



INDUSTRIAL COMMISSION

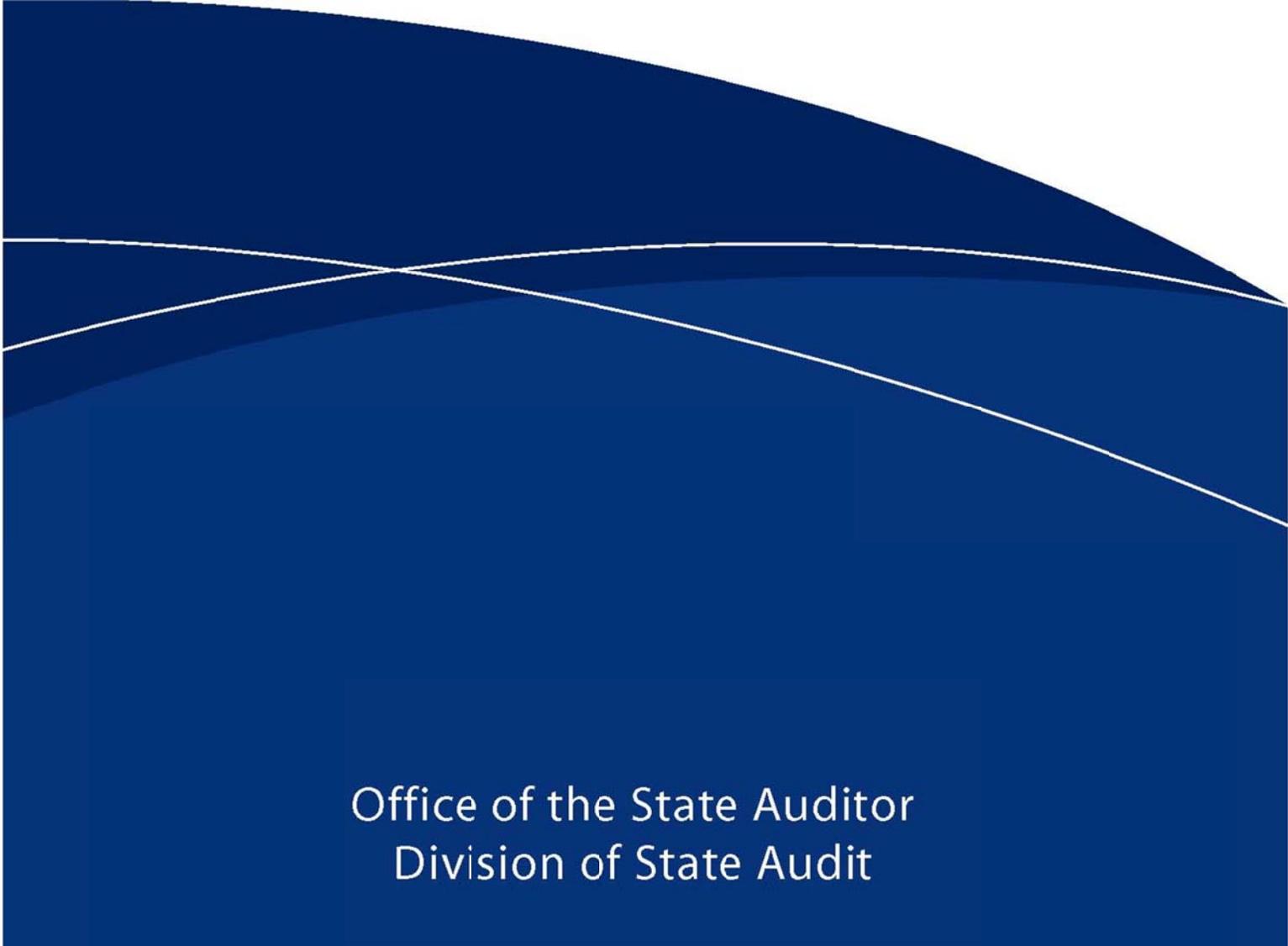
BISMARCK, NORTH DAKOTA

Department of Mineral Resources
Lignite Research Program
Oil and Gas Research Program
Biomass Incentive and Research Program
Renewable Energy Program
Pipeline Authority
Transmission Authority

Audit Report

For the Biennium Ended
June 30, 2009

ROBERT R. PETERSON
STATE AUDITOR



Office of the State Auditor
Division of State Audit

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Transmittal Letter

May 20, 2010

The Honorable John Hoeven, Governor
Members of the North Dakota Legislative Assembly
Karlene Fine, Executive Director, Industrial Commission

We are pleased to submit this audit of the Industrial Commission for the biennium ended June 30, 2009. This audit resulted from the statutory responsibility of the State Auditor to audit or review each state agency once every two years. The same statute gives the State Auditor the responsibility to determine the contents of these audits.

