STATE OF NORTH CAROLINA

FISCAL CONTROL AUDIT REPORT ON

NORTH CAROLINA DEPARTMENT OF COMMERCE

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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JAMES T. FAIN, III

SECRETARY OF COMMERCE

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AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Mr. James T. Fain, III, Secretary
North Carolina Department of Commerce

This report presents the results of our fiscal control audit of the North Carolina Department of Commerce 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 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.

Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

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BACKGROUND INFORMATION

The Department of Commerce was established as a part of the State Government Reorganization Act of 1971 and consists almost entirely of regulatory agencies. The head of the Department, the Secretary of the Department of Commerce, is appointed by and reports directly to the Governor. The Secretary serves as a member of the Governor's cabinet. Five assistant secretaries and two executive directors assist the Secretary in overseeing the Department's varied programs.

Specifically, the Assistant Secretary for Administration is responsible for several divisions and commissions, including the operations of the Fiscal Management Division and the administrative oversight of the Alcoholic Beverage Control Commission and Warehouse, the Banking Commission, and the Industrial Commission. The responsibilities of these commissions and division include the following:

Fiscal Management Division

The Fiscal Management Division is responsible for the accounting, budgeting, and purchasing functions and for depositing revenue collections of the various divisions and commissions of the Department.

Alcoholic Beverage Control Commission and Warehouse

The purpose of the Alcoholic Beverage Control (ABC) Commission is to provide regulation and control of the manufacture, distribution, advertisement, sale, possession, and consumption of liquors, wines, and malt beverages. The ABC Commission controls the sale of alcoholic beverages in the State through operation of a centralized warehouse, oversight of the local government operated retail sales outlets, and permitting of facilities authorized to sell alcohol in bulk or by the drink.

The ABC Warehouse is a central warehouse for storage, distribution, and monitoring of all liquors sold by the 158 local county and municipal ABC boards in the State. The Commission contracts with J. A. Jones Management Services, Inc. for the storage and distribution of spirituous liquor and the collection of all ABC bailment fees and surcharges for spirituous liquor distributed to the local ABC boards.

Banking Commission

The Banking Commission is responsible for chartering and regulating North Carolina's state-chartered banks, branches and trust companies, as well as registration and licensing of various financial institutions operating in the State, including check-cashers, consumer finance companies, mortgage bankers and mortgage brokers, money transmitters and refund anticipation lenders.

Industrial Commission

The Industrial Commission administers the Workers' Compensation Act for employers and employees in the State to protect them against loss due to work-related injury or disease. The Industrial Commission also has jurisdiction over tort claims against the State and claims by families of law enforcement officers, fire fighters, and rescue squad workers.

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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 North Carolina Department of Commerce. 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>General</u>

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.

<u>Financial Accounting and Reporting</u>

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 collected by the Fiscal Management Division, the ABC Commission, the Banking Commission, and the Industrial Commission.

Finance-related Compliance

Receivable Collection - Laws and regulations impose requirements on State agencies to exercise due diligence and execute specific procedures to collect amounts owed by outside parties. For example, amounts unpaid for a specified period may be required to be turned over for collection. Our audit included certain receivable collections of the Fiscal Management Division, the ABC Commission, the Banking Commission, and the Industrial Commission.

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. Practices related to depositing of receipts by the Fiscal Management Division, the ABC Commission, the Banking Commission, and the Industrial Commission were included in our audit.

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.

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.

ALCOHOL BEVERAGE CONTROL COMMISSION

1. CONTROLS OVER CASH RECEIPTS ARE INADEQUATE

We noted the following internal control weaknesses related to cash receipts of the Alcohol Beverage Control Commission:

- The Commission does not prepare a daily mail receipts log and was unable to document when mail collections were received.

- The receipt forms used by the Commission are not prenumbered.

- Receipts for cash are not always written.

- Copies of receipts are not submitted with the deposit documentation taken to the Fiscal Management Division. The Commission could not document which receipts supported the individual deposits taken to the Fiscal Management Division.

- The legal section does not deposit receipts on the next business date following the date of collection. The legal section holds daily collections, ranging from $100 to $3,000, until the end of the week before taking them to the Fiscal Management Division for deposit. We identified an instance in which cash receipts of $1,900 were held for one month before being deposited.

Failure to process and deposit cash in accordance with good management practices and the Daily Deposit Act exposes the Commission to risk of misappropriation of funds. In addition, the State loses the interest it could earn on these amounts if they were deposited as required.

Recommendation: The Commission should prepare a daily mail receipts log, document when mail collections are received, clearly document all amounts submitted for deposit, and should make timely deposits as required by the Daily Deposit Act. Prenumbered receipt forms should be used and accounted for, both used and unused. Receipts should be written for all amounts received, whether in cash or check.

