



Report on a System for Monitoring the Fiscal Health of Local Government Units

FINAL REPORT

Presented to the North Carolina General Assembly

By the North Carolina Department of State Treasurer

May 1, 2022

SECTION 1. INTRODUCTION

North Carolina Session Law 2021-180 (enacted on November 18, 2021), Section 36.1.(a) requires:

The Department of State Treasurer, State and Local Government Finance Division, in consultation with the Local Government Commission (hereinafter “Commission”), shall evaluate the State’s current system for monitoring the financial operations of local government units (hereinafter “unit” or “units”) and approving their requests to issue new debt and amend current debt. For purposes of this section, the term “unit” has the same meaning as in G.S. 159-7(b)(15). The Department shall develop a plan to transition to a system for monitoring the financial operations of units that does all of the following:

- (1) Uses a “value added” approach to reviewing the State’s current practices and policies.
- (2) Directs current Commission staffing resources to the units in greatest need and away from units with adequate governance, staff, resources, and technical expertise.
- (3) Implements a schedule of reporting to the Commission based on a unit’s financial health.
- (4) Standardizes training of unit officials and staff, as deemed appropriate by the Commission.
- (5) Authorizes the Commission to compel units to comply with Commission directives.
- (6) Incorporates a clear definition of the term “fiscal distress.”
- (7) Implements a new fiscal warning system for units at risk of fiscal distress.



(8) Expands the criteria and parameters for measuring a unit's fiscal health to incorporate economic and demographic factors.

(9) Incorporates factors impacting a unit's fiscal health, including changes in population, tax base, and business and economic indicators.

SECTION 36.1.(b) requires that a final report and plan be submitted by May 1, 2022, to the Joint Oversight Committee on General Government, the Senate Appropriations Committee on General Government and Information Technology, the House Appropriations Committee on General Government, and the Fiscal Research Division and that the report shall contain any recommendations for legislation deemed appropriate to implement the provisions of the section.

This final report is hereby submitted pursuant to Section 36.1.(b) and contains the following:

- Sections II and III summarize the current system for monitoring the financial operations of local government units and for approving their requests to issue new and amend current debt, respectively.
- Section IV presents a plan to transition to a system for monitoring the fiscal operations of units.
- Section V contains recommendations for legislation.

SECTION II. CURRENT SYSTEM FOR MONITORING THE FINANCIAL OPERATIONS OF LOCAL GOVERNMENT UNITS

Local Government Commission (LGC) staff currently use a number of processes and tools to monitor financial operations and fiscal health of units of local government. Each provides LGC staff with insight into units' fiscal health and their need for any additional support, resources, or guidance, and helps LGC staff determine if a unit is in danger of fiscal distress.

- 1) **Review of Annual Audit.** N.C. Gen. Stat. § 159-34 requires each unit of local government to have its accounts audited annually and to file a copy of the audit report with the LGC. Pursuant to North Carolina Administrative Code (20 NCAC 03 .0502), data from the audited financial statements is used to calculate Financial Performance Indicators and identify Financial Performance Indicators of Concern which may indicate inadequate financial conditions or fiscal management concerns within the local government unit. If the audited financial statements include one or more significant deficiencies, material weaknesses, or other findings, or if Financial Performance Indicators of Concern were identified, then the governing body must submit a response to the Secretary of the LGC providing a plan to address each Financial Performance Indicator of Concern. Audit reports



also are reviewed by LGC staff to ensure the audits are performed in accordance with the applicable auditing standards based on the units' expenditure of federal and State financial assistance.

- 2) **Review of Semiannual Report on the Status of Deposits and Investments.** N.C. Gen. Stat. § 159-33 requires each unit of local government to report by January 25 and July 25 of each year the amounts of cash, deposits, and investments held by the local government. LGC staff utilize the data submitted in these reports to identify units that may be out of compliance with the statutes governing the deposit and investment of funds.
- 3) **Unit Assistance List.** The Unit Assistance List (UAL) developed by LGC staff serve as a tool for directing staff resource to units needing additional assistance and monitoring based on an assessment of their financial health and fiscal management practices. The list utilizes data from audited financial statements of local governments and identifies units with internal control issues, financial issues in the general fund, and financial issues in the water/sewer fund (if applicable). The UAL also includes units that have not submitted an annual audit report timely. An annual audit report provides essential information on the financial condition of a unit to LGC staff, and to the unit's governing body, officials, and citizens. Failure to submit an annual audit timely may indicate financial management weaknesses and precludes an assessment of the unit's financial health by LGC staff.
- 4) **Fiscal Accountability Agreements.** Fiscal Accountability Agreements (FAAs) are formal agreements entered into between the governing bodies of local governments and the Secretary of the LGC that identify areas of concern regarding the units' fiscal management practices or internal controls and outline clear and measurable goals to implement best practices, ensure compliance with statutes, and strengthen their financial position. FAAs are used to implement enhanced monitoring and are not punitive in nature but are intended to help units address and remedy financial or fiscal management challenges.