In determining the contents of the audits of state agencies, the primary consideration was to determine how we could best serve the citizens of the state of North Dakota. Naturally we determined financial accountability should play an important part of these audits. Additionally, operational accountability is addressed whenever possible to increase efficiency and effectiveness of state government.

The in-charge auditor for this audit was Richard Fuher, CPA. Kristi Morlock was the staff auditor. Fred Ehrhardt, CPA, was the audit supervisor. Paul Welk, CPA, was the audit manager. Inquiries or comments relating to this audit may be directed to the audit supervisor by calling (701) 328-3647. We wish to express our appreciation to Karlene Fine, Lynn Helms, and their staff for the courtesy, cooperation, and assistance they provided to us during this audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Bob Peterson".

Robert R. Peterson
State Auditor

Executive Summary

Introduction

The North Dakota Industrial Commission was created by the Legislature in 1919 to conduct and manage, on behalf of the state, certain utilities, industries, enterprises, and business projects established by state law. The members of the Industrial Commission are the Governor, the Attorney General, and the Agriculture Commissioner of the state.

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state agencies. Those items and the Office of the State Auditor's response are noted below.

Responses to LAFRC Audit Questions

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

Financial statements were not prepared by the Industrial Commission in accordance with generally accepted accounting principles so an opinion is not applicable. The agency's transactions were tested and included in the state's basic financial statements on which an unqualified opinion was issued.

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

Other than our finding addressing "Noncompliance With Performance Bonus Laws" (page 13), the Industrial Commission was in compliance with significant statutes, laws, rules, and regulations under which it was created and is functioning.

3. Was internal control adequate and functioning effectively?

Yes.

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?

There were no recommendations included in the prior audit report.

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

Yes, a management letter was issued and is included on page 15 of this report, along with management's response.

LAFRC Audit Communications

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

There were no significant changes in accounting policies, no management conflicts of interest were noted, no contingent liabilities were identified or significant unusual transactions.

8. *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.*

The Industrial Commission's financial statements do not include any significant accounting estimates.

9. *Identify any significant audit adjustments.*

Significant audit adjustments were not necessary.

10. *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.*

None.

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

None.

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

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

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

None.

14. *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 high-risk information technology systems critical to the Industrial Commission.

Audit Objectives, Scope, and Methodology

Audit Objectives

The objectives of this audit of the Industrial Commission for the biennium ended June 30, 2009 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the highest risk areas of the Industrial Commission's operations and is internal control adequate in these areas?
2. What are the significant and high-risk areas of legislative intent applicable to the Industrial Commission and are they in compliance with these laws?
3. Are there areas of the Industrial Commission's operations where we can help to improve efficiency or effectiveness?

Audit Scope

This audit of the Industrial Commission is for the biennium ended June 30, 2009. The scope of our audit included all balances and activities attributed to the following North Dakota Industrial Commission agencies: Department of Mineral Resources, Lignite Research Program, Oil and Gas Research Program, Biomass Incentive and Research Program, Renewable Energy Program, Pipeline Authority, and Transmission Authority. The Bank of North Dakota, Building Authority, Housing Finance Agency, Public Finance Authority, and Student Loan Trust are audited separately each year and will not be in the scope of our audit. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Industrial Commission has operations in the following locations. Each location was included in the audit scope:

- Administrative office in the State Capitol.
- Department of Mineral Resources office, Bismarck.
- Core and Sample Library, Grand Forks.
- Regional offices in Dickinson, Minot, and Williston.

Audit Methodology

To meet the objectives outlined above, we:

- Prepared financial statements from the legal balances on the state's accounting system tested as part of this audit and the audit of the state's Comprehensive Annual Financial Report and reviewed management's discussion and analysis of the financial statements.

