NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

LEGISLATIVE AUDIT AND FISCAL REVIEW COMMITTEE

Wednesday, May 12, 2010
Roughrider Room, State Capitol
Bismarck, North Dakota

Senator Randel Christmann, Chairman, called the meeting to order at 9:00 a.m.

Members present: Senators Randel Christmann, Joan Heckaman, Jerry Klein, Judy Lee; Representatives Rick Berg, Merle Boucher, Patrick R. Hatlestad, RaeAnn G. Kelsch, Jerry Kelsh, Keith Kempenich, Gary Kreidt, Louis Pinkerton, Chet Pollert, Bob Skarphol, Blair Thoreson, Benjamin A. Vig

Members absent: Representatives Jeff Delzer, Lonny Winrich

Others present: Jim W. Smith, Legislative Council, Bismarck

Senator David O'Connell and Representatives Al Carlson and Shirley Meyer, members of the Legislative Management, were also in attendance.

See Appendix A for additional persons present.

It was moved by Representative Skarphol, seconded by Representative Kreidt, and carried on a voice vote that the minutes of the February 10, 2010, meeting be approved as distributed.

The legislative budget analyst and auditor presented a memorandum entitled *State Liability for Boards, Commissions, and Commodity Groups*. He said the term "commodity group," as defined in North Dakota Century Code Section 4-01-26, includes the following entities: North Dakota Barley Council, North Dakota Beef Commission, North Dakota Beekeepers Association, North Dakota Corn Utilization Council, North Dakota Dairy Promotion Commission, North Dakota Dry Bean Council, North Dakota Dry Pea and Lentil Council, North Dakota Oilseed Council, North Dakota Potato Council, North Dakota Soybean Council, North Dakota Turkey Federation, and North Dakota Wheat Commission. He said Chapter 32-12.2 provides for the procedures, limits, and exclusions for bringing claims against the state for personal injury or property damage. Under Section 32-12.2-01(7), he said, "state" is defined to include "an agency, authority, board, body, branch, bureau, commission, council, department, division, industry, institution, instrumentality, and office of the state." He said a board, commission, or other entity, such as a commodity group, for the purposes of liability, is a state entity that participates in and is covered by the state's risk management fund. He said the state would defend and be liable for a claim against a board, commission, or commodity group for an injury proximately caused by the alleged negligence, wrongful act, or omission of the board, commission, or commodity group. Because boards, commissions, and commodity groups are treated as state entities for purposes of tort liability, he said, it is likely that the state would be liable for the debt of a commodity group. He said Section 54-16-03 prohibits commodity groups from incurring debt unless authorized by the legislature.

Ms. Sara E. Chamberlin, Fiscal Analyst, Legislative Council, presented a memorandum entitled *Agriculture Commodity Groups*. She reviewed the statutory reference, number of board members, current assessments, reserve balances, the estimated number of months of operating costs in reserve, projected 2009-11 biennium expenditures, and estimated expenditure percentage by category for 13 agriculture commodity groups.

INTERNAL CONTROL AND COMPLIANCE REPORTS

Mr. John Grettum, Audit Manager, College and University Audit Section, State Auditor's office, Fargo, presented the State Auditor's office internal control and compliance report on the audit of the general purpose financial statements included in the June 30, 2009, annual financial report for the North Dakota University System. He reviewed the auditor's responses to the committee guidelines and said four prior audit recommendations were not implemented. He said the prior audit recommendations not implemented related to:

- Proper use of account codes, funds, fund groups, and functions available on PeopleSoft to comply with generally accepted accounting principles.
- Preparation of financial statements in accordance with generally accepted accounting principles.
- Comprehensive fraud and control risk assessments and establishment of appropriate internal controls.
- Segregation of duties relating to inventory.

Mr. Grettum said the report identifies five current audit recommendations relating to:

- Noncompliance with generally accepted accounting principles by the North Dakota State University Development Foundation on its financial statements.

