COUNTY AND MUNICIPAL GOVERNMENT IN NORTH CAROLINA

ARTICLE 18

Accounting, Fiscal Control, and Cash Management

by Gregory S. Allison

The Finance Officer / 2

Official Bonds / 3

The Accounting System / 3
- Statutory Requirements / 3
- Generally Accepted Accounting Principles for Governments / 5
- Counties' and Cities' Own Needs and Capabilities / 5

Control of Expenditures / 6
- Preauditing Obligations / 6
  - The Meaning of "Appropriation" / 6
  - Encumbrances / 6
  - The Preaudit Certificate / 6
- Disbursements / 7
  - The Finance Officer's Certificate / 7
  - Governing Board Approval of Bills, Invoices, or Claims / 7
- Form of Payment / 7

Cash Management / 8
- Daily Deposits / 8
- Official Depository / 8
- Insurance and Collateralization of Deposits / 9
- Investments / 9
  - Custody of Investment Securities / 10
  - Authorized Investments / 10
- Guidelines for Investing Public Funds / 13

The Annual Audit / 14
- Contents of the Comprehensive Annual Financial Report / 14
  - Introductory Section / 14
  - Financial Section / 14
  - Statistical Section / 16
- The Auditor's Opinion / 16
- Selection of an Independent Auditor / 17

Audits of Federal and State Grants / 17

Additional Resources / 18

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Public confidence in government depends on proper stewardship of public moneys. The North Carolina Local Government Budget and Fiscal Control Act sets forth requirements for fiscal control that provide a framework for ensuring accountability in a local government's budgetary and financial operations. This article focuses on these requirements, which are generally equally applicable both to county governments and city governments. They pertain to the appointment and the role of the finance officer, the accounting system, control of expenditures, cash management and investments, the annual audit, and audits of federal and state financial assistance.

To facilitate the understanding of references that occur throughout this article, we will briefly discuss the role of the North Carolina Local Government Commission and its relationship to North Carolina local government entities. The Local Government Commission, often referred to as simply the LGC, was briefly mentioned in Article 17 of this volume.

The Local Government Commission, established by G.S. 159-3, operates as a division of the State Treasurer's Office. The Commission itself consists of nine members. The State Treasurer, the State Auditor, the Secretary of State, and the Secretary of Revenue serve as ex officio members; the remaining five members are appointed by the governor (three members) and the General Assembly (two members). The Commission's primary responsibility is to provide fiscal and debt-management oversight to local government entities in North Carolina. The Commission's policy directives are carried out on a day-to-day basis by the staff to the LGC, who are employees of the State Treasurer's office.

The LGC's oversight role to the counties and cities in North Carolina is extensive. A local government's financial condition, cash management practices, and audit procurement procedures are all subject to LGC review and approval. As a general rule, counties and cities are not allowed to enter into most types of indebtedness without the express permission of the LGC. Counties and cities in North Carolina have benefited extensively by this level of oversight in that their financial condition and reputation in the national debt markets are among the best in the nation.

The Finance Officer

G.S. 159-24 requires that each county and city government have a finance officer who is legally responsible for establishing the accounting system, controlling expenditures, managing cash and other assets, and preparing financial reports. The Local Government Budget and Fiscal Control Act (LGBFCA) does not specify who is to appoint this official, leaving the decision to each jurisdiction. In many counties and cities, the manager appoints the finance officer (G.S. 153A-82 for counties; G.S. 160A-148 for cities). In counties and cities that do not have a manager, the governing body typically makes the appointment. According to G.S. 159-24, the finance officer serves at the pleasure of whoever makes the appointment.

In most counties the official exercising the statutory duties of finance officer carries that title; in most cities, the official exercising these same duties carries the title of finance director. In some of the larger counties and cities, the title chief financial officer (CFO) is being used. Other titles such as accountant or treasurer may be used by some jurisdictions, but this is less common. There are also other derivations of some smaller counties. For example, the county manager may also be the legally designated finance officer. In others, the finance officer may also serve as an assistant county manager. The LGBFCA permits the duties of the budget officer and finance officer to be conferred on one person. In contrast, G.S. 105-349(e) specifies that the duties of tax collector and those of the "treasurer or chief accounting officer," by which should be understood finance officer, may not be conferred on the same person, except with the written permission of the secretary of the North Carolina Local Government Commission. This limitation recognizes both the hazards to internal control of one person holding the two offices and the fact that some local government entities are too small to make any other arrangement. While it is currently very rare for one person to serve as both the finance officer and tax collector in a county, the commission has allowed a number of cities to operate under this arrangement. However, these approvals have typically been made with restrictions, such as suggesting that the city contract with the county for property tax billing and collection.

The finance officer's duties are summarized in G.S. 159-25(a): establish and maintain the accounting records, disburse moneys, make financial reports, manage the receipt and deposit of moneys, manage the county's or the city's debt service obligations, supervise investments, and perform any other assigned duties.

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Official Bonds

The finance officer must give "a true accounting and faithful performance bond" of no less than $50,000; the amount is to be fixed by the governing board (G.S. 159-29). The usual public official's bond covers faithful performance as well as true accounting. In determining the amount of the bond, the board should seek protection against both a large single loss and cumulative smaller ones. The bond insures the county or the city for losses that it suffers as a result of the actions or negligence of the finance officer; it offers no insurance or protection to the officer. The county or the city must pay the bond's premium.

G.S. 159-29 also requires that each "officer, employee, or agent . . . who handles or has in his custody more than one hundred dollars . . . at any time, or who handles or has access to the inventories" be bonded for faithful performance. If separate bonds for individuals are purchased, the $100 minimum should be understood to mean that the bonding requirement applies only to those persons who frequently or regularly handle that amount or more. The governing board fixes the amount of each such bond, and the county or city may (and normally does) pay the premium.

In lieu of requiring a separate bond for each employee, counties and cities may purchase a "blanket" faithful-performance bond, and nearly all counties and cities do (primarily for cost reasons, as blanket bonds are more economical than the total cost of separate bonds). The blanket bond does not substitute for the separate bond required for the finance officer or other county officials (tax collector, sheriff, and register of deeds) or city officials (tax collector), who must still be bonded individually and separately.

The Accounting System

An accounting system exists to supply information. It provides the manager and other officials with the data needed to ascertain financial performance, as well as to plan and budget for future activities with projected resources. The accounting system is also an essential part of internal control procedures.

The governing board depends on accounting information in making its budgetary and program decisions, as well as in determining whether or not they have been carried out. This kind of information is also valuable to outside organizations. The investment community and bond-rating agencies rely on it as they assess a county's or a city's financial condition. Also, in counties and cities where bonds have recently been issued, the local government is often required to provide various annual financial information to meet continuing disclosure requirements. State regulatory agencies such as the Local Government Commission review data generated by the accounting systems to determine whether counties and cities have complied with the legal requirements regulating accounting and finance. Federal and state grantor agencies use the information to monitor compliance with the requirements of the financial assistance programs that they administer. The media and the public depend on the information to evaluate a local government's activities.

County and city accounting practices are formed in response to the general statutory requirements set forth in G.S. 159-26, generally accepted accounting principles (GAAP) promulgated nationally by the Governmental Accounting Standards Board (GASB) and other organizations. In North Carolina the rules and regulations of the Local Government Commission, as well as the local government's own needs and capabilities, directly impact its accounting practices.

