

STATE OF NORTH CAROLINA

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA



DEPARTMENT OF STATE TREASURER

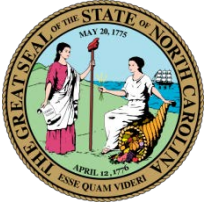
RALEIGH, NORTH CAROLINA

AUDIT REPORT ON THE SCHEDULE OF CASH AND INVESTMENTS HELD IN
THE STATE TREASURY
AS OF DECEMBER 31, 2016



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The Taxpayers' Watchdog

STATE OF NORTH CAROLINA
Office of the State Auditor



Beth A. Wood, CPA
State Auditor

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AUDITOR'S TRANSMITTAL

The Honorable Roy Cooper, Governor
The General Assembly of North Carolina
The Honorable Dale R. Folwell, State Treasurer

In accordance with *North Carolina General Statute* 147-64.6(c)(8), we have completed an audit of the North Carolina Department of State Treasurer's balances in the state treasury as of December 31, 2016. The law requires such an audit whenever a new State Treasurer assumes office. You will note from the independent auditor's report that we determined that the schedule of cash and investments held in the state treasury is presented fairly in all material respects.

The results of our tests disclosed no deficiencies in internal control over financial reporting that we consider to be material weaknesses in relation to our audit scope or any instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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 cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA
State Auditor



Beth A. Wood, CPA
State Auditor

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INDEPENDENT AUDITOR'S REPORT

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INDEPENDENT AUDITOR'S REPORT

The Honorable Dale R. Folwell, State Treasurer
North Carolina Department of State Treasurer
Raleigh, North Carolina

Report on the Schedule

We have audited the accompanying schedule of cash and investments held in the state treasury of the North Carolina Department of State Treasurer as of December 31, 2016 and related notes (hereafter referred to as the "schedule").

Management's Responsibility for the Schedule

Management is responsible for the preparation and fair presentation of the schedule and related notes in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the schedule that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the schedule based on our audit. 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the schedule. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the schedule, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the department's preparation and fair presentation of the schedule and related notes in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the schedule.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the schedule referred to above presents fairly, in all material respects, the cash and investments held in the state treasury of the North Carolina Department of State Treasurer as of December 31, 2016, in accordance with accounting principles generally accepted in the United States of America.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated March 15, 2017 on our consideration of the department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the department's internal control over financial reporting and compliance.

Restriction on Use

Our report is intended solely for the information and use of the State Treasurer, others within the entity, the Governor, and the General Assembly and is not intended to be and should not be used by anyone other than these specified parties.



Beth A. Wood, CPA
State Auditor

Raleigh, North Carolina

March 15, 2017



SCHEDULE OF CASH AND INVESTMENTS

North Carolina Department of State Treasurer
Schedule of Cash and Investments Held in the State Treasury
As of December 31, 2016

	<u>(Dollars in Thousands)</u>
EXTERNAL INVESTMENT POOL:	
Cash and Cash Equivalents	\$ 204,833
Debt Investments:	
U.S. Treasuries	12,477,586
U.S. Agencies	9,865,005
Mortgage Pass-Throughs	7,676,634
Repurchase Agreements	1,680,000
Certificates of Deposit	10,600
Domestic Corporate Bonds	7,770,110
	<hr/>
Total Debt Investments	39,479,935
	<hr/>
Securities Purchased with Cash Collateral Under the Fixed Income Securities Lending Program:	
Repurchase Agreements	47,594
Money Market Mutual Funds	72,876
Domestic Corporate Bonds	776,703
	<hr/>
Total Securities Lending	897,173
	<hr/>
Other Investments:	
Cash and Cash Equivalents	69,641
U.S. Treasuries	280,076
Collateralized Mortgage Obligations	55,583
Commercial Mortgage-Based Securities	29,995
Collective Investment Funds	1,254,140
Bond Index	1,559,840
Domestic Corporate Bonds	185,151
Equity Securities	863
Futures Contracts	7,367
Equity Based Trust-Domestic	20,146,755
Equity Based Trust-International	17,370,277
Commingled Equity Fund - Local OPEBs	129,554
Alternative Investments:	
Multi-Strategy Investments	1,632,181
Private Equity Investments	4,486,917
Real Estate Trust Fund	8,235,488
Credit Investments	5,385,977
Inflation Protection Investments	5,461,280
	<hr/>
Total Other Investments:	66,291,085
	<hr/>
Securities Purchased with Cash Collateral Under the Equity Securities Lending Program:	
Repurchase Agreements	383,324
Money Market Mutual Funds	35,353
Asset-Backed Securities	29,427
	<hr/>
Total Securities Lending	448,104
	<hr/>
Total External Investment Pool	107,321,130
	<hr/>

