



STATE OF NORTH CAROLINA

RESULTS OF STATEWIDE FINANCIAL AUDIT PROCEDURES AT THE DEPARTMENT OF STATE TREASURER

FOR THE YEAR ENDED JUNE 30, 2005

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR



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Office of the State Auditor

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February 3, 2006

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, 2005. 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 audit 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 "Leslie W. Merritt, Jr." The signature is written in a cursive style with a prominent "L" and a stylized "M".

Leslie W. Merritt, Jr., CPA, CFP
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 significant deficiencies in internal control and/or noncompliance with laws, regulations, contracts or grants.

1. FUNDS INAPPROPRIATELY ADVANCED FROM THE TEACHERS AND STATE EMPLOYEES' RETIREMENT SYSTEM

At the end of the 2004-05 fiscal year, the Department of State Treasurer transferred money from the Teachers and State Employees' Retirement System to the General Fund before it was due. This is inconsistent with provisions of the state constitution.

Administrative costs of the pension funds are budgeted in and paid from the General Fund, and the Department transfers money from the pension funds as needed to pay the expenditures. In order to carry forward budget authority from one fiscal year to the next, state budget practices require that money be available in the General Fund to cover the budget transfer. At June 30, 2005, the Department carried forward budget of approximately \$7.8 million for retirement system costs to the next fiscal year, and in accordance with Office of State Budget and Management instructions, the Department transferred money from the pension fund to the General Fund even though it was not needed to pay costs immediately. As of September 30, 2005, \$6.4 million of the original transfer was still held in the General Fund, and the retirement system had lost approximately \$40,000 in interest earnings.

The State constitution requires that Teachers and State Employees' Retirement System assets "not be applied, diverted, loaned or used by the State, any State agency, State officer, public officer or public employee." Transferring the money to the General Fund in advance of incurring pension fund costs is in essence a loan, with the General Fund earning interest that otherwise would go to the pension fund.

Furthermore, the costs involved were actually allocable to several pension and employee benefit plan funds, but since the other funds did not have the necessary cash available, the full amount of the transfer was made from the Teachers and State Employees' Retirement System. On July 29, 2005, the Department reimbursed \$2.5 million owed from the other funds to the Teachers and State Employees' Retirement System. Also, the \$7.8 million transfer was recorded as an expenditure in the various funds for the year ended June 30, 2005, when in fact, no such expenditure should have been recognized.

Recommendation: The amount of unspent money transferred from each pension and other employee benefit plan should be returned immediately, along with computed interest earnings on the money. The Department should work with the Office of State Budget and Management to determine an alternative practice for carrying forward General Fund budget paid from pension and other employee benefit plan assets.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

Agency's Response: At the end of each fiscal year, unexpended funds for which we had legislative approval are carried forward to the new fiscal year. The mechanism by which the Office of State Budget and Management (OSBM) requires this to happen is for the agency to write a state warrant to itself as of June 30, and on July 1, deposit the warrant back into its account. This procedure is used for all State government agencies, whether receipts based or supported by appropriations.

Prior to this past fiscal year, our financial staff approached OSBM to explore a different method for this process, recognizing the potential loss of interest earnings inherent in the method. Because the State operates on a cash basis, no other mechanism was deemed a viable option. Although the procedure was no different than in any other year in which we had carry forwards, FY 04-05 involved significantly higher amounts.

As soon as we became aware of your concern, we again made inquiry of OSBM regarding possible alternatives to meet our carry forward needs. With their assistance, we have now developed a budgetary account through which we will record the authorized budget for the project. All remaining unexpended budget for the project will be carried forward to the next fiscal year, but will not require any actual funds to be moved. This will be accomplished entirely through budget revisions and journal entries. We believe this to be a good common sense solution.

2. INVESTMENT VALUES MISSTATED

The values of real estate and alternative investment portfolio assets reported in the financial statements were understated by approximately \$130 million at June 30, 2005. Generally accepted accounting principles require that such assets be reported at fair value as of the end of the fiscal year.

The Department's accounting service provider did not receive year-end reports from external investment managers that were needed to report up-to-date asset values. As a result, the reported values of approximately 40% of individual real estate and alternative investment holdings were six to eighteen months old.

Recommendation: The Department should ensure that investment managers provide needed information in a timely manner.

Agency's Response: The Department of State Treasurer contracts with State Street Bank ("custodian") to perform master custody functions. The custodian is responsible for maintaining the accounting records on all investments, and for communicating with all external investment managers to obtain current valuation data for our portfolio. The custodian failed to execute their responsibilities properly for a period of time during this audit period. We have had lengthy discussions with them about this problem and have been assured corrective measures are in place. Our custodian is our book of record, and should be an independent verification of the valuations that we report.

AUDIT FINDINGS AND RECOMMENDATIONS (CONCLUDED)

It is important to note that our Investments Division had copies of all of the year-end reports noted in this finding, and were monitoring our investments. Our custodian had the opportunity to receive the same information, but was not as diligent as they should have been. We have implemented a process that requires the Accounting office to receive the information from the Investment office to verify that the custodian is performing its duties as prescribed.

DISTRIBUTION OF AUDIT REPORT

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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Director, Fiscal Research Division

February 9, 2006

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