The Department of Commerce should ensure that the Commission has instituted corrective action. The Department should also review its policies and procedures related to the cash receipting process, should appraise the receipts practices of the various other divisions and commissions of the Department and should require that all divisions and commissions comply with established department policies and procedures and the Daily Deposit Act.

Department's Response: The ABC Commission has instituted corrective action. Cash receipt forms have been incorporated into the Commission's automated accounting system and support all individual deposits. The accounting system logs all mail and walk-in receipts, which are processed when received and submitted daily for deposit to the Department.

The Department has policies and procedures in place relating to cash receipting process and the Daily Deposit Act. These policies are available to all employees on the Commerce Intranet. All divisions and commissions are required to comply with these established policies. Fiscal Management has met with the acting Chair of the ABC Board and staff members and discussed all findings.

2. OVERSIGHT OF WAREHOUSE CONTRACT NEEDS IMPROVEMENT

The following control weaknesses and noncompliance with the warehouse contract were identified. (The ABC Commission contracted with J. A. Jones Management Services, Inc. for the storage and distribution of spirituous liquor and the collection of all ABC bailment fees and surcharges for spirituous liquor distributed to the local ABC boards.)

- The Commission did not receive an audit report of the financial statements of the warehouse contractor for fiscal year ended October 31, 2002. The audit report is used by the Commission to determine the financial condition of the warehouse contractor and its impact on the performance of the contract.

- The Commission did not obtain an independent audit of the financial records maintained on behalf of the Commission by the warehouse contractor for fiscal year ended 2002. In prior periods, an independent CPA firm conducted audits and prepared a "Schedule of Selected Accounts Information" of warehouse operations. The last audit was conducted for State fiscal year ended 2001.

  This independent audit is the Commission's primary mechanism of oversight of the financial records maintained by the warehouse contractor. The purpose of the audit is to gain assurance that the financial records are reliable and fairly stated and to provide reasonable assurance that bailment fees and surcharges collected are properly recorded in the financial records.

- Software used by the warehouse contractor to track accounts receivable was not programmed to properly age receivables. All distiller receivables for special services, totaling $120,937 on the aged trial balance report as of July 10, 2002, were listed as over 90 days outstanding. However, we identified $45,761 in receivables, with invoice dates from April 12 through June 30, 2002, which indicate that these invoices were not over 90 days outstanding.

Recommendation: The Commission should improve oversight procedures to ensure that the warehouse contractor complies with the terms of the contract. The Commission should request the required audit of the contractor and the independent audit of the selected accounts information and should require that the contractor correct the problem with the accounts receivable aging program.

Department's Response: The Chief Fiscal Officer for Commerce has met with the acting Chair of the ABC Board and discussed all findings.

The Commission has received an unaudited report of the financial statements of the warehouse contractor's parent company, J.A. Jones Services Group, Inc. for fiscal year ended December 31, 2002. The Commission's warehouse contractor is J.A. Jones Global Services, LLC (formerly J.A. Jones Management Services, Inc.), a subsidiary company of J.A. Jones Services Group, Inc., which is a subsidiary of J.A. Jones, Inc. The Commission is unable to obtain a certified financial statement of the contractor for the following reasons: The audit of J.A. Jones Services Group or its parent company, J.A. Jones, Inc. has not been completed for the year ended December 31, 2002. Consequently, they have not provided such audited statements. They have provided the ABC Commission with the unaudited financial statements for the parent company for this period. Certain business circumstances that have arisen at J.A. Jones, Inc. during the past twelve months have resulted in a delay of the completion of this audit and the availability of financial statements.

J. A. Jones, Inc. was a wholly owned subsidiary of Philipp Holzmann, AG. In March 2002, Philipp Holzmann declared insolvency under German law and became subject to the control of a court appointed Administrator. The Administrator has been conducting the sale and liquidation of Philipp Holzmann's assets, including Philipp Holzmann's investment in J.A. Jones, Inc.

In March of 2003, the J.A. Jones, Inc. Board of Directors elected to initiate an aggressive restructuring effort to address liquidity arising as a result of the several years of lack of investment by Philipp Holzmann in J.A. Jones, Inc. and the delays in the sale of Holzmann's stock in J.A. Jones, Inc. At this time, a decision was made to not complete the audit for the year ended December 31, 2002 until the restructuring was completed. It was determined that this restructuring would or may involve several adjustments to the balance sheets of the various J.A. Jones entities to accurately reflect the financial position of the restructured entity. The majority of these adjustments as they relate to J.A. Jones Services Group have been made and are reflected in the statements provided to ABC Commission. Until corporate-wide restructuring is completed, however, these statements remain unaudited.

The Commission is closely monitoring the situation with the contractor's parent companies, and is receiving regular reports on the impact, if any, of the parent's financial situation on the subsidiary companies, including the warehouse contractor. The contractor's management personnel in Raleigh and Charlotte, N.C. are responsive and cooperative in this effort.