- Lack of internal auditors at nine campuses and lack of reporting to the State Board of Higher Education by University of North Dakota and North Dakota State University internal auditors.
- The need for improvement in imaging application procedures at Bismarck State College and the University of North Dakota.
- Lack of timely legislative approval of additional construction costs for presidents' houses at the University of North Dakota and North Dakota State University.
- Noncompliance with criminal history background checks for new employees at the Dickinson State University and the University of North Dakota.

In response to a question from Representative Skarphol, Mr. Grettum said a position at the University System office could be reclassified to an internal auditor position to monitor projects and ensure compliance with statute and policy. He said internal auditors at the campuses or the University System office should report to the State Board of Higher Education's Budget, Audit and Finance Committee.

In response to a question from Representative Pinkerton, Mr. Grettum said there is potential for state liability for certain projects, such as building projects, paid for by a university's foundation.

Mr. Ron Tolstad, Technical Specialist, State Auditor's office, presented the State Auditor's office report on the internal control, compliance, and other matters of the state of North Dakota Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2009. He said the State Auditor's office has audited the general purpose financial statements for the state of North Dakota for the year ended June 30, 2009. He said two prior audit recommendations relating to lack of adequate resources devoted to financial reporting and financial reporting errors by the State Treasurer were not implemented. He said the report identifies six internal control weaknesses relating to:

- Lack of adequate controls over financial reporting for the CAFR.
- Financial reporting errors by the State Treasurer.
- Inability of the State Treasurer's office to perform cash reconciliations.
- Lack of approval documentation for all accounts payable transactions.
- Improper reconciliation by the Department of Transportation of its motor vehicle money market account.
- Financial reporting errors by the State Water Commission.

Representative Boucher asked that information be presented at a future committee meeting by the State Treasurer's office regarding reasons for cash reconciliations not being completed and financial reporting errors and the State Treasurer's office's plans to ensure completion of cash reconciliations in a timely manner and to prevent future financial reporting errors.

UNIVERSITY SYSTEM ANNUAL FINANCIAL REPORT

Ms. Robin Putnam, Director of Financial Reporting, North Dakota University System, presented written testimony (Appendix B) regarding the annual financial report for the University System for the fiscal year ended June 30, 2009. She said an unqualified opinion was issued on the financial statements. As of June 30, 2009, she said, the University System had total assets of $1,109 million and total liabilities of $358 million, resulting in net assets of $751 million. She said net assets increased $28 million during fiscal year 2009.

Ms. Putnam said the annual degree credit headcount for the fall of 2008 was 43,442, an increase of 4 percent from the previous fall enrollment. She said total operating revenues of the University System increased by 3 percent from fiscal year 2008 as a result of increases in tuition and fees and revenue from auxiliary enterprises, such as housing, bookstore, and food services.

Ms. Putnam presented information regarding significant audit adjustments included in the annual financial report and the University System's plans to prevent future adjustments (Appendix C). She said reasons for significant audit adjustments include staff error, lack of adequate technology tools, limited staff resources and staff turnover, and the complexity and volume of operations. She said the solutions to prevent future adjustments include systemwide training for accounting staff, computer system upgrades, risk assessments focused on transaction process review, and accountability for campus presidents.

In response to a question from Representative Boucher, Ms. Putnam said she would provide information to the committee regarding whether component units use the state's bond rating and the extent to which the state is liable for debts of component units.

COMPREHENSIVE ANNUAL FINANCIAL REPORT

Ms. Eileen Holwegner, Office of Management and Budget, presented the state of North Dakota CAFR for the fiscal year ended June 30, 2009. She reviewed the information contained in the report and a supplemental report entitled *2007-09 Biennium Budget and Actual Detail*. Copies of both reports are on file in the Legislative Council office.