Statutory Requirements

G.S. 159-26 requires that each county and city maintain an accounting system, which must do the following:

1. Show in detail its assets, liabilities, equities, revenues, and expenditures.
2. Record budgeted as well as actual expenditures and budgeted or estimated revenues as well as their collection.
3. Establish accounting funds as required by G.S. 159-26(b). A *fund* is a separate fiscal and accounting entity having its own assets, liabilities, equity or fund balance, revenues, and expenditures. Government activities are grouped into funds to isolate information for legal and management purposes. The types of funds that are set forth in G.S. 159-26(b) for use by counties and cities are discussed in Article 18 of this volume.

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4. Use the modified accrual basis of accounting. *Basis of accounting* refers to criteria for determining when revenues and expenditures should be recorded in the accounting system.[1] The *modified accrual basis* requires that expenditures be recorded when a liability is incurred (time of receipt) for a good or service provided to the local government. The expenditure should be recorded then, usually before the funds are disbursed. This type of accounting also requires that revenues be recorded when the revenues are measurable and available. *Measurable* means that they can be reasonably estimated, and *available* means that they will be received within the current fiscal year or soon enough thereafter to be able to pay liabilities of the current fiscal year. In actual practice for various reasons, some revenues are recorded when they are received in cash. For example, in North Carolina, property tax revenues are generally recorded on the cash basis because taxes receivable are not considered to be collectible soon enough after the year's end to meet the availability criterion. Permits and fees are also recorded on the cash basis because they are not considered to be measurable at the year's end. However, certain revenues collected after the fiscal year end but soon enough thereafter to pay liabilities outstanding as of June 30 would be reflected as revenue for the year ending June 30 because they would be considered measurable and available. For example, the monthly sales-tax payment received by counties and cities in July, August, and September is recorded by most local governments as revenue for the year ending June 30 because the payments can be measured, they are directly related to sales that occurred during the previous fiscal year (i.e., the July distribution is related to the previous April's sales, the August distribution is related to the previous May's sales, and the September distribution is related to the previous June's sales), and it is received soon enough after June 30 to be able to pay liabilities at the fiscal year's end.

   The modified accrual basis of accounting helps keep financial practices on a prudent footing: expenditures are recorded as soon as the liabilities for them are incurred, and some revenues are not recorded until they have actually been received in cash. In addition, the modified accrual basis enhances the comparability of financial reporting for counties and reduces the opportunity for manipulation of financial information.
5. Record encumbrances represented by outstanding purchase orders and contractual obligations that are chargeable against budgeted appropriations. An *encumbrance* is created when a contract that will require a county or a city to pay money is entered into or when a purchase order is issued.

   Although the LGBFCA does not explicitly mention any exceptions, in practice, expenditures for salaries and wages, fringe benefits, and utilities are usually not encumbered. Salaries, wages, and fringe benefits are not encumbered because they are generally budgeted at the full amounts expected for all positions, and this significantly reduces the risk of over-expenditure. Utilities expenditures are normally not encumbered because the amounts are generally not known in advance.

   An encumbrance exists as long as the contractor or supplier has not delivered the goods or the services and the contract or purchase order is outstanding. While this is the case, the local government is not yet liable to pay for the goods or the services and has not yet incurred an expenditure for it. G.S. 159-26(d) requires that a county's or a city's accounting system record encumbrances as well as expenditures. This recognizes that the encumbrance is a potential liability, and, once the purchase order is filled or the contract fulfilled, liability for payment is created and an expenditure is incurred. Although this requirement applies only to counties with more than 50,000 citizens or cities with more than 10,000 citizens, nearly all counties and cities record encumbrances in their accounting systems.

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1. Although the LGBFCA requires the use of the modified accrual basis of accounting, it also requires that financial reporting be in conformity with generally accepted accounting principles (GAAP). Enterprise, internal service, and certain trust funds primarily follow commercial (accrual) accounting standards for reporting in accordance with GAAP. A county's annual financial report must both demonstrate compliance with legal requirements (i.e., the LGBFCA) and report on operations in conformity with GAAP. Therefore, enterprise funds should be reported on both the modified accrual and accrual basis in a county's financial statements, and internal service and certain trust funds should also be reported on the accrual basis in the annual financial report.

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Generally Accepted Accounting Principles for Governments

Governmental accounting, as a branch of general accounting practice, shares basic concepts and conventions with commercial accounting. However, because of major differences in the governmental environment, a distinct set of national accounting and financial reporting principles has evolved in this field. They are promulgated by the Governmental Accounting Standards Board (GASB). Established in 1984, the GASB is responsible for the establishment of generally accepted accounting principles (GAAP) for county and city governments, as well as state governments. The GASB succeeded the National Council on Governmental Accounting (NCGA), which had formerly established GAAP for government entities. Although the GASB at its creation accepted the existing NCGA pronouncements, it has actively set forth standards in areas of accounting and finance that the NCGA did not formally consider. Likewise, it has updated and modified much of the guidance that it initially accepted.

The Local Government Commission plays a key role in defining and interpreting accounting standards and procedures for local governments in North Carolina. It issues rules and regulations that interpret state statutes as well as national professional standards, and it provides advice about requirements and improvements in accounting and financial reporting practices. The commission's staff has focused much attention in recent years on annual financial reports, working closely with local officials and the state's public accounting profession to keep local government accounting systems up to date with the increasingly more rigorous reporting and disclosure standards being promulgated by the GASB.

Counties' and Cities' Own Needs and Capabilities

Counties' and cities' own needs and capabilities also shape their accounting and financial reporting systems. For example, a growing number of both counties and cities have improved their annual financial reports to the point that they have earned the Certificate of Achievement for Excellence in Financial Reporting, awarded by the Government Finance Officers Association of the United States and Canada, to recognize outstanding achievement in governmental financial reporting. While all North Carolina local governments issue professionally acceptable annual financial reports, those winning the Certificate of Achievement provide full disclosure above and beyond the minimum standards set by GAAP and relate current financial conditions and performance to past financial trends. Approximately 3,500 local governments in the United States participate in the Certificate of Achievement program, which offers a tremendous resource for local governments to continually improve their financial reporting.

Nationwide, capital asset accounting and reporting continues to be one of the more significant challenges in state and local government accounting. In recent years, the Local Government Commission and the independent public accountants auditing local governments, as well as the aforementioned GFOA, have placed increased emphasis on capital asset records. If they are inadequate, the annual auditor's opinion may be qualified, and this may adversely affect a county's or a city's bond rating. Also, a qualified audit opinion may affect a county's or city's ability to obtain approval from the Local Government Commission for debt issuance. In addition, an adequate capital asset accounting system can provide significant advantages. It places responsibility for the safekeeping of such assets with management, thereby improving internal control. It also serves as a basis for establishing maintenance and replacement schedules for equipment and for determining the level of fire and hazard insurance that should be carried on buildings and other capital assets.