- Performed detailed analytical procedures including computer-assisted auditing techniques. These procedures were used to identify high-risk transactions and potential problem areas for additional testing.
- Tested internal control and compliance with laws and regulations which included selecting representative samples to determine if controls were operating effectively and to determine if laws were being followed consistently. Non-statistical sampling was used and the results were projected to the population. Where applicable, populations were stratified to ensure that particular groups within a population were adequately represented in the sample, and to improve efficiency by gaining greater control on the composition of the sample.
- Interviewed appropriate agency personnel.
- Queried the ConnectND (PeopleSoft) system. Significant evidence was obtained from ConnectND.
- Observed Industrial Commission's processes and procedures.

In aggregate there were no significant limitations or uncertainties related to our overall assessment of the sufficiency and appropriateness of audit evidence.

Management's Discussion and Analysis

The accompanying financial statements have been prepared to present the Industrial Commission's revenues and expenditures on the legal (budget) basis. The accompanying financial statements are not intended to be presented in accordance with generally accepted accounting principles (GAAP).

The following management discussion and analysis was prepared by Industrial Commission's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of this supplementary information to ensure it does not conflict with the knowledge we gained as part of our audit.

For the biennium ended June 30, 2009, operations of the Industrial Commission were primarily supported by appropriations from the state's general fund and special funds. This is supplemented by interest income and fees credited to the agency's operating fund.

Financial Summary

Total revenues and other sources for the Industrial Commission were \$6,588,987 in fiscal year 2008 compared to \$7,627,189 in fiscal year 2009. Revenues consisted primarily of income from an investment with Dakota Gasification Company (DGC) under the Lignite Research Program. The provisions of the Investment Agreement state that the annual repayment to the Lignite Research Fund is linked to a formula based percentage of DGC's net income. DGC had profitable years in both 2008 and 2009. In 2008 the Lignite Research Program also received a return of funds in the amount of \$562,500 when Westmoreland decided to not proceed with a project at Gascoyne, North Dakota. The remaining revenues came from federal funds, investment earnings on the research funds, charges for services, licenses, permits, and fees. Transfers in were higher in 2009 than in 2008 as a result of a transfer from two special funds held at the Bank of North Dakota to the Biomass Incentive and Research Fund. The Commission delayed transferring the majority of the funds from the Bank until the funding was actually needed for the approved projects. (During fiscal year 2008, \$30,000 was transferred and in fiscal year 2009, \$1,080,000 was transferred.)

Total expenditures and other uses for the Industrial Commission were \$11,226,395 for the year ended June 30, 2009 as compared to \$11,108,163 for the prior year. The majority of the expenditures remained fairly constant, but there was an increase in salaries and benefits as it was during this time frame we began to see increased workload and hiring demand on our staff as a result of increased oil and gas drilling activities in North Dakota. In order to retain experienced staff retention bonuses were distributed in 2009. Also funding for two additional FTE was approved by the Emergency Commission in March 2008 based on the number of drilling rigs active in North Dakota during three consecutive months. This has continued to be a significant issue for the Department of Mineral Resources in the current biennium and is expected to continue into the 2011-2013 biennium as well.

Analysis of Significant Changes in Operations

During the 2007-2009 biennium the Industrial Commission was given authorization to develop and oversee the Renewable Energy Development Fund/Program and Biomass Incentive and Research Fund/Program. These programs were structured similar to the Lignite Research and

Oil and Gas Research Programs. Appropriation authority for these two new programs totaled \$22,000,000 with \$3,000,000 coming from the General Fund, \$2,000,000 from two special funds (Beginning Farmer Revolving Loan Fund and Biofuel Partnership in Assisting Community Expansion Fund) and \$17,000,000 from federal funds. Unfortunately no federal funds were made available to the state for the Renewable Energy Program.

Analysis of Significant Variances Between Final Budgeted and Actual Expenditures

The Commission continued to see unexpended appropriation authority in its grants line item. This is a result of the timing of payments for Lignite Research Program Projects. Payments are made on projects based on work accomplished. Because of uncertainty at the federal level on energy issues, lignite projects have been delayed. The Commission has approved state funding for three significant lignite projects in excess of \$20,000,000. These projects are the Spiritwood Energy Project near Spiritwood, the Great Northern Power Development Project near South Heart, and the American Lignite Energy Project in McLean County.

