



STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT

NORTH CAROLINA AGRICULTURAL FINANCE AUTHORITY

RALEIGH, NORTH CAROLINA

FOR THE YEARS ENDED JUNE 30, 2001 AND 2000

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

FINANCIAL STATEMENT AUDIT REPORT

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RALEIGH, NORTH CAROLINA

FOR THE YEARS ENDED JUNE 30, 2001 AND 2000

BOARD MEMBERS OF THE AUTHORITY

RICHARD A. HOLDER, CHAIRMAN

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JIMMY A. HARRELL, JR.

GARY HYATT

THE HONORABLE VERNON G. JAMES

THE HONORABLE PAUL S. SMITH

WILLIAM C. THACKER

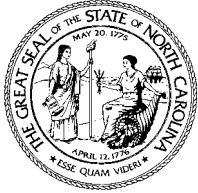
ROBERT FRANK TIMBERLAKE, JR.

JACK CULVER WELBORN

COMMISSIONER MEG SCOTT PHIPPS

ADMINISTRATIVE OFFICER

DR. FRANK BORDEAUX, EXECUTIVE DIRECTOR



Ralph Campbell, Jr.
State Auditor

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AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
The Board Members, North Carolina Agricultural Finance Authority

This report presents the results of our financial statement audits of the North Carolina Agricultural Finance Authority (the Authority), a component unit of the State of North Carolina, for the years ended June 30, 2001 and 2000. Our audits were made by authority of Article 5A of G.S. §147.

The accounts and operations of the Authority are an integral part of the State's reporting entity represented in the State's *Comprehensive Annual Financial Report (CAFR)* and the State's *Single Audit Report*. In those reports, the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report*, the State Auditor also presents the audit results on the State's internal controls and on the State's compliance with laws, regulations, contracts, and grants applicable to the State's financial statements and to its federal financial assistance programs.

As part of the audit work necessary for the CAFR and the *Single Audit Report*, the accounts and operations of the Authority were subject to audit procedures as we considered necessary. In addition, we performed auditing procedures that we considered necessary for us to report on the accompanying financial statements that relate solely to the Authority. The 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.

The purpose of this report is to present the results of our audits on the accompanying financial statements that relate solely to the Authority. A summary of our reporting objectives and audit results are:

- 1. Objective** - Express an opinion on the financial statements that relate solely to the Authority.

Results - The financial statements present fairly, in all material respects, the amounts and disclosures made in accordance with accounting principles generally accepted in the United States of America. These matters are described in the Independent Auditor's Report on the Financial Statements.

AUDITOR'S TRANSMITTAL (CONCLUDED)

2. **Objective** - Present instances of noncompliance, if any, with laws, regulations, contracts, or grants.

Results - Our tests disclosed no instances of noncompliance which require disclosure herein under *Government Auditing Standards*.

3. **Objective** - Present significant deficiencies, if any, in internal control over financial reporting which could adversely affect the Authority's ability to record, process, summarize, and report financial data in the financial statements.

Results - The following significant deficiencies were detected in internal control over financial reporting:

Finding

1. Control Environment
2. Segregation of Duties

These matters are described in the Independent Auditor's Reports on Compliance and on Internal Control over Financial Reporting and the Audit Findings and Recommendations section of this report.

We also noted another matter involving an issue of a management control nature that is described in the Audit Findings and Recommendations section of this report.

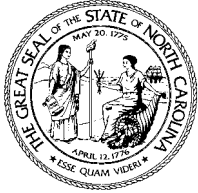
North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.



Ralph Campbell, Jr.
State Auditor

TABLE OF CONTENTS

	PAGE
INDEPENDENT AUDITOR’S REPORT ON THE FINANCIAL STATEMENTS.....	1
FINANCIAL STATEMENTS	
Exhibits	
A Balance Sheets	2
B Statements of Revenues, Expenses, and Changes in Fund Equity	4
C Statements of Cash Flows	6
Notes to the Financial Statements.....	8
INDEPENDENT AUDITOR’S REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH <i>GOVERNMENT AUDITING STANDARDS</i>	23
AUDIT FINDINGS AND RECOMMENDATIONS	25
DISTRIBUTION OF AUDIT REPORT	29



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INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

The Board Members
North Carolina Agricultural Finance Authority
Raleigh, North Carolina

We have audited the accompanying Balance Sheets of the North Carolina Agricultural Finance Authority (the Authority), a component unit of the State of North Carolina, as of June 30, 2001 and 2000, and the related Statements of Revenues, Expenses, and Changes in Fund Equity and Statements of Cash Flows for the years then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the North Carolina Agricultural Finance Authority as of June 30, 2001 and 2000, and the changes in fund equity and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 20, 2001 on our consideration of the Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. This report is an integral part of our audits performed in accordance with *Government Auditing Standards* and should be read in conjunction with the independent auditor's report in considering the results of our audits.

A handwritten signature in black ink that reads "Ralph Campbell, Jr." in a cursive script.

Ralph Campbell, Jr.
State Auditor

November 20, 2001

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North Carolina Agricultural Finance Authority
Balance Sheet
June 30, 2001

Exhibit A

ASSETS	
Cash and Cash Equivalents	\$ 1,423,937
Investments	1,000,000
Interest Receivable	67,887
Notes Receivable	3,347,957
Inventories	1,739
Total Assets	\$ 5,841,520
LIABILITIES AND FUND EQUITY	
Liabilities:	
Accounts Payable	\$ 1,880
Due to Primary Government	512
Accrued Vacation Leave	24,122
Total Liabilities	26,514
Fund Equity:	
Contributed Capital	2,700,000
Fund Equity - Unreserved	2,115,006
Fund Equity - Reserved (Note 8)	1,000,000
Total Fund Equity	5,815,006
Total Liabilities and Fund Equity	\$ 5,841,520

The accompanying notes to the financial statements are an integral part of this statement.

