

STATE OF SOUTH CAROLINA

**INDEPENDENT AUDITORS' REPORT ON
INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND
OTHER MATTERS BASED ON AN AUDIT
OF FINANCIAL STATEMENTS PERFORMED
IN ACCORDANCE WITH *GOVERNMENT
AUDITING STANDARDS***

June 30, 2004

CONTENTS

PAGE

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH <i>GOVERNMENT AUDITING STANDARDS</i>	1
INTERNAL CONTROL OVER FINANCIAL REPORTING	
04-1 Financial Reporting Employment Security Commission	3
04-2 Financial Reporting Department of Mental Health	3
04-3 Reconciliation of Investments Department of Insurance	4
04-4 Federal Reporting Department of Social Services	4
COMPLIANCE AND OTHER MATTERS	
04-5 National Guard Pension System Office of the Comptroller General	5
04-6 Collateral Requirements Office of the State Treasurer	6
SUMMARY OF PRIOR FINDINGS	7
MANAGEMENT RESPONSES	8

State of South Carolina



Office of the State Auditor



**INDEPENDENT AUDITORS' REPORT ON INTERNAL
CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE
AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS
PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

The Honorable Mark Sanford, Governor
and
Members of the General Assembly
State of South Carolina
Columbia, South Carolina

We have jointly audited the financial statements of the governmental activities, the business activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of South Carolina as of and for the year ended June 30, 2004, which collectively comprise the State's basic financial statements and have issued our report thereon dated December, 10, 2004. We did not jointly audit the financial statements of certain component units and agencies of the State of South Carolina, which represent the indicated percent of total assets and total revenues as presented in the table below. Those financial statements were audited by other auditors, including KPMG LLP acting separately, whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for those component units and agencies, is based solely on the reports of the other auditors.

	<u>Percentage not jointly audited</u>		<u>Percentage audited by KPMG separately</u>		<u>Percentage audited by other auditors</u>	
	<u>Total Assets</u>	<u>Total Revenue</u>	<u>Total Assets</u>	<u>Total Revenue</u>	<u>Total Assets</u>	<u>Total Revenue</u>
<u>Government-wide</u>						
Governmental activities	76	21	1	1	75	20
Business-type activities	99	98	39	53	60	45
Component units	100	100	5	2	95	98
<u>Fund statements</u>						
Local Government Infrastructure	100	100			100	100
Department of Transportation						
Special Revenue Fund	100	100			100	100
Higher Education	100	100	61	61	39	39
Unemployment Compensation	97	91			97	91
Housing Authority	100	100			100	100
Education Assistance Authority	100	100			100	100
Other remaining fund information	95	87	10	46	85	41

The Honorable Mark Sanford, Governor
and
Members of the General Assembly
State of South Carolina

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

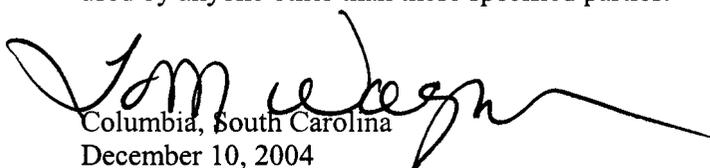
In planning and performing our audit, we considered the State of South Carolina's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the State of South Carolina's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and responses as items 04-1, 04-2, 04-3, and 04-4.

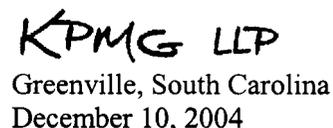
A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of South Carolina's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance and other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and responses as items 04-5 and 04-6.

This report is intended solely for the information and use of the Governor, Members of the General Assembly, and the governing body and management of State agencies and is not intended to be and should not be used by anyone other than these specified parties.


Columbia, South Carolina
December 10, 2004


Greenville, South Carolina
December 10, 2004

INTERNAL CONTROL OVER FINANCIAL REPORTING

04-1 Financial Reporting

Employment Security Commission

The Comptroller General's STARS Policies and Procedures Manual (STARS Manual) Section 2.1.7.20 states that agencies with federal subfunds are required to perform monthly reconciliations between the State's Comptroller General (CG) CSA 467CM report (Trial Balance by Subfund, Project and GLA) and the agency's records for each project and phase code.

The complexity of the Employment Security Commission's (the "Commission") accounting system has prevented them from implementing a process to efficiently and effectively meet the requirements of the STARS Manual. As a result, there is no process in place to detect and identify variances between the amounts recorded in the Commission's general ledger and the Comptroller General's accounting records (STARS). A similar comment was included in our four prior reports.