North Carolina Department of State Treasurer
Schedule of Cash and Investments Held in the State Treasury
As of December 31, 2016

BOND PROCEEDS INVESTMENT ACCOUNTS:

Repurchase Agreements	307,963
Commercial Paper	22,885
Yankee Commercial Paper	45,721
	<hr/>
Total Bond Proceeds Investment Accounts	376,569
	<hr/>

PUBLIC HOSPITALS INVESTMENT ACCOUNT:

Commingled Equity Fund	235,405
	<hr/>

ESCHEAT INVESTMENT ACCOUNT:

Private Credit Limited Partnership	8,478
Private Equity Investment Partnerships	25,379
Private Natural Resources Limited Partnership	5,215
	<hr/>
Total Escheat Investment Account	39,072
	<hr/>

Total Cash and Investments Held in the State Treasury	<u>\$ 107,972,176</u>
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The accompanying notes to the schedule are an integral part of this statement.



NOTES TO THE SCHEDULE

**NORTH CAROLINA DEPARTMENT OF STATE TREASURER
NOTES TO THE SCHEDULE OF CASH AND INVESTMENTS HELD IN THE
STATE TREASURY
DECEMBER 31, 2016**

NOTE 1 - FINANCIAL REPORTING ENTITY

The cash and investments held in the State Treasury consist of the investments in the North Carolina Department of State Treasurer External Investment Pool (the "Pool") and investments held for other ancillary governmental participants. The participants of the Pool include Teachers' and State Employees' Retirement System, Consolidated Judicial Retirement System, Legislative Retirement System, Firefighters' and Rescue Squad Workers' Pension Fund, North Carolina National Guard Pension Fund, Local Governmental Employees' Retirement System, Teachers and State Employees' Benefit Trust, Retiree Health Benefit Fund, Disability Income Plan of N.C., and Register of Deeds' Supplemental Pension Fund as well as component units of the State of North Carolina and other external entities. Other ancillary governmental participants with investments held at the State Treasury include, among others, Public Hospitals, certain investments of the Escheat Fund, and the Bond Proceeds Investment Accounts.

The Pool, a governmental set of investments of the Treasurer, consists of the following individual investment portfolios: Short-term Investment Fund, Long-term Investment Fund, External Fixed Income Portfolio, the Bond Index Fund, Equity Investment Portfolio, Real Estate Investment Portfolio, Alternative Investment Portfolio, Credit Investment Portfolio, Inflation Protection Investment Portfolio, and OPEB Equity Investment Portfolio. The Pool operates under General Statutes 147-69.1 to 147-69.3.

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES

A. State Treasury - Unless specifically exempt, every agency of the State and certain component units are required by General Statute 147-77 to deposit moneys received with the State Treasurer or with a depository institution in the name of the State Treasurer. Certain local governmental units that are not part of the reporting entity are also allowed to deposit money with the State Treasurer. Expenditures for the primary government and certain component units are made by wire transfers, ACH transactions, and warrants issued by the agencies and drawn on the State Treasurer. The State Treasurer processes these transactions each day. General Statute 147-69.1 authorizes the State Treasurer to invest all deposits in obligations of or fully guaranteed by the United States; obligations of certain federal agencies; specified repurchase agreements; obligations of the State of North Carolina; time deposits with specified financial institutions; prime quality commercial paper with specified ratings; specified bills of exchange or time drafts; asset-backed securities with specified ratings; and corporate bonds and notes with specified ratings.