The Commission has received an independent audit report of the financial records maintained on behalf of the Commission by the warehouse contractor for fiscal years ended 2002 and 2003. These audit reports were also sent directly to the Office of the State Auditor by the independent CPA firm on June 10, 2003 and September 6, 2003 respectively. They have also been faxed to the Audit Supervisor at the Office of the State Auditor.

The warehouse contractor is currently working with a computer vendor to upgrade all software and hardware at the warehouse. Additional reports will be generated and submitted to the Chairperson and the ABC Administrator on a monthly basis. Monthly reports of accounts receivables at the warehouse will be submitted to the ABC Administrator for signature and forwarding to the Fiscal Management Division for financial reporting.

3. INCORRECT SALES TAX RATES IN THE ABC COMMISSION ACCOUNTING SYSTEM

The Commission's accounting system has not been updated to reflect changes in the sales tax rates. The Commission's accounting system is incorrectly calculating the State and county sales tax on publications at 6%. The sales tax rate is 7% effective December 2002.

Recommendation: The Commission should develop and implement procedures that ensure that the accounting system is updated timely to reflect the proper sales tax rate. Additionally, the Commission should correct the sales tax rates in the accounting system to ensure proper calculation and reimbursement to the State.

Department's Response: Upon verbal notification by the auditor to Fiscal Management of this finding, several members of the Fiscal Management Staff immediately met with staff from the ABC Commission administration.

A contracted IT programmer has entered correct tax rates provided by the Office of the State Controller into the accounting software program.

INDUSTRIAL COMMISSION

4. PRENUMBERED CASH RECEIPTS NOT ALWAYS USED

The Industrial Commission's cash receipting process is not consistent and does not adequately document cash collections. The Commission uses prenumbered receipts in some but not all cases. The receipt book being used at the time of our review contained receipts that were not written sequentially and contained unexplained missing receipt numbers.

The risk of theft and misuse of cash increases when prenumbered receipts are not used or accounted for.

Recommendation: The Commission should comply with established policies and procedures related to the use of prenumbered receipts. Receipt books should be controlled, receipts should be issued for all collections, and all receipts, both used and unused, should be accounted for properly.

Department's Response: The Industrial Commission annually collects in excess of three million dollars in revenues. The majority of this is payment for hearing costs, or fees for the processing of certain agreements entered by attorneys as the result of settled workers' compensation cases. Payments received come from insurance companies, third party administrators and law firms for the most part and these fees are paid by check.

The Commission several years ago outsourced the sale of publications, which was the primary source of cash payments. Therefore the large "walk-in retail trade" (purchase of publications, forms, etc.) that the Commission previously experienced ended. Consequently with outsourcing, cash purchases and the receipt of cash by the agency has ended except for an occasional pro se claimant or tort claimant that chooses to pay fees by cash.

The Commission has initiated the use of a new numbered receipt book for use when in the rare instances cash is received and all receipts both used and unused are accounted for properly.

5. INADEQUATE SEPARATION OF DUTIES

We noted inadequate separation of the receipting and accounts receivable duties at the Industrial Commission. An accounting clerk opens the mail, writes receipts, codes and endorses checks, enters check data into the receipts subsystem, has custody of cash, performs the daily receipt reconciliations, prepares the daily deposit, researches delinquent invoices, reconciles cancellation notices to invoice cancellation report, cancels incorrect billings, prepares correct billings, and writes off delinquent accounts after three years.

Proper separation of duties within the Commission's control structure will reduce the potential risk resulting from the inadvertent or intentional actions of any one individual. Improper separation of duties may allow internal controls to be circumvented for operational convenience or conceal unintentional errors or irregularities.

Recommendation: The Commission should develop and implement changes to strengthen the internal control structure relating to receipts and the accounts receivable process. Duties should be segregated such that individuals having custody of cash or other assets have no access to nor are able to record or adjust related accounting records.

Department's Response: The Commission has only two individuals on staff (due to budget restraints) to handle the accounts receivable function. The agency collects a large volume of checks. Total collected receipts of over $3,100,000 annually are made up primarily of checks averaging $200.

The Commission has in place a formal system of checks and balances. The agency's administrative officer following preparation by the accounting clerk reviews all deposits and daily collection reports. Deposits and collection records are checked for accuracy and matching amounts.

The agency will involve another employee (as availability allows) in the initial opening of mail and counting of checks received daily to further augment the accounts receivable process. The Administrative Officer and Chairman will continue to oversee collections and determine that reports of collections and deposits are reconciled.

