

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, 2014

ROBERT R. PETERSON
STATE AUDITOR

Office of the State Auditor
Division of State Audit

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Transmittal Letter

December 17, 2014

Legislative Audit and Fiscal Review Committee

Honorable Jack Dalrymple, Governor

Members of the North Dakota Legislative Assembly

Ms. 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, 2014. 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,

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

Robert R. Peterson
State Auditor

Executive Summary

Responses to LAFRC Audit Questions

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

Unmodified (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 "Improper Reconciliation of Motor Vehicle Clearing Account" (page 8), and "Taxes Receivable Errors" (page 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?*

No. "Improper 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 127) 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 14-2. These adjustments related to errors found in taxes receivable. 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 14-1 relates to the Department of Transportation's Vehicle Registration and Titling System (VRTS). The significant deficiency identified as Finding 14-2 relates to the Tax Department's GenTax system.

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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

Ms. Pam Sharp, CPA, Director
Office of Management and Budget

We have audited, in accordance with auditing standards general 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, 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, 2014, and the related notes to the financial statements, which collectively comprise the state's basic financial statements and have issued our report thereon dated December 17, 2014.

Our report includes a reference to other auditors who audited the following entities, as described in our report on the state of North Dakota's financial statements:

Bank of North Dakota
Beginning Farmer Revolving Loan Fund
Building Authority
College SAVE
Community Water Facility Loan Fund
Department of Trust Lands
Guaranteed Student Loan Program
Housing Finance Agency
Housing Incentive Fund

Job Service North Dakota
Mandan Remediation Trust
PACE and AG PACE Funds
Public Employees Retirement System
Rebuilders Loan Program
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 foundations, that are discretely presented component units, were not audited in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the state of North Dakota's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of the state of North Dakota's internal control.

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. 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weakness. We did identify certain deficiencies in internal control as described in the accompanying schedule entitled "Findings, Recommendations, and Management Response," (Findings 14-1 and 14-2) that we consider to be significant deficiencies.

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*.

State of North Dakota's Response to Findings

The state of North Dakota's response to the findings identified in our audit is described in the accompanying schedule of findings, recommendations, and management response. The state of North Dakota's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Robert R. Peterson
State Auditor



Edwin J. Nagel, Jr., CPA
Director

December 17, 2014

Findings, Recommendations, and Management Response

Improper Reconciliation of Motor Vehicle Clearing Account (Finding 14-1, 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 Department of Transportation failed to implement this recommendation in the past two audits as the Vehicle Registration and Titling System (VRTS) 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.

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 a 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 attempt to resolve this issue, NDDOT assembled a large, multi-disciplinary task force made up of individuals with accounting, auditing, Motor Vehicle, and information technology expertise. This group actively worked on the reconciliation project for more than two years. Each unique category of transaction was researched, mapped and traced through the VRTS system in a test environment. As discrepancies were revealed through this process, procedural and/or information technology solutions were developed, implemented, and further tested to ensure that a satisfactory solution was put in place.

While the task force identified and resolved several issues affecting the reconciliation, they were not able to fully reconcile the Motor Vehicle clearing account.

NDDOT addressed the VRTS problems with the 2013 Legislature. It was emphasized that 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. To address the numerous problems with the VRTS system, the 2013 Legislature approved a major IT project to replace the system and appropriated funding for the replacement. Accordingly, the NDDOT efforts to reconcile the clearing account under the VRTS system have been discontinued and efforts are now focused on obtaining and implementing a replacement to the VRTS system. One of the requirements for the new system is that it must fully support reconciliation of all related accounts.

NDDOT has entered into a contract with an entity to replace the VRTS system. Work will commence on the new system in mid-February, 2015. The new system is expected to be operational by late summer of 2016.

Taxes Receivable Errors

(Finding 14-2)

Condition:

The Office of the State Tax Commissioner's original taxes receivable closing package was misstated. Closing package amounts are used by the Office of Management and Budget to prepare the state's financial statements.

Effect:

Prior to corrections, taxes receivable were overstated by approximately \$28 million and the allowance for doubtful accounts was overstated by approximately \$18 million.

Cause:

Software consultants made last minute changes without notifying the appropriate personnel. This resulted in some of the amounts included in the taxes receivable balance to include accounts where payments were received by the Office of State Tax Commissioner on June 30, 2014, and therefore were no longer receivables at fiscal year-end.

Criteria:

The Office of Management and Budget requires closing packages to be in proper order to accurately prepare the state's financial statements.

Recommendation:

We recommend the Office of State Tax Commissioner take steps to insure software changes are properly implemented and communicated to the necessary personnel.

Views of Responsible Officials / Planned Corrective Actions:

The Office of State Tax Commissioner provided the Office of Management and Budget an adjusted taxes receivable closing package in time to be included in the state's 2014 financial statements. Procedures when backing out and reinstating program changes for taxes receivable reports are being updated to ensure changes are properly implemented and communicated to staff.

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, 2014, and have issued our report thereon dated December 17, 2014. 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 22 to the financial statements, the state of North Dakota adopted the provisions of GASB 65 *Items Previously Reported as Assets and Liabilities*, GASB 66 *Technical Corrections - 2012 - an amendment of GASB Statements No. 10 and No. 62*, and GASB 70 *Accounting and Financial Reporting for Nonexchange Financial Guarantees*. Our opinions were not modified with the implementation of these GASB pronouncements.

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.

The nature and amount of significant audit adjustments (corrected misstatements) are discussed in Finding 14-2.

The Office of Management and Budget determined four audit adjustments were immaterial and did not adjust the financial statements. The State Auditor agreed with this assessment and these uncorrected misstatements did not have an effect on our audit opinions.

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 17, 2014.

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.

Other Matters

In June 2012, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 68, Accounting and Financial Reporting for Pensions. Under GASB No. 68, the state of North Dakota, as a cost-sharing employer, will be required to recognize its proportionate share of the collective unfunded net pension liability, pension expense, and deferred pension outflows (inflows) of the North Dakota Public Employees' Retirement System (PERS) plan within its financial statements. This will be a significant change for the state of North Dakota. The state of North Dakota will see significant liabilities reflected in various opinion units along with significant increases to pension expenses and a corresponding reduction to unrestricted net position. PERS reports that the state's proportionate share of the unfunded net pension liability to be approximately \$350 million for the fiscal year ended June 30, 2014. The provisions of this statement are effective for financial statements for the year ending June 30, 2015.

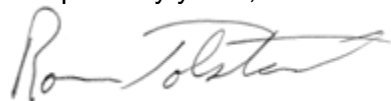
The following standards will be implemented for the fiscal year ending June 30, 2015:

- GASB Statement No. 65 "Items Previously Reported as Assets and Liabilities"
- GASB Statement No. 67 "Financial Reporting for Pension Plans – an Amendment of GASB Statement No. 25"

The full impact from these new standards has not been determined.

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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