STATE OF NORTH CAROLINA

FISCAL CONTROL AUDIT REPORT ON

THE OFFICE OF THE GOVERNOR

RALEIGH, NORTH CAROLINA

FOR THE PERIOD JULY 1, 2002 THROUGH JANUARY 31, 2003

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

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THE HONORABLE MICHAEL F. EASLEY
GOVERNOR

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AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Ms. Susan Rabon, Senior Assistant for Administration, Office of the Governor
Mr. David T. McCoy, State Budget Officer

This report presents the results of our fiscal control audit of the Office of the Governor for the period July 1, 2002 through January 31, 2003. Our work was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes* and was conducted in accordance with the standards contained in *Government Auditing Standards* issued by the Comptroller General of the United States. The objective of the audit was to gather and evaluate evidence about selected internal control policies and procedures designed to ensure reliable financial accounting and reporting and compliance with finance-related laws, regulations, and contract provisions.

The results of our audit disclosed significant weaknesses in internal control and management control issues that are described in the Audit Findings and Recommendations section of this report.

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Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

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BACKGROUND INFORMATION

The Governor has many roles. His constitutional and statutory duties include the roles of Chief Executive, Director of the Budget, Commander-in-Chief of the State military, and Chairman of the Council of State. He is directed to ensure that all State laws are faithfully executed and has the authority to convene extra sessions of the General Assembly. He has final authority over all State expenditures and ultimate responsibility for administration of federal funds and loans.

The Office of the Governor and its staff exist to help the Governor carry out his responsibilities and serve at his pleasure. The Governor's staff advises the Governor on policy matters; serve as liaisons to the public, media and legislature; and supports the administrative operation of the Governor's Office. The Office of the Governor has offices in Raleigh, New Bern, Asheville, and Washington D.C.

In addition to the Governor's internal staff, there are key offices reporting to the Governor through Senior Assistants. These offices include:

- Office of State Budget and Management (OSBM)
- Information Technology Services
- Office of State Personnel

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OBJECTIVES, SCOPE, METHODOLOGY, AND RESULTS

OBJECTIVES

As authorized by Article 5A of Chapter 147 of the *North Carolina General Statutes* and in accordance with the standards contained in *Government Auditing Standards* issued by the Comptroller General of the United States, we have conducted a fiscal control audit at the Office of the Governor. The objective of the audit was to gather and evaluate evidence about selected internal control policies and procedures designed to ensure reliable financial accounting and reporting and compliance with finance-related laws, regulations, and contract provisions for the period July 1, 2002 through January 31, 2003.

Management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that relevant objectives are achieved. Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

SCOPE

Our audit scope included selected internal controls in the following areas:

<u>Financial Accounting and Reporting</u>

Revenue Cycle – Public School Building Fund – The entity's revenue cycle consists of the activities associated with the receipt of cash and billing for amounts due from other parties. The financial statement account impacted by this cycle for the Public School Building Fund is interest income.

Expenditure Cycle – Office of the Governor General Fund, OSBM General Fund, and Public School Building Fund – The entity's expenditure cycle consists of the activities associated with disbursing cash for items other than payroll costs. Financial statement accounts impacted by this cycle include supplies, travel, services, capital outlay, and grants.

<u>Finance-related Compliance</u>

Procurement - Laws, regulations, and/or contracts prescribe purchasing procedures for certain types of transactions and specified dollar thresholds. The North Carolina Administrative Code establishes requirements for the procurement of goods and services by State agencies including requisitioning, approval and solicitation procedures.

Travel - Laws, regulations, and/or contracts set reimbursement requirements and limits on amounts paid for travel, transportation, subsistence, and related activities.

Special Provisions – Public School Building Fund – The North Carolina General Statutes specify the requirements for the allocation and use of funds in the Public School Building Fund.

Special Provisions – More at Four Pre-Kindergarten Program – Classification of Contracts and Local Contribution Requirement – The North Carolina Administrative Code identifies criteria to be used in determining whether a contract should be classified as purchase of service or financial assistance. Also, the State Appropriations Act requires the More at Four Pre-Kindergarten Program to include a local contribution.

METHODOLOGY

To accomplish our audit objective, we gained an understanding of internal control and performed tests of control effectiveness as we considered necessary in the circumstances. Specifically, we performed procedures such as interviewing personnel, observing operations, reviewing policies, analyzing accounting records, and examining documentation supporting recorded transactions and balances. Our procedures were more limited than would be necessary to give an opinion on internal control, and accordingly, we do not express such an opinion.