North Carolina Agricultural Finance Authority
Balance Sheet
June 30, 2000

Exhibit A

<i>ASSETS</i>	
Cash and Cash Equivalents	\$ 1,648,200
Interest Receivable	109,852
Notes Receivable	3,782,659
Inventories	3,045
Total Assets	\$ 5,543,756
<i>LIABILITIES AND FUND EQUITY</i>	
Liabilities:	
Accounts Payable	\$ 1,814
Due to Primary Government	641
Accrued Vacation Leave	17,348
Total Liabilities	19,803
Fund Equity:	
Contributed Capital	2,700,000
Fund Equity - Unreserved	2,823,953
Total Fund Equity	5,523,953
Total Liabilities and Fund Equity	\$ 5,543,756

The accompanying notes to the financial statements are an integral part of this statement.

North Carolina Agricultural Finance Authority
Statement of Revenues, Expenses, and Changes in Fund Equity
For the Year Ended June 30, 2001 **Exhibit B**

Operating Revenues:		
Sales and Services	\$	48,842
Investment Earnings		285,111
Interest Earnings on Loans		390,449
Fees, Licenses and Fines		2,075
Total Operating Revenues		726,477
Operating Expenses:		
Personal Services		278,860
Employee Benefits		59,824
Supplies and Materials		3,990
Travel		8,712
Other Services		89,265
Communication		4,151
Rental Expenses		26,286
Other Fixed Charges		1,298
Property, Plant and Equipment		8,888
Other Expenditures		9,191
Total Operating Expenses		490,465
Operating Income		236,012
Non-Operating Revenues (Expenses):		
Federal Grants		155,425
Grants, Aid and Subsidies		(96,812)
Miscellaneous		19,453
Income Before Operating Transfer		314,078
Operating Transfers:		
Transfer from Primary Government		129,406
Transfer to Primary Government		(152,431)
Total Operating Transfers Out		(23,025)
Net Income		291,053
Fund Equity - July 1, 2000		5,523,953
Fund Equity - June 30, 2001	\$	5,815,006

The accompanying notes to the financial statements are an integral part of this statement.

North Carolina Agricultural Finance Authority
Statement of Revenues, Expenses, and Changes in Fund Equity
For the Year Ended June 30, 2000

Exhibit B

Operating Revenues:	
Sales and Services	\$ 47,765
Investment Earnings	235,408
Interest Earnings on Loans	285,564
Fees, Licenses and Fines	2,325
Total Operating Revenues	571,062
Operating Expenses:	
Personal Services	244,542
Employee Benefits	46,016
Supplies and Materials	784
Travel	8,843
Other Services	49,089
Communication	4,478
Rental Expenses	23,353
Other Fixed Charges	5,096
Property, Plant and Equipment	16,991
Other Expenditures	3,636
Total Operating Expenses	402,828
Operating Income	168,234
Non-Operating Revenues:	
Miscellaneous	116
Income Before Operating Transfer	168,350
Operating Transfers:	
Transfer from Primary Government	127,921
Transfer to Primary Government	(218)
Total Operating Transfers	127,703
Net Income	296,053
Fund Equity - July 1, 1999	5,227,900
Fund Equity - June 30, 2000	\$ 5,523,953

The accompanying notes to the financial statements are an integral part of this statement.

North Carolina Agricultural Finance Authority
Statement of Cash Flows
For the Year Ended June 30, 2001

Exhibit C

Cash Provided From (Used For) Operations:	
Operating Income	\$ 236,012
Adjustments to reconcile operating income to net cash flows from operating activities:	
Investment Earnings	(285,111)
Loan Principal Repayments	315,794
Loan Sales	3,253,898
Loans Issued	(3,134,990)
Non-Operating Miscellaneous Income	19,453
(Increases) Decreases in Assets:	
Decrease in Interest Receivable	41,965
Decrease in Inventories	1,306
Increases (Decreases) in Liabilities:	
Increase in Accounts Payable	66
Decrease in Due to Primary Government	(129)
Increase in Accrued Vacation Leave	6,774
Total Cash Provided From (Used For) Operations	455,038
Cash Provided From (Used For) Non-Capital Financing Activities:	
Federal Grants	155,425
Grants, Aid and Subsidies	(96,812)
Transfer from Primary Government	(23,025)
Total Cash Provided From (Used For) Non-Capital Financing Activities	35,588
Cash Provided From (Used For) Investment Activities:	
Investment Earnings	285,111
Net Increase in Cash and Cash Equivalents	775,737
Cash and Cash Equivalents at July 1, 2000	1,648,200
Cash and Cash Equivalents at June 30, 2001	\$ 2,423,937

The accompanying notes to the financial statements are an integral part of this statement.

