Office of the State Auditor

Division of State Audit

Comprehensive Annual Financial Report
State of North Dakota

Governance Communication
Including the Report on Internal Control,
Compliance, and Other Matters

For the year ended June 30, 2010
Client Code 100

Robert R. Peterson
State Auditor

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Transmittal Letter

December 15, 2010

Legislative Audit and Fiscal Review Committee

Honorable Jack Dalrymple, Governor

Members of the North Dakota Legislative Assembly

Pam Sharp, CPA, Director
Office of Management and Budget

I am pleased to submit our report on internal control, compliance, and other matters for the state of North Dakota. This report relates to the audit of the state's basic financial statements for the year ended June 30, 2010. This report on internal control, compliance, and other matters has been completed in accordance with *Government Auditing Standards*, as issued by the Comptroller General of the United States.

Also enclosed you will find our audit findings and governance communication. These communications are required by auditing standards.

The audit manager for this audit was Paul Welk, CPA. Inquiries or comments relating to this audit may be directed to Mr. Welk by calling him at (701) 328-2320. I would like to express my appreciation to Ms. Sharp and her staff for the courtesy, cooperation, and assistance they provided to this office during the audit.

Respectfully submitted,

Robert R. Peterson
State Auditor

Executive Summary

Responses to LAFRC Audit Questions

1. *What type of opinion was issued on the financial statements?*

   Unqualified (clean) opinions were given on the state of North Dakota's financial statements.

2. *Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?*

   Yes.

3. *Was internal control adequate and functioning effectively?*

   No, see our finding addressing "financial reporting errors by the Office of State Treasurer" (page 8).

4. *Were there any indications of lack of efficiency in financial operations and management of the agency?*

   No.

5. *Has action been taken on findings and recommendations included in prior audit reports?*

   Yes, except for "financial reporting errors by the Office of State Treasurer" (page 8), which was a prior recommendation from the last two audits that has not been implemented.

6. *Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.*

   A management letter was not issued.

LAFRC Audit Communications

1. Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.

As discussed in the attached governance communication, the state of North Dakota implemented GASB Statements 51 and 53 in fiscal year 2010. There were no other significant changes in accounting policies, and no management conflicts of interest or significant unusual transactions noted. The state's commitments and contingencies are reported on pages 117-119 of the Comprehensive Annual Financial Report.

2. Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Management's estimates of claim losses relating to insurance activities include Workforce Safety and Insurance, Risk Management Fund, and the Fire and Tornado Fund. For Workforce Safety and Insurance, actuaries are employed to assist in calculating the liability. Other auditors evaluated the key factors and assumptions used to develop the liability and the actuary's qualifications in determining that it is reasonable in relation to the financial statements taken as a whole. Estimated claim losses for the other insurance activities are made by professional insurance adjusters on a case by case basis. We evaluated the key factors and assumptions used to develop the liability in determining that it is reasonable in relation to the financial statements taken as a whole.

Management's estimates of pension liabilities are based on valuation of actuarial amounts, provided by reputable actuaries. Other auditors evaluated the key factors and assumptions used to develop the liability and the actuaries' qualifications in determining that pension liabilities are reasonable in relation to the financial statements taken as a whole.

Management's estimate of the Medicaid liability is based on historical trends and analysis of individual components. We evaluated the key factors and assumptions used to develop the liability in determining that it is reasonable in relation to the financial statements taken as a whole.

Allowance for loan losses and receivables are based on management's periodic review of their collectability in the light of historical experience, the nature of the receivable, adverse situations that may affect the borrower's ability to repay, and where applicable the value of any collateral and loan guarantees. Other auditors and we evaluated the key factors and assumptions used to develop the allowance in determining the allowances were reasonable in relation to the financial statements taken as a whole.

Tax refunds payable are based on historical trends and analysis of individual components. We evaluated the key factors and assumptions used to develop the liability in determining it is reasonable in relation to the financial statements taken as a whole.

3. *Identify any significant audit adjustments.*

   There were no significant audit adjustments.

4. *Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.*

   We did not have any disagreements with management that were significant to the financial statements.

5. *Identify any serious difficulties encountered in performing the audit.*

   We did not experience any serious difficulties in performing the audit.

6. *Identify any major issues discussed with management prior to retention.*

   This is not applicable for audits conducted by the Office of the State Auditor.

7. *Identify any management consultations with other accountants about auditing and accounting matters.*

   While OMB does employ consultants to assist in the preparation of the CAFR, we are not aware of any applicable management consultations with other accountants.

8. *Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.*

   ConnectND Finance and Human Resource Management System (HRMS) are the most high-risk information technology systems critical to the operations of the state. There are numerous other high-risk systems which are identified in the agency audit reports. The significant deficiency identified as Finding 10-1 does not relate to ConnectND.