Limited FAAs are implemented with certain units that are on the Unit Assistance List (UAL). These FAAs provide a means for LGC staff to establish an ongoing, structured monitoring process and to provide enhanced assistance to these units with the goal of guiding the units to take the actions needed to allow removal from the UAL. Under Limited FAAs, LGC staff conduct a unit visit, provide training, and review the unit's proposed annual budget prior to its adoption by the unit's board; the governing board agrees to provide budget-to-actual reports to LGC staff on a schedule established in the FAA. LGC staff are currently entered into 42 limited FAAs.



Comprehensive FAAs are implemented with units that LGC staff identify as facing significant challenges to their fiscal health or financial management practices. These FAAs include all of the requirements of Limited FAAs plus clear and measurable goals to implement best practices, ensure compliance with statutes, and strengthen the units' financial position.

SECTION III. CURRENT SYSTEM FOR DEBT REQUESTS BY LOCAL GOVERNMENT UNITS

LGC staff provide resources, guidelines, and suggestions to help units seeking LGC approval of debt to expedite and streamline the application process. Guidance related to fiscal management practices, debt management practices, and statutory considerations is provided to units seeking to issue debt and is reviewed with units and their finance staffs, financial advisors, and others as requested. LGC staff have established the following process for units wishing to issue debt.

- 1) **Unit Inquiry.** A request for debt approval often begins with a phone call or email from a unit to LGC staff inquiring as to the need for LGC approval of debt and the application process. Not all debt requires LGC approval (depending on the amount financed, term of financing, and other factors) and LGC staff can provide appropriate guidance based on the details of the financing and statutory requirements.
- 2) **Pre-application Conference.** Units planning to issue debt that requires LGC approval are then scheduled to participate in a pre-application conference with LGC staff. This conference allows LGC staff to obtain background and details on the proposed application including financing amount and type, purpose, and timeline for the project and LGC approval. LGC staff also provide guidance to the units regarding factors the LGC may consider related to financial management (timely submission of annual audits, timely response to LGC staff concerns, etc.) and debt management (debt burden, financing amount and type, etc.).
- 3) **Analysis and Research.** Following a pre-application conference, LGC staff perform research and analysis to identify any financial impacts of the request and to compile any relevant information needed by LGC members in their consideration of the request. Fiscal and debt management practices, citizen support or opposition, and pending or completed investigations of the unit are all researched to provide a complete assessment of the unit's ability to issue and repay debt without negative financial impact to the unit and allow staff to develop a recommendation for approval or denial to the LGC.



- 4) **Debt Application.** Following the pre-application conference, units are provided with an application that identifies the documentation needed and steps in the debt approval process. Completed applications must be received by LGC staff approximately one month before the LGC meeting at which the unit wishes to have its application considered; specific deadlines for each scheduled LGC meeting are provided to the units and are available on the LGC website. Financial analysts on LGC staff guide units through the application process, ensuring that all information necessary for the LGC to consider the application has been received.

It is important to note that not all inquiries necessarily lead to pre-application conferences and not all pre-application processes lead to requests for debt applications. In addition, some debt applications may be initiated and then placed on hold by the unit or LGC staff for a variety of reasons. Because of this variety of contact with units and the need to track the details, status, and progress of each, LGC staff utilize an internal system for tracking units who have initiated contact regarding issuing debt requiring LGC approval.