North Carolina Agricultural Finance Authority
Statement of Cash Flows
For the Year Ended June 30, 2000

Exhibit C

Cash Provided From (Used For) Operations:	
Operating Income	\$ 168,234
Adjustments to reconcile operating income to net cash flows from operating activities:	
Investment Earnings	(235,408)
Loan Principal Repayments	84,438
Loan Sales	1,724,747
Loans Issued	(3,299,109)
Non-Operating Miscellaneous Income	116
(Increases) Decreases in Assets:	
Increase in Interest Receivable	(74,844)
Increase in Inventories	(991)
Increases (Decreases) in Liabilities:	
Increase in Accounts Payable	1,544
Increase in Due to Primary Government	318
Decrease in Accrued Vacation Leave	(952)
Total Cash Provided From (Used For) Operations	(1,631,907)
Cash Provided From (Used For) Non-Capital Financing Activities:	
Transfer from Primary Government	127,703
Total Cash Provided From (Used For) Non-Capital Financing Activities	127,703
Cash Provided From (Used For) Investment Activities:	
Investment Earnings	242,587
Net Increase in Cash and Cash Equivalents	(1,261,617)
Cash and Cash Equivalents at July 1, 2000	2,909,817
Cash and Cash Equivalents at June 30, 2001	\$ 1,648,200

The accompanying notes to the financial statements are an integral part of this statement.

NORTH CAROLINA AGRICULTURAL FINANCE AUTHORITY
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2001 AND 2000

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

- A. Organization** - The North Carolina Agricultural Finance Authority (the Authority) was established in 1986 by the North Carolina Agricultural Finance Act. The Authority was created and empowered to alleviate the severe shortage of capital and credit available at affordable interest rates for investment in agriculture and for the export of agricultural products, commodities and services by providing such capital and credit at interest rates within the financial means of persons and businesses engaged in agriculture and agricultural exports. The Authority is a body politic and corporate created within the Department of Agriculture and Consumer Services. The Authority is constituted as a public agency and an instrumentality of the State for the performance of essential public functions as established by the General Assembly (NCGA General Statutes - Chapter 122D).
- B. Financial Reporting Entity** - The concept underlying the definition of the financial reporting entity is that elected officials are accountable to their constituents for their actions. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. An organization other than a primary government serves as a nucleus for a reporting entity when it issues separate financial statements. The North Carolina Agricultural Finance Authority is a component unit of the primary government of the State of North Carolina and is an integral part of the State's *Comprehensive Annual Financial Report (CAFR)*.

Component units are legally separate entities for which the State is financially accountable. Accountability is defined as the State's substantive appointment of a majority of the component unit's governing board. Furthermore, the State must be able to impose its will upon the component unit or there must be a possibility that the component unit may provide specific benefits to, or impose specific financial burdens on, the State.

As required by General Statute 122D-4, the governing body of the Authority is composed of 10 members. The Commissioner of Agriculture serves ex officio, with the same rights and privileges, including voting rights, as other members. The remaining nine members are appointed by

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

the Governor of North Carolina (3 members), the General Assembly upon recommendation of the Speaker of the House (3 members), and the General Assembly upon recommendation of the President Pro Tempore of the Senate (3 members). In addition, the State has provided significant operating subsidies as well as loan funds to the Authority creating a benefit/burden relationship. Because of the State's appointment of the board and the benefit/burden relationship, the Authority is a component unit of the State of North Carolina and the Authority's financial statements are included in the State's CAFR.

C. Basis of Presentation - The North Carolina Agricultural Finance Authority is accounted for as a proprietary fund type (enterprise fund) in conformity with the accounting and reporting requirements of the Governmental Accounting Standards Board (GASB). In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Authority does not apply Financial Accounting Standards Board (FASB) pronouncements issued after November 30, 1989 for proprietary activities, unless the GASB amends its pronouncements to specifically adopt FASB pronouncements issued after that date. The measurement focus is upon determination of net income, financial position, and changes in cash flows. The accounting principles used are those generally accepted in the United States of America and applicable to similar businesses in the private sector; thus, the accompanying financial statements have been prepared in accordance with the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recognized when incurred.

D. Cash and Cash Equivalents - This classification appears on the balance sheet and statement of cash flows. It includes short-term investments with the State Treasurer's Cash and Investment Pool (a governmental external investment pool) and a certificate of deposit reported at cost. The short-term investment portfolio maintained by the State Treasurer has the general characteristics of a demand deposit account in that participants may deposit additional cash at any time and also may withdraw cash at any time without prior notice or penalty.

The certificate of deposit is reported on the balance sheet as an Investment; however, it is included in this classification for the purposes of the statement of cash flows. In addition, the Authority has pledged this certificate of deposit as additional security for one of its Borrowers in accordance with a collateral pledge agreement. The Authority has granted a security interest in and to the certificate of deposit held by the bank together with all interest earned on the funds and subject to all

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

modifications to the collateral agreement. As such, the release and use of these funds are restricted by the terms of the agreement and are not available for operating uses.

- E. Notes/Loans Receivable and Allowance for Doubtful Accounts** - The North Carolina Agricultural Finance Authority (the Authority) provides the following direct loan programs:

Farm Loan Programs – Loans made for the purpose of buying, improving, or enlarging farms. This category comprises the majority of loans made by the Authority. Loan rates are variable based on the Prime Rate as published in the Wall Street Journal plus an additional percentage. Loan terms and limits vary depending on the type of loan; however, all are secured by liens on the real estate owned or purchased, improvements made with the loan funds, and any other additional security that might be required on an individual loan basis.

Agribusiness Loan Program – Loans made to assist agribusinesses in obtaining capital to start-up, increase, or make changes to their business. Agribusiness loans are designed to provide capital to acquire and build facilities. Loan rates are variable based on the Prime Rate as published in the Wall Street Journal.

Agricultural Facilities Disaster Loans – Loans made to assist agricultural property owners who have suffered property damage due to natural disasters to repair or replace structures and to return to normal work routines as quickly as possible. These loans are designed to provide for damages to farm facilities (structures) not fully covered for replacement costs or covered by federal disaster funds. Interest rates are fixed for the life of the loan and established on criteria tied to the Prime Rate. Maximum length of the loan cannot exceed 10 years.