We again recommend the Commission work with the Comptroller General to develop a process to prepare monthly reconciliations of agency accounting records to the CSA 467CM report in a timely manner. The reconciliation should be documented in writing, in an easily understandable format with all supporting working papers maintained for audit purposes including the signatures of the preparer and independent reviewer and the dates of preparation and review. The reconciliation of parallel accounting systems assures that transactions are accurately processed by both the agency and the Comptroller General, strengthens the internal accounting controls for both the agency and the State, and assures proper classification of transactions presented in the State's financial statements.

04-2 Financial Reporting

Department of Mental Health

The Comptroller General's Policies and Procedures Manual (STARS Manual) Section 2.1.7.20 requires agencies to perform monthly reconciliations for revenues, expenditures, and ending cash balances at the level of detail in the Appropriation Act.

We selected the three largest cash accounts at the Department of Mental Health (the "Department") to test reconciliation controls. We determined that the Department did not prepare monthly cash reconciliations of these accounts. In addition, the Department did not prepare monthly reconciliations of its expenditure accounts. Reconciliations provide management with assurance that transactions are accurately recorded in the accounting records. In addition, monthly reconciliations help to ensure timely identification and correction of errors and irregularities.

We recommend that the Department take appropriate action to ensure timely reconciliation of cash and expenditure accounts. Monthly reconciliations will enhance the Department's ability to ensure the timely detection and correction of errors and to provide accurate financial information to management.

04-3 Reconciliation of Investments

Department of Insurance

Sound accounting practices and accurate financial reporting require that financial transactions be accurately reported.

We determined that the cash and investments closing package submitted to the Comptroller General's Office by the Department of Insurance (the "Department") overstated the Department's investment account balance.

Insurance companies doing business in the State of South Carolina are required by law to maintain bonds or securities with the Department for payment of claims against an insurer arising out of its failure to meet obligations incurred in the State. The Department improperly reported surety bonds as investments.

We recommend that the Department reevaluate its accounting treatment of surety bonds to ensure that the transactions are properly reported in the State's basic financial statements.

04-4 Federal Reporting

Department of Social Services

Sound accounting practices require that records used to report federal expenditures and awards be reconciled to the agency's general ledger detail. Further, effective internal controls require that transactions be reviewed and authorized by someone independent of document preparation.

During the course of our testwork, we noted certain matters related to the Department of Social Services' (the "Department") federal reporting process that impacted our financial statement audit. For the fiscal year-ended June 30, 2004 and through the date of our testwork, the Department had not reconciled the Schedule of Federal Financial Assistance (SFFA) to the General Ledger (GAFRS). When this reconciliation was prepared by management subsequent to year-end, a significant discrepancy was identified in the deferred revenue balance.

Furthermore, during the course of our testwork, we noted several instances in which the federal cash draw packages were not reviewed or approved by someone other than the preparer.

We recommend the Department establish written procedures to ensure that amounts reported on the SFFA are adequately supported by accounting records. Furthermore, we recommend the Department develop procedures to ensure that the SFFA is reconciled to the GAFRS system. Finally, we recommend that the Department adopt more formal procedures to ensure that Federal cash draws are reviewed and authorized by someone independent of the document preparation.

COMPLIANCE AND OTHER MATTERS

04-5 National Guard Pension System

Office of the Comptroller General

Article X, Section 16 of the South Carolina Constitution states, "The General Assembly shall annually appropriate funds and prescribe member contributions for any state-operated retirement system which will insure the availability of funds to meet all normal and accrued liability of the system on a sound actuarial basis as determined by the governing body of the system." Section 25-1-3235 (C) of the South Carolina 1976 Code of Laws, as amended, further states that such determination shall be made by the State Budget and Control Board in its capacity as governing body of state-operated retirement systems.

The National Guard Pension System (NGPS) is a state-operated retirement plan that is administered by the State Adjutant General. All other state-operated retirement plans are administered by the South Carolina Retirement System.

The General Assembly has inadequately funded the NGPS for every fiscal year since fiscal year 1995-1996. The current year's actuarially required contribution was \$2.870 million; however, the General Assembly funded only \$1.977 million of the total required amount. Independent plan actuaries have calculated that NGPS has actuarial accrued liabilities of \$47.281 million, of which \$33.714 million was unfunded at June 30, 2004.

