

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, 2018

JOSHUA C. GALLION
STATE AUDITOR



Office of the State Auditor
Division of State Audit

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AUDITOR AND AGENCY PERSONNEL

State Auditor Personnel

Allison Bader, Audit Manager

Primary Agency Contacts

Joe Morrissette, Director
Rachel Kmetz, Accounting Manager

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STATE AUDITOR
Joshua C. Gallion



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

Transmittal Letter

December 10, 2018

Legislative Audit and Fiscal Review Committee

Honorable Doug Burgum, Governor

Members of the North Dakota Legislative Assembly

Mr. Joe Morrissette, 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, 2018. 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 Allison Bader. Inquiries or comments relating to this audit may be directed to Ms. Bader by calling (701) 328-2241. I would like to express my appreciation to Mr. Morrissette and his staff for the courtesy, cooperation, and assistance they provided to this office during the audit.

Respectfully submitted,

/S/

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?*

No. See significant deficiencies included in this report under "Schedule of Findings, Recommendations, and Responses."

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?*

Not applicable. There were no findings or recommendations in the prior audit report.

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

No.

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 changes in accounting policies related to the adoption of the provisions of Government Accounting Standards Board (GASB) GASB 75 *Accounting and Financial Reporting for Postemployment Benefits Other than Pension*, GASB Statement No. 81 *Irrevocable Split-Interest Agreement*, GASB Statement No. 85 *Omnibus 2017*, and GASB Statement No. 86 *Certain Debt Extinguishment Issues*.

There were no management conflicts of interest or significant unusual transactions noted. The state's commitments and contingencies are reported in Note 18 of the Comprehensive Annual Financial Report.

2. *Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.*

Significant accounting estimates are discussed in the Governance Communication on page 11 of this report.

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.

None of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole.

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 the Office of Management and Budget 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 individual agency biennial audit reports. None of the exceptions identified in the six audit report questions are directly related to these systems.



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Report on 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

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, 2018, 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 10, 2018.

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	Mandan Remediation Trust
Bank of North Dakota	Medical Facility Infrastructure Loan Program
Beginning Farmer Revolving Loan Fund	PACE and AG PACE Funds
Building Authority	Public Employees Retirement System
College SAVE	Rebuilders Loan Program
Community Water Facility Loan Fund	Retirement and Investment Office
Department of Trust Lands	School Construction Assistance Revolving Loan Fund
Guaranteed Student Loan Program	State Fair Association
Housing Finance Agency	Student Loan Trust
Housing Incentive Fund	Workforce Safety and Insurance
Infrastructure Revolving Loan Fund	All Discretely Presented Component Units
Job Service North Dakota	

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

reported as 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. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control described in the accompanying *Schedule of Findings, Recommendations, and Responses* as items 2018-01, 2018-02, and 2018-03 that we consider to be significant deficiencies.

Responses to Findings

The Office of Management and Budget's and Department of Human Services' responses to the findings identified in our audit are described in the accompanying *Schedule of Findings, Recommendations, and Responses*. These responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the responses.

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*.

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

state of North Dakota'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 state of North Dakota's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

/S/

Joshua C. Gallion
State Auditor

December 10, 2018

Schedule of Findings, Recommendations, and Responses

Material Weaknesses

We did not identify any deficiencies in internal control that we consider to be material weaknesses.

Significant Deficiencies

We identified the following deficiencies in internal control that we consider to be significant deficiencies.

Finding 2018-01

Improper Calculation of Net Investment in Capital Assets

Condition:

The Office of Management and Budget did not properly calculate net investment in capital assets for governmental activities on the Government-Wide Statement of Net Position.

Effect:

Inaccurate financial statement presentation of net investment in capital assets.

Cause:

The Office of Management and Budget did not identify all necessary adjustments to properly calculate investment in capital assets net of related debt.

Criteria:

The calculation of net investment in capital assets utilizes multiple standards including Governmental Accounting Standards Board (GASB) Statement 34 para. 33-34; GASB Codification Section 2200.118; Governmental Accounting, Auditing, and Financial Reporting (GAAFR) pages 300-303.

Recommendation:

We recommend the Office of Management and Budget properly calculate net investment in capital assets for governmental activities on the Government-Wide Statement of Net Position.

Office of Management and Budget Response/Corrective Action:

The Office of Management and Budget agrees with the recommendation. OMB will ensure all necessary adjustments are made to calculate capital assets net of related debt in future financial statements.

Finding 2018-02

Non-Descriptive State Special Revenue Fund Balance Classification

Condition:

The Office of Management and Budget is not disclosing significant state special revenue fund balance amounts as to descriptive purpose within the notes to the financial statements (Note 5). Approximately \$266 million state special revenue committed fund balance is classified for "other" purposes. This amount comprises 67% of the state special revenue committed fund balance.

Effect:

The purpose of commitment of significant amounts of state special revenue fund balance are not sufficiently disclosed.

Cause:

The Office of Management and Budget is not evaluating the significance of amounts in the "other" category of fund balance for further disclosure.

Criteria:

Governmental Accounting Standards Board (GASB) Statement 54 requires that fund balance be reported from the perspective of the underlying resources within fund balance and specific purpose information be disclosed in the notes to the financial statements. (GASB 54 para. 25)

Recommendation:

We recommend the Office of Management and Budget disclose significant committed state special revenue fund balance by purpose within the notes to the financial statements.

Office of Management and Budget Response/Corrective Action:

The Office of Management and Budget agrees with the recommendation. The "other" committed state special revenue fund balance will be further investigated to determine if any other significant purposes should be reported separately.

