

Chapter 8

Managing and Disbursing Public Funds

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A local government and public authority (collectively, local units) needs to pay for the personnel, supplies, infrastructure, and other expenses necessary to carry out the purposes for which it was established. Proper management and expenditure of a local unit’s revenues are important both to ensure that sufficient funds are available and to maintain public trust in the government.

Internal controls are processes designed to safeguard the assets of the unit. Although the exact nature of internal controls will vary significantly from government to government due to

differences in size, resources, and organizational structure, all local government entities need to take steps to ensure the proper stewardship of public funds. And that duty should take precedence over the efficiency and expediency of business processes. Internal controls introduce redundancies and, to the frustration of local government officials, may cause administrative delays of even routine transactions. They serve an invaluable function, though: to ensure that moneys are managed and spent appropriately, according to clear budget directives by the governing board. That is a necessary trade-off in the public sector.

Internal controls fall roughly into two categories—preventative (policies and procedures that do not allow certain events to occur) and detective (backup procedures to ensure that primary internal controls operate as intended). A local government needs to incorporate both categories into its financial operations. Perhaps the most common internal control is segregation of duties—so that no employee or official handles an entire transaction from start to finish. Other controls include providing oversight of financial activity by supervisors and board members, periodically rotating staff duties, doing a thorough and accurate audit of all receipts and claims, requiring that adequate records be maintained and presented for intermittent inspection by an internal audit committee, responding to deficiencies identified through the yearly external audit, educating employees and officials about detecting red flags of potential fraudulent activity, and even mandating that employees use all of their vacation time each year. Employees and officials at all levels of local government must implement, monitor, and periodically reevaluate the sufficiency of controls relating to the collection, management, obligation, and disbursement of public funds.

A local unit has a good deal of flexibility in establishing and implementing internal controls. At a minimum, internal controls must serve to detect, mitigate, and ideally prevent, the misappropriation of moneys collected or received by the unit. The Local Government Budget and Fiscal Control Act (LGBFCA)¹ specifies certain internal controls, most notably,

- accounting system requirements (G.S. 159-26);
- annual independent audit (G.S. 159-34);
- Local Government Commission/State Board of Education oversight (G.S. 159-25, -33, -33.1, -34, -36, -181, -182);
- appointment of finance officers, budget officers, and deputy finance officers (G.S. 159-9, -24, -28);
- daily deposit in official repository requirement (G.S. 159-31, -32);
- disbursement process (G.S. 159-28);
- dual signature requirement (G.S. 159-25);
- employee and official bonding requirement (G.S. 159-29);
- governing board oversight provisions (G.S. 159-25, -28, -29, -30, -31, -34);
- investment limitations (G.S. 159-30);
- preaudit process (G.S. 159-28).

This chapter reflects the law as of June 1, 2023.

1. Chapter 159, Article 3 of the North Carolina General Statutes (hereinafter G.S.). Note that the School Budget and Fiscal Control Act, G.S. Chapter 115C, Article 31, prescribes similar, and in many cases exactly analogous, requirements for local school administrative units.

These provisions in the LGBFCA set the minimum internal controls required by law. Basic legal compliance could go a long way toward preventing fiscal malfeasance but often is not sufficient to fully insulate a government entity from an employee or vendor/contractor mistake or fraud. Most units need to implement additional financial internal controls to safeguard public funds.

Some of the above-listed controls are discussed in detail in other chapters. This chapter will focus on the daily deposit requirement, investment limitations, preaudit and disbursement processes, dual signature requirement, and governing board oversight.

Daily Deposits and Official Depositories

The first statutory requirement related to the management of a local unit’s revenues is that the funds be deposited and insured. Specifically, Chapter 159, Section 32 of the North Carolina General Statutes (hereinafter G.S.) states that, except as otherwise provided by law, all moneys “collected or received” by an “officer or employee” of a local unit must be deposited daily “with the finance officer or in an official depository,” or must be submitted to “a properly licensed and recognized cash collection service. . . .”

Daily Deposit Requirement

“Officer or Employee”

The daily deposit requirement applies to all local government and public authority officials, even those such as sheriffs and registers of deeds who are independently elected or local board of elections personnel who are independently appointed. If an agency is part of a local unit for purposes of budget adoption and control, it and its officers and employees also are part of the local unit for purposes of the daily deposit requirement.

“Collected or Received”

The statute also makes no distinction among types of moneys. It applies to all moneys “collected or received” by a local unit, including taxes and fees, as well as moneys collected through fundraisers, state or federal appropriations, donations, grants, loans, and gifts. It applies, for example, when a sheriff’s office receives a check from the federal government pursuant to a federal drug-share program. It applies when a recreation staff member of a municipality collects fees on-site for the local unit’s open gym night. It applies when a social services department receives monetary donations around holiday time to support its outreach programs.² And it applies if a municipal library holds a used-book-sale fundraiser.³

2. Increasingly, donations to a county’s social services department are being made by bank gift card instead of in the form of cash or a check. Bank gift cards are not “moneys” for purposes of the daily deposit statute but should be treated as revenue. For budget purposes, if the unit intends to use a gift card to pay for unit expenditures, its governing board must first recognize the amount of the gift card as revenue in the budget ordinance and appropriate it to a specific department, function, or project. The finance officer also should establish appropriate internal controls for accepting and securely storing bank gift cards.