General Statute 147-69.2 authorizes the State Treasurer to invest the deposits of certain special funds, including the pension trust funds, the Disability Income Plan of N.C., the Escheat Fund, the Public School Insurance Fund, Local Government Other Post-Employment Benefits (OPEB) Trust, and deposits of certain component units including trust funds of the University of North Carolina System, and funds of the State Health Plan and State Education Assistance Authority in the investments authorized in General Statute 147-69.1; general obligations of other states; general obligations of North Carolina local governments; asset-backed securities bearing specific ratings; and obligations of any company incorporated within or outside the United States bearing specific ratings. The deposits of the pension trust funds may be invested in all of the above plus certain insurance contracts; group trusts; individual, common or collective trusts of banks and trust companies; real estate investment trusts; limited partnership interest in limited liability partnerships or limited liability companies; and certain stocks and mutual funds.

- B. Basis of Presentation** - The accompanying schedule of cash and investments held in the state treasury is prepared in accordance with accounting principles generally accepted in the United States ("GAAP") as applicable to governments. The Governmental Accounting Standards Board ("GASB") establishes standards of financial accounting for state and local governmental entities.
- C. Cash and Cash Equivalents** - The Pool reports all cash on hand and deposits in banks, including demand deposits as cash and cash equivalents. Cash equivalents are highly liquid investments with an original maturity of ninety days or less when purchased.
- D. Investments** - Investment transactions are recognized when purchased or sold (trade date) rather than when received or delivered (settlement date). Investments and derivatives are reported at fair value with significant exceptions noted below. Repurchase agreements and non-negotiable certificates of deposit in the Short-term Investment portfolio are reported at cost which approximates fair value. Additional investment valuation information is provided in the notes below for each specific investment portfolio and account.
- E. Valuation of Investments and Derivatives** - Fair values are determined daily for the Long-term Investment, Equity Investment, Bond Index, and OPEB Equity Investment portfolios. The Real Estate Investment and Alternative Investment portfolios are valued quarterly except for Real Estate Investment Trusts in the Real Estate Investment Portfolio which are valued daily and hedge funds in the Alternative Investment portfolio which are valued monthly. The Credit Investment portfolio is valued quarterly except for hedge fund investments which are valued monthly. The Inflation Protection Investment portfolio consists of limited partnerships which are valued quarterly, futures which are valued daily or monthly, and US Treasury Inflation Protected Securities (TIPS) which are valued daily. In the Long-term Investment portfolio, the fair value of fixed income securities is calculated by a third party pricing vendor based on

future principal and interest payments discounted using market yields. For the Alternative Investment portfolio (private equity investment partnerships and hedge funds), the Real Estate Investment portfolio (limited partnerships and other investments), the Credit Investment and Inflation Protection Investment portfolios (limited partnerships, hedge funds, and other non-publicly traded investments) the methodology for determining an estimated fair value is established by the general partner, which may utilize a third party pricing source or an independent real estate appraiser. Contracts with these partnerships, hedge funds, and other investments require an annual audit, except for certain older investments that are immaterial to the schedule.

The general partners' estimated fair values are based on the partnership's and fund's respective net asset values ("NAV"). The most significant input into the NAV of such an entity is the fair value of its holdings. These non-publicly traded assets are valued at current fair value, taking into consideration the financial performance of the issuer, cash flow analysis, recent sales prices, market comparable transactions, a new round of financing, a change in economic conditions, and other pertinent information. The fair values of certain investments may require significant management judgment or estimation. Fair value is determined using the best information available for a hypothetical transaction at the measurement date, not using forced sale or fire sale pricing. Participants' shares sold and redeemed are determined in the same manner as is used to report investments, and the Treasurer does not provide or obtain legally binding guarantees to support share values.

Derivative instruments are securities that derive value from another asset and are in the form of a contract between two or more parties. Common derivatives are futures contracts, forward contracts, options and swaps. The Pool maintained by the Treasurer has investments in equity and commodity futures, foreign currency forward and spot currency contracts. All of these derivative instruments are designated as investment derivatives; they are used to implement portfolio strategies, capture valuation opportunities, and to exploit market inefficiencies. Derivatives are primarily held in the Equity Investment and Inflation Protection Investment portfolios.