In fiscal year 2001-2002 the Budget and Control Board contracted with an actuary to perform an actuarial valuation of the NGPS. The study, dated December 2001, examined the performance of the NGPS as of June 30, 2000. The executive summary and recommendations of the study follow.

Executive Summary

- The NGPS is a poorly funded system and is not actuarially sound since the annual required contributions are not being contributed. The NGPS will continue to be poorly funded and actuarially unsound if the actual contributions to NGPS are less than the annual required contributions.
- For many years the annual required contribution to the NGPS has not been made, worsening the financial status of the System.
- In recent years the annual required contribution has been sent to the NGPS as part of their (Adjutant General's Office) budget. Budget cuts to the agency have not only come from the operating budget but have come out of the annual required contributions.
- The assumed net investment return of 7.25% will not likely be attained unless the assets of the NGPS are partially invested in equities

Recommendations

- Annual required contributions need to be made every year in the future.
- The annual required contributions must be placed in a trust fund and not used for agency budget costs.
- Explore investing a portion of the assets in equities.

Subsequent independent actuarial valuations support these earlier findings, including a valuation report dated December 8, 2004 that was done for the NGPS 2003-2004 fiscal year. This valuation report again reveals that since required State contributions have not been made, the plan is not being operated in an actuarially sound manner; and that if contributions are not increased to the required level, the ability to pay promised future benefits will be in serious jeopardy. Actuarially-based projections reveal that without the State taking appropriate corrective action, plan assets will be depleted in approximately 12 years.

We recommend the Comptroller General, as the State Accounting Officer and a member of the Budget and Control Board, meet with the other Board members to develop a plan for funding the NGPS to eliminate the plan's unfunded actuarial accrued liability. The plan should be made available to the General Assembly for timely action during the 2005-2006 legislative session.

04-6 Collateral Requirements

Office of the State Treasurer

Section 11-13-60 of the South Carolina Code of Laws as amended, states:

A bank or savings and loan association, upon the deposit of state funds by the State Treasurer, must secure these deposits by deposit insurance, surety bonds, collateral securities, or letters of credit to protect the State against loss in the event of insolvency or liquidation of the institution or for any other cause. To the extent that these deposits exceed the amount of insurance coverage provided by the Federal Deposit Insurance Corporation, the bank or savings and loan association, at the time of deposit, shall:

- 1) furnish an indemnity bond ...
- 2) pledge as collateral ...
- 3) provide an irrevocable letter of credit ...

The State Treasurer's Office (the "STO") did not monitor the collateral balance of its investments at one financial institution to ensure that uninvested deposits held by the institution were properly collateralized. As a result the STO did not detect that there were uncollateralized deposits and accordingly the STO was in violation of South Carolina Code of Laws Section 11-13-60.

The cause of the uncollateralized deposits was due to a miscommunication with the financial institution. The STO believed the financial institution was investing the cash in collateralized repurchase agreements when in fact they were being deposited in Federal Deposit Insurance Corporation (FDIC) insured demand deposit accounts.

Although this situation has since been corrected by the STO and the financial institution, we recommend that the STO enact policies and procedures to ensure the consistent monitoring of collateralized investments to prevent future uncollateralized or under-collateralized investments and violations of South Carolina State Law.

SUMMARY OF PRIOR FINDINGS

During the current engagement, we reviewed the status of corrective action taken on the finding in the prior report on compliance and on internal control over financial reporting at the basic financial statement level, dated December 19, 2003 to determine if the condition still existed. Based on our audit procedures we determined that adequate corrective for the Financial Reporting deficiency at the Employment Security Commission had not been corrected. We have repeated our comment in finding 04-1 of this report.

MANAGEMENT'S RESPONSE

COMMISSIONERS
J. William McLeod
Becky D. Richardson
McKinley Washington, Jr.

EXECUTIVE DIRECTOR
Roosevelt T. Halley
803.737.2617



Your
onestop
for Workforce Solutions!
www.sces.org

1550 Gadsden Street
Post Office Box 995
Columbia, South Carolina 29202

January 21, 2005

Mr. Thomas L. Wagner, Jr.
State Auditor
Office of the State Auditor
1401 Main Street, Suite 1200
Columbia, South Carolina 29211

Dear Mr. Wagner:

As requested, the following is the response regarding the State of South Carolina's statewide joint audit of the general purpose financial statements, relating to the Fiscal Year 2003-2004 financial packages submitted by the Commission.

Reconciliation related finding: We concur with the recommendation for monthly reconciliation of Agency accounting records with the State's Comptroller General CSA467 CM Report.

