



# **STATE OF NORTH CAROLINA**

**FISCAL CONTROL AUDIT REPORT ON  
NORTH CAROLINA DEPARTMENT OF INSURANCE  
RALEIGH, NORTH CAROLINA  
FOR THE PERIOD JULY 1, 2002 THROUGH FEBRUARY 28, 2003**

**OFFICE OF THE STATE AUDITOR**

**RALPH CAMPBELL, JR.**

**STATE AUDITOR**

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NORTH CAROLINA DEPARTMENT OF INSURANCE  
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**THE HONORABLE JAMES E. LONG  
COMMISSIONER OF INSURANCE**



Ralph Campbell, Jr.  
State Auditor

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## AUDITOR'S TRANSMITTAL

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The Honorable Michael F. Easley, Governor  
The General Assembly of North Carolina  
The Honorable James E. Long, Commissioner,  
North Carolina Department of Insurance

This report presents the results of our fiscal control audit of the North Carolina Department of Insurance for the period July 1, 2002 through February 28, 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 significant instances of noncompliance that are described in 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.

A handwritten signature in black ink that reads "Ralph Campbell, Jr." in a cursive script.

Ralph Campbell, Jr.  
State Auditor

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## **BACKGROUND INFORMATION**

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The North Carolina Department of Insurance (the Department) was created in 1899 by the General Assembly. In general, the Department is responsible for regulating the various kinds of insurance sold in the State as well as the companies and agents that sell it. The Department also regulates motor clubs, collection agencies, and bail bondsmen. In addition, the Department administers the State building code, regulates manufactured housing, and administers the self-insurance fund for State owned property. The main statutory authority for the Department is contained in Chapter 58 of the General Statutes.

In order to carry out its duties, the Department is divided into five sections:

1. Administration
  - a. Commissioner's Office
  - b. Personnel
  - c. Office of the General Counsel
  - d. Media Regulations Office
  - e. Controller's Office
  - f. Legislative Liaison
2. Public Services Group
  - a. Agent Services Division
  - b. Consumer Services Division
  - c. Investigations Division
3. Company Services Group
  - a. Financial Evaluation Division
  - b. Actuarial Services Division
  - c. Information Systems Division
  - d. Administrative Supervision Division
  - e. Estate Operations Division
4. Technical Services Group
  - a. Property and Casualty Division
  - b. Life and Health Division
  - c. Market Examinations Division
  - d. Seniors Health Insurance Information Program
  - e. Managed Care and Health Benefits Division
  - f. Health Care External Review Division

## **BACKGROUND INFORMATION (CONCLUDED)**

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5. Office of the State Fire Marshal
  - a. Engineering Division
  - b. Manufactured Building Division
  - c. Risk Management Division
  - d. Fire and Rescue Commission
  - e. Program Development, Prevention, and Grants Division
  - f. Fire and Rescue Training and Inspections Division

## **OBJECTIVES, SCOPE, METHODOLOGY, AND RESULTS**

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### **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 North Carolina Department of Insurance. 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 February 28, 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:

#### General

*Control Environment* - The control environment consists of the actions, policies, and procedures that reflect the overall attitude of top management about control and its importance to the agency. The control environment sets the tone of the organization, influencing the control consciousness of its employees.

#### Financial Accounting and Reporting

*Revenue Cycle* - An agency's revenue cycle generally consists of the activities associated with the receipt of cash and billing for amounts due from other parties. Financial statement accounts typically impacted by the cycle include cash, accounts receivable, taxes, intergovernmental grants, sales and services, fees, contributions and gifts, and transfers in. Our audit included certain revenue items (sale of publications, fees, licenses, fines, and insurance premiums) collected by the following divisions: Agent Services, Property and Casualty, Engineering, Risk Management, Manufactured Building, and the Controllers Office.

## **OBJECTIVES, SCOPE, METHODOLOGY, AND RESULTS (CONTINUED)**

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*Surety Cycle* - The surety cycle consists of the activities associated with the receipt and accounting for surety deposits held in trust for certain organizations doing business in North Carolina such as insurance companies; manufacturers, dealers, and set-up agents of manufactured housing; and bail bondsmen. The surety deposits, consisting of various assets such as cash deposits, interest bearing bonds, and certificates of deposit, were subjected to audit. The surety deposits are in safekeeping with a surety agent or the State Treasurer as required by general statutes.