Cotton Gin Air Quality Loan Program – Loans are made to assist modern day cotton gins in complying with changes in the dust emissions regulations. Eligible cotton gins must have been in operation at least one year prior to application and the financed improvements must comply with state and federal air quality standards.

Each loan program has specified eligibility that must be met. These loans are normally secured by a first lien on collateral. The loan committee determines the interest rate on the loans and the interest accrues from the original date that the loan is closed. Principal payments can be made either annually, quarterly, or monthly. The loans are repaid over various term lengths, generally with a maximum of 20 years. Application fees and loan processing fees vary by loan type. Notes/Loans Receivables

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

occur in the normal course of business and are shown in the accompanying financial statements at gross as the Authority expects to collect the receivable amounts.

- F. Inventories** - Inventories held by the Authority are priced at the lower of cost or market value using the first-in, first-out method. The inventories consist of expendable supplies and postage.
- G. Fixed Assets and Depreciation** – Fixed assets are stated at cost at the date of acquisition or fair market value at the date of donation in the case of gifts. The Authority capitalizes fixed assets that have a value or cost in excess of \$5,000 at the date of acquisition and an expected useful life of one or more years. Fixed assets are depreciated on the straight line basis over their useful lives which ranges from 3 to 10 years for machinery and equipment.
- H. Lease Obligations** – All leases are accounted for as operating leases and are not recorded on the balance sheet. Operating lease payments are recorded as expenses when incurred. All leases of the Authority contain appropriation clauses indicating that continuation of the lease is subject to continued funding by the Legislature. For reporting purposes, leases are fully disclosed since cancellation due to lack of appropriation is deemed unlikely.
- I. Compensated Absences** - The Authority's policy is to record the cost of vacation leave when earned. The policy provides for the maximum accumulation of unused vacation leave of 30 days which can be carried forward each January 1st or for which an employee can be paid upon termination of employment. Also, any accumulated vacation leave in excess of 30 days at December 31st is converted to sick leave. Under this policy, the accumulated vacation leave for each employee at June 30th equals the leave carried forward at the previous December 31st plus the leave earned, less the leave taken between January 1st and June 30th.

The Authority has the policy of recording the cost of sick leave when taken and paid rather than when the leave is earned. The policy provides for unlimited accumulation of sick leave, but the employee cannot be compensated for any unused sick leave upon termination of employment.

Full-time permanent, probationary and trainee employees earn vacation leave ranging from .98 to 2.15 days per month, depending upon years of service. Part-time employees earn the same range of leave on a pro-rata amount based on the number of hours a week they work. At termination, employees are paid for any accumulated vacation leave. Full-time permanent, probationary and trainee employees earn sick leave at the rate

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

of one day per month with an unlimited accumulation. Part-time employees earn a percentage of the total of 8 hours per month based on the number of hours a week they work. While payment for accumulated sick leave upon termination is not allowed, additional service credit for retirement pension benefits is given for accumulated sick leave upon retirement.

- J. Fund Equity** – Contributed capital is recorded for the receipt of capital grants or contributions from other sources. Restricted fund equity represents that portion of fund equity that is (1) not available for expenditure and/or (2) that is legally segregated by third parties for a specific future use. See Note 8 for disclosure on fund equity restrictions.

NOTE 2 - DEPOSITS AND INVESTMENTS

- A. Deposits** – All of the Authority’s deposits are held by the State Treasurer. The cash on deposit with the State Treasurer is pooled with state agencies and similar institutions in short-term investments with the State Treasurer’s Cash and Investment Pool. These moneys are invested in accordance with G.S. 147-69.1(c) and 147-69.2, and as required by law are “readily convertible into cash.” All investments of the fund are held either by the Department of State Treasurer or its agent in the State’s name. The fund’s uninvested cash is either covered by federal depository insurance or, pursuant to 20 NCAC 7, is collateralized under either the dedicated or pooling method.

The financial statements and disclosures for the State Treasurer’s Cash and Investment Pool are included in the State of North Carolina’s *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller’s Internet home page <http://www.osc.state.nc.us/> and clicking on “Financial Reports”, or by calling the State Controller’s Financial Reporting Section at (919) 981-5454.

At June 30, 2001, the carrying amounts and bank balances of cash on deposit were:

	<u>Carrying Amount</u>	<u>Bank Balance</u>
Cash with the State Treasurer	\$ 1,423,937	\$ 1,532,454
Certificate of Deposit	<u>1,000,000</u>	<u>1,000,000</u>
Total Deposits	<u><u>\$ 2,423,937</u></u>	<u><u>\$ 2,532,454</u></u>

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

At June 30, 2000, the carrying amounts and bank balances of cash on deposit were:

	Carrying Amount	Bank Balance
Cash with the State Treasurer	\$ 1,648,200	\$ 1,718,544

B. Investments – At June 30, 2001, the Authority held a certificate of deposit in the amount of \$1,000,000 that is not subject to categorization of custodial credit risk. As the funds are deposited with a commercial bank, insurance is provided by the Federal Deposit Insurance Corporation (FDIC) up to \$100,000. Deposits over this amount subjects the Authority to a concentration of credit risk. At June 30, 2001, the Authority’s bank deposits in excess of the FDIC insured limit was \$900,000. The certificate of deposit is a component of the deposit totals reported in the deposits section of this note for the 2001 fiscal year.