It should be noted that the capitalization threshold that management establishes for financial reporting purposes should *not* be presumed to be directly correlated to adequate internal control of government property. For years, there has often been the misconception that the lower a capitalization threshold, the less likely the capital asset will be lost, misplaced, or misused. However, low capitalization thresholds simply clutter the internal capital asset records with immaterial items and actually make them less useful. The external financial statements should focus on material items and there is a significant internal cost to maintaining unusually low capitalization thresholds. For North Carolina governments, it is recommended that capital asset thresholds be no less than $1,000, and that thresholds up to $5,000 are preferable. The threshold is only used to determine *where* on the external financial statements capital assets will be reported. The threshold does *not* mitigate the need for management at the departmental level to maintain adequate internal controls and records to safeguard *all* government property. Also, it should be noted that, as a general rule, capitalization thresholds for financial reporting purposes are a management responsibility and there is no required official action by governing boards to establish or modify them.

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Control of Expenditures

Preauditing Obligations

Through the annual budget ordinance and any project ordinances (see Articles 15 and 17 in this volume), the governing board authorizes county and city managers and other officials to undertake programs and projects and to spend moneys. Except for trust and agency funds and internal service funds, which may be excluded from the budget ordinance, G.S. 159-8 directs that no county or city "may expend any moneys . . . except in accordance with a budget ordinance or project ordinance."

The proper functioning of the budgeting process depends on adherence to the terms of these two types of ordinances. For example, budget and project ordinances are required by law to be balanced. If they are complied with, deficit spending should not occur. Just as important, these ordinances embody the county's or the city's policies and priorities, which are carried out if the ordinances are followed.

The preauditing of obligations, required by G.S. 159-28(a), is a principal legal mechanism for assuring compliance with the budget ordinance and each project ordinance. The preaudit rule provides that no obligation may be incurred in an activity accounted for in a fund included in the budget ordinance or for a project authorized by a project ordinance unless two requirements are met. First, the obligation must be authorized; that is, one of the ordinances must contain an appropriation to cover it. Second, the authorization must not be exhausted; sufficient unspent and unencumbered funds must remain in the appropriation to meet the obligation when it comes due. Only if both requirements are met is the obligation validly incurred.

The Meaning of "Appropriation"

The *appropriations* that may not be overspent without violating the law are the figures that *actually appear* in the annual budget ordinance or a project ordinance. For example, the annual budget ordinance may make appropriations by department. If $2,200,000 is appropriated to the recreation department and the ordinance contains no further breakdown of that amount, the $2,200,000 is the maximum that the recreation department may spend, and all its expenditures are charged against that figure. Various line items or *objects of expenditure* within the overall departmental appropriation could be overspent without violating the budget ordinance or the Local Government Budget and Fiscal Control Act as long as total departmental expenditures do not exceed $2,200,000.

In counties and cities where the governing board makes appropriations by department in the annual budget ordinance, the budget officer, sometimes at the board's direction, typically imposes a further requirement that each operating department stay within the object of expenditure amounts set out in its budget. Typically, the budget officer's or finance officer's permission is needed to exceed these line-item limits. However, such a requirement is administrative rather than legal in nature because the legally binding appropriations in the budget ordinance are only made by department, not by line item.

Encumbrances

To find out whether a particular contract or purchase will cause an appropriation to be overspent, it is not enough to know the unexpended balance of the appropriation. The preauditor must also ascertain whether contracts or purchase orders are outstanding and chargeable against the appropriation. As already mentioned, an encumbrance is created when a county or a city enters into a contract that will require it to pay moneys, or when it issues a purchase order. This encumbered portion of an appropriation is unavailable for a proposed expenditure as if the funds had already been expended; once the contract is completed or the purchase order is filled, the encumbrance is replaced by an expenditure. To make the required preaudit, one must know the *unexpended and unencumbered balance* (which is often referred to simply as the *unencumbered balance*) of the proper appropriation.

The Preaudit Certificate

An obligation is invalid if incurred without meeting the preaudit requirements [G.S. 159-28(a)]. For this reason, those who deal with a local government entity—vendors, contractors, consultants, and others—understandably want to be told whether the purchase order they have received or the contract they have been offered is a valid obligation. This information is provided by the *preaudit certificate*. G.S. 159-28(a) requires that any contract or agreement requiring the payment of moneys and any purchase order for supplies or materials include on its face "a certificate stating that the [contract, agreement, or purchase order] has been pre-audited to assure compliance" with the preaudit requirements, namely that the budget includes an appropriation for the contract or the agreement and that unspent and unencumbered moneys remain in the appropriation to cover payments in the current year for the contract or the agreement.

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The certificate, which may be printed or stamped, should read substantially as follows: "This instrument has been pre-audited in the manner required by the Local Government Budget and Fiscal Control Act." It must be signed by the finance officer or by a deputy finance officer approved for this purpose by the governing board.

Besides providing some assurance to a vendor, the certificate emphasizes to the person who signs it the importance of the preaudit to the entire budget and fiscal control system. Any finance officer or deputy finance officer giving a false certificate is personally liable for any sums illegally committed or disbursed thereby [G.S. 159-28(e)].

Disbursements

Two Stages of Review

G.S. 159-28(b) outlines a two-stage procedure for approving payment of any "bill, invoice, or claim" (these include any item for which an expenditure may be made). First—and this stage applies to transactions involving moneys in any of the local government's funds—the finance officer must determine that the amount claimed is owed to the claimant. Second—and this stage applies only to transactions authorized by the annual budget ordinance or a project ordinance —the finance officer must ascertain that the expenditure is authorized and that either an encumbrance exists for it or a sufficient unencumbered balance remains in the appropriation to pay the claim. Only if the finance officer has made both determinations may the disbursement be made.

The Finance Officer's Certificate

Completion of the two-stage review is evidenced by placing the *finance officer's certificate* on the face of the check or draft used for payment. The certificate, which may be printed or stamped on the check, must follow substantially the following form: "This disbursement has been approved as required by the Local Government Budget and Fiscal Control Act." Normally the certificate is signed by the finance officer or by a deputy finance officer approved for this purpose by the governing board [G.S. 159-28(d)]. Having a deputy finance officer authorized to sign checks is especially important. The absence of the finance officer could delay their issuance if that officer were the only one authorized to sign the certificate. While not a common practice in cities, in some counties the board of commissioners designates a deputy finance officer in the county finance department or another county department to regularly sign checks on a limited basis to make certain specific payments such as monthly benefit payments to public assistance recipients. Such delegation of the payment function should occur only with the approval of the county finance officer and only if adequate internal controls are built into the payment procedures that are used.

Governing Board Approval of Bills, Invoices, or Claims

The LGBFCA authorizes the governing board to approve by formal resolution a bill, an invoice, or another claim that has been disapproved by the finance officer. The governing board may do this only for a valid claim for which an encumbrance exists or an unencumbered appropriation remains in the budget ordinance or a project ordinance, and only by following certain specified procedures. Governing board members approving invalid payments under this statute may be held personally liable for the payments. These procedures are rarely, if ever, used.

Form of Payment

Payment of obligations by cash are not allowed. G.S. 159-28(d) directs that all bills, invoices, salaries, or other claims be paid by check or draft on an official depository. This statute, by implication, also permits payment by wire transfer or from automated clearing house (ACH) charges to official depositories. Wire transfers are used, for example, to transmit the money periodically required for debt service on bonds or other debt to a paying agent, who in turn makes the payments to individual bondholders. Automated Clearing House transactions are used by local governments to make retirement system contributions to the state, to make payroll payments, and to make certain other payments. The state has extended the use of the ACH system to most transfers of moneys between the state and local governments that are related to grant programs and state-shared revenues.

