Client Code 100

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, 2012

ROBERT R. PETERSON
STATE AUDITOR

Office of the State Auditor
Division of State Audit

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STATE AUDITOR
ROBERT R. PETERSON

PHONE
(701) 328-2241
FAX
(701) 328-1406

STATE OF NORTH DAKOTA
OFFICE OF THE STATE AUDITOR
STATE CAPITOL
600 E. BOULEVARD AVENUE - DEPT. 117
BISMARCK, NORTH DAKOTA 58505

Transmittal Letter

December 14, 2012

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, 2012. 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 "Capital Asset Reporting" (page 8) and "Reconciliation of Motor Vehicle Clearing Account" (page 9).

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 the finding entitled "Reconciliation of Motor Vehicle Clearing Account" has been made in past audit reports.

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.*

   There were no 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 (Page 63) 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 significant audit adjustments detected as a result of our audit procedures are discussed in Finding 12-1. These adjustments related to one agency improperly deleting construction-in-progress ($15.5 million) and double counting one agency's capital assets ($5.8 million). These audit adjustments were corrected by the Office of Management and Budget.

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.*

   The PeopleSoft 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 12-1 relates to ConnectND's Capital Asset system and Finding 12-2 relates to the Department of Transportation's Vehicle Titling and Registration System (VRTS).

STATE AUDITOR
ROBERT R. PETERSON

PHONE
(701) 328-2241
FAX
(701) 328-1406

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BISMARCK, NORTH DAKOTA 58505

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, 2012, which collectively comprise the state's basic financial statements and have issued our report thereon dated December 14, 2012. Our report includes a reference to other auditors. Our report was modified as follows:

- for the emphasis of a matter relating to the funding of the North Dakota Public Employees Retirement System and the Highway Patrolmen's Retirement System;
- to include a reference to other auditors, and;
- 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.

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. Other auditors audited the financial statements of the following entities, as described in our report on the State of North Dakota's financial statements.

Bank of North Dakota	Job Service North Dakota
Beginning Farmer Revolving Loan Fund	Mandan Remediation Trust
Building Authority	PACE and AG PACE Funds
College SAVE	Public Employees Retirement System
Community Water Facility Loan Fund	Rebuilders Loan Program
Department of Trust Lands	Retirement and Investment Office
Developmentally Disabled Facility Loan Program	State Fair Association
Guaranteed Student Loan Program	Student Loan Trust
Housing Finance Agency	Workforce Safety and Insurance
Housing Incentive Fund	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 foundations, that are discretely presented component units, 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.

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 previously. However, we identified certain deficiencies in internal control over financial reporting, described in the accompanying section entitled "Findings, Recommendations, and Management Response," that we consider to be significant deficiencies in internal control over financial reporting (Findings 12-1 and 12-2). 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.

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 responses to the findings identified in our audit are included in the accompanying schedule of findings, recommendations, and management response. We did not audit the state of North Dakota's responses and, accordingly, we express no opinion on them.

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 14, 2012

Findings, Recommendations, and Management Response

Capital Asset Reporting (Finding 12-1)

Condition:
The Office of Management and Budget does not have adequate internal control to ensure capital assets are properly reported. Errors included agencies not reporting significant software systems and improperly deleting construction in progress. Additionally the PeopleSoft Asset system double counted capital assets.

Effect:
Capital assets and the related note disclosures are at risk of being misstated.

Cause:
Better training and communication is needed along with clearer reporting guidelines (CAFR closing packages). Additionally the Office of Management and Budget does not have procedures in place to ensure the capital asset control accounts reconcile with the detailed records.

Criteria:
The publication *Internal Control – Integrated Framework* from the Committee of Sponsoring Organizations (COSO) of the Treadway Commission includes chapters on information and communication and control activities that address these areas.

Recommendation:
We recommend the Office of Management and Budget evaluate controls surrounding capital assets to 1) improve information and communication, including where necessary applicable training; 2) reconcile control accounts to detailed records; and; 3) where applicable, add preventative or detective controls as necessary.

Views of Responsible Officials / Planned Corrective Actions:
The Office of Management and Budget agrees with the recommendation. OMB has adequate reporting guidelines available for agencies. However, we will continue to train and better communicate with the agencies to ensure closing packages are completed accurately. We will also develop controls to ensure control accounts reconcile to detailed records.

Reconciliation of Motor Vehicle Clearing Account (Finding 12-2 Prior Audit Finding)

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, but the Department of Transportation is unable to completely identify the proper allocation of the remaining funds. Consequently, monies remain undisbursed from the motor vehicle clearing account each month.

Effect:
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:
The Vehicle Registration and Titling System was not designed to provide the necessary reconciliations.

Criteria:
Proper 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 properly reconcile the motor vehicle clearing account.

