

# NORTH DAKOTA LEGISLATIVE MANAGEMENT

## Minutes of the

### LEGISLATIVE AUDIT AND FISCAL REVIEW COMMITTEE

Friday, October 1, 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, Gary Kreidt, Chet Pollert, Bob Skarphol, Benjamin A. Vig, Lonny Winrich

**Members absent:** Representatives Jeff Delzer, Keith Kempenich, Louis Pinkerton, Blair Thoreson

**Others present:** Senator Tracy Potter, member of the Legislative Management, was also in attendance.

See [Appendix A](#) for additional persons present.

**It was moved by Representative Kreidt, seconded by Senator Klein, and carried on a voice vote that the minutes of the May 12, 2010, meeting be approved as distributed.**

#### RETIREMENT AND INVESTMENT OFFICE PERFORMANCE AUDIT

Mr. Thomas Rey, Auditor, Clifton Gunderson LLP, Baltimore, Maryland, presented the performance audit report of the Retirement and Investment Office. A copy of the report is on file in the Legislative Council office. He said there were seven objectives of the audit:

1. Determine whether the former executive director/chief investment officer adhered to executive limitation policies regarding:
  - a. The protection, maintenance, and risk of assets; and
  - b. Not allowing conflicts of interest in the procurement of goods and services.
2. Determine whether the former executive director/chief investment officer's actions directed:
  - a. The receipt of cost-effective investment services directed at meeting the written financial goals under the prudent investor rule; and
  - b. The receipt of investment returns consistent with the written investment policies and market variable.
3. Determine whether the former executive director/chief investment officer performed adequate due diligence in the selection, retention, and compensation of money managers.

4. Determine whether the former executive director/chief investment officer complied with all laws applicable to the State Investment Board and the Retirement and Investment Office as outlined in the North Dakota Century Code.
5. Determine whether the former executive director/chief investment officer exercised any exclusive fund transaction access which could lead to any irregular financial activity or discrepancies related to the management of the Retirement and Investment Office or its funds.
6. A comparison of benchmarking of money manager compensation to comparable investment, public pension, or other state investment agencies.
7. Verification of the classification of investments into designated categories of:
  - a. Equities;
  - b. Fixed income;
  - c. Real estate;
  - d. Alternative investments; and
  - e. Cash.

Mr. Rey said the audit revealed no evidence of corruption or fraud. He reviewed a summary of the report findings and recommendations as follows:

- Enhance current conflict of interest policies.
- Update the executive limitation policy to address new federal Securities and Exchange Commission regulations.
- Update current policies regarding the selection and hiring process of investment managers.
- Expand the number of individuals involved in the initial investment manager due diligence process.
- Consider the prudence of obtaining fee concessions from external managers either by negotiation or reallocation.
- Expand disclosures of certain investment vehicles and their categorization with asset classes.
- Consider modifying the makeup of the State Investment Board and the creation of subcommittees specific to investments and oversight.
- Develop a strategic plan.
- Implement a formal valuation policy.

- Implement a policy for formal compliance reports and documentation received from the external investment managers.
- Reevaluate/realign the compliance officer position and/or create a deputy investment executive whose duties include compliance responsibilities.
- Maintain a formal log of compliance-related issues.
- Develop a policy dictating actions to be taken when a compliance matter arises.

### **INVESTMENT FEE ANALYSIS - STATE INVESTMENT BOARD**

Mr. Paul Erlendson, Callan Associates, Inc., Denver, Colorado, presented a report on the analysis of investment management fees paid to the State Investment Board's private equity asset managers. A copy of the report is on file in the Legislative Council office. He said the purpose of the analysis was to determine the amount and rate of fees paid by the pension and insurance trusts for the one-year period ended March 31, 2010, and how the fees paid by the State Investment Board compare with those paid by other large institutional investors. He said fee schedules for North Dakota's conventional strategies are near or below industry averages for accounts of similar size. He said fee schedules for North Dakota's special strategies, or those that invest in private markets, use leverage, or incorporate performance fees, result in increased fees within the asset classes to which these strategies have been assigned. He said the State Investment Board's pension trust's plan level fees are higher than average, and the insurance trust's overall fees are generally competitive.