As noted above, the federal funding authority of \$17,000,000 provided for the Renewable Energy Development Program was not utilized. During the 2007 legislative session it had been anticipated that federal funds would be made available to the state. However, federal funding made available for renewable energy projects was disbursed directly to projects rather than being made available to the state for distribution. The Industrial Commission delayed drawing down funds from the two special funds at the Bank of North Dakota until near the end of the biennium. Two projects were approved for funding from the Biomass Incentive and Research Fund totaling \$1,080,000 plus funding was made available as directed by the Legislature to the Agriculture Commissioner's Office for organic agriculture initiatives and programs. The Legislature had authorized a total of \$2,000,000 for the Biomass Incentive and Development Fund of which \$1,110,000 was approved for funding. The remaining amount of \$890,000 was not transferred from the Bank of North Dakota.

Financial Statements

Statement of Revenues and Expenditures

	<u>June 30, 2009</u>	<u>June 30, 2008</u>
<u>Revenues and Other Sources:</u>		
Dakota Gasification Company Loan Revenue	\$ 1,515,780	\$ 899,640
Refund of Prior Biennium Expenditures	247	565,276
Interest and Investment Earnings	171,919	351,909
Charges for Services/Sales	293,863	196,421
Licenses, Permits, and Fees	305,741	165,395
Federal Revenue	125,442	132,808
Fines and Forfeitures		60,150
Contributions and Private Grants	18,375	15,200
Program Income	1,200	1,600
Transfers In	5,194,622	4,200,228
Total Revenues and Other Sources	<u>\$ 7,627,189</u>	<u>\$ 6,588,987</u>
<u>Expenditures and Other Uses:</u>		
Grants, Benefits, and Claims	\$ 5,923,401	\$ 6,106,683
Salaries and Benefits	3,868,408	3,361,356
Professional Services	288,386	390,104
Travel	300,470	285,338
Rentals/Leases – Building/Land	155,313	368,707
Repairs	71,525	228,803
Other Operating Expenses	178,135	87,772
Supplies	138,584	76,925
Equipment	157,303	54,768
Data Processing/Communications	97,396	97,877
Professional Development	37,474	29,830
Transfers Out	10,000	20,000
Total Expenditures and Other Uses	<u>\$11,226,395</u>	<u>\$11,108,163</u>

Statement of Appropriations

For The Biennium Ended June 30, 2009

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Benefits	\$ 6,852,056	\$ 302,811	\$ 7,154,867	\$ 7,117,554	\$ 37,313
Operating Expenses	2,033,017	30,250	2,063,267	1,822,471	240,796
Capital Assets	256,500		256,500	255,544	956
Grants	19,410,600		19,410,600	8,654,871	10,755,729
Grants – Fossil Restoration	250,000		250,000	250,000	
Oil and Gas Div. Contingency	285,000	(285,000)			
Biomass Incentive Research	2,000,000		2,000,000	30,300	1,969,700
Renewable Energy Development	20,000,000		20,000,000	3,000,000	17,000,000
Totals	<u>\$ 51,087,173</u>	<u>\$ 48,061</u>	<u>\$ 51,135,234</u>	<u>\$ 21,130,740</u>	<u>\$ 30,004,494</u>
Expenditures by Source:					
General Fund	\$ 11,756,004	\$ 42,632	\$ 11,798,636	\$ 11,547,566	\$ 251,070
Other Funds	39,331,169	5,429	39,336,598	9,583,174	29,753,424
Totals	<u>\$ 51,087,173</u>	<u>\$ 48,061</u>	<u>\$ 51,135,234</u>	<u>\$ 21,130,740</u>	<u>\$ 30,004,494</u>

Appropriation Adjustments:

The \$285,000 transfer from the Oil and Gas Division Contingency line item to the salaries and benefits (\$238,500) and operating expenses (\$46,500) line items was approved by the Emergency Commission and made pursuant to House Bill 1017, Section 28 from the 2007 Legislative Session. This transfer was made to hire two additional FTEs due to the active drilling rig count exceeding 45 for three consecutive months. At a later Emergency Commission meeting the above adjustment was amended and salaries and benefits was increased by \$16,250 and operating expenses was decreased by the same amount.

Another increase of \$48,061 in the salaries and benefits line was for an equity adjustment authorized by Senate Bill 2189 of the 2007 Session.

Expenditures Without Appropriations Of Specific Amounts:

Fossil Excavation and Restoration fund has a continuing appropriation authorized by NDCC section 54-17.4-09.1 (\$238,773 of expenditures for this biennium).