AUDITS OF STATE AGENCIES, BOARDS, AND COMMISSIONS

Mr. John Mongeon, Brady, Martz & Associates PC, Certified Public Accountants, presented the audit report for the Public Finance Authority for the years ended December 31, 2009 and 2008. He reviewed

the auditor's responses to the committee guidelines and said the report contains an unqualified opinion and identifies one internal control finding relating to segregation of duties.

Mr. Mongeon presented the audit report for the developmentally disabled facility loan fund for the years ended December 31, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report contains an unqualified opinion and does not include any findings or recommendations.

Mr. Mongeon presented the audit report for the community water facility loan fund for the years ended December 31, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report contains an unqualified opinion and does not include any findings or recommendations.

Mr. Mongeon presented the audit reports for the beginning farmer revolving loan fund for the years ended December 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the June 30, 2009, report contains an unqualified opinion and does not include any findings or recommendations.

Mr. Mongeon presented the audit report for the Bank of North Dakota for the years ended December 31, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report contains an unqualified opinion and does not include any findings or recommendations.

Mr. Ed Nagel, Director, State Auditor's office, presented the audit report for the Department of Public Instruction for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report includes one finding of noncompliance with procurement laws and four areas of operational improvement relating to school employee background checks, school emergency and disaster drills, grant monitoring procedures, and purchase card usage.

Mr. Nagel presented the audit report for the Department of Transportation for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report identifies two internal control findings relating to controls over system access and reconciliation of the motor vehicle clearing account.

Mr. Nagel presented the audit report for the Department of Human Services for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report identifies one internal control finding relating to establishing fraud risk assessments and controls.

Mr. Nagel presented the audit report for the Labor Department for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report does not include any findings or recommendations.

Mr. Nagel presented the audit report for the Department of Corrections and Rehabilitation for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report identifies two internal control findings relating to computer access controls and establishing fraud risk assessments and controls. He said the finding relating to computer access controls is also a prior recommendation that has not been implemented.

Mr. Grettum presented the audit report for Bismarck State College for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report identifies one internal control finding relating to segregation of duties.

Mr. Grettum presented the audit report for Dickinson State University for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report does not include any findings or recommendations.

Mr. Grettum presented the audit report for Mayville State University for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report identifies one finding of noncompliance with Section 44-04-07 relating to departmental equipment inventory. He said this finding was also a prior recommendation that has not been implemented.

Mr. Grettum presented the audit report for Minot State University for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report does not include any findings or recommendations.

Mr. Grettum presented the audit report for Dakota College at Bottineau for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report identifies one internal control finding relating to approval of online entries. He said the finding was also a prior recommendation that has not been implemented.

Mr. Grettum presented the audit report for Valley City State University for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report does not include any findings or recommendations.

Mr. Grettum presented the audit report for Williston State College for the years ended June 30, 2009 and 2008. He reviewed the auditor's responses to the committee guidelines and said the report identifies two internal control findings relating to proper approval and adequate support for general ledger input documents and evaluation of the allowance for doubtful accounts to ensure reasonableness.

Representative Skarphol suggested that the Legislative Council provide a list of prior recommendations not implemented to the appropriate committees at the beginning of the 2011 legislative session.

Representative Boucher suggested each agency provide a progress report on its audit recommendations to the 2011 Legislative Assembly.

It was moved by Representative R. Kelsch, seconded by Senator Lee, and carried on a roll call vote that pursuant to Section 54-35-02.2 the committee accept the following reports presented to the committee:

1. **North Dakota University System annual financial report (June 30, 2009).**
2. **North Dakota Comprehensive Annual Financial Report (June 30, 2009).**
3. **Public Finance Authority (December 31, 2009 and 2008).**
4. **Developmentally disabled facility loan fund (December 31, 2009 and 2008).**
5. **Community water facility loan fund (December 31, 2009 and 2008).**
6. **Beginning farmer revolving loan fund (December 31, 2009 and 2008).**
7. **Bank of North Dakota (December 31, 2009 and 2008).**
8. **Department of Public Instruction (June 30, 2009 and 2008).**
9. **Department of Transportation (June 30, 2009 and 2008).**
10. **Department of Human Services (June 30, 2009 and 2008).**
11. **Labor Department (June 30, 2009 and 2008).**
12. **Department of Corrections and Rehabilitation (June 30, 2009 and 2008).**
13. **Bismarck State College (June 30, 2009 and 2008).**
14. **Dickinson State University (June 30, 2009 and 2008).**
15. **Mayville State University (June 30, 2009 and 2008).**
16. **Minot State University (June 30, 2009 and 2008).**
17. **Dakota College at Bottineau (June 30, 2009 and 2008).**
18. **Valley City State University (June 30, 2009 and 2008).**
19. **Williston State College (June 30, 2009 and 2008).**

Senators Christmann, Heckaman, Klein, and Lee and Representatives Berg, Boucher, Hatlestad, R. Kelsch, Kempenich, Kreidt, Pinkerton, Pollert, Skarphol, Thoreson, and Vig voted "aye." No negative votes were cast.

It was moved by Senator Klein, seconded by Representative Thoreson, and carried on a roll call vote that pursuant to Section 54-35-02.2 the committee accept the following reports available but not selected for presentation:

1. **Board of Pharmacy (June 30, 2009 and 2008).**
2. **Board of Occupational Therapy Practice (June 30, 2009 and 2008).**
3. **Board of Counselor Examiners (June 30, 2008 and 2007).**
4. **Real Estate Commission (June 30, 2009).**
5. **Board of Chiropractic Examiners (December 31, 2009 and December 2007).**
6. **Board of Dietetic Practice (September 30, 2009 and 2008).**
7. **Board of Registration for Professional Engineers and Land Surveyors (June 30, 2009).**
8. **Board of Veterinary Medical Examiners (June 30, 2008 and 2007).**
9. **Board of Law Examiners (June 30, 2009 and 2008).**

Senators Christmann, Heckaman, Klein, and Lee and Representatives Berg, Boucher, Hatlestad, R. Kelsch, Kempenich, Kreidt, Pinkerton, Pollert, Skarphol, Thoreson, and Vig voted "aye." No negative votes were cast.

The committee recessed for lunch at 12:00 noon and reconvened at 1:00 p.m.

Mr. Sparb Collins, Executive Director, Public Employees Retirement System, presented information regarding the status of the agency's retirement funds and any proposals to address the funds' unfunded liability (Appendix D). He said there are 27,778 members in the Public Employees Retirement System. He said the school district members include nonteaching staff. He said teachers are included in the Teachers' Fund for Retirement. He said judges, law enforcement agents, and the Highway Patrol have their own retirement plans. He said Chapter 54-52 provides that under the main retirement system, employers contribute 4.12 percent and employees contribute 4 percent to the employees' retirement plan. He said in lieu of a salary increase a number of years ago, the state also pays the employee contribution. He said the normal retirement is at age 65 or the rule of 85.

Mr. Collins said challenges facing the Public Employees Retirement System fund include stabilizing the fund and improving its funded status. He said the department reviewed the potential of investment returns to lead to recovery, the effect of benefit reductions, and the effect of changing contributions. He said investment returns would need to be at least 11 percent per year for 20 years to allow the fund to recover. He said reducing benefits for new employees would not likely improve the fund's status significantly. He said changing the contribution rates would stabilize the plan and return it to a 100 percent funded level over approximately 30 years.

Ms. Fay Kopp, Acting Executive Director, Retirement and Investment Office, presented information on the status of the Teachers' Fund for Retirement and proposals to address its unfunded liability (Appendix E). She said the Teachers' Fund for Retirement's funded level is expected to decline from its 2009 level of 78 percent to approximately 50 percent within the next five years and continue to decrease in the future. She said even with a 16 percent rate of return in 2010 and 8 percent returns in the future, the funding levels are projected to decline to unacceptable levels.