### **Finance-related Compliance**

*Deposit of Receipts* - Laws and regulations require State agencies to deposit moneys coming into their control as soon as possible in order to safeguard assets and to enhance the cash management and investment program. For example, receipts over a specified amount may be required to be deposited on a daily basis.

*Sureties* - Laws and regulations require certain organizations to maintain surety deposits with the State Treasurer or a designated surety agent as a prerequisite of doing business in North Carolina. The surety deposit provides assurance that the organization intends to comply with those laws and regulations. For example, bail bondsmen and insurance companies applying for licenses in North Carolina are required to make a surety deposit with the designated surety agent.

*Monitoring* - Laws, regulations, and/or contracts commonly require State agencies to monitor their grantees or to regulate organizations under their realm of authority to ensure that they comply with General Statutes. For example, the Department may visit insurance companies and agents to determine compliance with standards established in the statutes. Our audit was limited to the Financial Evaluation, Market Examination, Agent Services and Managed Care and Health Benefits divisions.

## **METHODOLOGY**

To accomplish our audit objective, we gained an understanding of internal control, performed tests of control effectiveness, and performed corroborating direct tests of the accounting records, reports, and/or compliance 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 significant instances of noncompliance 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.

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## AUDIT FINDINGS AND RECOMMENDATIONS

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### 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. CONTROLS OVER CASH RECEIPTS NEED IMPROVEMENT

The following weaknesses were noted in the Department's processing of cash receipts:

- The Manufactured Housing and Engineering Divisions did not send copies of prenumbered receipts along with the deposits to the Controller's Office as required by the Department's Cash Management Plan, preventing independent verification of amounts received.
- The Engineering Division did not use prenumbered receipts for the sale of building codebooks. Instead, the Division used invoices/order forms, which were not prenumbered.
- The Controller's Office did not maintain a control log for the unused receipt books on hand. These books were kept in an unlocked file cabinet.

The risk of theft and misuse of cash increases when prenumbered receipts are not used. Good internal controls require prenumbered receipts to be accounted for and controlled.

*Recommendation:* The Department should enforce policies and procedures outlined in its Cash Management plan. Prenumbered receipts should be used for all cash collections. The receipts should be accounted for and matched to actual deposits. The Controller's Office should also establish a log of receipt books on hand and should maintain the receipt books in a secured place.

*Response:* The following procedures have been implemented to ensure that the above audit findings and recommendations are addressed:

- The Controller's Office has informed the Manufactured Housing and Engineering Divisions to send the pink copies of the prenumbered receipts used for cash transactions with the deposits to the Controller's Office. As a result, the Divisions are now sending the pink copy of the cash receipt along with their cash deposits and are now in compliance with the Department's Cash Management Plan. Upon receipt of the cash deposits, the Controller's Office is verifying that all cash receipts are accounted for and matched to actual deposits.

## AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

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- The Engineering Division is now using prenumbered receipts for the cash sales of building code books in addition to the order forms. The pink copy of the prenumbered receipt is being sent to the Controller's Office along with the cash deposit. The Controller's Office is verifying that all cash receipts are accounted for and matched to actual deposits.
- The Controller's Office has implemented procedures that include maintaining a control log of all unused receipt books on hand. This log is updated each time new shipments of receipt books are received and when a receipt book is issued to a division. In addition, the Department of Insurance has established procedures to ensure that the unused receipt books are locked in a file cabinet at all times. Additionally, when completed receipt books are returned to the Controller's Office they are being reviewed to ensure that all receipts (copy that is maintained in the receipt book) have been accounted for in the book.

### 2. LARGE AMOUNTS OF FUNDS WERE NOT DEPOSITED IN A TIMELY MANNER

The Agent Services Division did not deposit receipts daily and intact in accordance with the requirements of the Daily Deposit Act. There were thirty-two batches of checks, received by the Division between February 11 and March 6, 2003 and estimated to total in excess of \$300,000, that had not been processed or deposited as of March 10. The largest batch contained \$269,415 and was received on March 6. Also, it was noted that the checks were stored in an unlocked file cabinet, had not been restrictively endorsed, and were not included on a mail receipt log.