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Internal Control and Compliance

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 Jack Dalrymple, Governor
of the state of North Dakota

Members of the Legislative Assembly
of the state of North Dakota

Pam Sharp, CPA, Director
Office of Management and Budget

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the state of North Dakota as of and for the year ended June 30, 2010, which collectively comprise the state's basic financial statements and have issued our report thereon dated December 15, 2010. Our report was modified as follows:

- to include a reference to other auditors;
- for the emphasis of a matter (the actuaries for the ND Teachers' Fund for Retirement, the ND Public Employee Retirement System and the Highway Patrolmen's Retirement System found the statutory contribution rates are insufficient);
- to justify a departure from generally accepted accounting principles as described in Note 17 to the basic financial statements, the Bank of North Dakota elected to present an unclassified balance sheet because the presentation of a classified balance sheet would be misleading to the extent that the financial statements may be materially misstated, and;
- to address consistency as described in Note 20 to the basic financial statements, the state of North Dakota implemented two new accounting standards for the year ending June 30, 2010. The new standards were GASB Statement No. 51, "Accounting and Financial Reporting for Intangible Assets" and GASB Statement No. 53, "Accounting and Financial Reporting for Derivative Instruments."

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.

As described in our report on the state of North Dakota's financial statements, other auditors audited the financial statements of the following entities:

- Bank of North Dakota
- Beginning Farmer Revolving Loan Fund
- Board of University and School Lands
- Building Authority
- College SAVE Plan
- Community Water Facility Loan Fund
- Developmentally Disabled Facility Loan Program
- Guaranteed Student Loan Program
- Housing Finance Agency
- Job Service North Dakota
- Mandan Remediation Trust
- PACE and AG PACE Funds
- Public Employees Retirement System
- Retirement and Investment Office
- State Fair Association
- Student Loan Trust
- Workforce Safety and Insurance
- All Discretely Presented Component Units

This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of the North Dakota University System's component units, which were audited by other auditors, were not audited in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the state of North Dakota's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the state of North Dakota's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the state of North Dakota's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect 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 entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified a certain deficiency in internal control over financial reporting, described in the accompanying schedule of finding, recommendation, and management response (Finding 10-1) that we consider a significant deficiency in internal control over financial reporting. 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.

Compliance and Other Matters

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

We noted certain matters that we reported to management of the state of North Dakota in the Governance Communication under the section entitled "Other Audit Findings or Issues"

The state of North Dakota's response to the finding identified in our audit is included in the accompanying schedule of finding, recommendation, and management response. We did not audit the state of North Dakota's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Office of Management and Budget and others within the state, Legislative Audit and Fiscal Review Committee, members of the North Dakota Legislative Assembly, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Robert R. Peterson
State Auditor

Edwin J. Nagel, Jr., CPA
Director

December 15, 2010

Finding, Recommendation, and Management Response

Financial Reporting Errors by the Office of State Treasurer

Finding 10-1 (Prior recommendation not implemented from the last two audits)

Condition:

The Office of State Treasurer made several errors in their closing packages submitted to the Office of Management and Budget (OMB). The closing packages are used by OMB to prepare the state's Comprehensive Annual Financial Report. One of the errors exceeded $4.6 million and another error exceeded $2 million. In our judgment, there is an unacceptably high risk of additional errors occurring.

Effect:

Fixing these errors caused unnecessary complications for OMB and introduced the risk of additional errors occurring during a period of peak work demands.

Cause:

Individuals responsible for preparing and approving the closing packages do not understand the closing package process and the requirements of generally accepted accounting principles.

Criteria:

At the end of each fiscal year, all state agencies are required to report financial information to the Office of Management and Budget in closing packages. The criteria are contained in the Office of Management and Budget CAFR Closing Manual and generally accepted accounting principles.

Recommendation:

We recommend the Office of State Treasurer ensure that individuals responsible for preparing and approving the closing packages have adequate knowledge and training to ensure closing packages are properly completed.

Views of Responsible Officials / Planned Corrective Actions:

The Office of State Treasurer agrees that these errors occurred. We will continue to work with the Auditor's Office and the Office of Management and Budget to strengthen our policies surrounding CAFR reporting. Additionally, we will continue to strengthen the skills of our staff. Most recently, we have reclassified a position to bolster the accounting base within the office. We will continue to strengthen the skills and classification of our staff as opportunities and funds become available.

Governance Communication

Legislative Audit and Fiscal Review Committee
North Dakota Legislative Assembly

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the state of North Dakota for the year ended June 30, 2010, and have issued our report thereon dated December 15, 2010. Professional standards require that we provide you with the following information related to our audit.

Qualitative Aspects of Accounting Practices
Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the state of North Dakota are described in Note 1 to the financial statements. As described in Note 20 to the financial statements, the state of North Dakota implemented two new accounting standards for the year ending June 30, 2010. Those new accounting standards were:

- GASB Statement No. 51, "Accounting and Financial Reporting for Intangible Assets," was issued in June 2007. This statement establishes criteria that governments will use to establish accounting and financial reporting requirements for intangible assets. The provisions of this statement are effective for periods beginning after June 15, 2009.

