STATE OF NORTH CAROLINA

DEPARTMENT OF STATE TREASURER

STATEWIDE FINANCIAL STATEMENT AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2009

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

DEPARTMENT OF STATE TREASURER

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AUDITOR'S TRANSMITTAL

The Honorable Beverly Eaves Perdue, Governor
Members of the North Carolina General Assembly
The Honorable Janet Cowell, State Treasurer
Department of 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, 2009. 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 findings referenced in the report are also evaluated to determine their 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*, these findings are 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.

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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*

The Honorable Janet Cowell, State Treasurer
and Management of the Department of State Treasurer

As part of our audit of the State of North Carolina's financial statements, we have audited selected elements of the Department of State Treasurer's financial statements, as of and for the year ended June 30, 2009. 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 Department of State Treasurer included the following:

- State Treasurer's Investment Pool
- Teachers and State Employees' Retirement System
- Local Government Employees' Retirement System - Statement of Plan Net Assets
- Retiree Health Benefit Plan
- General Long-Term Debt Accounts and Transactions

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.

<u>Internal Control Over Financial Reporting</u>

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 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 findings 2, 3, and 4 in the Audit Findings and Responses section of this report 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 statements 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, of the significant deficiencies described above, we consider finding 2 to be a material weakness.

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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and are described in finding 1 in the Audit Findings and Responses section of this report.

We noted certain other matters related to weaknesses in information systems general controls that, due to the sensitive nature of the conditions found, are conveyed to management in a confidential letter pursuant to *North Carolina General Statute* 147-64.6(c)(18).

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* (CONCLUDED)

Management's responses to the findings identified in our audit are included in the Audit Findings and Responses section of this report. We did not audit the responses, and accordingly, we express no opinion on them.

This report is intended solely for the information and use of management, the State Treasurer, others within the entity, 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.

Beth A. Wood

Beth A. Wood, CPA
State Auditor

December 8, 2009

Matters Related to Financial Reporting

1. NONCOMPLIANCE WITH STATUTORY INVESTMENT LIMITS

The Department of State Treasurer did not comply with the statutory requirement limiting the North Carolina retirement systems' holdings in alternative investments to five percent of the systems' invested assets. The limit, established by *North Carolina General Statute* 147-69.2(b)(9), was first exceeded in September 2008. As of June 30, 2009, the retirement systems' alternative investments holdings were 5.43 percent of all invested assets.

The Department exceeded the statutory limit after a significant decline in the world's financial market impacted the values of other investments held by the North Carolina retirement systems more than the value of the alternative investments. The market value of equity-based securities held by the systems decreased 22 percent between June 30, 2008 and June 30, 2009, while the market values of alternative investments remained relatively steady. Also, the Department had to invest additional cash in certain alternative investment holdings in order to meet contractual obligations. As a result, alternative investments became a greater percentage of the retirement systems' total invested assets.

Recommendation: The Department should enhance its monitoring of the retirement systems' holdings to more proactively respond to changing market conditions and ensure compliance with investment limits set by law.

Agency Response: The audit finding states that "[t]he Department of State Treasurer did not comply with the statutory requirement limiting the North Carolina retirement systems' holdings in alternative investments to five percent of the systems' invested assets." We first note that new investment allocations have reduced Alternative allocations below the statutory limit. Specifically, the 2009 legislative session (Session Law 2009-98) authorized two new allocations to Credit and Inflation initiatives. These new allocations were effective on January 1, 2010. Following an internal and external review of the existing portfolios, certain Alternatives portfolios were reclassified into the two new allocations. As a result, the December 31, 2009 Alternative allocation of 5.79% was reduced to 4.59% on January 1, 2010. In addition, we note that compliance with the statutory limitations is based on a number of external and complicated factors, including the unprecedented credit crisis of 2008-2009. These factors are discussed in more detail in the Department's full response, which appears at the end of the Audit Findings and Responses section of this report.

2. DEFICIENCIES IN FINANCIAL REPORTING

The year-end financial information prepared by the Department of State Treasurer contained misstatements that were corrected as a result of our audit. These audit adjustments are indicative of a significant deficiency in internal control over financial reporting. Without these corrections, the disclosures in the State's *Comprehensive Annual Financial Report (CAFR)* could have been misleading to readers.

