

STATE OF NORTH CAROLINA

DEPARTMENT OF STATE TREASURER

FINANCIAL RELATED AUDIT

JULY 2013

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

DEPARTMENT OF STATE TREASURER

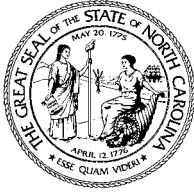
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AUDITOR'S TRANSMITTAL

July 2, 2013

The Honorable Pat McCrory, Governor
The General Assembly of North Carolina
The Honorable Janet Cowell, State Treasurer
Fran Lawrence, Chief Financial Officer, Department of State Treasurer

This report presents the results of our financial related audit at the Department of State Treasurer. Our work was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes* and was conducted in accordance with the performance audit standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The results of our audit disclosed deficiencies in internal control and/or other matters that are considered reportable under *Government Auditing Standards*. These items are described in the *Audit Findings and Responses* section of this 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 ways listed in the back of this report.

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA
State Auditor

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BACKGROUND

As authorized by Article 5A of Chapter 147 of the *North Carolina General Statutes*, we have conducted a financial related audit at the Department of State Treasurer (Department). There were no special circumstances that caused us to conduct the audit, but rather it was performed as part of our effort to periodically examine and report on the financial practices of state agencies and institutions.

The Department serves the people of North Carolina through a variety of functions related to the financial health of the state and its citizenry. In addition to serving as the State's banker and investment officer, the Department administers retirement plans, health benefit programs, and other benefit programs for public employees. It also manages the State's unclaimed property program. By law, property such as bank accounts, wages, utility deposits, insurance policy proceeds, stocks, bonds, and contents of safe deposit boxes that have been abandoned are escheated, or turned over, to the Department for safekeeping.

AUDIT SCOPE AND OBJECTIVES

The general objective of this financial related audit was to identify improvements needed in internal control over selected fiscal matters. Management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that relevant objectives are achieved. Errors or fraud may nevertheless occur and not be detected because of the inherent limitations of internal control. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or that compliance with policies and procedures may deteriorate. Our audit does not provide a basis for rendering an opinion on internal control, and consequently, we have not issued such an opinion.

Our audit scope covered the period July 1, 2012 through December 31, 2012 and included selected internal controls in the following organizational units:

Retirement Systems Division - The Retirement Systems Division oversees the statutory retirement and benefit plans that cover over 870,000 active and retired public employees in the State. The Consolidated Judicial Retirement System and the Disability Income Plan of North Carolina are among the various retirement and other benefit plans administered by the Division. The Division is responsible for:

- Collecting employer and employee contributions that support the retirement and disability plans,
- Processing the applications for retirement and disability benefits,
- Calculating the benefits and processing monthly payments, and
- Identifying and collecting overpayments of benefits.

Unclaimed Property and Escheats Division - The Division oversees and maintains the State's database of unclaimed property. Property is typically considered unclaimed once it is abandoned for one to five years. The Unclaimed Property and Escheats Division is responsible for recovering and returning such property to all rightful owners. Unclaimed property is held by the Department for at least one year then sold through a cooperative effort with State Surplus Property. Proceeds from the sale are maintained under the owner's name and held indefinitely. All unclaimed cash held by the Department is invested and earns interest. The interest earnings are provided to the North Carolina State Educational Assistance Authority to finance grants and loans to needy North Carolina students in State-supported institutions of higher education.

The State Health Plan for Teachers and State Employees (State Health Plan) - The State Health Plan provides health care coverage to over 660,000 teachers, state employees, retirees, current and former lawmakers, state university and community college personnel, state hospital staff, and their dependents. The Executive Administrator of the State Health Plan is appointed by the State Treasurer. The Executive Administrator's major duties include negotiating and executing contracts with third parties after consultation with the State Treasurer. However, the State Health Plan's Board of Trustees is responsible for approving large contracts with third parties.

AUDIT SCOPE AND OBJECTIVES (CONCLUDED)

During our audit, we considered internal control in the organizational units listed above related to the following accounts/control objectives:

Short-term and Long-term Disability Payments and Related Accounts Receivable - During our audit period approximately \$36 million of short-term and long-term disability benefits were paid from the Disability Income Plan of North Carolina (Disability Plan). As of December 31, 2012, the Department reported over \$21 million of accounts receivable for the Disability Plan. We examined the Department's procedures to ensure only eligible members receive disability benefits, disability payments are correctly calculated, and over-payments of disability benefits are identified and collected. We evaluated the design of internal control over all these matters, but only performed detailed audit procedures on the identification of over-payments.