Oil and Gas Research fund has a continuing appropriation authorized by NDCC section 57-51.1-07.3 (\$2,313,771.31 of expenditures for this biennium).

Cash Bond fund has a continuing appropriation authorized by NDCC section 38-08-04.11 (\$88,245).

Cartographic Products fund has a continuing appropriation authorized by NDCC section 54-17.4-10 (\$4,172).

Global Positioning System Community-Base Station fund has a continuing appropriation authorized by NDCC section 54-17.4-12 (\$1,318 of expenditures for this biennium).

Oil and Gas Reservoir Data fund has a continuing appropriation authorized by NDCC section 38-08-04.6 (\$245,766 of expenditures for this biennium).

Abandoned Oil and Gas Reclamation fund has a continuing appropriation authorized by NDCC section 38-08-04.5 (\$32,395 of expenditures for this biennium).

Pipeline Authority Administrative fund has a continuing appropriation authorized by NDCC section 54-17.7-11 (\$264,310 of expenditures for this biennium).

Renewable Energy Development fund has a continuing appropriation authorized by NDCC section 54-63-04 (\$1,440,022 of expenditures for this biennium).

Geo Mineral Coal Exploration fund has a continuing appropriation authorized by NDCC section 38-21-01 (\$44 of expenditures for this biennium).

Internal Control

In our audit for the biennium ended June 30, 2009, we identified the following areas of the Industrial Commission's internal control as being the highest risk:

Internal Controls Subjected to Testing:

- Controls surrounding the processing of revenues.
- Controls surrounding the processing of expenditures.
- Controls effecting the safeguarding of assets.
- Controls relating to compliance with legislative intent.
- Controls surrounding the ConnectND (PeopleSoft) system.

The criteria used to evaluate internal control is published in the publication *Internal Control – Integrated Framework* from the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

We gained an understanding of internal control surrounding these areas and concluded as to the adequacy of their design. We also tested the operating effectiveness of those controls we considered necessary based on our assessment of audit risk. We concluded internal control was adequate.

Auditors are required to report deficiencies in internal control that are significant within the context of the objectives of the audit. 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 (1) misstatements in financial or performance information, (2) violations of laws and regulations, or (3) impairments of effectiveness or efficiency of operations, on a timely basis. Considering both qualitative and quantitative factors, we did not identify any significant deficiencies in internal control. However, we noted a matter involving internal control that we have reported to management of Industrial Commission in a management letter dated May 20, 2010.

Compliance With Legislative Intent

In our audit for the biennium ended June 30, 2009, we identified and tested Industrial Commission's compliance with legislative intent for the following areas that we determined to be significant and of higher risk of noncompliance:

- Compliance with Lignite Research, Development, and Marketing Program – Lignite Marketing Feasibility Study (2007 North Dakota Session Laws chapter 14, section 18).
- Compliance with Contingent Oil and Gas Funding (2007 North Dakota Session Laws chapter 14, section 28).
- Compliance with the revenue cap on the Geo Mineral Coal Exploration Fund (North Dakota Century Code section 38-21-03).
- Proper use of the following legally restricted funds:
 - Fossil Excavation and Restoration Fund.
 - Renewable Energy Development Fund.
 - Oil and Gas Research Fund.
 - Pipeline Authority Administrative Fund.
 - Biomass Incentive and Research Fund.
 - Cash Bond Fund.
 - Cartographic Products Fund.
 - Global Positioning System Community-Base Station Fund.
 - Lignite Research Fund.
 - Oil and Gas Reservoir Data Fund.
 - Geo Mineral Coal Exploration Fund.
 - Abandoned Oil And Gas Reclamation Fund.
- Application of proper statutory rates relating to revenue.
- Compliance with appropriations and related transfers (2007 North Dakota Session Laws chapters 14, 42, and 462).
- Compliance with OMB's Purchasing Procedures Manual.
- Statutory authority for investments, interest on investments, and the proper utilization of the Bank of North Dakota for credit cards.
- Adequate blanket bond coverage of employees (NDCC section 26.1-21-08).
- Compliance with fixed asset requirements including record keeping, surplus property, lease and financing arrangements in budget requests, and lease analysis requirements.
- Compliance with payroll-related laws including statutory salaries for applicable elected and appointed positions, and certification of payroll.

The criteria used to evaluate legislative intent are the laws as published in the *North Dakota Century Code* and the *North Dakota Session Laws*.