NOTE 3 - LEASE OBLIGATIONS - OPERATING

The following is a schedule by years of future minimum rental payments required under leases that have noncancelable lease terms as of June 30, 2001:

Fiscal Year	Operating Leases
2002	\$ 18,196
2003	18,196
2004	10,614
Total Minimum Lease Payments	\$ 47,006

Total rental expenses for all operating leases were \$18,196 for both the fiscal years ended June 30, 2001 and 2000.

NOTE 4 - RETIREMENT PLANS

Each permanent full-time employee, as a condition of employment, is a member of the Teachers’ and State Employees’ Retirement System of North Carolina. This plan is a cost-sharing, multiple-employer, defined benefit pension plan established by the State of North Carolina to provide pension

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

benefits for employees of the State, its component units, and local boards of education not in the State's reporting entity. Membership is comprised of employees of state agencies and institutions, local boards of education, universities and community colleges and certain proprietary component units.

Benefits and administrative expenses are funded by plan investment income, member contributions of 6% of compensation, and by employer contributions of 5.33% and 8.15% of covered payroll for the periods ending June 30, 2001 and June 30, 2000, respectively. Benefit and actuarially based contribution provisions are established by G.S. 135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Additional detail information about the plan is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

For the year ended June 30, 2001, the Authority had a total payroll of \$278,560, all of which was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were \$16,714 and \$14,847, respectively. For the year ended June 30, 2000, the Authority had a total payroll of \$228,865, all of which was covered under the Teachers' and State Employees' Retirement System. Total employee and employer contributions for pension benefits for the year were \$13,732 and \$18,652, respectively. The Authority made one hundred percent of its annual required contributions for the years ended June 30, 2001, 2000, 1999, and 1998, which were \$14,847, \$18,652, \$17,303, and \$16,696, respectively.

In accordance with constitutional provisions requiring a balanced budget for the State of North Carolina, the Governor issued an executive order requiring the employers' share of retirement contributions for the months February 2001 through June 2001 to be transferred to a reserve account rather than paid to the Teachers' and State Employees' Retirement System. A portion of those funds was ultimately used by the State of North Carolina for general fund purposes and not released to the retirement system. The total amount of employer contributions paid by the Authority has been recognized as pension costs in the financial statements. The contributions which were not released to the Teachers' and State Employees' Retirement System are considered immaterial to the Authority's financial statements taken as whole. The Authority has no liability for pension costs beyond the contributions already made.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 5 - DEFERRED COMPENSATION PLANS

IRC Section 457 Plan – General Statute 143B-426.24 authorized the creation of the Board of Trustees of the North Carolina Public Employee Deferred Compensation Plan (the Board). The Board was established as an agency of the State of North Carolina to offer the State’s permanent employees, university employees, and the employees of certain other component units, a uniform Deferred Compensation Plan (the Plan) in accordance with the Internal Revenue Code Section 457. The Plan permits each participating employee to defer a portion of his or her salary until future years by having the funds invested in various instruments that make up the North Carolina Public Employee Deferred Compensation Trust Fund. This fund is held in trust by the Plan for the exclusive benefit of participating employees and their beneficiaries. The deferred compensation is available to employees upon separation from service, death, disability, retirement or financial hardships if approved by the Board. All costs of administering and funding the Plan are the responsibility of the plan participants.

IRC Section 401(k) Plan – Effective January 1, 1985, Chapter 135, Article 5 of the North Carolina General Statutes authorized the creation of the Supplemental Retirement Income Plan of North Carolina (the Plan) in accordance with Internal Revenue Code Section 401(k). All members of the Teachers’ and State Employees’ Retirement System are eligible to enroll in the Plan and may contribute up to 20% (limited to \$10,500 for both 2001 and 2000) of their compensation during the plan fiscal year. Members of the Plan may receive their benefits upon retirement, disability, termination, or death. All contributions and costs of administering the Plan are the responsibility of the participants.

NOTE 6 - OTHER POSTEMPLOYMENT BENEFITS

Health Care for Long-Term Disability Beneficiaries and Retirees – The Authority participates in State administered programs that provide health care benefits to eligible former employees. The State Health Plan provides postemployment health insurance to former employees of the State. Those former employees who are eligible to receive health care as another postemployment benefit are long-term disability beneficiaries of the Disability Income Plan of North Carolina (DIPNC) and retirees of the Teachers’ and State Employees’ Retirement System (TSERS), with five or more years of contributory membership service in the Retirement System prior to disability or

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

retirement. The health insurance plan is the same as for active employees as described in Note 7, except that coverage becomes secondary when former employees become eligible for Medicare. These former employees are eligible to participate in either the self-funded Comprehensive Major Medical Plan (Plan) or one of the health maintenance organization (HMO) plans.

The funding for the health care benefit for long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. These health care benefits are funded by employer contributions that are established in the biennial appropriation bill by the General Assembly. The Authority contributed a monthly amount equal to 1.28% and 0% of active employees' salaries to the General Fund's Reserve for Retirees' Health Premium Account (Reserve) for June 30, 2001 and 2000, respectively. The Reserve pays the full cost of coverage for long-term disability beneficiaries and retirees enrolled in the Plan and makes similar contributions for long-term disability beneficiaries and retirees enrolled in the HMO plans. Additional cost of HMO coverage in excess of the Reserve's contribution is the responsibility of the beneficiaries and retirees. These benefits are established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly.

Disability Income – As discussed in Note 7, short-term and long-term disability benefits are provided to the eligible members of the TSERS through the Disability Income Plan of North Carolina (DIPNC). Long-term disability benefits are payable as another postemployment benefit from DIPNC after the conclusion of the short-term disability period or after salary continuation payments cease, whichever is later, for as long as an employee is disabled. An employee is eligible to receive long-term disability benefits provided he/she meets specified requirements. For the DIPNC's plan year, (the calendar years ended December 31, 2001 and 2000), the Authority contributed .52% of active employees' salaries to fund the disability benefits. The contributions cannot be separated between the amounts that relate to other postemployment benefits and employment benefits for active employees. These benefits are established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly.

