STATE OF
NORTH CAROLINA

DEPARTMENT OF STATE TREASURER

STATEWIDE FINANCIAL STATEMENT AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2010

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, 2010. 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 the standards applicable to financial audits contained in *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, 2010. 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
- 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 of the Department's internal control over financial reporting.

A *deficiency in internal control* 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 *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses, and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we consider the deficiency described in finding 2 in the Audit Findings and Responses section of this report to be a significant deficiency in internal control over financial reporting, as defined above.

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 its 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 which are described in findings 1 and 2 in the Audit Findings and Responses section of this report.

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, the Governor, the General Assembly, 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, 2010

AUDIT FINDINGS AND RESPONSES

Matters Related to Financial Reporting

Management's responses are presented after each audit finding. We did not audit the responses, and accordingly, we express no opinion on them. However, *Government Auditing Standards* require that we add explanatory comments to the report whenever we disagree with an audit finding response. In accordance with this requirement and to ensure that the nature and seriousness of the findings are not minimized or misrepresented, we have provided comments to the Department's responses when appropriate.

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, 2010, the retirement systems' alternative investments holdings were 5.15 percent of all invested assets.

We reported this finding last year. The Department has since requested legislative changes to the types of investments the retirement systems' are authorized to hold. These changes became law, and as a result, investments previously classified as alternative investments were now considered to be other types of investments. Reclassifying a portion of the alternative investments reduced the holdings percentatge below the statutory limit. However, the Department had to invest additional cash in certain alternative investments in order to meet contractual obligations. This resulted in the Department exceeding the statutory limit again.

Recommendation: The Department should continue to monitor the retirement systems' holdings and seek to identify a solution to achieve compliance with investment limits set by law.

Department Response: General Statute 147-69.2(b)(9) governs the Retirement Systems' alternative investment allocation. Specifically, § 147-69.2(b)(9) permits investments in interests of limited partnerships, limited liability companies or other limited liability investment vehicles that are not publicly traded if the primary purpose of the vehicle is to invest in public or private equity, or corporate buyout transactions. The statute requires that alternative investments not exceed 5% of the market value of all invested assets of the Retirement Systems. The statutory limitation on the size of the alternatives allocation was initially exceeded in September 2008 when the stock market plummeted, resulting in significantly reduced market value of all investment assets ("denominator effect"). Since that time, the allocation has been as large at 6.3% of the invested assets of the Retirement Systems. While complying with existing investment contracts which required the investment of additional capital, the State Treasurer has also actively taken steps to reduce the alternatives allocation by prudently redeeming holdings in certain investments. Redemption of monies will continue in 2011, and we also plan to ask for additional statutory flexibility from the legislature. In addition, Legislative authorities approved the creation of two new asset allocations, the credit and inflation allocations, in 2009. Subsequent to the creation of these new investment allocations, certain limited liability investment vehicles were reclassified from the alternatives allocation into the credit and inflation allocations, pursuant to internal and external reviews of the existing portfolio. These efforts have reduced the holdings that would have otherwise been included within the 5% alternatives allocation. As of October 31, 2010, the statutory limitation on the size of the alternative allocation was exceeded by approximately .07%.

2. SECURITIES LENDING AMOUNTS NOT REPORTED OR DISTRIBUTED TIMELY

The Department of State Treasurer did not report timely all assets and investment income from securities lending transactions, including changes in the fair value of investments, in the State Treasurer's Investment Pool financial statements. As a result, adjustments had to be made after June 30, 2010 to record transactions from October 2008 - June 2010 in both the Investment Pool financial statements and in the basic financial statements of the State's *Comprehensive Annual Financial Report (CAFR)*. Also, the Department did not distribute the net impact of these transactions to Pool participants.

From October 2008 to June 2009, the Department earned approximately $108 million of realized income on investments made with collateral received from securities lending transactions. Historically, this income had been recognized monthly in the Investment Pool's financial records and distributed to participants whose assets were invested by the Department. However, the Department did not report the earned revenue or related asset in the 2009 fiscal year, and thus neither did the entities who participate in the Pool.

In addition, as of June 30, 2009, the fair value of the investments purchased with cash collateral received from securities lending activity significantly decreased in value, resulting in the fair value of the investments held at year-end being approximately $771 million less than their cost value. Such a large change in value had not previously been experienced on these investments. The Department did not properly adapt to the change in circumstances and did not report this loss in the 2009 fiscal year.

The net impact of not reporting the investment transactions in the 2009 fiscal year resulted in the Investment Pool's June 2009 net assets being overstated by approximately $663 million. When preparing its 2010 year-end financial statements, the Department recorded a restatement to the Investment Pool's financial statements to correct the error. Furthermore, the Office of the State Controller had to record restatements to various financial statements in the State's *CAFR* to record the 2009 transactions for the entities who participate in the Pool. Since the transactions were not recorded timely in the Investment Pool financial records, the net loss, along with approximately $27.5 million of realized income earned in the 2010 fiscal year, was not distributed to Pool participants.

Under *North Carolina General Statutes* 147-69.1 and 147-69.3, the State Treasurer's duties include preparing statements that report all moneys invested, all revenues derived from the investments and all investments for which the State Treasurer is responsible. The income received from deposits and investments are to accrue pro rata among the funds whose assets are invested according to a formula prescribed by the State Treasurer and approved by the Governor and Council of State.

*Recommendatio*n: The Department should enhance its internal control procedures to ensure that all financial transactions are reported timely and in the proper accounting period. Timely reporting in the Investment Pool's financial records is critical to ensure that entities that invest in the Pool have the information they need to properly report investment transactions in the State's financial statements.

Agency Response: As noted above, when preparing the 2010 year-end financial statements, the Department recorded a restatement to the Investment Pool's financial statements to properly disclose the asset, realized income, and unrealized loss associated with the securities lending cash collateral pool for fiscal year 2009. All amounts were properly reflected in the 2010 fiscal year-end financial statements for the Investment Pool. The Department interprets the phrase "interest or income received and accruing," found in Section 147-69.1(d), to mean net, as opposed to gross, income. The Department as a fiduciary deemed it prudent to set aside future earnings from securities lending in dedicated reserve accounts to net against the unrealized losses in the securities lending collateral pools. At the point reserves are deemed sufficient to cover the final projected liabilities, net revenues from securities lending will be distributed to the participants. The Department will ensure that the appropriate investment income (loss) from securities lending is recorded accurately and timely in the Pool's financial statements.

Auditor Comment: While it is true that the Department made the necessary restatement to reflect the proper amounts in the 2010 financial statements, this was not done in time to ensure that all transactions were reported in the appropriate fiscal year. Also, if for income distribution purposes the Department believes it prudent to treat the net income from these transactions differently from other Investment Pool income and losses, then it should adopt a policy to that effect and obtain any necessary approvals required by statute. However, measures will need to be taken to ensure that all Investment Pool participants receive the information necessary to properly report their investment assets at fair value as required by generally accepted accounting principles.

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