The South Carolina Employment Security Commission's current procedures require that we reconcile the input of revenue and expenditures in STARS and the Agency accounting system (FARS) monthly. The South Carolina Employment Security Commission has also completed the reconciliation of receipts monthly, as required by STARS 2.1.7.20. This section also requires expenditures and cash balances be reconciled each month. We are reconciling to the 404 and 406 report each month, however due to the required federal program allocation in our FARS system, we have been unable to reconcile to the STARS 467 expenditures and cash balances. We have been working with the staff of the Comptroller General's Office to complete this reconciliation and plan to have it implemented effective July 1, 2004. In addition, all Agency reconciliation procedures require that the preparer, as well as the reviewer, sign and date.

If there are any questions, or if additional information is needed, please contact me at (803) 737-2560 or e-mail bmartin@sces.org.

Sincerely,

Billy R. Martin, CGFO
Assistant Finance Director

BRM:sc

The mission of the Department of Finance is to have professional accountants providing professional accounting through the sound fiscal management of the Agency's resources.



MISSION STATEMENT

To support the recovery of people with mental illness.

January 19, 2005

Thomas L. Wagner, Jr., CPA
State Auditor
1401 Main Street, Suite 1200
Columbia, SC 29201

Dear Mr. Wagner:

We agree with the audit comment that the Department of Mental Health did not perform monthly reconciliations of revenues, expenditures, and ending cash balances as required by the Comptroller General's STARS manual. During the fiscal year under examination, several experienced and long term financial employees terminated. Locating and hiring of experienced replacements was most difficult. Implementation of the new financial system (SAP) also occurred during this time period, placing additional work requirements on the remaining staff.

It should be noted that when the Comptroller General begins utilizing the SAP financial system, many of the required reconciliations will no longer be necessary as DMH and the Comptroller General will be using the same financial data base.

While we have worked diligently on these reconciliations, we will continue efforts to keep reconciliations current and are in the process of training new staff to assist with this effort.

Very truly yours,

John D. Bourne, CPA
Director, Office of Financial Services

JDB/lwf

Cc: Kenneth D. Long
Deputy Director



South Carolina Department of Insurance

MARK SANFORD
Governor

Division of Administration

300 Arbor Lake Drive, Suite 1200
Columbia, South Carolina 29223

Mailing Address:

P.O. Box 100105, Columbia, S.C. 29202-3105
Telephone: (803) 737-6130

January 14, 2005

Mr. Thomas L Wagner Jr., CPA
Office of the State Auditor
1401 Main Street, Suite 1200
Columbia, SC 29201

Reference: Response to audit exception regarding Reporting of Investments

Mr. Wagner:

The Department has reviewed the audit exception regarding our cash and investments closing package and agrees investments held on deposit for payment of claims was overstated by approximately \$25,000,000 of the approximate \$360,000,000 par value reported in the June 30, 2004 closing package. This overstatement was due to various items, primarily surety bonds, other than actual investments being reported on the closing package. Though the surety bond proceeds and other various items of security are pledged to the Department for the protection of policyholders, the pledged amounts are not cash or securities. The Department will exclude these items from its cash and investments closing package in the future. The Department intends to consult with the Comptroller's Office regarding proper accounting and reporting of these "other" security items.

Sincerely,

A handwritten signature in black ink, appearing to read "Bobby Troutman", with a long horizontal flourish extending to the right.

Bobby Troutman, CFE, CGFO
Director of Finance

DSS

Serving Children and Families

KIM S. AYDLETTE, STATE DIRECTOR

January 19, 2005

Ms. Sue Moss, CPA
Office of the State Auditor
1401 Main Street, Suite 1200
Columbia, SC 29201

SUBJECT: FY 2003-2004 GAAP Financial Reporting

Dear Ms. Moss:

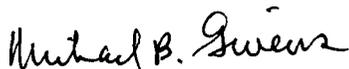
This letter is in response to FY 2003-2004 GAAP management letter comments, as follows:

Recommendation: Finding 04-6, Federal Reporting – Department of Social Services stated: We recommend the Department of Social Services establish written procedures to ensure that amounts reported on the Schedule of Federal Financial Assistance (SFFA) are adequately supported by accounting records. Furthermore, we recommend the Department develop procedures to ensure that the schedule is reconciled to the GAFRS system. Finally, we recommend that the Department adopt more formal procedures to ensure that Federal cash draws are reviewed and authorized by someone independent of the document preparation.