We identified the following misstatements in the State Treasurer's investment pool financial statements and disclosures that were submitted to the Office of the State Controller for inclusion in the State's *CAFR*. These occurred because new staff prepared the information and their work was not effectively supervised and reviewed.

a. The Department overstated cash and understated investment assets by $1.8 billion because certificates of deposit and repurchase agreements were not presented in accordance with generally accepted accounting principles and/or state accounting policy.

b. The Department's financial statements did not agree to the supporting accounting records. The financial statements contained a $500 million reporting error that resulted in an understatement of investment income and a related understatement of income distributed to investment pool members. In addition, liabilities of $164 million were not properly presented in the financial statements. The Department netted liabilities with other assets, and as a result the financial statement assets and liabilities were understated. Generally accepted accounting principles do not allow the netting of assets and liabilities.

c. The value of foreign government bonds was overstated by approximately $10 billion in the required note disclosure of investment credit ratings. This misstatement occurred because the value of foreign government bonds was presented to the dollar when it was expected to be rounded to thousands.

d. The Department misclassified $72 million between collateralized mortgage obligations, commercial mortgage-backed securities, asset-backed securities, and domestic corporate bonds. As a result, the required disclosure of investments by maturity period and the separate disclosure of investment credit ratings both contained errors in the reported values for these debt securities.

e. The value of investments presented in the required note disclosure of debt securities by maturity period contained misclassifications of $3.2 billion across the various maturity ranges. Accounting standards provide guidance on how to determine the maturity of debt investments with variable rates. The standards allow governments to choose from one of two options. The Department did not consistently apply the assumption they chose across all debt investments with variable rates. As a result, debt securities disclosed as having maturities of less than one year were understated and the various amounts disclosed in the other maturity ranges were overstated.

f. The total principal amount of investments as presented in a required note disclosure was understated by $713 million. The error occurred because the Department disclosed the cost value of investments instead of the principal amount.

We also identified the following misstatements in other disclosures submitted to the Office of the State Controller for inclusion in the *CAFR*:

- The value of international equity investments was overstated by approximately $3.9 billion in the Escheat Investment Account's disclosure of foreign currency risk. The misstatement occurred because the values disclosed in this note were presented to the dollar when it was expected to be rounded to thousands.
- The Department did not include disclosures about the following as required by generally accepted accounting principles: $5.7 billion of outstanding investment commitments, noncompliance with statutory limits, and $855 million in demand bonds.
- The financial information for the Supplemental Retirement Income Plan submitted to the Office of the State Controller required numerous adjustments and corrections and did not agree to the amounts in the audited financial statements submitted with the information. Also, due to a delay in receiving final audited information from the auditor of the Deferred Compensation Plan, the information submitted to the Office of the State Controller was not based on, and did not include, the final audited financial statements.

Recommendation: The Department should place greater emphasis on the year-end financial reporting process and implement effective internal control to ensure the completeness and accuracy of the information submitted to the Office of the State Controller for inclusion the State's *CAFR*.

Agency Response: The misstatements on the year-end financial report were due to several factors. First, new and complex investment vehicles required qualitative judgments on the classification for accounting. Second, recently hired staff was unfamiliar with the overall reporting process at that time. Although additional reviews were performed, the underlying errors in data still existed. To remedy the deficiencies in financial reporting, we are pursuing a twofold approach around technology and process. Further details about this approach are described in the Department's full response, which appears at the end of the Audit Findings and Responses section of this report.

3. INELIGIBLE PAYMENTS AND OVERPAYMENTS OF RETIREE MEDICAL INSURANCE PREMIUMS

The Department of State Treasurer has not implemented effective internal control to determine eligibility for participation in the Retiree Health Benefit Fund (the Fund) or to ensure the Fund pays the correct rate for retirees' medical insurance premiums. As a result, we estimate that the Department overpaid approximately $669,000 in medical insurance premiums to the State Health Plan during the 2009 fiscal year.