Finding 2018-03

Lack of System Edit Checks for Medicaid Eligibility Verifications

Condition:

The computer system (SPACES) used by the Department of Human Services to determine eligibility for Medicaid Affordable Care Act cases does not have system edit checks in place to ensure the verification procedures are used in the eligibility determination process.

Effect:

Incorrect eligibility determinations are occurring that may cause payment errors. The FY 2018, 2017 ND Single Audit determined the Round 5 Pilot performed by the Department of Human Services' Quality Control Unit for July thru September 2016 identified 42 of 200 cases tested had eligibility determination errors or deficiencies, an error rate of 21%.

Cause:

Failure to fully implement a prior single audit recommendation which was originally issued in the FY 2014, 13 Single Audit. The SPACES system has the required verifications in place but does not require their use before the eligibility determination is made. The Department of Human Services has indicated the SPACES release 2 will address the identified weaknesses but the release has been delayed until the first quarter of 2019.

Criteria:

45 CFR 75.303 (Code of Federal Regulations) states that the non-Federal entity must establish and maintain effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and the terms and conditions of the Federal award.

Recommendation:

We recommend the Department of Human Services develop system edit checks within the SPACES system to ensure verifications are used in the eligibility determination process.

Department of Human Services' Response/Corrective Action:

Verification procedures will be enhanced in SPACES release 2. Eligibility workers will receive tasks related to interface information received from various sources such as Social Security Administration, Internal Revenue Services, Job Service North Dakota, etc.

In addition, the following system fixes have been implemented:

- Verification notice did not include data and due date, fix implemented in SPACES 07-27-2016.*
- Due date for requested verification was incorrect, fix implemented in SPACES 08-30-2016.*
- Added selection options for verification of identity types in SPACES 08-30-2016.*
- Incorrect due date on verification request notice, fix implemented 02-09-2017.*

The State also included information regarding training on policy and SPACES provided to eligibility workers by DHS Regional Representatives, E-Learning and through County Training Champion Webinar.

Noncompliance and Other Matters

We did not identify instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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, 2018 and have issued our report thereon dated December 10, 2018. Professional standards require that we provide you with the following information related to our audit.

Qualitative Aspects of Accounting Practices

The most significant changes in accounting policies related to the adoption of the provisions of Government Accounting Standards Board (GASB) *GASB 75 Accounting and Financial Reporting for Postemployment Benefits Other than Pension*, GASB Statement No. 81 *Irrevocable Split-Interest Agreements*, GASB Statement No. 85 *Omnibus 2017*, and GASB Statement No. 86 *Certain Debt Extinguishment Issues*.

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.

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, current and anticipated economic conditions, 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. Real asset investments comprise 16% 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, 2018. 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.

Also for the Department of Trust Lands, the estimate of unclaimed property liability is based on the historical average payout percentage per subsequent year to determine the current year liability. The historical average is based on a ten-year rolling average percentage of the total unclaimed property amounts collected during a specific fiscal year paid out in subsequent fiscal years. Other auditors evaluated the key factors and assumptions and checked the clerical accuracy of the spreadsheet used to determine the liability and determined that 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 the instruments in determining that it is reasonable in relation to the financial statements as a whole.

Job Service North Dakota estimates the amount of unemployment, penalties, and interest that will be receivable and uncollectible. Management estimates the taxes, penalties, and interest at year end by determining the amount of collections from July 1, 2018 to August 15, 2018. Other auditor's conclusion is based on the past history of collections and subsequent payment of the receivables after year end.

The actuarial valuations for retirement systems include management estimates that were based on the actuarial assumptions and methods adopted by the Public Employees Retirement System (PERS) Board, including an actuarial expected investment rate of return of 7.75% for the PERS, 7.75% for the Highway Patrolmen's Retirement System (HPRS), 7.5% for the Retiree Health Insurance Credit Fund (RHIC) and 4.75% for the retirement plan for employees of Job Services North Dakota (JSD).

The discount rate used for HPRS, RHIC and JSD was equal to their respective expected investment rate of return. The discount rate for PERS was a Single Discount Rate (SDR) of 6.32%. The SDR is required when assets are not projected to be sufficient to meet future benefit obligations. The SDR reflects (1) the expected investment rate of return on pension

plan investments during the period in which the fiduciary net position is projected to be sufficient to pay benefits and (2) a tax-exempt municipal bond rate based on an index of 20-year general obligation bonds with an average Standard and Poor's Corp.'s AA credit rating as of the measurement date (3.62%), to the extent that the contributions for use with the long-term expected rate of return are not met.

In accordance with GASB 68, the total pension liability of the PERS, HPRS and JSD were calculated with an actuarial valuation and measurement date of June 30, 2017. In accordance with GASB 75, the total OPEB liability of the RHIC was calculated with an actuarial valuation and measurement date of June 30, 2017. Other auditors evaluated the key factors and assumptions used to develop the estimate of the total pension and OPEB liabilities in determining that they are reasonable in relation to the financial statements taken as a whole.

The Teacher's Fund for Retirement's (TFFR) actuarial valuation was based on the actuarial assumptions and methods adopted by the TFFR 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, 2018 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 management to adequately provide for probable losses in the loan portfolio at the statement of net position date. The allowance for loan losses is based on management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing 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.

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.

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. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole.

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 10, 2018.

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,

A handwritten signature in cursive script that reads "Allison Bader".

Allison Bader
Audit Manager

You may obtain audit reports on the internet at:

www.nd.gov/auditor

or by contacting the Office of the State Auditor at:

Email: ndsao@nd.gov

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