RESULTS

The results of our audit disclosed significant weaknesses in internal control and management control issues that are described in the Audit Findings and Recommendations section of this report. The purpose of this report is to provide management and oversight organizations recommendations needed to improve internal control over financial accounting and reporting and compliance with finance-related laws, regulations, and contract provisions. Consequently, reporting on accomplishments in areas that appear to be functioning properly is beyond the scope of this audit.

AUDIT FINDINGS AND RECOMMENDATIONS

Matters Related to Financial Accounting, Reporting, or Compliance

Current Year Findings and Recommendations - The following findings and recommendations were identified during the current audit and describe conditions that represent significant deficiencies in internal control over financial accounting and reporting or noncompliance with finance-related laws, regulations, and contract provisions.

1. MORE AT FOUR CONTRACTS CLASSIFIED AS PURCHASE OF SERVICE RATHER THAN FINANCIAL ASSISTANCE

The More at Four Office (State Office) has classified its More at Four Pre-Kindergarten Program contract activities as purchases of services. Our review disclosed that these contracts should instead be classified as financial assistance, not unlike similarly constructed State and federal programs. As a result of classifying these contracts as purchases of services, recipients receiving $300,000 or more in More at Four funds are subject to less State oversight than that required of other governmental and nongovernmental organizations receiving State funds. For instance,

- The More at Four funds are not required to be audited, accounted for or reported to the State Auditor and the Office of State Budget and Management as prescribed in General Statute 143-6.1. In fact, the State Office amended its 2003 contract template to specifically state that the More at Four Program was not subject to General Statute 143-6.1 and that an audit is not required for the contract.

- A State Compliance Supplement is not required for the More at Four Program as required of all other State grants.

- The program is not subject to a compliance audit at the local level as are State programs that are classified as financial assistance grants.

Title 10A of the North Carolina Administrative Code, Subchapter 1A, Section .1003, lists the general criteria for classifying payments to grantees, including the following:

- A recipient/sub-recipient is distinguished from a vendor (purchase of service agreement) by the degree of responsibility assumed to meet the requirements of the program.

- A vendor normally operates in a competitive environment and once a predetermined unit price has been established in a contract, usually there is no interest in how the vendor expends funds in meeting the vendor’s obligation under the terms of the contract.

- Although recipients/sub-recipients generally have cost reimbursement grants/contracts, it is possible for them to have a fee/rate per unit of service arrangement.

The State Office views this program as a purchase of service because the program is controlled from the State level. Services are paid for on a fee per slot basis similar to purchase of service activities. If the service is not rendered, then payment does not occur.

A fee or rate per unit of service is a legitimate form of payment under either contract structure; therefore, it is not a deciding factor when determining how to classify a program. Also, the first reason cited by the State Office, that of control from the State level, is a reason for, not against, classifying the program as a financial assistance contract. The considerable amount of control and the additional requirements imposed on the More at Four contractors by the State Office make this much more than a simple transaction where an amount is paid for a readily recognizable product or service.

The transaction and the State Office's relationship with its contractors are more complex. The purpose of the contracts is to carry out a public purpose to support the State's education initiatives. The State Office has precisely defined the services needed and has required many administrative activities internal to the recipient organizations. There is a strong interest in how, and for what, recipients expend funds in meeting their obligations. The State has dictated how the service will be produced, not merely, that it will be produced.

Some of the compliance requirements and administrative responsibilities the State Office has passed down to recipient organizations include:

- Making eligibility determinations based upon predetermined eligibility requirements.

- Program planning including development of a countywide plan for serving the number of funded slots allocated to the county.

- Compliance with program requirements such as staff credentials and standards, classroom size, adult to child ratios, and facility licensing requirements.

- Monitoring sub-recipients for programmatic and financial compliance.

- The use of start-up funds is restricted and grantees must report the use of those funds to the More at Four Program. Although grantees are not required to report monthly expenditures by line item, the restrictions and reporting requirements on the use of start-up funds and the programmatic and financial monitoring requirements indicate that there is an interest in how the recipients expend funds in meeting the obligations under the contract.

Monitoring of recipient organizations is a key component of the program. Given the detailed, specific requirements of the program, it would be nearly impossible to verify performance without the independent verification afforded by on-site monitoring. Indeed, the existence of the need to monitor to verify compliance is another very strong indication that what exists here is a grantor/grantee relationship. Vendors typically are not told how to do their jobs, either on or off their premises.

Recommendation: The State Office should classify the More at Four contracts as financial assistance contracts and require compliance with General Statute 143-6.1. To so classify them would make program operators more accountable, would provide the State Office and the legislature an unbiased assessment independent of program staff, and would help to preserve the long-term integrity of the program.

Agency's Response: We respectfully disagree with the Auditor's conclusion that the More at Four contracts be classified as financial assistance rather than purchase of service contracts. The Auditor's conclusion is bottomed on the belief that a financial assistance contract provides greater oversight and accountability. We disagree.