6. DELINQUENT ACCOUNTS NOT PROPERLY PROCESSED FOR COLLECTIONS

Delinquent accounts were not processed for collection in accordance with Department policy. Three invoices, delinquent 150 or more days, were not sent to a collection agency, yet two invoices, delinquent 60 or fewer days, were sent to a collection agency. Additionally, two invoices not on the delinquent report and two invoices already paid were sent to a collection agency.

The Department's policies require that accounts less than $500 and 150 or more days delinquent be turned over for collection.

Recommendation: The Commission should process accounts for collection in accordance with established policies.

Department's Response: The Commission follows established policies and laws and has in place a well defined collection procedure for past due accounts:

a. Original Invoice Mailed

b. 30 days—Second Notice Invoice Mailed

c. 60 days—Computer Generated "Past Due" Letter Mailed

d. 90 days—"Immediate Payment Request" Mailed

e. 120 days—"Notice of Legal Action" Mailed

f. Accounts turned over to state approved collection agency

Invoices are generated automatically by computer when legal orders are issued by the agency in contested cases, agreements are approved, motions are filed, etc. Certain state agencies are exempt by law from payment of costs. Also in bankruptcy cases where insurers or individual companies are under stay orders by bankruptcy courts payments are not required. The Guaranty funds established by law to handle "qualified claims" in the case of insolvent insurers are exempt from fees. Consequently all invoices appearing on the agency's receivable printout are not payable.

In addition the agency in the past two years has worked with the national trade groups for insurers to speed up the payment process by directly referring groups of past due accounts to identified insurers. These invoices are not sent to collection while working with insurers. This has resulted in improved collection. (In these collection cases the agency receives 100% of an invoice in payment as opposed to a few cents on the dollar if collected by a collection agency.).

The agency will continue to follow the adopted collection procedure and work with various organizations that can help in the collection process.

FISCAL MANAGEMENT DIVISION

7. RECEIPT BOOKS ARE NOT CONTROLLED

The Fiscal Management Division does not maintain a control log of the receipt books on hand and issued to the Department's various divisions and commissions. There is no review process in place to ensure that all receipt numbers are accounted for and voided receipts and altered amounts are explained.

Recommendation: The Division should establish a log to control the issuance of receipt books and establish procedures to account for receipts. Alterations to receipts should be documented and verified immediately, at the time of the original transaction.

Department's Response: The Division has established a log to control the issuance of receipts books and established procedures to account for receipts. Alterations to receipts will be documented and verified immediately at the time of the original transaction. The Division has drafted a revised Accounts Receivables and Cash Management policy that is waiting final approval. This policy enforces strong internal controls over cash and accounts receivables.

8. ACCOUNTS RECEIVABLE BALANCES OMITTED FROM 2002 FINANCIAL STATEMENTS

The Fiscal Management Division failed to record $1.2 million in accounts receivable balances for the fiscal year ended 2002. The Division's accrual reporting procedures were not adequate to ensure that all financial statement balances were properly reported at fiscal year end.

Recommendation: Accounts receivable balances should be recorded in the accounting records and the Department's financial statements.

Department's Response: The Division of Fiscal Management has procedures in place that request accounts receivable information from all divisions and commissions at year-end. This procedure provides the supporting information and documentation to write the financial statements. Accounts receivables for year ending 2002 were requested from the divisions and commissions twice by the Division of Fiscal Management; once in March with year-end close instructions and again in June via email as a reminder. Unfortunately, the State's current accounting system does not have an accounts receivable module. Therefore, if the Division of Fiscal Management is not given information regarding accounts receivables owed to various divisions, we cannot book them.

The Chief Fiscal Officer for Commerce has met with all commissions cited by the auditors regarding accounts receivables and all parties have a better understanding of what accounts receivables are and reporting requirements necessary to maintain the accounting records and the Department's financial statements.

The Chief Fiscal Officer has confirmed and booked all accounts receivables for the fiscal year ending 2003.

BANKING COMMISSION

9. REVENUES CODED INCORRECTLY

The Banking Commission does not verify that fee and assessment revenues are coded properly in the accounting records. We identified five receipts that were coded incorrectly and recorded to the incorrect account.

Recommendation: The Commission should develop and implement review procedures to ensure that fee and assessments revenues are coded to the correct account.

Department's Response: The Banking Commission does check the coding on revenue documents on a monthly basis; however, sometimes it is after they have been sent to the Division of Fiscal Management and keyed. If incorrect coding is found after documents have been keyed, journal entries to correct the coding have been made.

The Banking Commission has reviewed procedures and will make a stronger effort to check coding before documents are sent to the Division of Fiscal Management for processing.

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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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The Honorable Richard H. Moore	State Treasurer
The Honorable Roy A. Cooper, III	Attorney General
Mr. David T. McCoy	State Budget Officer
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James T. Fain, III	Secretary, Department of Commerce

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Representative Richard Morgan	Speaker of the NC House of Representatives
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October 20, 2003

ORDERING INFORMATION

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