G.S. 159-25(b) requires each check or draft to "be signed by the finance officer or a properly designated deputy finance officer and countersigned by another official . . . designated for this purpose by the governing board." The finance officer's signature attests to completion of review and accompanies the certificate described above. The second signature may be by the chair of the board of commissioners, the mayor of the city, or some other official. (If the governing board does not expressly designate the counter-signer, G.S. 159-25(b) directs that for counties it be the chair or the county's chief executive officer (i.e., the county manager); for cities it should be the mayor.

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The purpose of requiring two signatures is internal control. The law intends that the finance officer review the documentation of the claim before signing the certificate and check. The second person can independently review the documentation before signing and issuing the check. The fact that two persons must separately be satisfied with the documentation should significantly reduce the opportunities for fraud.

In many local government entities, however, the second signer does not exercise this independent review, perhaps relying on other procedures for the desired internal control. Recognizing this, G.S. 159-25(b) permits the governing board to waive the two-signature requirement (thus requiring only the finance officer's signature or a properly designated deputy finance officer's signature on the check) "if the board determines that the internal control procedures of the unit or authority will be satisfactory in the absence of dual signatures."

As an alternative to manual signatures, G.S. 159-28.1 permits the use of signature machines, signature stamps, or similar devices for signing checks or drafts. In practice, these are widely used in counties and cities all across North Carolina. The governing board must approve the use of such signature devices through a formal resolution or ordinance, which should designate who is to have custody of the devices. For internal control purposes it is essential that this equipment be properly secured. The finance officer or another official given custody of the facsimile signature device(s) by the governing board is personally liable under the statute for illegal, improper, or unauthorized use of the device(s).

Cash Management

Daily Deposits

G.S. 159-32 generally requires that "all taxes and other moneys collected or received by an officer or employee of a local government" be deposited daily, either with the finance officer or in an official depository. (Deposits made under the second alternative must immediately be reported to the finance officer.) If an agency is part of a county or a city for purposes of budget adoption and control, it and its officers and employees are also part of the county or the city for purposes of the daily deposit requirement.

In many counties and cities, the daily deposit(s) to an official depository are made before the cutoff time (e.g., 2:00 P.M.) set by the depository for crediting interest earnings on deposits made that day. A deposit should be made intact; all moneys collected up to the deposit time should be included. There need be only one deposit per day, although in some local governments a second one is made toward the end of the day if substantial moneys are received after the first deposit. It is more common, however, for entity's to place funds collected after the daily deposit is made into a locked vault for inclusion in the following day's deposit.

There is a potential exception to the requirement for daily deposit. If the governing board approves, an officer or employee need make deposits only when moneys on hand amount to $250 or more, although one must always be made on the last business day of each month. Note that only the governing board may approve the use of this exception. Managers, finance officers, other officers, or advisory boards or commissions may not authorize it.

Official Depository

All moneys belonging to a county or a city (including those transmitted to a fiscal agent for payment of debt service) must be deposited in an official depository [G.S. 159-31(a)]. The governing board designates which banks or financial institutions are to serve as the official depositories. It also decides how many of them there will be. It may so designate any bank, savings institution, or trust company in the state. With the permission of the secretary of the Local Government Commission, the governing board may also designate a nationally chartered bank located in another state to serve as an official depository. For a number of reasons the secretary to the Local Government Commission will approve the use of out-of-state depositories only in rare circumstances, such as when authorizing a governing board to designate a nationally or state-chartered out-of-state bank as a depository or fiscal agent for payment of debt service.

G.S. 14-234 generally forbids governing board members and other officials involved in the contracting process to make contracts for the local governments in which they have an interest. An exception exists, however, for transacting business with "banks or banking institutions." Therefore, a county or a city may designate as a depository a bank or a savings institution in which a governing board member, for example, is an officer, owner, or stockholder.

Depository accounts may be non-interest-bearing accounts with unlimited check-writing privileges; interest-bearing accounts with unlimited check-writing privileges (NOW or super-NOW accounts); interest-bearing money-market accounts for which check-writing privileges are restricted; or certificates of deposit that have no check-writing privileges. Generally, the use of interest-bearing accounts is recommended.

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Both counties and cities follow a variety of methods in selecting or designating official depositories. Some name each bank and savings institution with an office located within their jurisdiction as a depository and place an account in each. Others maintain just one account, rotating it among the local financial institutions that are qualified to serve as official depositories, changing according to a predetermined schedule (commonly every one to three years). Although these methods demonstrate a local government's support of local banks and financial institutions, they can complicate the government's cash-management procedures, hinder its investment program, and cause it to pay more than it would otherwise for banking services. For these reasons, the majority of counties and cities statewide follow a third method—selecting the bank or financial institution to serve as the depository through a request-for-proposals process. This method is currently recommended by the Local Government Commission staff. It awards the business to that institution offering the most in services for the fees charged or for the lowest compensating balance that the county or the city must maintain at the bank or financial institution.

Insurance and Collateralization of Deposits

G.S. 159-31(b) requires that funds on deposit in an official depository (except funds deposited with a fiscal agent for the purpose of making debt service payments to bondholders) be fully secured. This is accomplished through a combination of methods. First, government funds on deposit with a bank or savings institution or invested in a certificate of deposit (CD) issued by such an institution are insured by the Federal Deposit Insurance Corporation (FDIC). If the funds that a county or a city has on deposit or invested in a CD do not exceed the maximum amount of FDIC insurance—currently $100,000 per official custodian for interest-bearing accounts and an additional $100,000 per official custodian for non-interest-bearing accounts—no further security is required. For purposes of FDIC regulation, the finance officer is always the official custodian.

Uninsured county or city funds in a bank or savings institution may be secured through a collateral security arrangement. Under one type of arrangement, the institution places securities with a market value equal to or greater than the local government's uninsured moneys on deposit or invested in CDs into an escrow account with a separate, unrelated third-party institution (usually the trust department of another bank, the Federal Reserve, or the Federal Home Loan Bank). The escrow agreement provides that if the depository bank or savings institution defaults on its obligations to the local government, then the county or the city is entitled to the escrowed securities in the amount of the default less the amount of FDIC insurance coverage. Under this method the local government must execute certain forms and take certain actions to ensure that deposits are adequately collateralized. Responsibility for assuring that the deposits are adequately secured under this method rests with the finance officer, who should closely supervise the collateral-security arrangement.

Alternatively, a bank or savings institution may choose to participate in a pool of bank- and savings-institution-owned securities sponsored and regulated by the state treasurer to collateralize state and local government moneys on deposit or invested in CDs with these institutions. A third-party institution, chosen by the various pooling-method banks, holds the securities in the pool. Participating depository banks and savings institutions are responsible for maintaining adequate collateral securities in the pool, although each financial institution's collateral balances are monitored by the state treasurer. In the unlikely event of defaults or similar financial troubles, the state treasurer would be considered the beneficiary of reclaimed deposits and collateral. Certain standards of financial soundness are required by the state treasurer before a financial institution is allowed to participate in this system.

Investments

Local governments cannot afford to let significant amounts of cash lie idle in non-interest-bearing depository accounts. Investment income can amount to the equivalent of several cents or more on the property tax rate. G.S. 159-30 makes the finance officer responsible for managing investments, subject to policy directions and restrictions that the governing board may impose. Because of the expanded opportunities and risks associated with the investments that both North Carolina counties and cities may legally make, both national investment authorities and the Local Government Commission recommend that governing boards establish general investment policies and restrictions for their finance officers to follow.