The More at Four Office and each of our contractors (approximately half local partnerships and half public school systems) are all annually audited by either the Office of the State Auditor or an independent auditor. Moreover, the purchase of service contract provides a strong accountability structure for the expenditure of all funds. Payment to the contractor is made only after the More at Four Office has received and reviewed written documentation that an eligible four-year old child has received the service from a (More at Four Office) pre-approved (1) site, (2) credentialed principal/director, and (3) teacher or assistant teacher, using the curriculum approved by the More at Four Office.

Finally, there is absolutely nothing in either State law or regulation prohibiting the More at Four Office from classifying these transactions as purchase of service contracts.

Auditor's Note: Criteria included in North Carolina Administrative Code and precedent set by other State programs such as Smart Start suggest that the More at Four contracts should be classified as "financial assistance." State funds granted as financial assistance to nongovernmental organizations are by General Statute 143-6.1 subject to additional State oversight. Likewise, State funds granted as financial assistance to local governmental units are by General Statute 159-34 subject to additional State oversight. This additional oversight, examples of which are included in the body of this finding, does not extend to State funds classified as "purchase of service."

2. STATE FUNDS ARE BEING CHARACTERIZED AS LOCAL CONTRIBUTIONS IN THE MORE AT FOUR PRE-KINDERGARTEN PROGRAM

The More at Four Office (State Office) has defined the types of funds that can be considered "local contributions" by recipient organizations to include "federal, State, and local funds." We are not aware of any other State or federal program where State or federal funds are characterized as local funds.

Even though certain documents prepared by the State Office for the General Assembly include the State Office definition of local contributions, the potential exists for the General Assembly and other knowledgeable third parties to misinterpret information regarding local contributions related to the More at Four Program. Misinterpretation of local contributions could lead to audit failures at the recipient organizations and incorrect program assessment of financial participation by the State, federal government, and local governmental units.

Characterizing federal and State funds as local funds is inconsistent with generally accepted and defined concepts employed elsewhere. The federal government through OMB Circular A-87 has defined "state" to be "exclusive of local governments." Its definition of local government includes counties, municipalities, school districts, and other instrumentalities of a local government. It is clear from the guidance that there is a distinct separation between the two levels of government.

No State agency with statewide oversight authority has promulgated rules and regulations regarding the administration and expenditure of State funds at the grantee level, much less the composition of local contributions. State law is silent to the composition of a local contribution for the More at Four Program except to say that "Programs must demonstrate that they are accessing resources other than "More at Four."

Recommendation: The State Office should change the definition of local contribution in the program guidelines to exclude State and federal pass through funds. The point of redefining local funds is not to stifle or to prohibit the use of other State funds, such as Smart Start, in the More at Four program. Such use appears to be not only allowed but also encouraged by the More at Four legislation. In addition, the State Office should consult with the Office of State Budget and Management to determine what types of funding should be included in the definition of local contributions. The result could lead to proposed legislative changes to improve the overall functioning, uniform reporting and accountability of all State funds at the local level. A need exists for a consistent application of requirements regarding the administration and allowable uses of all State funds.

Agency's Response: We respectfully disagree that our definition of "local contribution" in the program guidelines should exclude the use of any state funds.

When the 2001 General Assembly established the More at Four Program, it defined "a local contribution" as follows: "Programs must demonstrate that they are accessing resources other than 'More at Four'." 2001 N.C. Sess. Laws 424, Sec. 21.76B. (c)(19). The 2003 General Assembly defined "a local contribution" the same as it did in 2001. See, 2003 N.C. Sess. Laws 397, Sec. 10.40 (c)(10). Clearly, therefore, the General Assembly did not prohibit the use of state funds, other than More at Four funds, in meeting the program's "local contribution" requirement. To the contrary, and as the State Auditor has acknowledged in this audit finding, the General Assembly encouraged the use of other State funds, such as Smart Start, in the More at Four Program. See, 2001 Sess. Laws 424, Sec. 21.76B.(j).

Finally, and as mandated by the General Assembly, the More at Four Office has each year reported that its definition of "local contribution" included using state funds such as Smart Start funds to: (1) the Joint Legislative Commission on Governmental Operations; (2) the Joint Legislature Education Oversight Committee; (3) the Senate Appropriations Committee on Health and Human Services; and (4) the House of Representatives Appropriations Sub-committee on Health and Human Services.

Auditor's Note: The definition of local funds prescribed by the More at Four Office is unlike the definition commonly used by other State and federal programs. We recommend **uniform** accountability requirements for all State funds and encourage the More at Four Office to work with the Office of State Budget and Management to this end.