Government Auditing Standards requires auditors to report all instances of fraud and illegal acts unless they are inconsequential within the context of the audit objectives. Further, auditors are required to report significant violations of provisions of contracts or grant agreements, and significant abuse that has occurred or is likely to have occurred.

The results of our tests disclosed an instance of noncompliance that is required to be reported under *Government Auditing Standards*. The finding is described below. Other than this finding, we concluded there was compliance with the legislative intent identified above.

Noncompliance With Performance Bonus Laws (Finding 09-1)

In fiscal year 2008, the Industrial Commission paid 32 more performance bonuses than allowed by North Dakota Century Code (NDCC) without obtaining the approval of North Dakota Human Resource Management Services (HRMS).

Section 54-06-30 of the NDCC states that agencies may pay bonuses under this section during a fiscal year to not more than the number of employees equal to 25% of the employees employed by the agency on July 1st at the beginning of each state fiscal year without the approval of HRMS.

On July 1, 2007, the beginning of the fiscal year, the Industrial Commission had 50 regular employees. Therefore, the Industrial Commission would be eligible to provide not more than 12 performance bonuses without the approval of HRMS. During the fiscal year, the Industrial Commission provided monetary performance bonuses to 44 employees.

Recommendation:

We recommend that the Industrial Commission comply with North Dakota Century Code 54-06-30 when providing monetary performance bonuses to their employees.

Industrial Commission Response:

Management of Industrial Commission agrees with the finding/recommendation.

During fiscal year 2008 activity in the oil fields of North Dakota increased dramatically. As a result, the Industrial Commission (Department of Mineral Resources) experienced a significant impact on workload throughout the Department with limited additional staffing and several experienced employees leaving to work for industry. Even under these difficult circumstances the staff performed their jobs very well. In our efforts to reward the staff for their exceptional job performance we paid a large number of performance bonuses. At that time our internal bonus policy did not contain the statutory language regarding the 25% limit and HRMS exemption for performance bonuses. We have re-written our internal bonus policy (document) and put in place a process to track the number of performance bonuses given during a fiscal year. These changes will alert agency management if we are likely to exceed the 25% limitation so we can seek approval from HMRS as required by law.

Operations

This audit did not identify areas of Industrial Commission's operations where we determined it was practical at this time to help to improve efficiency or effectiveness.



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STATE CAPITOL
600 E. BOULEVARD AVENUE - DEPT. 117
BISMARCK, NORTH DAKOTA 58505

Management Letter (Informal Recommendations)

May 20, 2010

Ms. Karlene Fine, Executive Director
Industrial Commission
600 E. Boulevard Avenue
Bismarck, ND 58505

Dear Ms. Fine:

We have performed an audit of the Industrial Commission for the biennium ended June 30, 2009, and have issued a report thereon. As part of our audit, we gained an understanding of the Industrial Commission's internal control structure to the extent we considered necessary to achieve our audit objectives. We also performed tests of compliance as described in the same report.

Our audit procedures are designed primarily to enable us to report on our objectives including those related to internal control and compliance with laws and regulations and may not bring to light all weaknesses in systems and procedures or noncompliance with laws and regulations which may exist. We aim, however, to use our knowledge of your organization gained during our work to make comments and suggestions which we hope will be useful to you.

In connection with the audit, gaining an understanding of the internal control structure, and tests of compliance with laws and regulations referred to above, we noted a certain condition we did not consider reportable within the context of your audit report. This condition relates to areas of general business practice or control issues that have no significant bearing on the administration of federal funds. We do, however, want to present our recommendation to you for your consideration and whatever follow-up action you consider appropriate. During the next audit we will determine if this recommendation has been implemented, and if not, we will reconsider its status.

The following presents our informal recommendation:

Pervasive Controls

Informal Recommendation 09-1: We recommend the Industrial Commission establish a fraud risk assessment on a comprehensive and recurring basis. We recommend control activities be designed and documented to ensure each significant fraud exposure identified during the risk assessment process has been adequately mitigated.

Management of Industrial Commission agreed with the recommendation.

I encourage you to call myself or Fred Ehrhardt, audit supervisor, at 328-3647 if you have any questions about the implementation of recommendations included in your audit report or this letter.

Sincerely,

A handwritten signature in cursive script that reads "Richard Fuher".

Richard Fuher, CPA
Auditor in-charge

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