Views of Responsible Officials / Planned Corrective Actions:
NDDOT agrees with the finding and recommendation. NDDOT is currently pursuing a method to successfully reconcile the clearing account and properly transfer all funds out of the account.

It should be noted that Motor Vehicle management and NDDOT internal audit staff have reviewed the collection and deposit activities for the Motor Vehicle Division and have determined that all revenues received are being deposited into the Motor Vehicle clearing account in the Bank of North Dakota.

Existing controls as well as controls that have been implemented are designed to ensure segregation of duties and verification that all funds are properly deposited and accounted for. Existing controls include the following: Online transactions are automatically deposited into the Motor Vehicle Clearing account at the Bank of North Dakota. In-house transactions are reconciled daily to the daily drawer report from the Vehicle Registration Titling System (VRTS). Motor Carrier funds received in house are reconciled daily to the Commercial Vehicle Information System Network (CVISN).

Controls that have been implemented include: Each month the Bank of North Dakota clearing account is reconciled to ensure that proper supporting documentation is attached for all debits and credits passing through the account during the month. Branch payments are reconciled to *drawer reports from VRTS once received in the Bismarck office. Should Motor Vehicle or Motor Carrier drawer report be over/short cash the discrepancy is tracked and reported to the employee's supervisor. This ensures that there are no patterns or consistency in the same individual having discrepancies. Motor Vehicle accounting staff has created a schedule to conduct random audits of any employee using a cash drawer. Each drawer will be audited once per quarter to ensure that the drawer is being used for its intended purpose and that all moneys are accounted for throughout the day.*

All funds are properly deposited and accounted for in the clearing account; however, the problem lies in the fact that the funds are not all being distributed out of the clearing account and transferred to the ND State Treasurer's Office for subsequent distribution.

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 since the VRTS system was not designed to have a financial reconciliation function. Also, any problems with distribution may stem from the fact that the current VRTS system is incapable of handling the complex and multiple distributions required by law.

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.

To date the task force has determined and is in the process of implementing resolutions to several issues. One of the issues identified comes from the flow of moneys from CVISN into VRTS. It was determined that in some instances, transactions are being recorded into VRTS twice. A process has been implemented to cancel one of these transactions to prevent discrepancies in the distribution. Other items identified in the test environment are items that will be useful in the reconciliation of the distribution to the Bank of North Dakota clearing account. Some of the VRTS accounts are not included in distribution; these items need to be reconciled monthly. Items not included in distribution include: Suspended Monies Hold, Refund Distribution, Refund Hold, Returned Checks and RCT/Other Fund. Doc Prep has been identified as a possible balancing item however no resolution has been determined at this time. Because money is received and disbursed using these accounts they will require manual reconciliations to balance with the VRTS distribution amount.

Additionally, the VRTS system is approximately 12 years old and has major deficiencies that very significantly hinder the ability to meet the current Motor Vehicle registration and reporting needs, including the account reconciliation issue. Accordingly, NDDOT is addressing with the 2013 Legislature the need to replace the system

The department will continue to work towards a solution to fully resolve all issues.

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, 2012, and have issued our report thereon dated December 14, 2012. 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 21 to the financial statements, the state of North Dakota changed accounting policies related to other post-employment benefits measurements and derivative hedge accounting by adopting Statement of Governmental Accounting Standards (GASB Statement) Numbers 57 and 64. These changes did not have a significant impact on the State's financial statements.

We noted no transactions entered into by the governmental unit 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 and Corrected 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: software capitalization (we obtained adequate evidence the amount was not material to the governmental activities, but the actual amount of the error cannot be readily determined), internal payables ($1.7 million), transfers ($.65 million) and, accounts payable ($.6 million). Management has determined that their effects are immaterial, both individually and in the aggregate, to the applicable major funds, governmental activities and business-type activities. These errors did not have an effect on our opinion and they will be considered for our 2013 audit.

Finding 12-1 results from two audit adjustments, the first was an agency incorrectly deleting construction in progress ($15.5 million) and another agencies capital assets being recorded twice ($5.8 million). No other audit adjustments meet the threshold for reporting in this report.

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 14, 2012.

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, 2012 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 $873 and $689 million at June 30, 2012 and 2011, respectively. Also, the actuary for the Highway Patrolmen's Retirement System has determined that the Fund's unfunded actuarial accrued liability is approximately $20 and $17 million at June 30, 2012 and 2011. 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.

Recent auditing standards make a fundamental change to the relationship between auditors and when auditors can rely upon work of other auditors. Without appropriate cooperation from the auditors of the component units, the State Auditor may not be able to rely upon the work of other auditors, which could have a negative effect on future audit opinions. Management should ensure component units make sure their auditors are willing to work with the State Auditor relating to group audit requirements.

Other Matters
With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

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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Division of State Audit

Office of the State Auditor
600 East Boulevard Avenue – Department 117
Bismarck, ND 58505-0060

(701) 328-2241