Consolidated Judicial Pension Fund Payments – During our audit period approximately \$16 million of pension benefits were paid from the Consolidated Judicial Retirement System. We examined the Department's procedures to ensure retirement benefits are calculated correctly and paid to eligible members. We evaluated the design of internal control and performed detailed audit procedures on all these matters.

Unclaimed Cash and Other Property – During our audit period the Department received approximately \$92 million of unclaimed cash and receipts from unclaimed property sales, along with other property (such as contents of safe deposit boxes). We examined the Department's procedures to ensure that cash and property received are safeguarded. We evaluated the design of internal control, but due to deficiencies in the design of controls, no further audit procedures were performed.

Third Party Contracts - During our audit period the State Health Plan awarded five contracts, each in excess of \$500,000, for health care claims and related services. We examined the Department's procedures to ensure such contracts were awarded and written in accordance with state law and written to benefit the State by including provisions such as non-performance clauses and non-performance penalties. For all these matters, we evaluated the design of internal control. We then performed limited additional audit procedures on the largest of the five contracts. We reviewed certain provisions of the contract, but our procedures were not designed to identify all contract terms that may not be beneficial to the State. Consequently, we cannot provide assurance that all such matters were identified.

METHODOLOGY

To accomplish our audit objectives, we gained an understanding of internal control over matters described in the *Audit Scope and Objectives* section of this report and evaluated the design of the internal control. For certain objectives, we then performed further audit procedures consisting of tests of control effectiveness and/or substantive procedures that provide evidence about our audit objectives. Specifically, we interviewed personnel, observed operations, reviewed policies, analyzed accounting records, and examined documentation supporting recorded transactions and balances, as considered necessary in the circumstances. Whenever sampling was used, we applied a nonstatistical approach but chose sample sizes comparable to those that would have been determined statistically. As a result, we were able to project our results to the population but not quantify the sampling risk.

As a basis for evaluating internal control, we applied the internal control guidance contained in professional auditing standards. As discussed in the standards, internal control consists of five interrelated components: (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring.

We conducted this audit in accordance with generally accepted government auditing standards applicable to performance audits. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

RESULTS AND CONCLUSIONS

The results of our audit disclosed deficiencies in internal control and/or other matters that are considered reportable under generally accepted government auditing standards. These items are described in the *Audit Findings and Responses* section of this report. Management's responses are presented after each audit finding. We did not audit the responses, and accordingly, we express no opinion on them.

AUDIT FINDINGS AND RESPONSES

1. EFFORTS TO PREVENT OR DETECT DISABILITY OVERPAYMENTS NEED IMPROVEMENT

The North Carolina Department of State Treasurer (Department) does not adequately ensure that disability plan benefits are reduced when recipients also receive earnings or other benefits. As a result, benefit overpayments are not prevented or detected timely.

The Department typically pays over \$75 million in disability benefits in a fiscal year. As of December 31, 2012, the Disability Income Plan of North Carolina reported accounts receivable of over \$21 million related to cumulative benefit overpayments.

Recipients' disability benefits are reduced when they receive earnings or other benefits. Earnings and other benefits include, but are not limited to:

- Earnings - salaries and wages, fees, commissions, royalties, awards, and self-employment income.
- Other benefits - payments for workers' compensation, payments from any federal agency for the same disability, and/or payments for social security retirement benefits.

The Department primarily relies on annual self-reporting by recipients to identify earnings or other benefits. In addition to the risk that the recipients fail to report amounts received to avoid benefit reductions, only gathering the information annually results in larger benefit overpayments than would be made if the information were available more timely.

Recommendation: The Department should strengthen procedures to identify earnings and other benefits received by disability plan recipients. To enhance procedures, the Department should evaluate the cost effectiveness of procedures such as (subject to legal restriction on data access):

- a. Implementing a data sharing agreement with the Social Security Administration (SSA) to conduct periodic data matches (possibly quarterly) to identify disability plan recipients who have started receiving social security disability or retirement benefits.
- b. Implementing a data sharing agreement with the Office of Child Support Enforcement to conduct periodic data matches (possibly quarterly) with the National Directory of New Hires (Directory). This Directory contains quarterly state wage and new hire data and could be a resource to periodically monitor the earnings of disability recipients.
- c. Creating a "predictive model" to identify cases with the highest probability of having large overpayments and prioritizing them for more frequent review. The SSA has developed such a model for social security disability benefits. The Department could contact the SSA to obtain information on how this could be implemented for the Disability Income Plan of North Carolina.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

- d. Implementing a data sharing agreement with the Internal Revenue Service or the North Carolina Department of Revenue to match Department records against federal and state wage data. However, information received by this method may be less timely than others noted above (annually vs. quarterly).
- e. Requesting recipients to report earnings and other income more frequently and having recipients submit tax returns for verification of earnings reported.