Ms. Kopp said the Teachers' Fund for Retirement Board of Trustees has submitted two funding improvement proposals to the Legislative Management's Employee Benefits Programs Committee:

- Employee Benefits Programs Committee Bill No. 54 increases teacher contributions by 4 percent over two bienniums; increases school district contributions by 4 percent over two bienniums; requires reemployed retirees to pay employee contributions beginning July 1, 2012; modifies disability benefits; and modifies eligibility for unreduced retirement benefits and reduction factors for reduced retirement benefits for certain employees.
- In addition to the provisions included in Employee Benefits Programs Committee Bill No. 54, Bill No. 55 includes a one-time $75 million general fund appropriation to be transferred to the Teachers' Fund for Retirement on June 30, 2012, to reduce the unfunded actuarial accrued liability for the Teachers' Fund for Retirement.

In response to a question from Representative Boucher, Ms. Kopp said the Teachers' Fund for Retirement's unfunded liability at July 1, 2009, was $550 million. Ms. Kopp said the market value in 2007 was over $2 billion and at July 1, 2009, the value was $1.3 billion, indicating a $700 million loss. She said the market value has recovered since July 1, 2009, by approximately $150 million to $200 million.

Ms. Kopp presented information on the status of the Retirement and Investment Office (Appendix F). She said after the unexpected death of the former executive director, the State Investment Board appointed her as the Acting Executive Director and established an executive committee to hire an interim executive director/chief investment officer until a permanent director can be hired. She said the interim executive director/chief investment officer is expected to begin on May 17, 2010. She said the State Investment Board has issued a request for proposal for a third-party executive search firm to assist the board in hiring a permanent executive director/chief investment officer. She said the State Investment Board has authorized a special purpose audit to verify the assets and controls of the Retirement and Investment Office programs.

Ms. Connie Flanagan, Fiscal and Investment Officer, Retirement and Investment Office, presented an update on investment returns of funds invested by the State Investment Board, including the status of the funds in receivership (Appendix G). She said investment markets are beginning to recover, and for the first nine months of fiscal year 2010, the investment return for the Teachers' Fund for Retirement is 21.74 percent and the Public Employees Retirement System is 20.37 percent. She said for the 12-month period ending March 31, 2010, the Teachers' Fund for Retirement investment return is 34.01 percent and the Public Employees Retirement System return is 31.25 percent. She said the average annual return for the five-year period ending March 31, 2010, for the Teachers' Fund for Retirement is 3.63 percent and the Public Employees Retirement System is 3.87 percent. She said the estimated fiscal year 2010 return as of May 10, 2010, for the Teachers' Fund for Retirement is 20.14 percent and the Public Employees Retirement System is 19.58 percent. She said the two pension funds have different rates of return because they have different asset allocations, based on the underlying liabilities of the plans. She said the Teachers' Fund for Retirement has a slightly higher allocation of stocks.

Ms. Flanagan said the market value of the budget stabilization fund was $334,442,614 on March 31, 2010, compared to the value based on cost of $324,936,548.

Regarding the status of funds held in receivership, Ms. Flanagan said the State Investment Board and its six coclaimants have retained the services of a forensic accountant who will evaluate documents and a report from the receiver and assist in formulating a distribution plan for any funds that may become available.

Ms. Cindy Ternes, member, State Investment Board Audit Committee, presented written testimony regarding the board's plans for an audit of funds under its control (Appendix H). She said the board was advised by its investment consultant--Callan Associates--to contract for an independent audit. She reviewed Sections 1 through 3 of the request for proposal (Appendix I), which includes the purpose for the request for proposal, the proposal schedule, the scope of work, and the experience and qualifications required of the contractor.

UNIVERSITY SYSTEM CAPITAL PROJECTS PERFORMANCE AUDIT

Mr. Gordy Smith, Audit Manager, Performance Audit Section, State Auditor's office, presented the University System capital projects performance audit dated April 5, 2010. He said the objective of the performance audit was to determine if University System capital projects are adequately monitored.

