

STATE OF NORTH CAROLINA

RESULTS OF

STATEWIDE FINANCIAL AUDIT PROCEDURES AT THE

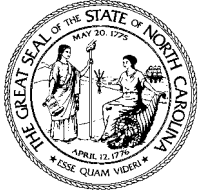
DEPARTMENT OF STATE TREASURER

FOR THE YEAR ENDED JUNE 30, 2004

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR



Ralph Campbell, Jr.
State Auditor

STATE OF NORTH CAROLINA
Office of the State Auditor

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January 7, 2005

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

We have completed certain audit procedures at the Department of State Treasurer related to the State of North Carolina reporting entity as presented in the *Comprehensive Annual Financial Report (CAFR)* and *Single Audit Report* for the year ended June 30, 2004. Our audit was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

In the *CAFR*, the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report*, the State Auditor presents the results of tests of internal control and compliance with laws, regulations, contracts and grants applicable to the State's financial statements and to its federal financial assistance programs. Our audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards* issued by the Comptroller General of the United States and the Single Audit Act as applicable. Our audit scope at the Department of State Treasurer included the following:

State of North Carolina's Financial Statements

- State Treasurer's Investment Funds
- Teachers' and State Employees' Retirement System
- Local Government Employees' Retirement System
- General Long-term Debt Accounts and Transactions

State of North Carolina's Administration of Federal Financial Assistance Programs

Subrecipient Monitoring – Local Government and Public Authority Audit Reports

Our audit procedures at the Department of State Treasurer were less in scope than would be necessary to report on the financial statements that relate solely to the Department or its administration of federal programs. Therefore, we do not express such conclusions.

The results of our audit procedures yielded audit findings and recommendations for the Department related to the State's financial statements that may require disclosure in the aforementioned reports. These findings are included in the findings and recommendations section contained herein. Our recommendations for improvement and management's response follow each finding.

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

AUDIT FINDINGS AND RECOMMENDATIONS

Matters Related to Financial Reporting or Federal Compliance Objectives

The following findings and recommendations were identified during the current audit and discuss conditions that represent deficiencies in internal control.

1. RETIREMENT BENEFITS COMPUTED INCORRECTLY

In our sample of 112 members of the Teachers' and State Employees' Retirement System and the Local Government Employees' Retirement System who retired during the 2003-04 year, we found 15 members whose monthly benefit amount had been calculated incorrectly. The errors in the retirees' monthly benefit payments ranged from underpayments of approximately \$83 to overpayments of approximately \$217.

Our sample of 112 retirees was chosen from a population of more than 10,000 retirement applications processed during the year in the two systems. For purposes of this test, we did not consider a benefit amount to be incorrect if it was within five dollars of the recalculated amount. The errors found often occurred because of the difficulty of determining service time and average final compensation using information available at the Department of the State Treasurer. Personnel sometimes have to subjectively interpret the data used to compute the benefit amount. The Department subsequently corrected all of the erroneous benefit amounts identified in our audit.

We also noted a continuing weakness in procedures for calculating revised benefits payable to beneficiaries when a retiree dies. The analysts who calculate the revised benefit and enter the change to the payroll file do so without supervisor review or authorization. The revised benefit amount is generally a very simple calculation that is not likely to be made incorrectly. However, without a review procedure in place, there is a risk that a benefit amount might be changed that should not have been changed or that an analyst fails to make a change that is required.

Agency personnel have cited a lack of sufficient staff resources as one reason for the retirement benefit problems. The Department plans to hire two internal auditors in the near future to monitor retirement benefit determinations. Also, the Department is developing a new computerized information system to improve the accuracy and efficiency of the benefit calculation process.

Recommendation: The Department should evaluate procedures used to determine retirement benefit amounts and implement changes to address the issues discussed above. Although the addition of staff to audit retirement benefits will improve internal control, that change alone may not be sufficient to reduce the calculation error rate to a tolerable level.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

Agency's Response: This finding involves the highly complex process of calculating retirement benefits, a part of the operational aspect of the Retirement Division we have already begun to address as part of our overall modernization and improvement efforts. As noted in your findings, there are many challenges in performing this function in a timely fashion based on the information that comes from more than 1,200 different state and local governmental agencies, retrieved from personnel files often 20 years old or older. As you noted in your audit, the data from which the calculations are made is often fragmented, incomplete, or missing entirely, necessitating staff make subjective decisions in the calculations process.

Within the Retirement Division, we are working to replace what was a totally antiquated technology infrastructure installed in the 1970s, and the new system will integrate six outdated mainframes applications and automate much of the employer data reporting, resolving many of the difficulties our staff experiences in securing accurate information from which calculations are made. The legislature has funded all but the final portion needed to complete the job, and we have included the amount needed to complete the project as a FY 05-06 expansion budget request.

