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, 2016

JOSHUA C. GALLION
STATE AUDITOR

Office of the State Auditor
Division of State Audit

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Transmittal Letter

December 15, 2016

Legislative Audit and Fiscal Review Committee

Honorable Doug Burgum, 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, 2016. 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.

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,

Joshua C. Gallion
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 finding titled "Improper Reconciliation of Motor Vehicle Clearing Account" (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 the 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.*

   The most significant change in accounting policy related to the implementation of Government Accounting Standards Board (GASB) GASB Statement No. 72*, Fair Value Measurement and Application*. GASB 72 resulted in the University System increasing their Net position by approximately $9.5 million as the result of reclassifying real estate to an investment and reporting those investments at fair value. The state also implemented GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, which identifies in the context of the current governmental financial reporting environment, the hierarchy of generally accepted accounting principles (GAAP), which did not have an impact on the state's financial statements.

There were no management conflicts of interest or significant unusual transactions noted. The state's commitments and contingencies are reported in Note 18 (page 136) 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 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.

Management's estimates of claim losses relating to insurance activities include the Risk Management Fund, and the Fire and Tornado Fund. 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.

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.

For the State Investment Board, the valuation of alternative investments, including private equity and real asset investments, are a management estimate which is primarily based upon net asset values reported by the investment managers and comprise 32% of the total investment portfolio. The values for these investments are reported based upon the most recent financial data available and are adjusted for cash flows through June 30, 2016. Other auditor's audit procedures validated this approach through the use of confirmations sent directly to a sample of investment managers and the review of the most recent audited financial statements for these funds. Furthermore, they reviewed management's estimate and found it to be reasonable.

For the Department of Trust Lands the fair value of investments is based on quoted market prices, estimates of fair value from investment managers, cash flow analysis, and yields currently available on comparable securities. Other auditors evaluated the key factors and assumptions used to develop the fair value estimate in determining it is reasonable in relation to the financial statements as a whole.

For the Housing Finance Agency the fair value of investments is based on the exchange value of investments between two willing parties. Other auditors evaluated the key factors and assumptions used to develop the fair value of investments in determining that it is reasonable in relation to the financial statements as a whole.

Also for the Housing Finance Agency, the fair value of financial derivative instruments is based on the zero-coupon method and the discounted cash flow method. Other auditors evaluated the key factors and assumptions used to develop the fair value of instruments in determining that it is reasonable in relation to the financial statements as a whole.

The Public Employee's Retirement System's actuarial valuation was based on the actuarial assumptions and methods adopted by their Board, including an actuarial expected investment rate of return of 8.00% for the PERS, HPRS, and RHIC plans and 7.00% for the JSND plan. The valuation takes into account all of the promised benefits to which members are entitled as of July 1, 2016 as required by the North Dakota Century Code. The valuation provides certain information required by GASB to be disclosed in the financial statements. Additionally, the valuation is used to determine the adequacy of the current employer contribution rate. Other auditor's audit procedures included reviewing the actuarial valuation and related assumptions used therein and they believe the estimate to be reasonable.

The Teacher's Fund for Retirement's actuarial valuation was based on the actuarial assumptions and methods adopted by their Board, including an actuarial expected investment rate of return of 7.75% per annum compounded annually. The valuation takes into account all of the promised benefits to which members are entitled as of July 1, 2016 as required by the North Dakota Century Code. The valuation provides certain information required by GASB to be disclosed in the financial statements. Additionally, the valuation is used to determine the adequacy of the current employer contribution rate. Other auditor's audit procedures included reviewing the actuarial valuation and related assumptions used therein and the auditors believe the estimate to be reasonable.

Management's estimate of the net pension liability is based on an actuary's calculation in accordance with the employment contracts. We evaluated the key factors and assumptions used to develop the net pension liability in determining that it is reasonable in relation to the financial statements taken as a whole.

For the Bank of North Dakota (BND) the allowance for loan losses is maintained at an amount considered by the BND's management to adequately provide for probable losses in the loan portfolio as of the statement of net position date. The allowance for loan losses is based on periodic analysis of the loan portfolio by management. In this analysis, management considers factors including, but not limited to, current economic conditions, loan portfolio composition and historical loss experience. Loans are charged off to the extent they are deemed to be uncollectible. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. Other auditors have evaluated the key factors and assumptions used to develop the allowance for loan losses in determining that it is reasonable in relation to the financial statements taken as a whole.

Also for the BND, management's estimate of the fair value of their Federal funds interest rate swap is based on the valuation techniques performed by a third party specialist. Management's specialist completes a quarterly pricing analysis, as well as tests the effectiveness of the hedge, which complies with appropriate GASB Accounting Standards for hedge accounting. Other auditors evaluated the key factors and assumptions used to develop the fair value of the interest rate swap in determining that it is reasonable in relation to the financial statements taken as a whole.