- F. Securities Lending** - Cash received as collateral on securities lending transactions is used to purchase investments. These investments are reported as securities lending collateral in the accompanying schedule and are generally measured at fair value with the exception of repurchase agreements, which are reported at cost. Additional investments priced at cost are money market funds in the securities lending cash collateral pools.

NOTE 3 - EXTERNAL INVESTMENT POOL

To ensure that these and other legal and regulatory limitations are met, all cash deposited with the State Treasurer, except for the Public Hospitals,

Escheat Fund, and Bond Proceeds investment accounts, is maintained in the Pool. The Pool consists of the following individual investment portfolios:

Short-term Investment – This portfolio may hold any of the investments authorized by General Statute 147-69.1. The Short-term Investment portfolio is the primary cash management account for the State and is managed in such a manner as to be readily convertible into cash. The primary participants of this portfolio are the General Fund, Highway Fund, and Highway Trust Fund. Certain other participants include the State Health Plan Reserve Fund, universities and various boards, commissions, community colleges, and school administrative units that make voluntary deposits with the State Treasurer as well as the remaining portfolios listed below.

Long-term Investment – This portfolio may hold the fixed-income investments authorized by General Statutes 147-69.1 and 147-69.2. Since the deposits in this fund are typically not needed for day-to-day operations, the investment vehicles used generally have a longer term and higher yield than those held in the Short-term Investment portfolio. The State's pension trust funds are the sole participants in the portfolio.

External Fixed Income Investment – This portfolio holds a portion of the Short-term Investment portfolio pursuant to General Statute 147-69.2. The State's pension trust funds are the sole participants in the portfolio.

Bond Index – This portfolio holds high quality debt securities authorized by General Statute 147-69.2(b). Since the deposits in this fund are typically not needed for day-to-day operations, the investment vehicles used generally have a longer term and higher yield than those held in the Short-term Investment portfolio. The portfolio is designed to produce a return consistent with the Barclay's U.S. Aggregate Bond Index benchmark. The participants of the portfolio include the EPA revolving loan funds, component units of the State, various local governments, community colleges, and school administrative units.

Equity Investment – This portfolio is managed pursuant to General Statute 147-69.2(b)(8) and primarily holds an equity-based trust. The State's pension trust funds are the sole participants in the portfolio.

Real Estate Investment – This portfolio holds investments in real estate-based trust funds and group annuity contracts, which are managed pursuant to General Statute 147-69.2(b)(7). The State's pension trust funds are the sole participants in the portfolio.

Alternative Investment – This portfolio holds investments in limited partnerships, hedge funds, U.S. Treasuries, and equities received in the form of distributions from its primary investments, which are managed pursuant to General Statute 147-69.2(b)(9). The State's pension trust funds are the sole participants in the portfolio.

Credit Investment – This portfolio may hold investments in debt-related strategies as defined by General Statutes 147-69.2(b)(6c). The State's pension trust funds are the sole participants in the portfolio.

Inflation Protection Investment – This portfolio may hold investments in assets that are acquired for the primary purpose of providing protection against risks associated with inflation, managed pursuant to General Statute 147-69.2(b)(9a). The State’s pension trust funds are the sole participants in the portfolio.

OPEB Equity Investment – This portfolio holds equity-based trusts. Pursuant to General Statute 159-30.1, the State Treasurer manages the trusts’ assets. These trusts are established for local governments, public authorities, any entity eligible to participate in the State’s Local Governmental Employees’ Retirement System, and local school administrative units. Eligible participants make voluntary contributions to the trusts for the purpose of depositing and investing all or part of the contribution from their other post-employment benefit plans. As of December 31, 2016, there were nineteen participants. Each participant is responsible for making its own investment decisions.

All of the preceding investment portfolios operate like individual investment pools, except that an investment portfolio may hold shares in other investment portfolios at the discretion of the State Treasurer and subject to the legal limitations discussed previously. To this extent, the State Treasurer considers all investment portfolios to be part of a single pool. The Pool is not registered with the Securities and Exchange Commission and is not subject to any formal oversight other than that of the legislative body.