- 5) **LGC Consideration of Request.** After all information requested by LGC staff and required for the LGC to consider the application is received, the debt request will be presented to the LGC for consideration and vote. Following approval, LGC staff provide the unit with a letter of approval and also meeting minutes and signature pages, as needed, for the debt's closing documents.
- 6) **Issuance of Debt Notices.** Following approval of debt, LGC staff has continuing responsibilities to monitor the repayment of the debt. N.C. Gen. Stat. § 159-35 requires the Secretary of the Local Government Commission to notify units of debt service obligations both annually with a statement of debt service obligations for the coming fiscal year, and 30 days prior to a debt service payment via a statement including the amount of principal and interest due, the due date, and other information required by statute. Debt payments made by units on outstanding debt approved by the LGC must be reported to the Secretary of the LGC under N.C. Gen. Stat. § 159-136 and are tracked by LGC staff.

SECTION IV. A SYSTEM FOR MONITORING THE FISCAL OPERATIONS OF UNITS

The requirements of Section 36.1.(a) are provided below, along with plans for implementing these requirements or information on current processes which support these requirements. Specifically, Section 36.1.(a) requires the Department to develop a plan to transition to a monitoring system that:



1) Uses a “value added” approach to reviewing the State’s current practices and policies.

The staff of the Local Government Commission used a “value added” approach in reviewing current practices and policies. With 43 permanent, full-time positions (including four recently added by the General Assembly but not yet filled) and approximately 1,100 units of local government subject to oversight, LGC staff must focus on practices and policies that optimize the impact and value to local governments while maintaining the reputation of, and confidence in, the LGC’s oversight role.

2) Directs current Commission staffing resources to the units in greatest need and away from units with adequate governance, staff, resources, and technical expertise.

Units of local government and public authorities subject to NC General Statute Chapter 159 must submit annual audit reports performed by an independent auditor, semi-annual reports of cash and investments, and/or annual financial information reports. The annual audit is the primary source for information used by staff to determine the financial and fiscal management well-being of a unit; this information may be supplemented by information obtained from local governments’ staffs, elected officials, and concerned citizens.

In 2021, North Carolina Administrative Code was modified to allow the LGC to define financial performance indicators and require units with indicators exceeding defined thresholds (indicators of concern) to respond to the LGC with a corrective action plan. These financial performance indicators, along with a unit’s history of non-compliance with the Local Government Budget and Fiscal Control Act, late annual audits, and significant deficiencies findings or material weaknesses in their annual audits are used to identify units requiring more stringent review and additional staff time. Units considered low-risk due to adequate governance, staff, resources, technical expertise, and a history of compliance with the Local Government Budget and Fiscal Control Act receive a limited review of their reports to fulfill the LGC’s statutory obligation to review the reports.

It is important to note that N.C. Gen. Stat. § 159-34(a) requires that all local governments and public authorities that are subject to the Local Government Budget and Fiscal Control Act, regardless of the adequacy of their governance, staff, resources, and technical expertise, submit annual audited financial reports that have been prepared in accordance with generally accepted accounting principles (GAAP). One of the key functions of the LGC staff is to monitor changes in GAAP and interpret how those changes apply in North



Carolina and provide guidance and technical support to units in implementing and conforming to these requirements. Examples of recent changes in GAAP include Governmental Accounting Standards Board (GASB) Statement Numbers 84 and 87, on accounting for and reporting of fiduciary activities and leases, respectively. LGC staff provided significant written guidance via its website, and presentations at various conferences and seminars on how to correctly implement these new standards. Governments across the state, large and small, rely on this guidance.

Additionally, when a new funding source and its resulting transactions surface, LGC staff must provide guidance to all local governments on how to apply existing GAAP and to local government auditors on how to audit these transactions. One such new funding source that has been prevalent over the last 14 months is funding provided by the federal government through the American Rescue Plan Act (ARPA), also known as Coronavirus State and Local Fiscal Recovery Funds (CSLFRF). LGC staff has worked collaboratively with the Office of State Budget and Management (OSBM), the UNC School of Government, the North Carolina League of Municipalities (NCLM), the North Carolina Association of County Commissioners (NCACC), the North Carolina Regional Councils of Government Association, and many other organizations to provide guidance on a variety of issues related to these funds. LGC has been and will continue to be instrumental in providing guidance on the detailed accounting, financial reporting, and auditing of these funds. These efforts will continue as the U.S. Treasury continues to modify the applicable regulations and as the local entities continue to expend these funds through December 31, 2026. Again, although governments across the state, large and small, rely on LGC staff to provide this type of guidance, it is especially valuable to units lacking the adequate staff, resources, technical expertise that are available to larger units.