Failure to process, maintain, and deposit cash in accordance with the Daily Deposit Act exposes the Division to risk of misappropriation of funds. In addition, the State lost the opportunity to earn interest on these amounts had they been deposited in a timely manner.

*Recommendation:* The Division should deposit receipts daily and intact in accordance with the Daily Deposit Act. The Division should maintain a check log and place restrictive endorsements on checks as soon as possible. Also, when temporary storage is required, checks should always be maintained and stored in a secure environment.

*Response:* The Division acknowledges the concerns raised and concludes that these concerns have existed for many years as evidenced by previous audit reports. To fully resolve the concern, the Division will require permanent clerical accounting employees. As resources have not been forthcoming, the Division is currently utilizing temporary employees as an interim solution.

Additionally, as the Division moves forth with adherence to national treatment of agent licensing matters, the Division anticipates signing onto programs/mechanisms wherein monies are centrally deposited and forwarded to the Division by means of electronic fund

## AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

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transfers. It is estimated that these programs/mechanisms will be available some two to three years from now.

In the interim, the Division will utilize temporary employees such that adherence to the Daily Deposit Act will occur. The Division will also ensure that when temporary storage is required, checks will be stored in a secure environment.

### 3. INDEPENDENT RECONCILIATION OF SURETY DEPOSITS NOT PERFORMED

The Department did not reconcile surety deposits reported by the surety agent to documentation maintained by the Department. The total February 2003 surety deposit balances for insurance companies and bail bondsmen were \$540.7 million and \$12.4 million, respectively. Unless a reconciliation is performed, the Department cannot be assured that the surety agent's balances are correct.

Our tests also revealed that the amount reported for bail bondsmen in the accounting records at February 2003 exceeded the surety agent's balance by \$177,300. The entry to the accounting records that recorded the February monthly activity was based on a memo that did not clearly indicate the amount that should have been recorded. Since the actual balance from the surety agent's records was not reviewed when making the entry and the monthly balance was not reconciled to the surety agent's records, the error was not detected.

Good internal controls dictate that amounts reported by the surety agent be reconciled to the documentation maintained by the Department.

*Recommendation:* Insurance company surety deposits and withdrawals authorized by the Department should be reconciled to balances maintained by the surety agent on at least a monthly basis. Bail bondsmen surety deposits should be reconciled to the acknowledgement letters received by the Department. Also, when reviewing the monthly bail bondsmen reports, the balances reported by the bail bondsmen should be compared to the surety agent's records and any differences should be investigated. In addition, the reconciled balance should be compared to the amount recorded in the accounting records.

*Response:* Insurance Company Surety Deposits

Wachovia Bank, NA, through a Custody Agreement with the Department, maintains surety deposits for insurance companies on behalf of the Commissioner of Insurance. Wachovia engages independent CPA's that, in conjunction with the independent annual audit, also review the internal controls and procedures of Wachovia including the administration of the collateral securities program. The Financial Analysis Division has relied upon this annual audit to ensure that the Bank maintains complete and accurate records in accordance with the Custody Agreement. However, after reviewing the recommendation above, the Division will design and implement, within the next sixty days, procedures whereby this Division will reconcile on a monthly basis, the balance of the deposits held on behalf of the insurance companies.

## **AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)**

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In addition, the Controller's Office will send the Division the insurance companies' surety deposit amounts that are recorded in the North Carolina Accounting System. This information will be sent to the division on a monthly basis and it will enable the Division to reconcile the insurance companies' surety deposits per their internal records and Wachovia's records to the accounting records. This information will also enable the Division to detect any overstatements or understatements of insurance company surety amounts that may be recorded in the accounting system.

### **Bail Bondsmen Surety Deposits**

The Agent Services Division has changed its procedures such that in-depth review of monthly reports submitted by professional bail bondsmen are undertaken. Monthly reports are currently reviewed with a primary emphasis placed on the surety deposit. Additionally, procedures have been implemented to ensure deposits, withdrawals and interest payments from each professional bondsman's account, as received from the custodian (Wachovia) are reconciled on a monthly basis. These transactions will be recorded with information submitted on the professional bail bondsman's monthly report and any discrepancies will be addressed immediately.