We determined that the Department paid the wrong medical insurance premium rate for approximately 613 members, resulting in an estimated overpayment to the State Health Plan of $500,000. Retired members of the Fund who are age 65 or over are eligible for Medicare and should have Medicare as their primary insurance. In accordance with

North Carolina General Statute 135-44.6(a) and state policy, the Department should pay a lower premium rate for retirees that are covered by Medicare. We performed an analysis of the medical insurance premiums paid from the Fund and determined that the lower premium rate was not always paid for members age 65 and older.

We also determined that the Department paid medical insurance premiums on behalf of 57 ineligible recipients, resulting in an estimated overpayment to the State Health Plan of approximately $169,000. According to *North Carolina General Statute* 135-45.2(a)(4a), the surviving spouse of a deceased retiree is eligible for noncontributory health coverage if the retiree's death occurred prior to October 1, 1986. All of the errors we noted were due to the Department enrolling surviving spouses of retired employees that deceased after October 1, 1986. These errors were partially due to temporary staff members being utilized during the enrollment period and an effective control was not in place to prevent or detect this enrollment error.

Recommendation: The Department should implement effective internal control to ensure the correct medical insurance premium rates are paid for Medicare eligible retirees and to ensure the State only pays the medical insurance premiums for eligible surviving spouses.

Agency Response: The Department concurs with the audit finding. Details on how management plans to correct the issues are described in the Department's full response, which appears at the end of the Audit Findings and Responses section of this report.

4. DEFICIENCIES IN INFORMATION SYSTEMS GENERAL CONTROLS

We noted deficiencies in the Department of State Treasurer's information systems general controls. The deficiencies increase the risk of unauthorized access and alteration of systems and data.

The Department has not updated information technology security policies and procedures to reference the appropriate regulatory agencies and the North Carolina Statewide Information Security Manual approved by the State Chief Information Officer on November 7, 2008. Up-to-date policies and procedures are necessary to help ensure that appropriate measures are being applied to protect systems and data.

We examined the Department's information technology security policies and procedures and found eleven policies or procedures that reference obsolete or replaced regulatory agencies and outdated standards. The policies and procedures reference the IRMC (Information Resource Management Commission), which no longer exists. Also referenced are the Information Technology Security State Information Security Policy Framework (May 2003), Information Technology Security Desktop and Laptop Security Standard (2002), and the North Carolina Information Technology Security Domain Name System Enterprise Security Standard (2001), which have been replaced by the Statewide Information Security Manual.

We also noted a number of other weaknesses in information systems general controls that, due to the sensitive nature of the conditions found, are conveyed to management in a confidential letter pursuant to *North Carolina General Statute* 147-64.6(c)(18).

Recommendation: The Department should update the information security policies and procedures to reference the appropriate regulatory agencies and security standards. Policies and procedures should be reviewed annually and updated as needed. Further, the Department should address the information systems general control weaknesses described in our separate confidential letter.

Agency Response: This finding has been addressed and the information security policies in question were updated accordingly. Our Information Security Policies will also be reviewed annually and updated as needed of this report.

Department of State Treasurer's Response and Corrective Action Plan

The findings you report have given us an opportunity to re-evaluate our processes and controls. Our responses to your findings are below.

1. NONCOMPLIANCE WITH STATUTORY INVESTMENT LIMITS

The audit finding states that "[t]he Department of State Treasurer did not comply with the statutory requirement limiting the North Carolina retirement systems' holdings in alternative investments to five percent of the systems' invested assets." We first note that new investment allocations have reduced Alternative allocations below the statutory limit. Specifically, the 2009 legislative session (Session Law 2009-98) authorized two new allocations to Credit and Inflation initiatives. These new allocations were effective on January 1, 2010. Following an internal and external review of the existing portfolios, certain Alternatives portfolios were reclassified into the two new allocations. As a result, the December 31, 2009 Alternative allocation of 5.79% was reduced to 4.59% on January 1, 2010. In addition, we note that compliance with the statutory limitations is based on a number of external and complicated factors, including the unprecedented credit crisis of 2008-2009. We discuss these factors in more detail below.

a. Background

The Alternative strategy consists of Private Equity and Hedge Funds. The allocation is based on three elements in the following equation:

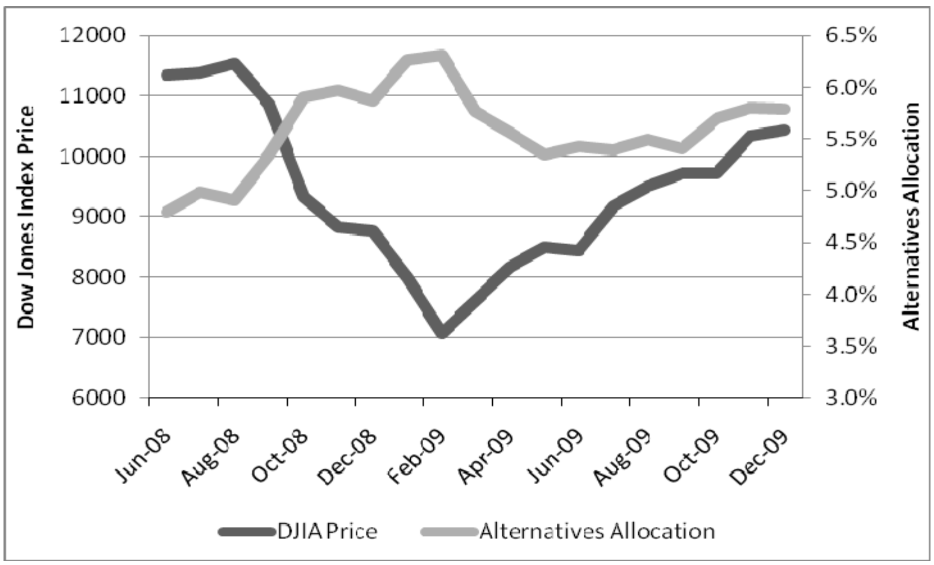
$$\frac{\text{(Private Equity market value) + (Hedge Fund market value)}}{\text{(Pension Plan market value)}}$$

The numerator represents Hedge Fund and Private Equity market value. In general, Hedge Fund commitments are fully invested over a short period of time. Once invested, fluctuations in pricing of underlying assets, which are generally liquid, will dictate the Hedge Fund market value. Private Equity commitments are more complex. Capital is committed to a fund manager, who will then "call" capital over the life of the fund, which is generally a ten year period. Private Equity investments are generally illiquid, with a market value applied to the investment on a quarterly basis by the fund manager. As Private Equity investments are realized or sold, the proceeds are distributed to the investors. This series of cash flows (calls and distributions), combined with changes in investment valuations, dictate Private Equity market value. The timing of such cash flows is difficult to predict.

The denominator represents the Pension Plan market value and is the sum of the market values of all of the asset classes. The vast majority of these assets are comprised of Public Equity and Fixed Income, which are both liquid securities.

b. Market Events and Credit Crisis of 2008-2009

We agree with the finding that "[t]he Department exceeded the statutory limits after a significant decline in the financial market impacted the values of other investments held by the North Carolina retirement systems more than the value of the alternative investments." Specifically, the market value of the Pension Fund declined 17% between June 30, 2008 and June 30, 2009. However, the Alternative market value declined at a smaller magnitude, down 5.6%. To further illustrate the impact of the financial event on the Alternative allocation, we have provided a chart which illustrates the allocation percentage from June 2008 to December 2009 and the corresponding change in the Dow Jones Index. This chart shows the allocation surpassing the 5% limitation beginning in the fall of 2008:



It is also important to note that the rate of decline of the numerator (Private Equity + Hedge Fund market value) was less than that of the denominator (Pension Plan), resulting in a greater allocation to Alternative assets. There were two contributing factors for this:

i. New Accounting Measures

Due to the Financial Accounting Standards Board (FASB) adoption of Statement No. 157, Private Equity market values declined less than Public Equity market values. FASB, the organization which establishes standards of financial accounting, adopted the so-called Fair Value Measurements rule that requires all investments be marked to market with publicly traded comparables and it was implemented for reporting purposes before the year ended in 2008. In general, because Private Equity assets are illiquid, they had historically been carried at a discount to their publicly traded comparables or held at the cost of the investment until a change in valuation was warranted. These changes included events such as contract awards, asset sales, and acquisitions. Therefore, as investments were marked to market and the public markets declined, the drop of Private Equity market values was less than the Public Equity assets. We would note that the market value of Public Equities declined 22% from June 30, 2008 to June 30, 2009, and that this asset class is most comparable to Private Equity in terms of marking to market.