In response to a question from Senator Christmann, Mr. Erlendson said he will provide information to the committee regarding the State Investment Board's trust returns compared to a broad stock market index for a nine-year rolling period ending on March 31, 2010.

Senator Heckaman requested the State Investment Board provide information regarding North Dakota companies included in its investment portfolio.

Mr. LeRoy Gilbertson, Interim Executive Director, Retirement and Investment Office, said the State Investment Board agrees with the recommendations included in the performance audit report and will implement the recommendations over time.

Representative Skarphol suggested the State Investment Board provide information regarding investment gains and losses over the last three fiscal years.

### **AUDITS OF STATE AGENCIES, BOARDS, AND COMMISSIONS**

Mr. John Grettum, Audit Manager, College and University Audit Section, State Auditor's office, Fargo, presented the audit report for North Dakota 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 internal control finding relating to inadequate purchasing card oversight and monitoring controls. He said the report also identifies two findings of noncompliance relating to equipment inventory and the competitive bidding process and one area of operational improvement relating to stewardship of public resources.

Mr. Grettum presented the audit report for Lake Region 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 three internal control findings relating to general ledger entry approval, purchasing cards, and daily deposits and proper support for receipts.

Mr. Grettum presented the audit report for the State College of Science 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 incorrect coding of federal grants and problems noted with consultant contracts. He said the finding relating to federal grants was also a prior recommendation that has not been implemented.

Mr. Grettum presented the audit report for the University of North Dakota 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.

The committee recessed for lunch at 12:05 p.m. and reconvened at 1:00 p.m.

Mr. Ed Nagel, Director, State Auditor's office, presented the audit report for the Department of Agriculture 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 a fraud risk assessment system. He said the internal control finding was also a prior recommendation that has not been implemented.

Mr. Nagel presented the audit report for the North Dakota Aeronautics Commission 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 a fraud risk assessment system.

Mr. Nagel presented the audit report for the Public Service Commission 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 a fraud risk assessment system and one finding of noncompliance with Office of Management and Budget policy relating to payment of moving expenses. He said the finding relating to fraud risk assessment was also a prior recommendation that has not been implemented.

Mr. Nagel presented the audit report for the State Water Commission 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 Tax Commissioner's office 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 tax revenue deposit requirements relating to the telecommunications carriers fund.

Mr. Nagel presented the audit report for the State Department of Health 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 a fraud risk assessment system. He said the internal control finding was also a prior recommendation that has not been implemented.

Mr. Nagel presented the audit report for the Governor's office 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 Office of Management and Budget 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 transfer requirements relating to a transfer to the state disaster relief fund.

Mr. Nagel presented the audit report for the Office of Administrative Hearings 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 Career and Technical Education 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 Parks and Recreation Department 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 state park revenue controls. He said the internal control finding was also a prior recommendation that has not been implemented.

Mr. Nagel presented the audit report for the Veterans' Home 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 relating to travel expenses and one prior recommendation that has not been implemented relating to computer processing controls.

Mr. Nagel presented the audit report for the judicial branch 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 unified court information system controls and one finding of noncompliance relating to fixed assets records. He said the identified findings were also prior recommendations that have not been implemented.

In response to a question from Representative Skarphol, the legislative budget analyst and auditor said the Legislative Council staff will arrange for information to be provided at the next committee meeting regarding the status of uncollected fines and fees of the judicial branch.

**It was moved by Representative R. Kelsch, seconded by Representative J. Kelsh, and carried on a roll call vote that pursuant to North Dakota Century Code Section 54-35-02.2 the committee accept the following reports presented to the committee:**

1. Lake Region State College (June 30, 2009 and 2008).
2. State College of Science (June 30, 2009 and 2008).
3. North Dakota State University (June 30, 2009 and 2008).
4. University of North Dakota (June 30, 2009 and 2008).
5. Department of Agriculture (June 30, 2009 and 2008).
6. North Dakota Aeronautics Commission (June 30, 2009 and 2008).
7. Public Service Commission (June 30, 2009 and 2008).
8. State Water Commission (June 30, 2009 and 2008).
9. Tax Commissioner's office (June 30, 2009 and 2008).
10. State Department of Health (June 30, 2009 and 2008).
11. Governor's office (June 30, 2009 and 2008).
12. Office of Management and Budget (June 30, 2009 and 2008).
13. Office of Administrative Hearings (June 30, 2009 and 2008).
14. Department of Career and Technical Education (June 30, 2009 and 2008).
15. Parks and Recreation Department (June 30, 2009 and 2008).
16. Veterans' Home (June 30, 2009 and 2008).
17. Judicial branch (June 30, 2009 and 2008).