Department Response: We agree with the Auditor's recommendation to strengthen procedures to identify earnings and other benefits received by disability plan recipients. The Director of the Retirement System will be responsible for coordination of the corrective action.

The General Statutes do not provide for the Retirement Systems Division (RSD) to stop or reduce a member's disability benefit unless RSD has evidence of one of the statutory offsets. Because the Social Security Administration (SSA) frequently awards disability benefits several years in arrears, such awards will inevitably create large overpayments from the Disability Income Plan (DIPNC). These retroactive awards from the SSA are the source of the majority of the overpayments created, with earnings from employment less of an issue.

State law mandates that DIPNC recipients report income annually. More frequent reporting and submission of tax returns, as was previously done, will not prevent the majority of the overpayments from the plan as described above and is not easily administrable. RSD in the past has attempted a data sharing arrangement with SSA, in order to attempt to reduce the number and amount of DIPNC overpayments due to SSA disability awards. However, RSD was unsuccessful in coming to an agreement and since that time SSA has become even more restrictive with beneficiaries' personal data. A "predictive model" for identifying overpayments would still not assist with the majority of the overpayments coming from these large retroactive SSA awards. RSD will continue to monitor the opportunity for a data sharing agreement with SSA.

The corrective action RSD is pursuing is to detect earnings by participation in a larger data sharing arrangement through NCFACETS, in which the North Carolina Department of Revenue, Employment Security Commission and others agencies will also participate. The Office of State Controller is leading this initiative and the Adoption Agreement between the parties (including DST) was executed in May 2013.

2. CONTROLS OVER UNCLAIMED CASH AND TANGIBLE PROPERTY NEED IMPROVEMENT

The Department's Unclaimed Property Division (Division) does not adequately safeguard the assets it receives. As a result, there is an increased risk that unclaimed cash and tangible property could be stolen or misplaced without detection, especially during the time of year when a high volume of property is received. The Division's cash collections and receipts from unclaimed property sales will exceed \$92 million in fiscal year 2012-13.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

The Division does not immediately establish reliable accountability for the unclaimed cash and tangible property it receives. The annual deadline for entities other than insurance companies to submit unclaimed cash or tangible property to the Department is November 1st, which means a high volume of cash and tangible property is received around that time. Due to the high volume of receipts, Division employees are unable to record details about the unclaimed cash and tangible property into the unclaimed property system timely.

Unclaimed Cash Reconciliations Not Timely

During the high-volume period of receipts, the Division does not perform timely reconciliations of monthly cash receipts recorded in the unclaimed property system to the amount of bank deposits made and recorded in the general ledger. As discussed above, the unclaimed property system is not kept up-to-date during this period. As of January 2013, the most current reconciliation performed was August 2012. Therefore, any loss or misappropriation of cash could go undetected for months.

Reliable Record of Tangible Property Received Not Established Immediately

We identified a six to eight week lag for recording tangible property and owner information into the unclaimed property system. Prior to the tangible property being entered in the unclaimed property system, the only record of the property received is a receiving document completed and signed by two employees. The receiving document is not sequentially numbered and a copy is not maintained separately from the tangible property. Thus, if assets are lost or misappropriated and the receiving document destroyed, there is no record of the tangible property and the loss or theft would likely go undetected.

The receiving document and the tangible property are stored in a secure location, and the key to access the property is kept in an employee's locked office. However, this employee or someone else who gains access to the office could take the tangible property and cover up the misappropriation.

Access to the System and Unclaimed Tangible Property Not Adequately Segregated

The Division does not appropriately restrict or monitor access rights to the unclaimed property system for employees who also have access to the tangible property. The employee who has custody of the key to the room where the tangible property is kept also has system access rights to add, update, alter, and delete property from the system records. Therefore, the employee could misappropriate tangible property and delete it from the records, thus covering up the theft.

A Division manager reviews a system report listing edits made by employees. However, the report only indicates an edit was made and does not detail the type or nature of the edit. Therefore, review of this report is not sufficient to ensure an employee does not make inappropriate changes to system records. For the employee with edit/update access

AUDIT FINDINGS AND RESPONSES (CONTINUED)

and the key to the tangible property room, the employee's duties also include recording property into the system, so it would not be unusual for the report to show edits by the employee.