One of the Workforce Safety and Insurance's (WSI) most sensitive estimates is the liability for unpaid losses and loss adjustment expenses (LAE). The liability for unpaid losses and LAE is estimated by WSI's actuary, taking into consideration past experience of WSI in paying claims, and the general conditions of the environment in which WSI operates. This liability is based on the estimated ultimate costs to settle both reported and incurred but not reported (IBNR) losses and LAE, and includes the effects of inflation and other societal and economic factors. The actuarial computation also includes a 5% discount to report this liability at its estimated present value. Other auditors relied upon a third party actuary review of the estimate as provided by WSI's actuary to ensure the estimate is reasonable.

WSI's dividend expense and related liability is calculated using the policyholder's prior year premium less any safety discounts awarded. This premium is an estimate based upon the previous year's actual payroll, and is subject to change once the current year's actual payroll is known. As that becomes known, and the premiums are adjusted, so too will the dividend liability and expense be adjusted. Other auditors reviewed the assumptions and calculation used in determining the estimate to ensure the estimate is reasonable.

3. *Identify any significant audit adjustments.*

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 Office of Management and Budget corrected several errors resulting from our audit work. The only material error is disclosed in Note 2 in the Comprehensive Annual Financial Report. We did not determine these adjustments were the result of a significant deficiency or a matter that we deemed necessary to bring to the attention of those charged with governance.

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

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.

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 (such as “opinion shopping”).

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 16-1 relates to STARS which is operated by the Department of Transportation.

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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 Doug Burgum, 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, 2016, 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 15, 2016.

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:

Addiction Counselor Internship Loan Program
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
Medical Facility Infrastructure Loan Program
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 a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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 weaknesses. We did identify a deficiency in internal control, described in the schedule entitled *Findings, Recommendations, and Management Responses* (Finding 16-1) that we consider 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.*

State of North Dakota's Response to the Finding

The state of North Dakota's response to the finding identified in our audit is described in the accompanying schedule entitled *Findings, Recommendations, and Management Responses.* 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.

Joshua C. Gallion
State Auditor

Edwin J. Nagel, Jr., CPA
Director

December 15, 2016

Findings, Recommendations, and Management Responses

Improper Reconciliation of the Motor Vehicle Clearing Account (Finding 16-1, 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 recently replaced the Vehicle Registration and Titling System (VRTS). VRTS was not a financial system and did not have the ability to provide the information necessary for a complete reconciliation. The new system (STARS) is still being refined.

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.

Department of Transportation Response:

NDDOT agrees with the finding and recommendation.

NDDOT replaced the VRTS system; the new system (STARS) became operational in June of 2016. Staff is able to balance daily to account for all funds. However, some program adjustments are necessary to fully reconcile with the bank account at the Bank of ND. Staff is closely working with IT and FAST Enterprises to fine tune the reconciliation process. We expect this finding will be fully resolved in the near future.

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, 2016, and have issued our report thereon dated December 15, 2016. Professional standards require that we provide you with the following information related to our audit.

Significant Audit Findings

Qualitative Aspects of Accounting Practices

The most significant change in accounting policy related to the implementation of Government Accounting Standards Board (GASB) GASB Statement No. 72, *Fair Value Measurement and Application*. GASB 72 resulted in the University System increasing their Net position by approximately $9.5 million as the result of reclassifying real estate to an investment and reporting those investments at fair value. The state also implemented GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, which identifies in the context of the current governmental financial reporting environment, the hierarchy of generally accepted accounting principles (GAAP), which did not have an impact on the state's financial statements. 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 follow.

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>
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WSI's dividend expense and related liability is calculated using the policyholder's prior year premium less any safety discounts awarded. This premium is an estimate based upon the previous year's actual payroll, and is subject to change once the current year's actual payroll is known. As that becomes known, and the premiums are adjusted, so too will the dividend liability and expense be adjusted. Other auditors reviewed the assumptions and calculation used in determining the estimate to ensure the estimate is reasonable.

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 Office of Management and Budget corrected several errors resulting from our audit work. The only material error is disclosed in Note 2 in the Comprehensive Annual Financial Report. We did not determine these adjustments were the result of a significant deficiency or a matter that we deemed necessary to bring to the attention of those charged with governance.

The Office of Management and Budget determined other audit adjustments were not material and did not adjust the financial statements for the potential audit adjustments. 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 15, 2016.

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.

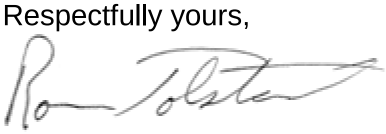
Other Audit Findings or Issues
We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our 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
We applied certain limited procedures to the management's discussion and analysis, budgetary comparison schedules and related reconciliations and notes, and information about the state of North Dakota's pension plans, which are required supplementary information (RSI) that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

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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