ii. Contractual Obligations

A fundamental characteristic of the Alternative asset class is the multi-year contractual agreement, which includes terms outlining capital requirements, lock-up periods, and fund duration. These terms also limit investors' ability to respond to rapidly changing market conditions. As a result, additional capital had to be invested in certain Private Equity investments in order to meet contractual obligations. The original commitments to Private Equity funds were made at a time when the allocation was below the 5% limit. However, capital obligations of existing commitments had to be met. Furthermore, while capital calls slowed dramatically as the markets deteriorated, distributions declined even greater to almost non-existent. The total net cash flows for the fiscal year ending June 2009 were negative $767 million. More capital was called for investment than was distributed from realizations, which increased the fund account balances and therefore the Private Equity market value.

The audit finding states that the "[t]he Department should enhance its monitoring of the retirement systems' holdings to more proactively respond to market changing conditions." However, as noted, the terms and conditions of investment management agreements control the Pension Fund's ability to react to the market. Not honoring these contractual obligations would cost the Pension Fund in terms of reputation as an investor and in monetary penalties.

2. DEFICIENCIES IN FINANCIAL REPORTING

The misstatements on the year-end financial report were due to several factors. First, new and complex investment vehicles required qualitative judgments on the classification for accounting. Second, recently hired staff was unfamiliar with the overall reporting process at that time. Although additional reviews were performed, the underlying errors in data still existed. To remedy the deficiencies in financial reporting, we are pursuing a twofold approach around technology and process.

a. Technology

As background, our custodian bank acts as the book of record for all investment accounting. Once the records are final, these are used to key the data to spreadsheets required by the Office of the State Controller (OSC). The manual input of thousands of pieces of data creates risk in the process.

In response to item (c), the financial records as audited were in fact accurate. However, once the statements were completed, staff manually entered those numbers into a separate spreadsheet in which the numbers were rounded to thousands, of which one number remained in whole dollars. Based on these findings, we are currently researching new technology to assist with the preparation of the statements and related disclosures. Such new technology will reduce the risk associated with the manual input of information.

In the interim, the accounting staff will include total columns as an additional control for review of totals between various schedules.

b. Process

Our custodian reports Certificates of Deposits and Repurchase Agreements as Cash Equivalents. In response to item (a), the format of our compilation has been changed to separate all categories of cash, cash equivalents, and investments. These items will no longer be included in the cash equivalents line on our reports.

In response to item (b), the Financial Operations Division has implemented an additional review process in our monthly reconciliation to ensure accuracy of accounting numbers.

Overall, several process changes have been researched, evaluated, and implemented to address the recommendation of greater internal control. The accounting staff has begun a checklist that will be used annually as part of a review of the overall package that is submitted to OSC. This checklist will include items such as verification of totals between schedules and that the proper valuations (cost, principal, or market value) were used correctly.

In addition, the staff members of the Financial Operations Division and Investments Division will establish working agreements that will include a structure for interdivisional communication. These will consist of a reconciliation process, a clarification of roles between the two divisions, and a clarification of the role of all of our vendors.

3. INELIGIBLE PAYMENTS AND OVERPAYMENTS OF RETIREE MEDICAL INSURANCE PREMIUMS

As retirees become Medicare eligible, the policy from Blue Cross Blue Shield (BCBS) states that no changes are to be made by DST until instructed to do so. It was discovered that BCBS was several months delinquent in advising our office of the changes to Medicare status. As updated information is received from BCBS on retirees, the rates are changed to reflect the Medicare rates with a true effective date. The Department's on-line retirement database (ORBIT) recovers any overpayments that may have occurred.

A report has been developed to be provided to BCBS on a quarterly basis of the retirees that are 65 or over and appear to be Medicare-eligible. BCBS will use this report to make a final determination and will advise accordingly.

Also, for the ineligible recipients of medical insurance, we have made the appropriate changes in our system and all funds have been recouped from those recipients. This error occurred due to having temporary workers assisting with keying of open enrollment forms, in conjunction with an unintended programming error in ORBIT. This error has been corrected and will be monitored periodically.

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