Agency Response: Written procedures pertaining to preparation of the Schedule of Federal Financial Assistance are being reviewed with the State Auditor during the January – February FY 2003-2004 Single Audit field work. The Department will strengthen procedures regarding the reconciliation of the Schedule of Federal Financial Assistance to the GAFRS accounting system. Finally, the Department will strengthen the review of the federal draw-down funds process.

Should you need additional information, please contact me or Karen Garrison at 898-7354 or 898-7484, respectively.

Sincerely,



Michael B. Givens, Interim Director
Budgeting Systems

MBG:gf

cc: Paul Moore
Cliff White
Wendell Price



RICHARD ECKSTROM
COMPTROLLER GENERAL

State of South Carolina
Office of Comptroller General

1200 Senate Street
305 Wade Hampton Office Building
Columbia, South Carolina 29201

Telephone: (803) 734-2121
Fax: (803) 734-2064
E-Mail: cgooffice@cg.state.sc.us

NATHAN KAMINSKI, JR.
CHIEF OF STAFF

January 20, 2005

Mr. Thomas L. Wagner, Jr.
State Auditor
Office of the State Auditor
1401 Main Street, Suite 1200
Columbia, South Carolina 29201

Jean
Dear Mr. Wagner:

I am writing as requested to respond to your Management Letter comment on the inadequate funding level of the National Guard Pension System (the Plan). You indicate that because of allowing the Plan to operate and remain in an unsound condition, the State is violating State Constitution Article X, Section 16 and State Code of Laws Section 25-1-3235.

Additionally, you asked that I discuss this matter with the other members of the Budget & Control Board. Because the Board is the governing body for all state-operated retirement systems, you call on the Board to develop a funding plan to restore the National Guard Pension System to actuarial soundness.

I have asked that this matter be included on the agenda of the next meeting of the Budget & Control Board, scheduled for January 25, 2005. I have invited the State Adjutant General, who oversees the Plan's administration, and Mr. Ed McDonald, who is engaged as the Plan's independent actuary, to attend the meeting to provide information and answer questions for Board members.

Your Management Letter refers to explanations and recommendations you obtained from a previous actuarial study of the Plan that was done on the Board's behalf, namely (italicized comments have been added for clarity):

- that the entire contribution requirement be funded every year (*the annual required contribution is determined by independent actuaries in connection with their biennial actuarial valuation of the Plan*).
- that each year's budget appropriation of the Plan's contribution requirement be made only to a separate trust fund, rather than bundling the Plan's contribution requirement with the Adjutant General's Office overall agency budget (*where appropriations to the Plan have been subject to mid year budget cuts and other reductions*).

Mr. Thomas L. Wagner, Jr.
January 20, 2005
Page 2

- that a portion of the Plan's assets be invested in equities (*in the same manner that assets are invested for all other state-operated retirement plans*).

I plan to seek the Board's support of these recommendations. I also intend to seek the Board's support for recommending that the General Assembly transfer the National Guard Pension System from the Adjutant General's Office to the South Carolina Retirement System so that the Plan can be more efficiently administered and operated consistent with the State's four other retirement plans. To gain additional consistency, I also intend to ask the Board to request an actuarial valuation of the Plan every year, rather than to continue its practice of obtaining an actuarial valuation only in alternating years.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard Eckstrom". The signature is fluid and cursive, with the first name "Richard" being more prominent than the last name "Eckstrom".

Richard Eckstrom

OFFICE OF STATE TREASURER

GRADY L. PATTERSON, JR.
STATE TREASURER



P.O. DRAWER 11778
COLUMBIA, SC 29211
TEL. (803) 734-2101

118 WADE HAMPTON OFFICE BUILDING
COLUMBIA, SC 29201

January 31, 2005

Mr. Tom Wagner
State Auditor
1401 Main Street, Suite 1200
Columbia, SC 29201

Dear Mr. Wagner:

In response to the finding in your management letter for the statewide audit as of June 30, 2004 regarding the collateral state deposits, we appreciate you bringing this to our attention and want to assure you all necessary steps were taken that day to assure all state deposits are fully collateralized in accordance with state statute and good business practices.

Sincerely,

A handwritten signature in black ink, appearing to read "Grady L. Patterson, Jr.", written in a cursive style.

Grady L. Patterson, Jr.
State Treasurer

21 copies of this document were published at an estimated printing cost of \$1.58 each, and a total printing cost of \$33.18. The FY 2004-05 Appropriation Act requires that this information on printing costs be added to the document.