Such board-adopted policies could, for example, limit the maximum maturities for investments of general fund moneys; require the use of informal competitive bidding for the purchase of securities; authorize the finance officer to invest in the cash and/or term portfolios of the North Carolina Capital Management Trust (discussed later); and make clear that safety and liquidity should take precedence over yield in the county's or the city's investment program. In a growing number of local governmental entities, governing boards are adopting such investment policies.

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In conducting their investment programs, finance officers must forecast cash resources and needs, thus determining how much is available for investment and for how long. They must also investigate what types of investment securities are authorized by law, as well as by their own internal investment policies, and decide which ones to purchase. If an investment security is to be sold before maturity, the finance officer must make that decision.

Custody of Investment Securities

G.S. 159-30(d) states: “Securities and deposit certificates shall be in the custody of the finance officer who shall be responsible for their safekeeping.” Investment securities come in two forms: *certificated* and *noncertificated*. Ownership of certificated investments is represented by an actual physical security. Some certificates of deposit and certain other securities are issued in certificated form. To obtain proper custody of certificated securities, the finance officer should hold the securities or the certificates in the county’s or the city’s vault or its safe deposit box at a local bank or trust company. Alternatively, certificated securities may be delivered to and held by the local government’s third-party safekeeping agent, which can be the trust department of a North Carolina bank.

Many investment securities—United States Treasury bills, notes, and bonds; federal agency instruments; some commercial paper; and other types of securities—are not certificated. Ownership of them is evidenced by electronic “book-entry” records that are maintained by the Federal Reserve System for banks and certain other financial institutions, and by the financial institutions themselves. Additionally, for certain other securities the Depository Trust Company in New York maintains the electronic records of ownership. When a county or a city buys noncertificated securities from a bank or a securities dealer, the record of ownership is transferred electronically from the seller or the seller’s bank to the local government’s custodial agent. To obtain proper custody of book-entry securities, a local government should have a signed custodial agreement in place with the financial institution that serves as its custodial agent. The financial institution agent should be a member of the Federal Reserve System and be authorized to conduct trust business in North Carolina. Counties and cities may not use securities brokers and dealers or the *operating divisions* of banks and savings institutions as custodial agents for their investment securities. Generally, the trust department of a bank or financial institution that sells securities to a county or a city may act as the custodial agent for the securities, as long as the trust department itself did not sell the securities to the local government and provided that the institution is licensed to do trust business in North Carolina and is a member of the Federal Reserve. It is essential that a county or a city or their applicable custodial agent obtain custody of all investments. Major losses from investments suffered by local governments in other states have been due to the failure of those governments to obtain proper custody of their investments.

Authorized Investments

Among the securities or the instruments in which both counties and cities invest are CDs or other forms of time deposit approved by the Local Government Commission that are offered by banks, savings institutions, and trust companies located in North Carolina [G.S. 159-30(b), (c)(5)]. CDs issued by banks in the state have traditionally been the most widely used investment instrument, especially by small- and medium-sized local governments. Other investments authorized by G.S. 159-30(c) include the following:

1. *United States Treasury obligations (bills, notes, and bonds)—called Treasuries—and U.S. agency obligations that are fully guaranteed by the United States government.* Because these obligations are full-faith-and-credit obligations of the United States, they carry the least credit risk—that is, risk of default—of any investment available to either counties or cities. As a result, short-term Treasuries are usually lower yielding than alternative investment securities. Long-term Treasuries and Government National Mortgage Association (GNMA) securities (fully guaranteed by the United States government) can experience significant price variations. This is characteristic of long-term securities in general; therefore such securities should be carefully evaluated and be considered only for investing certain, limited funds such as capital reserve moneys that will not be needed for many years.
2. *Direct obligations of certain agencies that are established and/or sponsored by the United States government but whose obligations are not guaranteed by it.* Examples are the Federal Home Loan Bank Board, the Federal National Mortgage Association, and the Federal Farm Credit System. Direct debt issued by these agencies generally carries very low credit risk although economic conditions adverse to an economic sector the agency finances (e.g., housing), can create some risk for local governments or others who invest in its securities. Some securities of these agencies are not their direct debt and are therefore not eligible investments for either North Carolina counties or cities. Moreover, longer-term direct debt of these agencies, although carrying low credit risk, can experience significant price fluctuations before maturity.

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3. *Obligations of the State of North Carolina or bonds and notes of any of its local governments or public authorities, with investments in such obligations subject to restrictions of the secretary of the Local Government Commission.* Because the interest paid to investors on these obligations, bonds, and notes is typically exempt from federal and state income taxes, they generally carry lower yields than alternative investment instruments available to counties and cities. However, should the state and local governments in North Carolina begin to issue significant amounts of securities on which the interest paid is subject to federal income taxes, those securities would carry higher interest rates than tax exempt state and local government obligations. This could make the taxable obligations attractive as investment instruments to both counties and cities.
4. *Top-rated U.S. commercial paper issued by domestic U.S. corporations.* Commercial paper is issued by industrial and commercial corporations to finance inventories and other short-term needs. Such paper is an unsecured corporate promissory note that is available in maturities of up to 270 days, although maturities from 30 to 90 days are most common. For any local government to invest in commercial paper, the paper must be rated by at least one national rating organization and earn its top commercial paper rating. If the paper is rated by more than one such organization, it must have the highest rating given by each.

   Historically, commercial paper has been relatively high yielding, and many counties and cities have invested heavily in it over the years. In economic recessions, some commercial paper issuers are downgraded. This means that their commercial paper is no longer eligible for investment by North Carolina local governments. Occasionally, the downgrade occurs after the investment is purchased, but before it matures. In this situation, it is most common for the entity to still hold the investment to maturity as the risk of loss is typically low. However, as long as a commercial paper issuer is top rated and the finance officer closely monitors its ratings, the risk for this type of investment is small. Officials should also understand that eligible commercial paper issued by banks is not a deposit and consequently is not covered by insurance and collateralization.
5. *Bankers acceptances issued by North Carolina banks or by any top-rated U.S. bank.* Bankers acceptances are bills of exchange or time drafts that are drawn on and guaranteed by banks. They are usually issued to finance international trade or a firm's short-term credit needs and are usually secured by the credit of the issuing firm, as well as by the general credit of the accepting bank. Most bankers acceptances have maturity terms of 30 to 180 days. Both counties and cities may invest in bankers acceptances issued by any North Carolina bank. Only the largest banks in the state issue them and they are not as common as they once were. For a local government to invest in bankers acceptances of non–North Carolina U.S. banks, the institution must have outstanding publicly held obligations that carry the highest long-term credit rating from at least one national rating organization. If the bank's credit obligations are rated by more than one national organization, it must have the highest rating given by each.
6. *Participating shares in one of the portfolios of the North Carolina Capital Management Trust.* This trust is a mutual fund established specifically for investments by North Carolina local governments and public authorities. It is certified and regulated by the Local Government Commission, and unlike other state-sponsored investment pools for public entity investments, it is registered with the United States Securities and Exchange Commission, which imposes extensive reporting and other requirements that ensure the safety of moneys invested in the trust. The trust manages two separate investment portfolios. One is the money-market portfolio, which was started in 1982 and is intended for the investment of short-term or operating cash balances. The principal value of moneys invested in a share in this portfolio remains fixed at $1. The term portfolio, which was established in 1987, is intended for capital reserve funds and other moneys that are not subject to immediate need. The principal value of investments in this portfolio fluctuates with changes in market interest rates. Because of this, the term portfolio should primarily be used for the investment of funds that will not be needed immediately or in the short term.

