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, 2011
Client Code 100

*Robert R. Peterson*
*State Auditor*

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BISMARCK, NORTH DAKOTA 58505

# *Transmittal Letter*

December 20, 2011

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, 2011. 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 Ron Tolstad Jr., M.Acc, CPA. Inquiries or comments relating to this audit may be directed to Mr. Tolstad by calling him at (701) 328-2243. 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?*

   Yes, other than our findings titled "Infrastructure Not Properly Capitalized" and "Proper Reconciliation of Motor Vehicle Clearing Account" (pages 9 and 10).

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.

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 on page 10 of this report, the state of North Dakota implemented GASB Statement 54 in fiscal year 2011. 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 in Note 18 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 that it is reasonable in relation to the financial statements taken as a whole.

3. *Identify any significant audit adjustments.*

   The only material misstatement detected as a result of our audit procedures is discussed in Finding 11-1. This audit adjustment was corrected by management.

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 11-2 relates to the Department of Transportation's Vehicle Titling and Registration System (VRTS).

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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, 2011, which collectively comprise the state's basic financial statements and have issued our report thereon dated December 20, 2011. Our report was modified as follows:

- for the emphasis of a matter relating to the funding of the North Dakota Public Employees Retirement System, the Highway Patrolmen's Retirement System, and the North Dakota Teachers' Fund for Retirement;
- to include a reference to other auditors;
- 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 a new accounting standard for the year ending June 30, 2011. The new standard is GASB Statement No. 54, "Fund Balance Reporting and Governmental Fund Type Definitions."

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

Management of the state of North Dakota is responsible for establishing and maintaining effective 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 opinions 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.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying section entitled "Findings, Recommendations, and Management Response," we identified a deficiency in internal control over financial reporting that we considered to be a material weakness and another deficiency that we considered to be a significant deficiency.

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. We consider the deficiency described in the accompanying section entitled "Findings, Recommendations, and Management Response" as *Finding 11-1* to be a material weakness.

A *significant deficiency* is a deficiency or combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency described in the accompanying section entitled "Findings, Recommendations, and Management Response" as *Finding 11-2* to be a significant deficiency.

**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.*

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 20, 2011

# Findings, Recommendations, and Management Response

## Infrastructure Not Properly Capitalized (Finding 11-1)

**Condition:**
The Department of Transportation did not properly capitalize infrastructure as of June 30, 2011. Construction in progress for infrastructure was understated by $37,640,478.

**Effect:**
The Department of Transportation's construction in progress additions required correction for inclusion in the 2011 Comprehensive Annual Financial Report.

**Cause:**
Methods used by the Department of Transportation to identify infrastructure for capitalization were changed and not properly communicated within the Department for accurate information to be accumulated.

**Criteria:**
The *Internal Control – Integrated Framework* from the Committee of Sponsoring Organizations (COSO) of the Treadway Commission states "pertinent information must be identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities." In addition, the *Integrated Framework* states "[personnel] must understand their own role in the internal controls system, as well as how individual activities relate to the work of others."

**Recommendation:**
We recommend the Department of Transportation properly capitalize infrastructure.

***Views of Responsible Officials / Planned Corrective Actions:***
*The North Dakota Department of Transportation (NDDOT) agrees with the finding and recommendation.*

*As indicated in the narrative, the methodology used by DOT to identify infrastructure for capitalization was no longer providing completely accurate information. Fortunately, after this was discovered, the correct amounts for construction in progress were able to be identified soon enough to enable to State's Comprehensive Annual Report for 2011 to reflect proper information.*

*To resolve this issue for the future, NDDOT will review and redefine the methodology and criteria used to identify infrastructure for capitalization. Additionally, we will develop a process to insure that such criteria are kept current and responsive to changing conditions.*

## *Proper Reconciliation of Motor Vehicle Clearing Account (Finding 11-2)*

**Condition:**
The Department of Transportation is not properly reconciling the motor vehicle clearing account. Monies are transferred to the State Treasurer on a monthly basis, however the Department of Transportation has not accounted for unallocated funds remaining in the motor vehicle clearing account.