3. INADEQUATE SEGREGATION OF DUTIES

Duties were not adequately segregated in the Governor's Office bill payment process. The person who authorizes invoices for payment also submits purchase orders and receives goods. Inadequate segregation of duties increases the risk that errors and irregularities may occur and not be detected.

The Office of the State Controller requires all State agencies to design and implement internal control procedures that provide adequate segregation of duties. Adequate segregation of duties ensures that no one individual can authorize and record transactions, issue and receive assets, and reconcile assets to accounting records.

Recommendation: The Governor's Office has developed an internal purchasing procedures policy that addresses segregation of duties. The Governor's Office should ensure that all personnel adhere to the policy.

Agency's Response: Eight months ago on April 3, 2003, the Office of the Governor implemented Purchasing Procedure Policies to address any potential concerns about its purchasing practices. The engagement letter for this audit was sent on March 4, 2003. For over seven months, the State Auditor's Office has been aware of the adoption of these new policies and procedures. Duties in the Governor's Office with regard to the bill payment process have been segregated during this entire time period. We respectfully suggest, therefore, that the recommendation is unnecessary as the concern it addresses has long since been remedied.

Auditor's Note: *Government Auditing Standards* and Office of the State Auditor audit policy require that deficiencies in internal control, which existed during the audit period and detected during the course of an audit, be reported by the State Auditor in its audit report. Such deficiencies are reported even in circumstances where corrective actions are subsequently taken during the course of the audit or prior to the release of the audit report.

4. NO WRITTEN POLICIES AND PROCEDURES FOR SMALL PURCHASES

The Governor's Office did not have written policies and procedures for small purchases as required by section V-2 of the State purchasing manual. Small purchases are defined as purchases of $5,000 or less and which are not covered by a term contract. The Governor's Office currently uses the State purchasing manual, which does not outline specific procedures for small purchases.

Recommendation: The Governor's Office has developed an internal purchasing procedures policy that includes procedures for small purchases. The Governor's Office should take steps to ensure that all personnel involved in the procurement process adhere to the policy.

Agency's Response: Eight months ago on April 3, 2003, the Office of the Governor implemented Purchasing Procedure Policies to address any potential concerns about its purchasing practices. The engagement letter for this audit was sent on March 4, 2003. For over seven months, the State Auditor's Office has been aware of the adoption of these new policies and procedures. Duties in the Governor's Office with regard to the bill payment process have been segregated during this entire time period. We respectfully suggest, therefore, that the recommendation is unnecessary as the concern it addresses has long since been remedied.

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5. INTERNAL CONTROL WEAKNESSES OVER THE BILL PAYMENT PROCESS

There were internal control weaknesses in the Governor's Office bill payment process. Our examination of thirty-nine payments disclosed the following:

- The Governor's Office did not use purchase requisitions and purchase orders for thirteen purchases. The Governor's Office has stated that verbal approvals for these purchases were obtained before purchases were made and that written approvals were obtained after the invoices were received.

- Two invoices were paid without written authorization.

- Eight transactions did not have documentation of verbal or written quotes being obtained. Five of these transactions were monthly recurring expenditures.

The absence of purchase orders, requisitions, and authorizations increases the risk of errors, misstatements, unauthorized purchases, and/or irregularities. Internal controls should be designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Section V-7 of the State purchasing manual requires all purchase transactions to be documented. Such documentation should consist of, as applicable, original offers in writing or written documentation of verbal offers received and written justification for waiver or emergency purchases.

Recommendation: The Governor's Office should use purchase requisitions and purchase orders, including blanket purchase orders, as required by the State purchasing manual. Requisitions should be completed by persons requesting the goods and services and approved by their supervisors or other authorized person prior to the procurement of goods and services. Procurement files should contain documentation of competition being solicited or written justification for waiver or emergency purchases when applicable. Invoices should be approved prior to payment. The Governor's Office has developed an internal purchasing procedures policy that outlines the procedures for obtaining verbal and written quotes, the approval process for small or immediate purchases and contracts, and the use of blanket purchase orders. The Governor's Office should take steps to ensure that all personnel involved in the procurement process adhere to the policy.

Agency's Response: Eight months ago on April 3, 2003, the Office of the Governor implemented Purchasing Procedure Policies to address any potential concerns about its purchasing practices. The engagement letter for this audit was sent on March 4, 2003. For over seven months, the State Auditor's Office has been aware of the adoption of these new policies and procedures. Duties in the Governor's Office with regard to the bill payment process have been segregated during this entire time period. We respectfully suggest, therefore, that the recommendation is unnecessary as the concern it addresses has long since been remedied.

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December 30, 2003

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