Securities Lending

Based on General Statute 147-69.3(e), the Treasurer lends securities from its Pool to broker-dealers and other entities (borrowers) for collateral that will be returned for the same securities in the future. There are no restrictions on the amount of loans that can be made. Substantially all security loans can be terminated on demand by either the Treasurer or the borrower. The Treasurer cannot pledge or sell the collateral securities received unless the borrower defaults.

Prior to the fourth quarter of 2016, securities lending for the internally managed fixed income portfolio was administered by the Treasurer’s custodian, while securities lending for the equity based trust was administered by a third party lending agent. As of September 15, 2016, a new agreement was signed restructuring the securities lending programs and replacing the third party agent with the Treasurer’s custodian to administer the equity based trust, along with the internally managed fixed income. The guidelines for acceptable collateral also changed as part of the restructuring, incorporating a greater level of risk aversion. The prior lending program allowed for a broader universe of acceptable collateral across security types, credit qualities, and maturity profiles. As part of the transition to the new securities lending program, management made the decision to not apply the new acceptable collateral guidelines to all of the collateral that was on the books as of the date of transition, as management believed a forced liquidation could create unnecessary losses. As a result of this, the current pool of collateral has legacy securities that do not meet the new acceptable collateral guidelines, namely asset backed securities and domestic corporate bonds.

The current program is permitted to receive cash, U.S. government and agency securities as collateral for the securities lent. The collateral is initially pledged at 102% of the market value of U.S. dollar denominated securities lent and 105% of the market value of non U.S. dollar denominated securities lent. Additional collateral is required if its value falls to less than 100% of the market value of the securities lent.

Cash collateral received is invested by the lending provider and held in a separate account in the name of the Treasurer. The policies for investments purchased with cash collateral under the securities lending program are set forth in the contract with the lending provider. The eligible investments are restricted to Repurchase Agreements with a maturity not greater than 5 business days issued by high quality counterparties, and money market mutual funds that are registered under the Investment Company Act of 1940, provided that such money market mutual funds invest solely in obligations that are issued by or fully guaranteed by the United States Government.

During the year, the securities lending programs lent U.S. government and agency securities, corporate bonds, and equity securities for collateral.

As of December 31, 2016, the Treasurer had no credit risk exposure to borrowers because the amounts the Treasurer owed the borrowers exceeded the amounts the borrowers owed the Treasurer. The lending providers are contractually obligated to indemnify the Treasurer for certain conditions, the most important is default on the part of the borrowers.

Securities Lending – Internally Managed Fixed Income

Under the prior securities lending guidelines for the internally managed fixed income portfolios, the following applied: asset-backed securities must bear the highest rating of at least one nationally recognized rating service, the expected maturity shall not exceed five years and securities having a final maturity greater than two years will be in floating rate instruments with interest rate resets occurring at no greater than 90-day intervals to minimize the effect of interest rate fluctuations on their valuations, corporate bonds and notes, including bank holding company obligations, rated AA must have a final maturity no greater than three years, securities rated A must have a final maturity no greater than two years, and no more than five percent of the cash collateral may be invested in a single issue.

During the market crisis of late 2008, there was a default in a Lehman Brothers floating rate note in which securities lending collateral had been invested in the fixed income securities lending program. Since that time, several other investments with potential losses were identified. The Treasurer directed that all securities lending revenues would be deposited into a separate account. In fiscal year 2016, these securities were sold and the funds in the separate account were used to offset the losses and the residual cash in the reserve accounts was moved to the internally managed fixed income portfolios.

As of December 31, 2016, the fair value of loaned securities in the fixed income program was \$6.56 billion; the fair value of the associated collateral was \$6.71 billion of which \$897 million was cash.

Securities Lending – Equity Based Trust

Under the current securities lending guidelines for the equity based trust adopted in 2010, but ended in 2016, the universe of eligible collateral was broader than what is allowed within the current program. As of December 31, 2016, the fair value of loaned securities in the equity based trust program was \$799 million; the fair value of the associated collateral was \$829 million, of which \$448 million was cash. As of December 31, 2016, noncash collateral of \$381 million was invested in U.S. government guaranteed securities which are not subject to credit risk.