Additional detailed information about the above postemployment benefits is disclosed in North Carolina's *Comprehensive Annual Financial Report*.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 7 - RISK MANAGEMENT AND INSURANCE

The Authority is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. These exposures to loss are handled by a combination of methods, including participation in various State-administered risk pools, purchase of commercial insurance and self-retention of certain risks.

State Health Plan – In accordance with Chapter 135, Article 3, Part 3, of the General Statutes, the State of North Carolina provides comprehensive major medical care for employees and retirees of the State and its participating component units, as well as their dependents. Coverage is self-funded by contributions to the State Health Plan (the Plan). Contributions for employee and retiree coverage are made by the State while contributions for dependent coverage are made by employees and retirees. As described in Note 6, coverage is also extended to certain individuals as another postemployment benefit. The Plan is administered by a third party contractor who is responsible for the processing of claims and administration of cost containment. Additionally, health care coverage is optionally available through contractual agreements with several Health Maintenance Organizations.

The Plan pays most expenses that are medically necessary and eligible for coverage based on usual, customary and reasonable allowances. Claims are subject to specified annual deductible and co-payment requirements. The Plan disallows claims in excess of a lifetime maximum of \$2 million.

Death Benefit Plan of North Carolina - Term life insurance (death benefits) is provided through the Death Benefit Plan to all members of the Teachers' and State Employees' Retirement System who have completed at least 12 consecutive months of membership in the System. The benefit payment is equal to the greater of (1) the compensation on which contributions were made by the member during the calendar year preceding the year in which his/her death occurs or (2) the member's highest twelve month's salary in a row during the twenty-four months prior to his/her death. The benefit is subject to a minimum of \$25,000 and to a maximum of \$50,000. Death benefits are funded by actuarially based employer contributions that are established in the biennial appropriation bill by the General Assembly. The State and participating component units contributed .16% of active employees' salaries to fund the Death Benefit Plan for the period ended June 30, 2000. Effective July 1, 2000, funding for the Death Benefit Plan was suspended by the General Assembly for the 2001 fiscal year. These benefits are established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Disability Income Plan of North Carolina - Short-term and long-term disability benefits are provided through the Disability Income Plan of North Carolina (DIPNC) to eligible members of the Teachers' and State Employees' Retirement System. Short-term benefits are payable after a waiting period of 60 continuous calendar days from the onset of disability, which is determined as the last actual day of service or the day succeeding at least 365 calendar days after the commencement of service, whichever is later. Short-term benefits are provided to currently active employees and the related liability is not measurable. As discussed in Note 6, long-term disability benefits are payable as another postemployment benefit from DIPNC after the conclusion of the short-term disability period or after salary continuation payments cease, whichever is later, for as long as an employee is disabled. These benefits are established by Chapter 135, Article 6, of the General Statutes and may be amended only by the North Carolina General Assembly.

Automobile, Fire and Other Property Losses – The State of North Carolina is required by Chapter 58, Article 31, Part 50, of the General Statutes to provide liability insurance on every state-owned motor vehicle. The State is self-insured for the first \$500,000 of any loss through a retrospective rated plan. The plan purchases excess insurance through a private insurer to cover losses greater than \$500,000. The liability limits for losses incurring in-state are \$500,000 per claimant and \$5 million per occurrence. For losses incurring out-of-state, the limits are \$1 million per claimant and \$5 million per occurrence. Users of the state cars are charged premiums to cover the cost of the excess insurance and to pay for those losses falling under the self-insured retention. Premiums charged are also based on the projected losses to be incurred. The private insurer processes all claims, establishes a reserve for amounts expected to be paid for claims, and pays claims after they are approved by the Attorney General's Office. Settled claims have not exceeded coverage in any of the past three fiscal years.

The State Property Fire Insurance Fund (the Fund) was also created by Chapter 58, Article 31, of the General Statutes. The Fund insures State owned buildings and contents for fire, extended coverage, and other property losses. Coverage for fire losses is free for all operations that are supported by the State's General Fund. Those operations that are not supported by the State's General Fund are charged for fire coverage. Extended coverage and other property coverage such as sprinkler leakage, business interruption, vandalism, theft, and "all risk" for buildings and contents can be purchased through the Fund at premiums discounted from industry manual rates. The fund insures losses up to \$2.5 million per occurrence. All losses covered by the Fund are

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

subject to a \$500 per occurrence deductible except for theft, which carries a \$1,000 per occurrence deductible. The Fund purchases excess insurance from a private insurer to cover losses over the amounts insured by the Fund. Settled claims have not exceeded coverage in any of the past three fiscal years.

Public Officers' and Employees' Liability Insurance – In accordance with Chapter 58, Article 32, Part 15, of the General Statutes, public officers' and employees' liability insurance is provided by private insurers for all employees of the State and participating component units. The policy provides \$11 million excess insurance over the \$500,000 statutory limit payable for any one claim under the State Tort Claims Act. The first \$150,000 of an award against a State agency is the responsibility of the state agency's general fund budget code or up to \$500,000 if a non-general fund budget code. For general fund budget codes, any award greater than \$150,000 but less than \$500,000 is funded by proportionate shares of estimated lapse salaries from all agencies' general fund budget codes. Since State agencies and component units are responsible for funding any tort claims of \$500,000 or less from their budget and/or lapse salaries, total claims liabilities are not measurable. Employers are charged a premium for the excess insurance based on a composite rate. The employers pay the premiums directly to the private insurer. Settled claims have not exceeded coverage in any of the past three fiscal years.