We have worked to address staffing inadequacies, including the addition of two internal auditor positions secured during the past legislative session to provide ongoing oversight and additional checks for retirement benefit calculations. The implementation of these positions will also address the issue raised regarding calculations and payroll entries for beneficiaries of deceased Retirement System members, as these internal auditors will serve as an additional check on the death benefit calculation process.

We have further expanded our employee training programs, and put in place written operating procedure guidelines for all processes (including the calculation of retiree benefits) of the Retirement Division – none of which existed four years ago. We feel very strongly that these efforts, when fully implemented, will provide comprehensive solutions to the issues identified in the finding.

Additionally, immediate steps have been taken to address the issue raised, including the addition of a third review of benefit calculations made prior to their becoming final, and the completion of a more statistically valid sampling of calculations to determine and identify what additional steps might be needed to address this issue. Our goal is total accuracy in all aspects of our agency's functionality, and through the work started in January 2001 we feel we can achieve that goal going forward.

2. FINANCIAL STATEMENT DISCLOSURES CONTAINED DEFICIENCIES

While we found no misstatements in any underlying accounting records, the year-end financial statement package that the Department of State Treasurer submitted to the Office of State Controller had several technical deficiencies. The Office of the State Controller uses the financial statement packages prepared by agencies to complete the

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

State's *Comprehensive Annual Financial Report*, which is relied on by creditors and others to evaluate the State's financial condition and operations.

During our audit of the Department's financial statement package, which includes financial statements and other disclosures required by the Office of the State Controller, we noted problems such as:

The disclosure of Investment Pool securities by type contained a misclassification between securities on loan and securities not on loan. The total amount of investments reported was correct, but the misclassification among these categories totaled \$1.5 billion. The Department's asset custodian did not provide the detailed reports needed to make the proper disclosure.

The disclosure of bond proceeds investment securities by type contained a misclassification of assets totaling \$167 million. The Department reported that all moneys were invested in repurchase agreements, when in fact commercial paper and U.S. government and agency securities were also held at year-end. The investment reports needed to properly classify the assets were on hand, but the Department did not note that the reports showed that the investment manager had purchased the different types of securities during the last quarter of the year.

Several of the long-term debt disclosures required revision by the Department after initial submission to the Office of the State Controller, and even then some of the resubmitted disclosures contained errors. For example, the amount of future interest payments on certificates of participation was overstated by approximately \$238 million.

We proposed audit adjustments for the problems noted, all of which were made by the Department.

Recommendation: The Department should place greater emphasis on year-end financial reporting and implement internal control changes to ensure the completeness, accuracy and timeliness of its financial statement disclosures.

Agency's Response: This audit rightly notes that there is absolutely no misstatement in the underlying accounting records in question, only human errors in the characterization of accounts that were corrected by the fiscal year end.

We take very seriously the role the agency plays in the accounting and reporting of debt and investment financial data, and have already undertaken necessary initiatives to establish additional controls as they relate to the Comprehensive Annual Financial Report (CAFR) reporting schedules especially relative to asset classifications, completeness and timeliness. These measures include:

AUDIT FINDINGS AND RECOMMENDATIONS (CONCLUDED)

- At a minimum, two staff members will work independently on the required accounting information and various note disclosures, with final approval coming only after reviews by senior managers. This collaboration of work and two-step review process will help ensure that all information is complete and classified correctly.
- Implementation of written procedures as they relate to contact with our asset custodian and other outside asset managers, including additional specific instructions regarding all year-end reports prepared for CAFR reporting.
- A new requirement that all draft asset and financial disclosure schedules supplied to the staff of the Office of the State Auditors (OSA) and Office of State Controller (OSC) will be marked clearly as “DRAFT” versus “FINAL,” to avoid any confusion by OSC or State Auditor staff as to whether information is preliminary or complete.

Please note that it is our opinion that the classification of “Assets on loan” vs. “Assets not on loan” is not an investment classification required under either Governmental Accounting Standards Board (GASB) 3 or 28, and there was no misstatement of the type of investment or the custodial risk classification.

OVERALL RESPONSE TO AUDIT FINDINGS

At the Department's request, a letter presenting an overall response to the audit findings has been included as supplementary information.



RICHARD H. MOORE
Treasurer
North Carolina

December 20, 2004

Honorable Ralph Campbell, Jr.
State Auditor
Office of the State Auditor
2 South Salisbury Street
Raleigh, NC 27603

Dear Auditor Campbell:

Since 2001, when we started the long-term effort of thoroughly modernizing the systems and procedures used in all divisions within the Department of State Treasurer, we have made great strides in improving our operational effectiveness and efficiency, and dramatically improved the level of customer service offered the citizens we serve. We are proud of what we have accomplished to date, and very much appreciate the role of the State Auditor's staff in working with our staff to identify areas where additional improvements are possible, including those items contained in this report.

