



STATE OF NORTH CAROLINA

**NORTH CAROLINA DEPARTMENT OF HEALTH
AND HUMAN SERVICES**

STATEWIDE FINANCIAL STATEMENT AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2008

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

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AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
Members of the North Carolina General Assembly
Dempsey Benton, Secretary
North Carolina Department of Health and Human Services

We have completed certain audit procedures at the North Carolina Department of Health and Human Services 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, 2008. 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. Our audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, issued by the Comptroller General of the United States.

Our audit objective was to render an opinion on the State of North Carolina's financial statements and not the Department's financial statements. However, the report included herein is in relation to our audit scope at the Department and not to the State of North Carolina as a whole.

The audit finding referenced in this report will also be evaluated to determine its impact on the State's internal control and the State's compliance with rules, regulations, contracts and grants. If determined necessary in accordance with *Government Auditing Standards*, the finding will be reported in the State's *Single Audit 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.

Leslie W. Merritt, Jr.

Leslie W. Merritt, Jr., CPA, CFP
State Auditor



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**REPORT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING AND ON COMPLIANCE
AND OTHER MATTERS BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Secretary Dempsey Benton
and Management of North Carolina Department of Health and Human Services

As part of our audit of the State of North Carolina's financial statements, we have audited selected elements of the North Carolina Department of Health and Human Services' financial statements, as of and for the year ended June 30, 2008. Our report on the State of North Carolina's financial statements is included in the State's *Comprehensive Annual Financial Report*. Our financial statement audit scope at the North Carolina Department of Health and Human Services included the following:

- General Fund, excluding the Division of Mental Health, Developmental Disabilities and Substance Abuse Services.

The audit results described below are in relation to our audit scope at the Department and not to the State of North Carolina as a whole.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the State's financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness the Department's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material

**REPORT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING AND ON COMPLIANCE
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weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying audit finding and response to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial misstatements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above are material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State's financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standard*.

Management's response to the finding identified in our audit is included in the Audit Findings and Responses section of this report. We did not audit the response, and accordingly, we express no opinion on it.

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This report is intended solely for the information and use of management, the Secretary, the Department's Audit Committee, others within the Department, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Leslie W. Merritt, Jr.

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

October 22, 2008

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AUDIT FINDINGS AND RESPONSES

Matters Related to Financial Reporting

DEFICIENCIES IN FINANCIAL REPORTING PROCESS

During our audit of the North Carolina Department of Health and Human Services, we identified the following misstatements in the information reported to the Office of the State Controller for inclusion in the State's financial statements:

- The Department applied the incorrect percentage rate in calculating the county share of the local governmental receivable applicable to the Medicaid claims payable. Legislation reduced the county share of the nonfederal costs from 15 percent to 7.5 percent effective July 1, 2008. By using the old rate, the Department overstated the receivable account by \$21 million.
- The fund balance worksheet submitted to the Office of the State Controller contained errors. Errors included identifying \$1.2 million of restricted funds as unrestricted, \$76 million of internally designated funds as undesignated, and \$48.5 million of internally designated funds as reserved funds. In addition, the restricted fund balance was overstated by \$2.3 million because the valuation was based only on the pooled cash balance amounts rather than the actual fund balance amounts.

As the Department is responsible for the fair presentation of its financial statements, it is essential that effective internal control over financial reporting be established to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements.

Recommendation: The Department should continue to enhance internal control procedures over the year-end reporting process to ensure that financial statements are free of material misstatements.

Department Response: The local government receivable has been consistently calculated during the CAFR process each year. However, unaware of the new rate for the county share effective July 1, 2008 set by the General Assembly, the Branch calculated the receivable at the old rate. We will increase controls by communicating more frequently with the Division of Medical Assistance to ensure the correct rates are used when accruing the Medical Claims Payable NCAS entries.

Every effort is made to identify fund balance information prior to the CAFR submission date; however, due to the size and complexity of the Department, some information is not received by the August 31 submission date. The fund balance worksheet was corrected by the Department as additional fund information was received after the August 31 submission date and errors were noted by the auditors. The adjustments were made by the Office of the State Controller on December 4, 2008. We will continue to improve our procedures to identify

AUDIT FINDINGS AND RESPONSES (CONCLUDED)

funds for proper financial statement classification in a timelier manner. Activities that will be considered for implementation include a fund authority worksheet that captures key information for each fund including restricted, unrestricted and internally designated/unrestricted status and a second party review of all fund balance classifications.

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