Employee Dishonesty and Computer Fraud – Blanket public employee dishonesty and computer fraud insurance is provided for agencies of the State and its component units with a limit of \$5 million per occurrence, subject to a \$50,000 deductible and a 10% participation in each loss above the deductible. The coverage is placed with a private insurance company and is handled by the North Carolina Department of Insurance. Agencies of the State and its component units are charged premiums by the private insurance company. Settled claims have not exceeded coverage in any of the past three fiscal years.

Statewide Workers' Compensation Program - The Workers' Compensation Program (the Program) was created by Chapter 97, Article 1, of the General Statutes to provide benefits to workers injured on the job and includes all employees of the State and its component units. An injury is covered under workers' compensation if it is caused by an accident that arose out of and in the course of employment. Also, certain occupational diseases specifically designated in the North Carolina Workers' Compensation Act are compensable. Losses payable by the Program include medical claims, loss of wages, disability, and death benefits. The State and its component units are self-insured for workers' compensation. State agencies and participating component units contribute to a fund administered by the Office of the State Controller to cover their workers' compensation claims. A third-party administrator handles workers' compensation claims, receives a per case

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

administration fee, and draws down State funds to make medical and indemnity payments on behalf of the State in accordance with the North Carolina Workers' Compensation Act.

Additional details on the State-administered risk management programs are disclosed in the State's *Comprehensive Annual Financial Report*, issued by the Office of the State Controller.

NOTE 8 - RESERVED FUND EQUITY

The Authority has a certificate of deposit in the amount of \$1,000,000 that is pledged as additional security for a borrower's third party loan. The certificate of deposit also serves as the Authority's guarantee that the loan will be repaid and is reported as an Investment and a Reserve for Loan Commitment on the Balance Sheet.

NOTE 9 - COMMITMENTS AND CONTINGENCIES

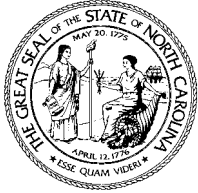
No Commitment Debt - Since 1995, the Authority has issued Agricultural Development Revenue Bonds to provide financial assistance to North Carolina farmers and agribusinesses for the acquisition, construction, and equipping of various agricultural projects deemed to be in furtherance of the Authority's purpose. The bonds are secured by an Indenture of Trust and a Letter of Credit and are payable solely from payments received on the underlying loan obligations. Neither the Authority nor the State of North Carolina is obligated in any manner for repayment of the bonds. Accordingly, the bonds are not reported as liabilities in the accompanying financial statements.

As of June 30, 2001, there were six series of Agricultural Development Revenue Bonds outstanding with an aggregate principal amount payable of \$16,410,000. There were six series of Agricultural Development Revenue Bonds outstanding with an aggregate principal amount payable of \$19,210,000 as of June 30, 2000.

NOTE 10 - SUBSEQUENT EVENTS

Subsequent to June 30, 2001, the 2001 General Assembly passed legislation that required the transfer of the functions and the board of directors of the North Carolina Rural Rehabilitation Corporation to the North Carolina Agricultural Finance Authority. The Authority is required to report back to various legislative entities no later than January 15, 2002 on the status of the transfer and any statutory changes that may be necessary to fully implement the transfer.

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Ralph Campbell, Jr.
State Auditor

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**INDEPENDENT AUDITOR'S REPORT
ON COMPLIANCE AND ON INTERNAL CONTROL
OVER FINANCIAL REPORTING BASED ON AN AUDIT OF
THE FINANCIAL STATEMENT PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Board of Directors
North Carolina Agricultural Finance Authority
Raleigh, North Carolina

We have audited the financial statements of the North Carolina Agricultural Finance Authority (the Authority) as of and for the years ended June 30, 2001 and 2000, and have issued our report thereon dated November 20, 2001. 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.

Compliance

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

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Authority's internal control over financial reporting in order to determine our auditing procedures for the purposes of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Authority's ability to record, process, summarize and

**INDEPENDENT AUDITOR'S REPORT
ON COMPLIANCE AND ON INTERNAL CONTROL
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report financial data consistent with the assertions of management in the financial statements. The reportable conditions noted as a result of our audit are described in the Audit Findings and Recommendations section of this report:

Finding

1. Control Environment
2. Segregation of Duties

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider Finding #1 to be a material weakness.

We also noted another matter involving an issue of a management control nature that is described in the Audit Findings and Recommendations section of this report.

This report is intended solely for the information and use of the management of the Authority, the Governor, and the General Assembly and is not intended to be, and should not be, used by anyone other than these specified parties.



Ralph Campbell, Jr.
State Auditor

November 20, 2001

AUDIT FINDINGS AND RECOMMENDATIONS

Matters Related to Financial Reporting

Current Year Findings and Recommendations - The following findings and recommendations were identified during the current audit and represent significant deficiencies in internal control.

1. CONTROL ENVIRONMENT

The reporting relationship between the North Carolina Agricultural Finance Authority (Authority) and the North Carolina Department of Agriculture and Consumer Services (Department) is not well defined resulting in inadequate financial oversight. The Authority was constituted as a public agency within the Department, authorized to establish a system of accounts and records for its activities, and is reported as a component unit to the State. However, the Authority is reliant on the Department for accounting services and financial statement preparation and is identified as a Board within the Department.