NOTE 4 - BOND PROCEEDS INVESTMENT ACCOUNTS

The State Treasurer has established separate investment accounts for each State bond issue to comply with Internal Revenue Service regulations on bond arbitrage. A private investment company under contract with the State Treasurer manages these separate accounts.

At December 31, 2016, the bond proceeds investment accounts were valued at \$376.6 million. The funds were substantially invested in repurchase agreements (81.8%) with a weighted average maturity of five days. Repurchase agreements are reported at cost.

NOTE 5 - PUBLIC HOSPITALS INVESTMENT ACCOUNT

The State Treasurer has contracted with an external party (“Trustee”) to create the Public Hospitals investment account. The investment account currently consists of Margaret R. Pardee Hospital Trust, New Hanover Regional Medical Center Trust, Columbus Regional Healthcare Trust and Watauga Medical Center Trust. These Trusts are part of commingled equity investment funds. The Trustee manages the assets, primarily in equity and equity-based securities in accordance with the General Statutes. The Trustee maintains custody of the underlying securities in the name of the Trust, services the securities, and maintains all related accounting records. One public hospital is a participant in the Pool’s portfolio.

NOTE 6 - ESCHEAT INVESTMENT ACCOUNT

Pursuant to General Statute 147-69.2(b)(12), the State Treasurer has established a separate investment account on behalf of the Escheat Fund. The investments are valued at fair market value. The methodology for determining an estimated fair value is established by the general partner, which may utilize a third party pricing source or an independent appraiser.

The general partners’ estimated fair values are based on the partnership’s and fund’s respective net asset values (“NAV”). The most significant input into the NAV of such an entity is the fair value of its holdings. These non-publicly traded assets are valued at current fair value, taking into consideration the financial performance of the issuer, cash flow analysis, recent sales prices, market comparable transactions, a new round of

financing, a change in economic conditions, and other pertinent information. The fair values of certain investments may require significant management judgment or estimation. Fair value is determined using the best information available for a hypothetical transaction at the measurement date, not using forced sale or fire sale pricing.

Private Credit Limited Partnership - This type includes three private credit funds. These investments are valued at net asset value using the most recent available financial information. These investments include a mix of non-investment grade or unrated obligations, debt securities and asset-backed securities, including but not limited to, bank loans, high yield, mortgage-backed securities, convertibles, whole loans, mezzanine debt, credit default swaps, collateralized debt obligations and sovereign debt. These funds are not eligible for redemption. Distributions are received as underlying investments within the funds liquidated, which on average can occur over the span of 5-10 years.

Private Equity Investment Partnership - This type includes nine private equity funds. These investments are value at net asset value using the most recent available financial information. These investments include a mix of buyout, venture capital, growth equity, and private special situations vehicles. These funds are not eligible for redemption. Distributions are received as underlying investments within the funds liquidated, which on average can occur over the span of 5-10 years.

Private Natural Resources Limited Partnership - This type includes one private natural resources fund. These investments are valued at net asset value using the most recent available financial information. These strategies may make non-public equity or debt investments in timberland, energy, agriculture, and other natural resources implementations. Currently, the strategy represented in this category is one which invests in oil and gas properties within the U.S. These funds are not eligible for redemption. Distributions are received as underlying investments within the funds are liquidated, which on average can occur over the span of 5-10 years.



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**INDEPENDENT AUDITOR'S 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 Dale R. Folwell, State Treasurer
North Carolina Department of State Treasurer
Raleigh, North Carolina

We have audited, in accordance with the 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, the schedule of cash and investments held in the state treasury of the North Carolina Department of State Treasurer as of December 31, 2016, and have issued our report thereon dated March 15, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the schedule of cash and investments held in the state treasury, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control.

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 and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the Department's schedule will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a 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 internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during

our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the schedule of cash and investments is free from 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 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 Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Department's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Department's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Beth A. Wood, CPA
State Auditor

Raleigh, North Carolina

March 15, 2017

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For additional information contact:
Bill Holmes
Director of External Affairs
919-807-7513



This audit required 828 hours at an approximate cost of \$85,284.