3) Implements a schedule of reporting to the Commission based on a unit's financial health.

In 2021, LGC staff implemented Fiscal Accountability Agreements (FAAs), a new process described in Section II above, under which units with significant financial health concerns report to the LGC on a pre-determined schedule throughout the fiscal year. These FAAs have implemented a schedule of reporting to the Commission based on a unit's financial health and include submission of budget-to-actual reports and a review of the unit's proposed annual budget prior to their governing board's adoption of the budget. LGC



staff's review of proposed budgets has allowed staff to intervene and coach these units to improve their budgeting practices.

4) Standardizes training of unit officials and staff, as deemed appropriate by the Commission.

In 2021, LGC staff launched virtual and in-person training for local government elected officials focusing on their financial responsibilities under the Local Government Budget and Fiscal Control Act. As of April 26, 2022, 350 elected officials or unit staff representing 101 local governments completed this training. Of those 101 units, 78 were local governments on the Unit Assistance List. This training was provided to the participants free of charge and has been very well received. Although the training is targeted at elected officials, LGC staff encouraged managers and administrators, as well as finance officers, to also participate in this training.

Additionally, the LGC has existing authority under N.C. Gen. Stat. § 159-25(d) to require any finance officer or any other employee who performs the duties of a finance officer to participate in training related to the powers, duties, and responsibilities of the finance officer under certain circumstances. Session Law 2021-124, enacted in August 2021, modified N.C. Gen. Stat. §§ 153A-82 and 160A-148 to require county and city managers, respectively, under certain circumstances, to complete six hours of education related to fiscal management and the requirements of Chapter 159 of the General Statutes.

5) Authorizes the Commission to compel units to comply with Commission directives.

The Commission has authority under several existing statutes to require action by units of local government:

- N.C. Gen. Stat. § 159-25(e) authorizes the LGC to require any local government or public authority to contract with outside entities to ensure fulfillment of the duties of the finance officer if the local government or public authority has received a unit letter from the Commission due to a deficiency in complying with North Carolina General Statutes Chapter 159 or the local government or public authority has an internal control finding in the most recently completed financial audit.
- N.C. Gen. Stat. § 159-181(c) and (d) allow the LGC to assume control of the financial affairs of a unit of local government or public authority, or the water or



sewer enterprise system of any unit of local government or public authority, respectively, under certain circumstances.

6) Incorporates a clear definition of the term “fiscal distress.”

The LGC has a number of systems and processes to monitor the financial health and fiscal management of units of local government including financial performance indicators, FAAs, and the Unit Assistance List. “Fiscal distress” may be defined as the status of a local government that has met the criteria under N.C. Gen. Stat. § 159-181(c) or (d) and whose financial affairs are under control of the LGC pursuant to the LGC’s authority to impound a unit’s books and records and assume full control of all its financial affairs.

7) Implements a new fiscal warning system for units at risk of fiscal distress.

LGC staff partnered with a practicum team from the NC State University Institute for Advanced Analytics to design a system that would analyze counties’ and municipalities’ current and historical financial data to identify risk factors and thresholds which could predict local governments’ fiscal distress. These factors could then be used to anticipate which units of government may be or become at-risk, and to allow the LGC staff to proactively assist the units in regaining their financial health and avoid fiscal distress. Using the results of that project, LGC staff will work to implement a new fiscal warning system for units at risk of fiscal distress.

8) Expands the criteria and parameters for measuring a unit’s fiscal health to incorporate economic and demographic factors; and

9) Incorporates factors impacting a unit’s fiscal health, including changes in population, tax base, and business and economic indicators.

The Unit Assistance List (UAL), developed annually by LGC staff, identifies units with concerns related to units’ general fund, water/sewer quick ratio, and internal controls. The UAL will be expanded to incorporate economic and demographic factors such a five-year trend in the unit’s population, population projections for the unit’s dominant county, and the trend in the unit’s valuation of taxable property. Other significant impacts to a unit’s fiscal health are often unknown by LGC staff or may only be discovered upon receipt of a unit’s annual audit report at the end of a fiscal year. Legislation requiring interim reporting by units when events occur that may have a material, adverse effect on the unit’s financial health, operations, or internal controls would assist LGC staff in incorporating changes in population, tax base, and other business and economic indicators into its analysis of units’ fiscal health.