   Either portfolio permits the return of funds invested with it within one day of notice; however, the managers of the portfolios do request that local governments provide longer advance notice if large withdrawals will be made. The trust's portfolios may invest only in securities in which local governments may invest under G.S. 159-30(c).
7. *Repurchase agreements.* A *repurchase agreement* is a purchase by an investor of a security, with the stipulation that the seller will buy it back at the original purchase price plus agreed-upon interest at the maturity date. These agreements were once popular for short-term or overnight investments by North Carolina local governments. Unfortunately, some local governments in other states suffered substantial losses by buying repurchase agreements from unscrupulous securities dealers. As a result, strict laws and requirements for the safe use of these agreements have been enacted, both in North Carolina and across the country. G.S. 159-30(c)

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authorizes local governments to invest in repurchase agreements, but only under very limiting conditions.[2] These conditions have greatly reduced the cost-effectiveness of local government investments in repurchase agreements, and such agreements are no longer used to any significant degree by either counties or cities.

8. *Evidences of ownership of, or fractional undivided interests in, future principal and interest payments of stripped or zero-coupon instruments issued directly or guaranteed by the United States government.* These instruments were first authorized as a local government investment in 1987. They are sold at discount from face or par value and pay no interest until maturity. At maturity, the investor receives the face value, with the difference between that value and the discounted purchase price of the security representing the effective interest earned. Stripped or zero-coupon securities may be a useful investment vehicle for certain limited moneys, such as those held in a Capital Reserve Fund that will not be needed until after the instrument matures. However, because most strips or zero coupons have long maturities, they are subject to considerable price fluctuations before maturity and should not be used for the investment of general county funds. If investments were made in these securities and market interest rates later rose substantially (as they did in 1994), a county that had to cash in the investment before maturity could lose a significant portion of the principal invested in the securities.
9. *Certain mutual funds for moneys held by either a county or a city that are subject to the arbitrage and rebate provisions of the Internal Revenue Code.* The LGBFCA authorizes unspent proceeds from bonds or other financings subject to the Internal Revenue Code's arbitrage and rebate provisions to be invested in tax-exempt and taxable mutual funds under strict procedures. Operating moneys and proceeds from financings that are not subject to the arbitrage and rebate provisions may not be invested in these mutual funds. Because of the complexity of the federal tax code and the wide variety of available mutual funds, a local government entity should consult with its bond counsel before placing moneys in this type of investment.
10. *Derivatives issued directly by one of the federal agencies listed in G.S. 159-30(c)(2) or guaranteed by the United States government.* Derivatives are not specifically mentioned in the law, but may be eligible investments if they are otherwise authorized in G.S. 159-30(c). *Derivatives* refer to a broad range of investment securities that can vary in market price, yield, and/or cash flow depending on the value of the underlying securities or assets, or changes in one or more interest-rate indices. Derivatives commonly include mortgage pass-through instruments issued by federal agencies, mortgage obligations "guaranteed" by federal agencies (but not by the United States government), callable step-up notes, floaters, inverse floaters, and still other securities that go by even more interesting names. It is beyond the scope of this article to explain these different types of derivatives. It shall suffice to say that derivatives are generally complex instruments, and many of them are subject to rapid and major changes in value as market interest rates change. Some local governments in other states have lost vast amounts of moneys by investing in derivatives. The volume of derivatives available to investors has grown dramatically, and investment brokers and dealers often try to sell various types of derivatives to county, city, and other local government finance officers. Many derivatives are not legal investment instruments for North Carolina's local governments. Those that are direct debt (i.e., a balance sheet liability) of the federal agencies listed in G.S. 159-30(c)(2) or guaranteed by the United States government are usually legal investments. However, many if not most of these are inappropriate as investment vehicles for counties or cities, except in very special circumstances. Even though legal, many of them are subject to extreme price and cash-flow volatility. A finance officer considering investing the county's or the city's moneys

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2. The following restrictions apply to local government investments in repurchase agreements: (a) The underlying security acquired with a repurchase agreement must be a direct obligation of the United States or fully guaranteed by the United States. (b) The repurchase agreement must be sold by a broker or a dealer that is recognized as a primary dealer by a Federal Reserve Bank, or be sold by a commercial bank, a trust company, or a national bank whose deposits are insured by the FDIC. (c) The security underlying the agreement must be delivered in physical or in electronic book-entry form to the county or its third-party agent. (d) The value of the underlying security must be determined daily and be maintained, at least, at 100 percent of the repurchase price. (e) The county must have a valid and perfected first security interest in the underlying security. This can be achieved through delivery of the security to the county or its third-party safekeeping agent under a written agreement. (f) The underlying security acquired in the repurchase agreement must be free of a lien or third-party claim.

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in one or more derivatives should do so only pursuant to a governing board investment policy that explicitly authorizes such an investment, only if the finance officer understands the nature of the security and the risks associated with it, and only for a short maturity.

Guidelines for Investing Public Funds

Because of great changes and technological innovation in financial markets, challenges presented by international events to these markets, and the availability of many new types of investment instruments, the investment and general management of public moneys have become very complex. North Carolina counties and cities can avoid many of these problems that have harmed local governments in other states by adhering to the following guidelines in conducting their investment programs:

1. *The investment program should put safety and liquidity before yield.* A local government should not put funds that it is investing at risk of loss for the purpose of obtaining higher investment earnings. The substantial highly publicized losses of several local governmental entities across the nation in 1994 and 1995 underscore the potential problems faced with risky investments. The temptation to sacrifice safety for yield is particularly great when interest rates are falling and a local government's officials are attempting to maintain investment earnings and revenues. Any local government entity, whether it be a county or a city, should always have funds available to meet payment obligations when they become due. This requires maintaining adequate liquidity in an investment portfolio and limiting most investments to securities with short-term maturities.
2. *A local government entity should invest only in securities that the finance officer understands.* Many investment vehicles, including most derivatives, are extremely complex. Before purchasing a security, a finance officer should thoroughly understand all its components, especially how its value is likely to increase or decrease with changes in market interest rates. Whenever the finance officer is considering investing in a type of security that has not been used before, the finance officer should obtain and study the prospectus or equivalent information for the security and talk to Local Government Commission staff and other informed, "disinterested" parties about the nature and risks of the security.
3. *The finance officer and other officials involved in investing a local governmental entity's funds should know the financial institutions, the brokers, and the dealers from which the government buys investment securities.* Investment transactions are made by phone, and investment funds and securities are often electronically transferred in seconds. Funds and securities can be lost or "misplaced" quickly in such an environment. To protect the local government, the officials conducting the investment program must be sure that they deal only with reputable and reliable institutions, brokers, and dealers. In fact, the authoritative literature that establishes GAAP also refers to the importance of knowing one's brokers or dealers. The finance officer should obtain a list of North Carolina local government clients of any firm or person attempting to sell investment securities and obtain references from officials in these other governments. The finance officer should also obtain and evaluate current financial statements from any institution, broker, or dealer that sells or wishes to sell securities to the local government entity. Local governments in other states have lost invested funds because they placed moneys with firms that later went bankrupt and were unable to return the funds. A discussion of how to analyze the financial position of banks and similar financial institutions can be found in the North Carolina Department of State Treasurer's *Policies Manual*.[3] A county should also enter into an investment trading agreement with any firm or person from which it buys investments. Model investment trading agreements are used by and are available from several of North Carolina's large counties.
4. *The finance officer should ensure that both the county and the city adequately insures or collateralizes all investments in CDs (as well as other deposits in banks), and that it has proper custody of all investment securities.*