**Effect:**
The motor vehicle clearing account represents significant activity for the Department of Transportation with approximately $190 million transferred to the state treasurer during fiscal year 2011. Without a proper reconciliation, there is an unacceptably high risk of errors in the management of the motor vehicle clearing account and monthly transfer to the State Treasurer and related distributions.

**Cause:**
Prior recommendations for proper reconciliation procedures from the Department of Transportation's biennium ended June 30, 2009 audit and the audit of the 2009 Comprehensive Annual Financial Report have not been implemented.

**Criteria:**
Reconciliation procedures are identified as critically important controls by COSO (*Internal Control - Integrated Framework* by the Committee of Sponsoring Organizations of the Treadway Commission).

**Recommendation:**
We recommend the Department of Transportation implement procedures to properly reconcile the motor vehicle clearing account.

***Views of Responsible Officials / Planned Corrective Actions:***
*The North Dakota Department of Transportation (NDDOT) agrees with the finding and recommendation.*

*Reconciliation of the motor vehicle clearing account is a very complex undertaking. The primary system involved in the processing of the related transactions is the Vehicle Titling and Registration System (VRTS). This system is extremely complex and it is used to process a multitude of unique transactions that are allocated to many separate funds as directed by our legislature. The reconciliation problems that have been encountered likely stem from procedural and/or information technology issues as related to the VRTS system. To successfully resolve this issue, NDDOT has assembled a large, multi-disciplinary task force. Currently, individuals with accounting, auditing, Motor Vehicle, and information technology expertise are actively pursuing a solution. Each unique category of transaction is being researched, mapped and traced through the VRTS system in a test environment. As discrepancies are revealed through this process, procedural and/or information technology solutions will be developed, implemented, and further tested to ensure that a satisfactory solution is put in place.*

# 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, 2011, and have issued our report thereon dated December 20, 2011. Professional standards require that we provide you with the following information related to our audit.

## Significant Audit Findings

**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 one significant new accounting standard for the year ending June 30, 2011. The new accounting standard is:

- GASB Statement No. 54, "Fund Balance Reporting and Governmental Fund Type Definitions," was issued in March 2009. This statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds. The provisions of this statement are effective for periods beginning after June 15, 2010. The new fund balance classifications and the minimum fund balance disclosure provided in Statement 54 are discussed in detail in Note 1S. Statement 54 requires the disclosure of the purpose of every major special revenue fund in the financial statement notes. Disclosures are found in Note 5.

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.

**Corrected and 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 in the amount of $2.9 million in the federal fund). Management has determined that their effects are immaterial, both individually and in the aggregate, to the federal fund and governmental activities. These errors did not have an effect on our opinion and they will be considered for our 2012 audit. The only material misstatement detected as a result of our audit procedures is discussed in Finding 11-1. This audit adjustment was corrected by management.

**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 20, 2011.

**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, 2011 financial statements included the following paragraphs that emphasize significant problems with the funding of the state of North Dakota's pension plans:

> The actuary for the North Dakota Public Employees Retirement System has determined that the Fund's unfunded actuarial accrued liability is approximately $689 and $586 million at June 30, 2011 and 2010, respectively. Also, the actuary for the Highway Patrolmen's Retirement System has determined that the Fund's unfunded actuarial accrued liability is approximately $17 and $12 million at June 30, 2011 and 2010, respectively. 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.
>
> The actuary for the North Dakota Teachers' Fund for Retirement has determined the Fund's unfunded actuarially accrued liability is approximately $927 and $795 million at June 30, 2011 and 2010, respectively. 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 the current actuarial assumptions. However, the 2011 Legislature has approved increases to member contribution rates and benefit changes. Once fully phased in, these legislative changes are projected to increase TFFR funding over the long term, and there would no longer be a contribution deficiency.

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,

Ron Tolstad Jr., M.Acc., CPA
Audit Manager

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