Senators Christmann, Heckaman, Klein, and Lee and Representatives Hatlestad, R. Kelsch, J. Kelsh, Kreidt, Pollert, Skarphol, Vig, and Winrich voted "aye." No negative votes were cast.

**It was moved by Representative Kreidt, seconded by Representative Pollert, 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. Soybean Council (June 30, 2009).
2. Athletic Training Board (June 30, 2009, 2008, 2007, and 2006).

3. **Board of Psychologist Examiners (June 30, 2009 and 2008).**
4. **Board of Architecture (June 30, 2009 and 2008).**
5. **Board of Professional Soil Classifiers (June 30, 2009 and 2008).**
6. **Board of Reflexology (June 30, 2009).**
7. **Board of Clinical Laboratory Practice (June 30, 2009).**
8. **Board of Addiction Counseling Examiners (June 30, 2009 and 2008).**
9. **North Dakota Firefighter's Association (December 31, 2009 and 2008).**

Senators Christmann, Heckaman, Klein, and Lee and Representatives Hatlestad, R. Kelsch, J. Kelsh, Kreidt, Pollert, Skarphol, Vig, and Winrich voted "aye." No negative votes were cast.

### **DEPARTMENT OF HUMAN SERVICES' ACCOUNTS RECEIVABLES**

Chairman Christmann called on Ms. Brenda Weisz, Chief Financial Officer, Department of Human Services, who presented information on the status of the department's accounts receivables pursuant to Sections 25-04-17 and 50-06.3-08 ([Appendix B](#)). Ms. Weisz said the total amount written off by the Department of Human Services for fiscal year 2010 was \$5,499,816, of which \$1,112,039 related to the human service centers, \$4,333,603 related to the State Hospital, and \$54,174 related to the Developmental Center.

### **POLITICAL SUBDIVISION AUDIT DIVISION STUDY**

Chairman Christmann called on Mr. Gordy Smith, Audit Manager, Performance Audit Section, State Auditor's office, who presented information on the status of the political subdivision audit division ([Appendix C](#)). Mr. Smith said political subdivisions can choose to have their audits completed by the State Auditor's office or a private certified public accountant firm. He said the State Auditor's office conducts approximately 85 political subdivision audits every two years, and private certified public accountant firms conduct approximately 600 political subdivision audits every two years. He said some political subdivisions choose to be audited annually.

Mr. Smith said travel and pay are two issues that contribute to turnover in the political subdivision audit division. In addition, he said, fewer private certified public accountant firms are conducting audits of

political subdivisions receiving federal funds due to requirements set forth by generally accepted governmental auditing standards and federal requirements surrounding federal funds.

In response to a question from Senator Christmann, Mr. Smith said the North Dakota League of Cities or the North Dakota Association of Counties may wish to survey political subdivisions to determine which counties and cities would be interested in jointly negotiating audit contracts.

Mr. Terry Traynor, Assistant Director of Policy and Programs, North Dakota Association of Counties, said cities and counties are concerned that if the State Auditor's office does not provide political subdivision audits, private certified public accountant firm fees will increase.

Representative Skarphol suggested the State Auditor's office provide information at the next meeting regarding the number of political subdivisions that are required to have audits and those that may submit annual reports for review by the State Auditor's office. He suggested that the State Auditor's office, with input from the North Dakota Association of Counties and North Dakota League of Cities, provide suggestions for the committee to consider in its study of the political subdivision audit division.

Representative Skarphol suggested the Legislative Council staff provide information to the committee regarding how other states provide for political subdivision audits.

### **COMMITTEE DISCUSSION AND STAFF DIRECTIVES**

Chairman Christmann said the next meeting of the Legislative Audit and Fiscal Review Committee is tentatively scheduled for Thursday, October 21, 2010.

No further business appearing, Chairman Christmann adjourned the meeting at 2:10 p.m.

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Becky Keller  
Senior Fiscal Analyst

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Allen H. Knudson  
Legislative Budget Analyst and Auditor

ATTACH:3