Our review of the reporting relationship between the two entities noted:

- All matters related to the financial presentations for the Authority are handled by the Department. Authority management does not currently approve journal entries or any of the year-end processes that result in its financial statement presentations.
- We identified a classification error that resulted in the understatement of the Authority's assets by \$1 million. Under the current relationship, it is not clear who reviews transactions for proper account classification.
- Transactions of the Authority are accounted for within the accounts of the Department. Separate bank reconciliations are not available for the activities of the Authority. It was noted during our review that the Department is not current with the reconciliations of its bank accounts.

Authority management is ultimately responsible for its financial presentations despite its reliance on the Department to perform certain accounting functions. Internal control procedures should be designed to provide reasonable assurance as to the reliability of financial reporting and the effectiveness and efficiency of operations.

Recommendation: We recommend that representatives from the Authority and the Department meet to evaluate their current reporting relationship and define a clear assignment of authority and responsibility for the financial activities of the Authority. Consideration should be given to consulting with the Office of State Controller to ensure compliance with any statutory requirements.

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

Agency's Response: The North Carolina Agricultural Finance Authority (Authority) agrees with your finding that there is presently no clear financial reporting relationship between the North Carolina Department of Agriculture and Consumer Services (Department) and the Authority; that the Authority and its management are ultimately responsible for its presentations, and that clear and well-defined assignments of authority and responsibility for the financial activities of the Authority should be agreed upon with the Department. We have already begun initial, informal discussions with appropriate Department officials regarding the Authority's assumption of responsibility for a system of accounts as a component unit of the state. We plan to formalize an agreement that will clearly define the functions and areas in which the Department will provide support to the Authority. We have also asked the Office of the State Controller (OSC) for their assistance. We will fully consult with OSC to assure compliance with all statutory requirements as we finalize an agreement with the Department.

2. SEGREGATION OF DUTIES

During our audit of the Authority's accounting functions, we observed a lack of separation of duties between the authorizing and processing of transactions. The Administrative Assistant was responsible for all phases of the receipting activities including opening the mail, restrictively endorsing checks, preparing the deposit, and making the deposit. The Administrative Assistant is also responsible for all purchasing and receipting activities for the Authority.

Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his/her duties.

Recommendation: We recommend that the Authority re-evaluate its current organizational structure and reassign accounting functions to achieve an adequate separation of duties. Consideration should be given to the key areas of authority and responsibility and establishing appropriate lines of reporting.

Agency's Response: The Authority agrees that a review of the manner in which it presently has duties assigned is in order. We are pleased that the Authority has received additional duties and responsibilities in recent months, in the form of active participation in the management of a USDA grant to demonstrate innovative ways of handling animal waste disposal to protect the environment, and in receiving responsibility from the North Carolina General Assembly to manage the assets and program of the (former) North Carolina Rural Rehabilitation Corporation. These added programs and responsibilities have given us resources that allow us to consider alternative ways to segregate the duties of the employees of the Authority in a manner that will minimize the possibilities that any single employee will be in a position to perpetrate and/or conceal errors or irregularities in the normal course of his/her duties. In addition, we have sought, and received approval, to add an additional receipt-supported position within the Authority

AUDIT FINDINGS AND RECOMMENDATIONS (CONTINUED)

which will have material budget and accounting responsibilities as one of its core duties. This will allow us the added flexibility to distribute other duties among the rest of our staff members in a manner that will minimize the concentrations of duties described in your finding.

Matters Not Related to Financial Reporting

Management Control Findings and Recommendations - The following finding and recommendation was identified during the current audit and represents a significant deficiency in the management control processes for matters not directly related to financial reporting.

3. PROCESSING OF TRANSACTIONS

The Authority's current mechanisms for processing transactions are inefficient and duplicative in nature. Transactions are recorded in manual ledgers, recorded in computer spreadsheets and an off-the-shelf accounting software, and processed by the State's accounting system through data entry at the Department. We noted duplications in the processes whereby data was entered numerous times for differing uses. We also identified errors in the supporting spreadsheets that serve as databases for the Authority's loan activities.

The Authority purchased a loan software package in June 2001 to record and track many of the loan processing activities currently performed manually. However, installation of the software has not occurred, staff has not been trained, and its capabilities of performance have not been completely tested.

Recommendation: The Authority should look for more efficient and effective uses of its resources. This includes the incorporation of information systems and new technology to provide competent and reliable data. Proper evaluation should be given to any accounting subsystems to ensure the capability to perform the necessary tasks. Discussions with the Office of State Controller may provide assistance in establishing proper accounting control systems.

Agency's Response: The Authority agrees that its current mechanisms for processing loan management financial transactions are inefficient and duplicative in nature, and by their very nature, may increase the risk of human error. We intend to immediately implement the loan software package that we purchased several months ago. Earlier implementation was delayed because of the added workload placed upon our staff by the inclusion of the NCRRC loan portfolio and program within the Authority. It is our intention that the newly created position, discussed above, will have a large measure of responsibility in the implementation and maintenance of this software program.

AUDIT FINDINGS AND RECOMMENDATIONS (CONCLUDED)

To deal with observed errors in loan database spreadsheets, we also intend to locate a computer based software program that will allow us to standardize the spreadsheets used to make and service the loan portfolios of the Authority. Further, as you recommended, we will consult with the Office of the State Controller for any assistance they may have in establishing proper accounting systems.

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In accordance with G.S. § 147-64.5 and G.S. § 147-64.6(c)(14), copies of this report have been distributed to the public officials listed below. Additional copies are provided to other legislators, state officials, the press, and the general public upon request.

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April 22, 2002

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