The first finding in this audit report involves the highly complex process of calculating retirement benefits, a part of the operational aspect of the Retirement Division we have already begun to address as part of our overall modernization and improvement efforts. As noted in your findings, there are many challenges in performing this function in a timely fashion based on the information that comes from more than 1,200 different state and local governmental agencies, retrieved from personnel files often 20 years old or older. As you noted in your audit, the data from which the calculations are made is often fragmented, incomplete, or missing entirely, necessitating staff make subjective decisions in the calculations process.

Within the Retirement Division, we are working to replace what was a totally antiquated technology infrastructure installed in the 1970s, and the new system will integrate six outdated mainframes applications and automate much of the employer data reporting, resolving many of the difficulties our staff experiences in securing accurate information from which calculations are made. The legislature has funded all but the final portion needed to complete the job, and we have included the amount needed to complete the project as a FY 05-06 expansion budget request.

We have worked to address staffing inadequacies, including the addition of two internal auditor positions secured during the past legislative session to provide ongoing oversight and additional checks for retirement benefit calculations. The implementation of these positions will also address the issue raised regarding calculations and payroll entries for beneficiaries of deceased Retirement System members, as these internal auditors will serve as an additional check on the death benefit calculation process.

We have further expanded our employee training programs, and put in place written operating procedure guidelines for all processes (including the calculation of retiree benefits) of the Retirement Division – none of which existed four years ago. We feel very strongly that these efforts, when fully implemented, will provide comprehensive solutions to the issues identified in the first finding.

Additionally, immediate steps have been taken to address the issue raised, including the addition of a third review of benefit calculations made prior to their becoming final, and the completion of a more statistically valid sampling of calculations to determine and identify what additional steps might be needed to address this issue. Our goal is total accuracy in all aspects of our agency's functionality, and through the work started in January 2001 we feel we can achieve that goal going forward.

Regarding the other finding in the report, you rightly note that there is absolutely no misstatement in the underlying accounting records in question, only human errors in the characterization of accounts that were corrected by the fiscal year end.

We take very seriously the role the agency plays in the accounting and reporting of debt and investment financial data, and have already undertaken necessary initiatives to establish additional controls as they relate to the Comprehensive Annual Financial Report (CAFR) reporting schedules especially relative to asset classifications, completeness and timeliness. These measures include:

- At a minimum, two staff members will work independently on the required accounting information and various note disclosures, with final approval coming only after reviews by senior managers. This collaboration of work and two-step review process will help ensure that all information is complete and classified correctly.

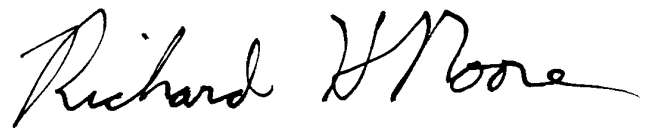
Honorable Ralph Campbell, Jr.
December 20, 2004
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- Implementation of written procedures as they relate to contact with our asset custodian and other outside asset managers, including additional specific instructions regarding all year-end reports prepared for CAFR reporting.
- A new requirement that all draft asset and financial disclosure schedules supplied to the staff of the Office of the State Auditors (OSA) and Office of State Controller (OSC) will be marked clearly as "DRAFT" versus "FINAL," to avoid any confusion by OSC or State Auditor staff as to whether information is preliminary or complete.

Specifically related to the second finding, please note that it is our opinion that the classification of "Assets on loan" vs. "Assets not on loan" is not an investment classification required under either Governmental Accounting Standards Board (GASB) 3 or 28, and there was no misstatement of the type of investment or the custodial risk classification.

I know you agree our Department has come along way in the last four years to address many of the deficiencies that existed prior to that time and appreciate your willingness to continue to assist us in identifying ways to improve our processes. We look forward to continuing this partnership in the future.

Best wishes,

A handwritten signature in black ink that reads "Richard H. Moore". The signature is written in a cursive style with a long, sweeping tail on the letter "e".

Richard H. Moore

RHM/jrs

DISTRIBUTION OF AUDIT RESULTS

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 Beverly M. Perdue
The Honorable Richard H. Moore
The Honorable Roy A. Cooper, III
Mr. David T. McCoy
Mr. Robert L. Powell

Governor of North Carolina
Lieutenant Governor of North Carolina
State Treasurer
Attorney General
State Budget Officer
State Controller

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Mr. James D. Johnson

Director, Fiscal Research Division

January 14, 2005

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Office of the State Auditor
State of North Carolina
2 South Salisbury Street
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