- GASB Statement No. 53, "Accounting and Financial Reporting for Derivative Instruments," was issued in June 2008. This statement requires that the fair value of financial arrangements called "derivatives" or "derivative instruments" be reported in the financial statements of state and local governments. Additional information about derivatives is disclosed in the notes to the financial statements, including identification of the risks to which hedging derivative instruments themselves expose the State. The provisions of this statement are effective for periods beginning after June 15, 2009.

We noted no transactions entered into by the state during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

- Management’s estimates of claim losses relating to insurance activities include Workforce Safety and Insurance, Risk Management Fund, and the Fire and Tornado Fund. For Workforce Safety and Insurance, actuaries are employed to assist in calculating the liability. Other auditors evaluated the key factors and assumptions used to develop the liability and the actuaries' qualifications in determining that it is reasonable in relation to the financial statements taken as a whole. Estimated claim losses for the other insurance activities are made by professional insurance adjusters on a case by case basis. We evaluated the key factors and assumptions used to develop the liability in determining that it is reasonable in relation to the financial statements taken as a whole.

- Management’s estimates of pension liabilities are based on valuation of actuarial amounts, provided by reputable actuaries. Other auditors evaluated the key factors and assumptions used to develop the liability and the actuaries' qualifications in determining that pension liabilities are reasonable in relation to the financial statements taken as a whole.

- Management’s estimate of the Medicaid liability is based on historical trends and analysis of individual components. We evaluated the key factors and assumptions used to develop the liability in determining that it is reasonable in relation to the financial statements taken as a whole.

- Allowance for loan losses and receivables are based on management’s periodic review of their collectability in the light of historical experience, the nature of the receivable, adverse situations that may affect the borrower’s ability to repay, and where applicable the value of any collateral and loan guarantees. Other auditors and we evaluated the key factors and assumptions used to develop the allowance in determining the allowances were reasonable in relation to the financial statements taken as a whole.

- Tax refunds payable are based on historical trends and analysis of individual components. We evaluated the key factors and assumptions used to develop the liability in determining that it is reasonable in relation to the financial statements taken as a whole.

Difficulties Encountered in Performing the Audit
We encountered no significant difficulties in dealing with management in performing and completing our audit.

Uncorrected Misstatements
Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. There were immaterial uncorrected potential audit adjustments related to accounts payable (likely or projected errors) and receivables (known errors). Management has determined that their effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. These errors did not have an effect on our opinion and they will be considered for our 2011 audit. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to the financial statements taken as a whole.

Disagreements with Management
For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations
We have requested certain representations from management that are included in the management representation letter dated December 15, 2010.

Management Consultations with Other Independent Accountants
In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the governmental unit's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues
We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention. It should be noted that the retention of the State Auditor is a matter of state law and is not under the control of the Office of Management and Budget.

Our opinion on the June 30, 2010 financial statements included the following paragraphs that emphasize significant problems with the funding of two of the state of North Dakota's pension plans:

> The actuary for the North Dakota Teachers' Fund for Retirement has determined the Fund's unfunded actuarial accrued liability is approximately $795 million at June 30, 2010. The funding for the actuarial accrued liabilities is predicated on employer and employee funding rates mandated by North Dakota statutes. The actuary has determined that the current statutory contribution rates will never fully fund the unfunded actuarial accrued liability based on current actuarial assumptions.
>
> The actuary for the North Dakota Public Employees Retirement System has determined that the Fund's unfunded actuarial accrued liability is approximately $586 million at June 30, 2010. Also, the actuary for the Highway Patrolmen's Retirement System has determined that the Fund's unfunded actuarial accrued liability is approximately $7 million at June 30, 2010. The funding for the actuarial accrued liabilities is predicated on employer and employee funding rates mandated by North Dakota statutes. The actuary has determined that the current statutory contribution rates are insufficient to meet the actuarially determined requirement. If unchanged, this difference will further increase the actuarial contribution requirement in future valuations.

These issues go back several years. They were first emphasized in the Teachers' Fund for Retirement's 2005 auditor's report and the Public Employees Retirement System's 2006 auditor's report.

In compliance with Federal Law, the Federal Trade Commission established the *Red Flags Rule* primarily to fight identity theft. Certain provisions will relate to governmental entities. The *Red Flag Program Clarification Act* recently made changes to federal law which will change FTC guidance. The Office of Management and Budget should gain an understanding of these rules and any changes to determine what actions are needed to comply with federal law. Information can be obtained from: www.ftc.gov/redflagsrule.

This information is intended solely for the use of Legislative Audit and Fiscal Review Committee, the Legislative Assembly, and management of the state of North Dakota and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully yours,

Paul Welk

Paul Welk, CPA
Audit Manager

You may obtain audit reports on the internet at:

www.nd.gov/auditor/

or by contacting the
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