SECTION V. RECOMMENDATIONS FOR LEGISLATION

Recommendations for legislation required to implement the proposed system described above and for improvements to financial oversight and support of local governments follow.

- 1) **New requirements for units on the Department of State Treasurer's Unit Assistance List (UAL).** These requirements would include:
 - a. Fiscal training for governing boards;
 - b. Annual budget review and approval by the LGC, prior to governing board adoption;
 - c. Interim budgetary reporting, including amendments and budgetary compliance, to the LGC; and
 - d. LGC approval for certain contracts currently excluded from approval in N.C. Gen. Stat. § 159-48(a) and (b).

These recommendations support requirements (1), (2), (3), and (4) of Section 36.1.(a).

Recommendation d. is included in Section 7 of [Senate Bill 265](#), a bill which has been introduced as eligible for consideration in the 2022 Short Session, but not enacted.

- 2) **Interim event reporting.** Units subject to North Carolina General Statutes Chapter 159 would be required to notify the LGC of any events that will or may have a material, adverse effect on the unit's financial health, operations, or internal controls.

This recommendation supports requirements (1), (2), (3), (7) and (9) of Section 36.1.(a).

This recommendation is included in Section 5 of [Senate Bill 265](#), a bill which has been introduced as eligible for consideration in the 2022 Short Session, but not enacted.

- 3) **Intercept of sales tax revenue for units with late audits.** The Commission would have the authority to request that the Secretary of Revenue withhold 150% of the cost of a unit's annual audit from the unit's distribution of sales tax revenue for units that have not submitted an annual audit report 12 months or more after fiscal year end. Funds would be held until such time as the audit is reviewed and accepted by the LGC.

This recommendation supports requirements (2) and (5) of Section 36.1.(a).

This recommendation is included in Section 6 of [Senate Bill 265](#), a bill which has been introduced as eligible for consideration in the 2022 Short Session, but not enacted.



- 4) Required notification of units created and subject to North Carolina General Statutes Chapter 159.** The General Assembly and any of its political subdivisions that create “units of local government” or “public authorities” conforming to those definitions pursuant to N.C. Gen. Stat. § 159-7 would be required to notify the LGC of the name, governance structure, and other details of the unit.

This recommendation supports requirement (2) of Section 36.1.(a).

- 5) Increased requirements for fidelity bonds.** N.C. Gen. Stat. § 159-29 currently requires a minimum \$50,000 faithful performance bond for unit finance officers and a faithful performance bond with sufficient sureties for others who handle a unit’s funds or inventories. Staff believes that these requirements are insufficient to protect the assets of local governments and public authorities and recommends changes, including a requirement that the amount of bond be indexed to the unit’s general fund budget to allow for a more adequate financial remedy for failures of the individuals in these positions to faithfully discharge their duties. Staff also recommends a requirement that the positions covered by § 159-29 may not be staffed by persons unable to secure the required bond.

This recommendation supports requirement (2) of Section 36.1.(a).

- 6) Criminal Referrals of reports of fraud findings.** Regardless of the strength of a unit’s financial health or fiscal management practices, fraud has the potential to threaten both a unit’s immediate-term financial stability and its ability to meet the needs of its citizens, and its long-term financial viability. In addition, when fraud is discovered, it is often not clear how or if the actors at fault will be held accountable or prosecuted if appropriate. After consultation with the State Auditor and other stakeholders, the LGC may consider a resolution that matters of fraud be directly referred to the Attorney General of North Carolina for prosecution. This is vital in order to protect taxpayers, punish embezzlers, and fully enforce the felony forfeiture laws regarding the North Carolina Retirement Systems.

This recommendation supports requirements (1), (2), and (5) of Section 36.1.(a).



SECTION VI. CONCLUSION

The processes currently in place for monitoring the financial operations of local government units and approving their requests to issue debt have been developed based on decades of experience and improvements, LGC policies, and requirements under North Carolina statutes and administrative code. Through these processes, LGC staff seek to minimize the administrative burden on both units and its own staff and to offer streamlined and user-friendly interactions between LGC staff and units. Areas for improvement exist, especially in continuing to leverage technology and automation to further streamline processes, and in considering legislative changes that better address the need for financial oversight and support of local governments. The staff of the LGC seeks to continuously improve and add value to its processes and will implement the requirements of this report as part of that effort.