In addition, the Controller's Office will send the division the bail bondsmen surety deposit amounts that are recorded in the North Carolina Accounting System. This information will be sent to the Division on a monthly basis and it will enable the division to reconcile the bail bondsmen surety deposits per their internal records and Wachovia's records to the accounting records. This information will also enable the Division to detect any overstatements or understatements of bail bondsmen surety amounts that may be recorded in the accounting system.

#### **4. MONTHLY REPORTING PROCEDURES OVER BAIL BONDSMEN NEED IMPROVEMENT**

The number of bail bondsmen listed on the Department's log used to track the monthly reports submitted by bail bondsmen did not agree with the number of bail bondsmen included on the surety agent's listing. The following differences were noted in the comparison of the monthly log and the surety agent's listing:

- The surety agent's listing contained nineteen bail bondsmen not on the monthly log.
- The monthly log contained six bail bondsmen not on the surety agent's list.

Good internal controls dictate that tracking systems be complete. Until the Department has a complete list of bail bondsmen, it cannot be assured that all required reports are being received.

In addition, the monthly reports submitted by bail bondsmen are not checked to determine that all bonds written by the bondsmen have been listed. Bonds written could be omitted

## AUDIT FINDINGS AND RECOMMENDATIONS (CONCLUDED)

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from the report in order to improperly demonstrate that deposit requirements imposed on bondsmen by North Carolina General Statutes have been met.

*Recommendation:* The Department should ensure that it has a complete listing of all bail bondsmen that are required to submit a report. This log should include all bondsmen on the surety listing as well as the bondsmen without deposits that are still required to submit a report. The reports should be tested on a sample basis to verify that all bonds written by the bondsmen are included. Bondsmen should be informed that this review is being performed.

*Response:* The Division has begun taking steps to put information relative to bail bondsmen in an automated environment. The Division believes that this concern will be erased once programming has been completed.

Prior to this automotive initiative, files on bail bondsmen were kept in paper format. The files became bulky (over a series of renewal periods) and difficult to track regulatory activity through numerous renewal cycles. Reconciliation of these files with reports submitted on a monthly basis made it difficult to maintain the necessary controls for accurate monitoring of the bail bondsmen.

This impending automation will involve linking all licensees to the supervising bondsman and/or surety company and all discrepancies will be handled immediately. This will also create an efficient method of ensuring that all licensees are in compliance with the statutory requirement of timely filing of the monthly report.

### 5. BAIL BONDSMEN'S DEPOSITS BELOW REQUIRED AMOUNTS

Twenty-four bail bondsmen had deposits below the \$15,000 minimum required by North Carolina General Statute 58-71-145. The Bail Bondsman Accounting Procedures Manual does not address monitoring for this requirement. The Department was not aware of a report that could be generated from the surety agent, which identified bail bondsmen with deposits below the \$15,000 minimum.

*Recommendation:* The Department should implement procedures to monitor the minimum surety deposit requirement. The procedures should be addressed in the Accounting Procedures Manual.

*Response:* The Division has implemented procedures to ensure compliance with the statute, which involves reconciling the "below minimum" report from the custodian (Wachovia) on a monthly basis and also from inconsistencies on monthly reports.

Additionally, automation of information on the bail bondsmen is underway and should assist in alleviating concerns in this area.

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## **DISTRIBUTION OF AUDIT REPORT**

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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.

### **EXECUTIVE BRANCH**

The Honorable Michael F. Easley  
The Honorable Beverly M. Perdue  
The Honorable Richard H. Moore  
The Honorable Roy A. Cooper, III  
Mr. David T. McCoy  
Mr. Robert L. Powell  
The Honorable James E. Long

Governor of North Carolina  
Lieutenant Governor of North Carolina  
State Treasurer  
Attorney General  
State Budget Officer  
State Controller  
Commissioner, Department of Insurance

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Speaker of the NC House of Representatives  
NC House and Senate  
Director, Fiscal Research Division

October 2, 2003

## **ORDERING INFORMATION**

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Copies of this report may be obtained by contacting the:

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