3. North Carolina Department of State Treasurer, *Policies Manual* (Raleigh, N.C.: NCDST, October 2005).

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5. *The local government's investment program should be conducted pursuant to the cash management and investment policy approved by the governing board.* Such a policy should be based on G.S. 159-30 and related statutes, setting forth the governing board's directions and expectations about which investments will be made and generally how they will be made, and establishing general parameters for the receipt, the disbursement, and the management of moneys.
6. *The finance officer should report periodically to the governing board on the status of the government's investment program.* Such a report should be made at least semiannually and preferably quarterly or monthly and show the securities in the local government's investment portfolio, the terms or the maturities for investments, and their yields. If possible, average investment maturity and yield should be calculated and also shown in this report.
7. *The use of investment managers does not relieve the finance officer of the responsibility of the safety of public funds.* A few counties and cities in North Carolina have considered the engagement of outside professional investment managers to administer their routine investment functions. Obviously, there are advantages and disadvantages to this arrangement. The most obvious disadvantage is the inability of the finance officer to have direct control of the investments even though the responsibility for them remains with that role. Also, because of the legal restrictions on the investments that local governments can make, the return that an investment manager can earn once management fees have been deducted may be lower than the return the unit can earn on its own. It should be noted that local legislation may be required for an entity to engage outside investment managers. If it is determined that an outside investment manager would be beneficial, a written agreement should be executed outlining permissible investments, safekeeping arrangements, diversification requirements, maturity limitations, the liability to be assumed by both parties, and the fees of the contract.

The Annual Audit

Contents of the Comprehensive Annual Financial Report

G.S. 159-34 requires local governments to have their accounts audited by independent auditors after the close of each fiscal year. The auditor's opinion is set out in an annual financial report, which must include "the [county's/city's] financial statements prepared in accordance with generally accepted accounting principles, all disclosures in the public interest required by law, and the auditor's opinion and comments relating to [the] financial statements."

Preparation of the report's financial statements and their accompanying notes is the responsibility of management. Finance officers and their staff should prepare the annual financial statements, though it is not uncommon for the independent auditors to assist with their preparation. It should be noted that it is obviously less costly if the finance department staff prepare as much of the annual financial statements as is possible.

More and more local governmental entities are preparing a comprehensive annual financial report (CAFR). CAFRs are not required by GAAP or by state statute, but they are very useful to external users of a government's financial statements. These reports go above and beyond the minimum external reporting requirements and provide useful financial and nonfinancial data about a local government. CAFRs contain three primary sections: introductory, financial, and statistical. A fourth section consisting of the compliance or single audit reports and schedules may be included, but this is not required. Table 18-1 summarizes the contents of the CAFR. If a local government does not prepare a CAFR, only the financial section, including financial statements and notes, will be found in the annual financial report.

Introductory Section

The introductory section of a CAFR includes the transmittal letter, which is primarily an overview of the report, a brief introduction of the government, and the official transmission of the report to the external users, an organization chart, and a list of principal elected and nonelected officials. The transmittal letter, which presents an overview of the government's operations and activities, should be of particular interest to the public—both citizens and the business community—who may not be completely aware of all the government's functions and services.

Financial Section

The financial section of a CAFR contains financial statements, which present information in various formats and levels of detail. The financial section includes the financial statements that are required by GAAP, known as the Basic Financial Statements, as well as financial presentations in greater levels of detail that are often used to exhibit budgetary compliance or simply provide opportunities for more detailed analysis.

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Table 18-1. *Contents of a Comprehensive Annual Financial Report*

Section	Description
Introductory Section	
Letter of transmittal	Overview of the unit's operations and financial statistics
Organizational chart	Diagram of the unit's organizational structure
List of principal officials	List of elected and appointed officials
Financial Section	
Auditor's opinion	Independent auditor's opinion on the financial statements
Management's Discussion and Analysis	Overview of the government-wide and fund financial statements and the changes in the financial condition of the local government unit during the reporting year
Government-wide financial statements	Statement of net assets and statement of activities for the unit's governmental activities and its business-type activities
Fund financial statements	Information on a unit's fund activity (e.g., General, Special Revenue, Enterprise), with a focus on the major funds
Notes to the financial statements	Explanations of accounting policies, statutory violations, and detailed explanations of financial statement items (e.g., cash and investments, capital assets, receivables, long-term liabilities)
Combining statements	Detailed information supporting columns reported in the fund financial statements that include more than one fund
Individual fund statements	Detailed information about individual funds (e.g., prior year amounts, budgeted amounts, actual amounts)
Required Supplementary Information	Trend data for funding of pension trust funds
Statistical Section	
Statistical tables	Tables, usually on multiyear basis (i.e., ten years), showing information on financial trends, revenue capacity, debt capacity, demographic and economic information, and operating information of the reporting unit
Compliance Section (optional)	
Single audit reports	Reports from independent auditor on compliance and internal control
Schedule of findings and questioned costs	Listing of grant findings and questioned costs
Schedule of expenditures of federal and state awards	Listing of federal and state financial assistance programs

The first presentation in the financial section is the Management's Discussion and Analysis (MD&A). The MD&A is a written summarization and overview of the government's financial condition, and how that financial condition has changed during the year. Governmental entities are required to prepare an MD&A regardless of whether they are preparing a CAFR.

The Basic Financial Statements are presented after the MD&A. As noted earlier, these statements represent the minimum information required to be reported in the external financial statements for them to be in accordance with GAAP. The Basic Financial Statements are broken down into two main sections—the governmentwide financial statements and the fund financial statements, as well as a comprehensive set of note disclosures that support both. The governmentwide financial statements, which include a statement of net assets and a statement of activities, focus on

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the two broad *activities* of a local government—the governmental activities and the businesstype activities. The fund financial statements, however, focus on the *funds* that are reported by and are unique to local governments. The three main categories of funds—governmental, proprietary, and fiduciary—include numerous fund types. The fund types most common to counties and cities in North Carolina include the General Fund, Special Revenue Funds, Capital Projects Funds, Enterprise Funds (e.g., utility funds), and Pension Trust Funds.

The notes to the financial statements immediately follow the governmentwide and fund financial statements, yet they are still considered to be an integral part of the Basic Financial Statements. The content and form of the notes are prescribed by GAAP. Through written advisory memoranda and illustrative financial statements interpreting GAAP, the Local Government Commission provides guidance to local officials and their independent auditors on the content of the note disclosures. These disclosures contain significant information for anyone attempting to interpret the financial statements and understand the finances of a local government entity. While all disclosures are important for a good understanding of information presented in the financial statements, the note disclosures related to the definition of the reporting entity, statutory violations (if any), the collateralization of deposits and investments, capital assets, and types and terms of long-term liabilities should be of particular interest to users of the financial statements.