Recommendation: The Division should strengthen controls over unclaimed cash and property by:

- Implementing interim procedures to reconcile cash received to cash actually deposited. An option is to reconcile the cash received to the bank confirmation received when funds are deposited. A separate employee from the one making the deposit should perform this reconciliation.
- Implementing procedures to track tangible property prior to it being logged into the system. An option is to use sequentially pre-numbered documents to initially document receipt of the tangible property and then review and reconcile the pre-numbered documents for completeness.
- Ensuring that employees with system access do not also have access to the tangible property or implementing adequate monitoring controls, such as reviewing the specific edits made to system records.

Department Response: We agree with the Auditor's recommendation to strengthen controls over unclaimed tangible property and cash. The Director of the Unclaimed Property Division has been responsible for coordination of the corrective action and all corrective action has been implemented as of the date of this letter.

When tangible property is received by the Division, historically it was recorded on an Inventory Control Sheet signed by two employees and taped to the package prior to the property being stored in the locked tangible property room until inventoried. As of January 31, 2013, a sequentially numbered Inventory Receipts Log is being used to record the receipt of tangible property packages. Each package received and recorded on the Inventory Receipts Log has a pre-assigned unique sequential item number that is also recorded on the Inventory Control Sheet attached to the package. Any packages received but not inventoried as of January 31, 2013 were retroactively recoded on the Inventory Receipts Log.

To ensure that employees with system access do not have unmonitored access to tangible property, the Division implemented a dual control system on February 11, 2013. The Vault Access Log Book ("Log Book") used to record entries to the safekeeping/tangible property area is placed under lock and controlled by the Receipts and Processing Supervisor. This position is separate from the two employees that are receiving and recording property into the Log Book and Unclaimed Property System. Also as of December 14, 2012, due to an Internal Audit, entries in the Log Book were expanded to include the date/month/year that any tangible property was removed from inventory due to being returned to the claimant, along with the claim number, and property ID number.

AUDIT FINDINGS AND RESPONSES (CONCLUDED)

As of June 24, 2013 the monthly reconciliation for refunds paid between Wagers and NCAS has been reconciled through May 2013. The Division's goal is to complete reconciliation within 30 days of Financial Operations providing month end reports which is typically 15 days after month end. To address the challenges with meeting this deadline during the high-volume reporting period, the Department is convening a Project Team to assess the Holder Reporting process and increase the timeliness of reconciliations. In the interim, to mitigate risk associated with delays in reconciliations during this period, a new Daily Receipts Log was created and implemented May 1, 2013 to record any checks received other than returned checks (checks issued by the Unclaimed Property Division). The Daily Receipt Log is then used to daily document the disposition, date of disposition, who processed the disposition, and who verified the disposition. The logging of checks and the deposit verification are conducted by two different employees.

3. CONTRACT TERMS NEED CLARIFYING

The Department's contract with the state health plan administrator does not clearly establish whether the State Health Plan (the Plan) will pay additional fees for collecting medical claims overpayments. As a result, there is a risk the Plan could be charged additional fees for services that should be covered by standard administrative fees.

The Plan awarded Blue Cross and Blue Shield of North Carolina (BCBSNC) a contract in August 2012 to provide a network of health care providers, process claims, and premium billing services. The contract will be effective July 1, 2013 and consists of several documents, including the BCBSNC cost and technical proposals. The Department estimates the BCBSNC administrative costs will be over \$89 million for fiscal year 2013-14.

Both the cost and technical proposals address fees BCBSNC will charge to collect amounts overpaid for medical claims. According to the cost proposal, fees for this service are included in the standard administrative fees. However, the technical proposal indicates additional fees will be charged for this service. In our judgment, the contradictory contract terms provide an opportunity for BCBSNC to charge the Plan additional fees.

Recommendation: The Plan should amend the contract to clarify the contract terms.

Department Response: We agree with the Auditor's recommendation to clarify the contract terms. The Executive Administrator of the Plan will be responsible for coordination of the clarification. BCBSNC has agreed to amend the contract effective July 1, 2013.

The amendment will clarify the Plan's original intention, which was not clearly stated in the RFP, to allow a different methodology and separate fee to be assessed for overpayments recovered by BCBSNC subcontractors (i.e. recovery vendors), as opposed to BCBSNC employees.

ORDERING INFORMATION

Copies of this report may be obtained by contacting the:

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