliations, errors in the custodian prepared summary report went undetected. After the creation of the single trust, investment managers were required to prepare a reconciliation of their net asset values with those recorded by the custodian. The custodian then prepared a summary reconciliation and provided it to the Department. However, during our audit, we obtained investment manager reconciliations and determined that some were not properly prepared. The Department's control was to only review the summary reconciliation prepared by the custodian.

Recommendation: The Department should expand its internal control related to critical investment services provided by external organizations. The Department should review closely the equity trust transaction process, monitor the effectiveness of current controls, and design any additional procedures that are needed.

Agency's Response: The Department staff had already detected the weakness noted, and taken corrective action during the audit year in question. Additional controls were implemented in March 2002 before the audit of the Pool began, and while the Department agrees a weakness existed, it was corrected by year-end.

3. MEMBERSHIP ON THE INVESTMENT ADVISORY COMMITTEE DOES NOT COMPLY WITH STATUTORY REQUIREMENTS

The present membership of the Investment Advisory Committee does not comply with the technical wording of the General Statutes. Consequently, the Retirement Systems were underrepresented.

Under General Statute 147-69.2 (b1), the State Treasurer shall appoint an Investment Advisory Committee, which shall consist of five members: the State Treasurer; two members selected from among the members of the boards of trustees of the Retirement Systems; and two members selected from the general public.

For the period from January 2002 through June 2002, the Investment Advisory Committee contained only one member from among the boards of trustees of the Retirement Systems. The Department indicated that the Treasurer was in the process of securing another retirement system board member, however this was not done by the completion of our field work.

In addition, since taking office in January 2001, the State Treasurer has increased the Committee's membership to seven as of June 30, 2002. Although, the General Statutes specifically outline the makeup of the Committee, including its size, the Department stated that the Treasurer wanted to add a fuller representation of perspectives to the committee. Since the language in the law is, "shall consist of five members", not, "shall consist of no more than five," they felt the additional members did not violate the spirit of the law.

Recommendation: The State Treasurer should review the statutes and take necessary actions to ensure compliance. If additional members or a different membership composition is deemed necessary, then the Department should obtain legislative authorization from the General Assembly by changing the existing law.

Agency's Response: We have reviewed the audit finding and acknowledge the issue raised. The State Treasurer concurs that two retirement system board members must serve on the Investment Advisory Committee (IAC) to comply with the law. Regarding the question of the number of members of the IAC, it is stated correctly in your narrative on the finding that the State Treasurer is of the opinion that there is flexibility implied in the existing statutes regarding this committee, which is a purely advisory body, and directly stated in North Carolina General Statute 147-69.3(g) which gives the State Treasurer the authority to "retain the services of independent appraisers, auditors, actuaries, attorneys, investment counseling firms, statisticians, custodians, or other persons or firms possessing specialized skills or knowledge necessary for the proper administration of investment programs…" The State Treasurer, in his management of increasingly complex and diverse investment programs, wants to ensure that he receives the best possible counsel from a full compliment of those with appropriate expertise and professional experience, and has indeed asked some individuals in addition to the five members referenced in North Carolina General Statute 147-69.2(b1) to attend and take part in the discussions at meetings of the IAC.

4. VIOLATION OF THE NORTH CAROLINA ADMINISTRATIVE CODE

Ten checks were written out of the Equity Investment Fund (EIF) commission recapture program for expenditures that benefited other funds, such as the Real Estate Investment Fund (REIF), Long-term Investment Fund (LTIF), and Venture Capital Investment Fund. The total amount of checks written that related to those other funds was $34,028.94, or 61% of the total commission recapture expenditures incurred during the year. Having the EIF pay for expenditures of other funds is a violation of the North Carolina Administrative Code (NCAC).

NCAC Title 20, Subchapter 1G, Section .0101 states that there shall be separate investment funds for Short-term Investments (STIF), (LTIF), (EIF) and (REIF). Section .0105 states that costs directly applicable to an investment fund shall be allocated to that fund. In addition, Sections .0304, .0404, and .0504 state that all income earned less the investment fund's share of the investment management expenses shall be distributed pro rata to each participant with ownership units.

Recommendation: Revenues from the EIF should only be used to pay for management expenses that are applicable to the EIF. As required by the NCAC, management costs directly applicable to an investment fund should be allocated to that fund. All indirect costs should be allocated so that each investment fund bears its proportionate share of the costs.

Agency's Response: We have reviewed the audit finding and agree with your recommendation. The amount in question of $34,028.94 was certainly not material to the total investment management and banking costs allocated to the Long-term Investment Fund, the Real Estate Investment Fund and the Venture Capital Investment Fund for the fiscal year under audit. The total cost allocated for the year under audit was $3,840,509. Also, it is important to recognize the fact that the total investment income distributed to the Pension Funds during the year under audit was correct and not impacted by this audit finding.

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In accordance with General Statutes 147-64.5 and 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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April 2, 2003

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