Statistical Section

The statistical section follows the financial section. It includes multiyear trend information on financial trends of a government, its revenue and debt capacity, relative demographic and economic information, and various operating information. The statistical section is considered an invaluable tool for bond-rating agencies, as well as for potential investors and creditors. As a general rule, the statistical tables include ten years' worth of comparative data. In a few cases, the comparisons are not for a complete ten years, but comparisons of the current year with nine years prior, thus exhibiting a ten-year spread.

The Auditor's Opinion

The auditor's essential task is to render an independent opinion on the accuracy and reliability of the Basic Financial Statements and the related note disclosures, as well as on their conformity with GAAP. The auditor opines not that the financial statements and disclosures are always exact, but that they are reliable enough for a knowledgeable reader to use them to make informed judgments about a local government entity's financial position and operations.

The auditor's opinion might take one of four forms. First, it may be *unqualified*. With an unqualified audit opinion, the auditor is opining that the financial statements present fairly the unit of government's financial position at the close of the fiscal year, in conformity with GAAP. Thus there is no *qualification* placed on the opinion (i.e., there are no exceptions noted). All North Carolina local governments should strive for an unqualified opinion.

A *qualified* opinion is a second possibility. If in some way a local government's practices vary from GAAP, the opinion may state that the statements fairly present the local government's financial position except for any such deviation. For example, the most common type of problem for local governments nationwide that may result in a qualified audit opinion is inadequate records supporting the valuation of a government's capital assets in their financial statements. Also, another example of an opinion qualification may be due to a *scope limitation*. This occurs when the independent auditor is unable to perform certain tests that are an essential part of the audit. For instance, assume that a county's or a city's accounting system fails to provide adequate documentation for some revenue and expenditure transactions and the auditor's ability to test such transactions is limited. This limitation may result in a qualified opinion.

Third, deviations from GAAP may be so material that the statements as a whole do not present fairly the government entity's financial position. If that occurs, an *adverse* opinion is rendered.

Fourth, and rarely, the auditor may *disclaim* any opinion at all as to the statements. In this case, the local government's accounting system is in such disarray that an opinion cannot be rendered.

The auditor normally suggests improvements to the government entity's internal-control procedures in a *management letter* that accompanies the audit report. This letter is a public document addressed to the governing board and typically makes various specific suggestions for improving internal control and financial procedures. These suggestions normally arise from the audit, and the letter is delivered at the same time as the audited financial statements. Often the suggestions have been informally made earlier, and some may already have been addressed at the time of the formal presentation. Significant weaknesses in internal controls will also be addressed by the independent auditor in the internal control reports that are required as part of the single audit on federal and state financial assistance programs. These are discussed in the next section.

Apart from the management letter, the independent auditor can often be an excellent source of advice on accounting system design, internal control procedures, and finance in general.

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Selection of an Independent Auditor

G.S. 159-34 establishes certain requirements and procedures regarding contracting for the annual audit. First, the auditor must be selected by and report to the governing board. The auditor should not report to the manager, the budget officer, or the finance officer.

Second, the governing board may choose any North Carolina certified public accountant (CPA) or any accountant certified by the Local Government Commission as qualified to audit local government accounts. In practice, no non-CPA accountants have requested certification or met the requirements for certification to perform local government audits in recent years. Board members should assure themselves that the person or firm selected is familiar with the particular features of government accounting and auditing. Auditors should be engaged early in the fiscal year so that they can become familiar with the government's procedures and can complete some of the necessary testing before the fiscal year's end. This also ensures that the auditor can plan the audit engagement and complete it in a timely manner.

Many counties and cities select the auditor through a *request-for-proposals* (RFP) process. Although this is not required by state statute, using an RFP is recommended by the Local Government Commission staff to secure the best audit proposal. Also, selecting an independent auditor through a competitive procurement process is often required by federal regulations in many grant agreements where audit costs are chargeable to the grant. It is most common for audit agreements procured through an RFP process to range from a three- to five-year term. The RFP should cover both the technical qualifications of a potential audit firm and the firm's cost proposals. Local officials should give more weight to an auditor's technical skills than to its proposed audit fees. References from other local government clients should be requested from an auditor. These references should be contacted so that local government officials may obtain information on other local governments' experiences with a potential auditor.

Contrary to popular belief, government entities are not required to rotate auditors periodically. As mentioned earlier, the Local Government Commission recommends governments issue an RFP process at least every three to five years. This does not preclude, however, current auditors from retaining the engagement if they continue to meet the service and price requirements established in the RFP. Many government entities have retained the same audit firm for years. Some benefits of these established relationships are the auditor's familiarity with the government's environment, as well as the government's avoidance of costs (particularly in staff time) incurred in changing auditors. On the other hand, some governing boards choose to contract with different auditors to provide a fresh look or allocate the work to other qualified auditors in the region. Either approach has merit, yet neither have been endorsed or encouraged by the Local Government Commission. It should again be noted that rotation is not statutorily required, but is a policy left to the discretion of each entity's governing board.

Finally, a local government's contract with an auditor must be approved by the Local Government Commission. Payment may not be made for any audit services until the secretary of the commission has approved the billing.

Audits of Federal and State Grants

Federal and state grants and other financial assistance programs provide moneys to support county and city programs. In the past, individual federal and state agencies providing these moneys would audit the recipient government's expenditure of them to verify that the moneys were spent for the purposes intended and in accordance with prescribed procedures. However, since the mid-1980s the federal government has required local governments to have a *combined financial and compliance audit*, or single audit, of all federal financial assistance programs that meet certain expenditure thresholds.

To build on the federal single audit, the 1987 General Assembly, with the support of local officials, passed a law requiring state financial assistance programs to be included with federal programs in a combined single audit. In North Carolina this combined single audit is performed in conjunction with the annual financial audit by the local government's independent auditor. Federal and state agencies are allowed to build on the single audit and perform monitoring work on the programs they administer. However, they should not duplicate the work performed by the independent auditor.

The independent auditor issues a number of compliance and internal control reports to disclose findings from the single audit. These reports usually are included in the last section of the annual financial report, or in a fourth section of the CAFR. The most significant items for local officials in these reports are the internal control weaknesses, findings, and questioned costs identified by the auditor. Internal control weaknesses are usually significant deficiencies and should be corrected unless corrective actions would not be cost-effective. For example, an internal control weakness commonly cited is the lack of proper segregation of duties. However, especially for small governments, complete

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correction of the problem could involve additional hirings, the costs of which could outweigh the benefits. In these situations, mitigating controls can be put into place that lessen the risks and weaknesses involved. Otherwise, findings and questioned costs almost always require corrective action, which may necessitate the repayment of grant funds. County and city officials' formal responses to findings and questioned costs and material internal control weaknesses are included in the single audit reports.

The Local Government Commission monitors the single audit of grant funds as part of its review of the annual financial report. If the commission staff determines that the single audit reports and schedules are not prepared according to the applicable standards, then the independent auditor may be required to revise them before the annual financial report can be accepted. If the commission staff finds that the single audit is satisfactory, then all state grantor agencies must accept the audit. Subsequent to the acceptance of the annual financial report, if the commission determines that the single audit is not reliable, it may revoke its approval. This opens a county or a city to individual federal and state agency audits.

Additional Resources

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