Mr. G. Smith said the performance audit contains 18 recommendations. A copy of the audit recommendations is attached as Appendix J. Based on the performance audit, he said, the State Auditor's office determined:

- Capital projects within the University System are not adequately monitored.
- The University System does not have a unified system for capital projects.
- Monitoring of compliance with State Board of Higher Education policies relating to capital projects is minimal.
- North Dakota State University and the University of North Dakota have not complied with capital project requirements in state law and State Board of Higher Education policies.

- Dickinson State University is in noncompliance with capital project requirements in State Board of Higher Education policies.

In response to a question from Representative Skarphol, Mr. G. Smith said a viability ratio measures an entity's ability to pay off debt with current assets. He said he would provide information to the committee relating to a historical analysis of viability ratios for institutions of higher education since 2002.

In response to a question from Representative Carlson, Mr. G. Smith said he believes the North Dakota State University Development Foundation issued bonds to purchase and renovate a building in downtown Fargo to be used for the College of Business. He said an Attorney General's opinion has been requested to determine if the financing provided by the bonds issued by the foundation is in compliance with the provisions of 2007 House Bill No. 1003, which authorized the project.

In response to a question from Representative Berg, Mr. G. Smith said there are no requirements in statute relating to the structure of capital leases. He said all leases require a clause that releases the state entity from the lease if the Legislative Assembly does not provide funding.

Mr. Claus Lembke, member, State Board of Higher Education, presented a letter on behalf of Mr. Jon W. Backes, the board's vice president (Appendix K). He said the University System has created a systemwide committee to review laws, policies, and procedures and make recommendations to ensure compliance with the applicable laws and policies. He said the State Board of Higher Education will request in its 2011-13 budget request a full-time equivalent position to provide project management for capital projects.

Mr. Lembke said the State Board of Higher Education has directed the chancellor to hire appropriate personnel to investigate the cause of and personnel involved in the circumvention of board policy which was identified during the performance audit.

Mr. William G. Goetz, Chancellor, North Dakota University System, said the University System is dedicated to rebuilding the trust of the public and policymakers. He said the University System office needs an employee with expertise in capital projects. He said the University System office will follow up on the audit findings and determine who was responsible for decisions that resulted in audit findings.

Representative Carlson expressed concern that the University System is planning to hire additional personnel to address issues that should be resolved within the system's current number of authorized positions.

It was moved by Representative Skarphol, seconded by Representative R. Kelsch, and carried on a roll call vote that pursuant to Section 54-35-02.2 the committee accept the performance audit of University System capital projects. Senators Christmann, Heckaman, Klein, and Lee and Representatives Berg, Boucher, Hatlestad, R. Kelsch, J. Kelsh, Kempenich, Kreidt, Pinkerton, Pollert, Skarphol, Thoreson, and Vig voted "aye." No negative votes were cast.

COMMITTEE DISCUSSION AND STAFF DIRECTIVES

It was moved by Representative Boucher and seconded by Representative J. Kelsh that the Legislative Audit and Fiscal Review Committee direct the State Auditor's office to conduct a performance audit of the Retirement and Investment Office, including a review of the types of investments being made, the process involved in investment decisions, the level of investment risk, and the appropriateness of investment fees paid. Senators Christmann and Heckaman and Representatives Boucher, J. Kelsh, Kempenich, Pinkerton, and Vig voted "aye." Senators Klein and Lee and Representatives Berg, Hatlestad, R. Kelsch, Kreidt, Pollert, Skarphol, and Thoreson voted "nay." **The motion failed.**

Chairman Christmann anticipates the next meeting of the Legislative Audit and Fiscal Review Committee to be in July 2010.

No further business appearing, Chairman Christmann adjourned the meeting at 5:20 p.m.

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Becky Keller
Senior Fiscal Analyst

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Allen H. Knudson
Legislative Budget Analyst and Auditor

ATTACH:11