3. As used in this book, the term “municipality” is synonymous with “city,” “town,” and “village.”

Sometimes a local unit collects moneys on behalf of other governments or on behalf of private entities or individuals. For example, a unit may collect funds for a local nonprofit along with its water and sewer payments. Or a unit may contract with a private electric or gas company to accept customer payments on behalf of the private company. County prison officials typically collect and hold funds belonging to inmates. Many municipalities collect funds to maintain private cemetery plots within a municipal cemetery. A unit typically holds these funds in a fiduciary or agency capacity. They are not recognized as revenue in the unit's budget. Nevertheless, these funds are subject to the daily deposit requirement because they are "collected or received" by the unit.

Similarly, some units collect deposits on equipment or facility rentals. These deposits also are "collected or received" by the unit and thus are subject to the daily deposit requirement, even if they are held for only a brief period of time. The appropriate procedure is for the unit to deposit the funds and then cut a refund check when the equipment is returned or the facility rental period is over.

There are at least three circumstances in which a local unit possesses moneys that arguably it has not "collected or received" for purposes of G.S. 159-32—vending machine proceeds, sealed bid deposits, and certain cash seized by law enforcement.

Vending Machine Proceeds

Moneys "*received* by a [local unit] on account of operation of vending facilities" must be deposited, budgeted, appropriated, and expended pursuant to the LGBFCA.⁴ The statute does not require that all proceeds from vending facilities on government property be received by that government. Rather, it simply requires that when such moneys are "received" by the government, they are to be deposited and otherwise handled pursuant to the LGBFCA's provisions. Therefore, if a unit permits others, whether a vending company or a group of employees, to place vending facilities on the unit's property and to retain the proceeds from those facilities, the moneys in question are not subject to the daily deposit requirement. If the unit itself collects and keeps the moneys, however, the funds must be deposited according to the law.

Sealed Bid Deposits

Another likely exception to the daily deposit requirement involves deposits included in sealed bids for construction projects that have yet to be opened by a local unit. It is reasonable to assume that the moneys have not been "received" or "collected" for purposes of G.S. 159-32 until the sealed bids are open.

Cash Seized by Law Enforcement

Cash seized by law enforcement as evidence of a crime also likely has not been "received" or "collected" by the local unit for purposes of G.S. 159-32. Seized cash should be handled by the law enforcement agency in the same manner as other evidence.

4. G.S. 159-17.1 (emphasis added).

Deposited Daily “With the Finance Officer or in an Official Depository”

The statute specifies that moneys must be deposited daily with a local unit’s finance officer or in an official depository. Under the latter option, the employee or official depositing the funds must immediately notify the finance officer by means of a “duplicate deposit ticket.”⁵ Alternatively, moneys may be submitted to a licensed and recognized cash collection service. The finance officer may audit the accounts of any officer or employee collecting or receiving moneys at any time and may prescribe the form and detail of these accounts.⁶ The finance officer must audit all such decentralized collections at least once annually. This is an internal audit; the annual independent audit does not suffice to satisfy this requirement.

Does the statute require that every dollar collected, whether at 9:00 A.M. or 4:59 P.M., be deposited the day it is collected? The answer is “probably not.” A reasonable interpretation of the law is that each department that collects or receives moneys must make at least one deposit each day, either in an official depository or with the unit’s finance officer. In many local units the daily deposit to an official depository is made before the cutoff time (e.g., 2:00 P.M.) set by the depository for crediting interest earnings on deposits made that day. This may result in some funds being retained overnight (or possibly even over a weekend) in a safe or other secure area within a department.

\$500 Threshold

The statute also allows a unit’s governing board to authorize an individual who collects or receives moneys to make the mandated deposit only when moneys on hand amount to \$500 or more, though a deposit must always be made on the last business day of each month.⁷ The board should adopt a resolution indicating its approval of such a policy and ensure that there are sufficient controls to safeguard the amounts outstanding.

Exemptions from Daily Deposit Requirement

G.S. 159-32 states that if another law provides for a different method of depositing moneys collected or received, the daily deposit requirement does not apply. Occasionally other statutes direct that funds collected by a unit be handled differently. For example, G.S. 1-339.70 directs a sheriff to turn over the net proceeds of an execution sale to the clerk of superior court. Similarly, G.S. 15-15 directs a law enforcement officer to disburse the net proceeds of a sale of confiscated, found, or abandoned property to “the treasurer of the county board of education of the county in which such sale is made.”

5. G.S. 159-32.

6. G.S. 159-32. As discussed below, the accounts of each officer or employee who collects or receives moneys must be audited by the finance officer at least once annually.

7. G.S. 159-32. 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 Requirement

Governing Board Selects Official Depositories

Who determines where collected or received moneys are deposited? This task is expressly delegated to the governing board of the unit or authority. A governing board must designate one or more banks, savings and loan associations, or trust companies in the state to serve as the unit's official depository or depositories.⁸ In fact, it is "unlawful for any public moneys to be deposited in any place, bank, or trust company other than an official depository."⁹ With the written permission of the secretary of the Local Government Commission (LGC) a board also may select a nationally chartered bank located in another state as an official depository. (For a number of reasons, the secretary of the LGC 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.) A board may not select a credit union as an official depository, even if it is located in the state.

Selection Process

Local units 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 an official depository and open an account in each. Others maintain just one account, rotating it among each local financial institution that is qualified to serve as an official depository and changing it 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 local units statewide follow a third method—selecting a bank or financial institution to serve as a depository through a request-for-proposals process that awards the business to the institution that offers the most services for the fees charged or the most services for the lowest compensating balance that the county or the municipality must maintain at the bank or financial institution.

Types of Accounts

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 (CDs) that have no check-writing privileges. Generally, the use of interest-bearing accounts is recommended.

8. G.S. 159-31. State law (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 municipality 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.

9. G.S. 159-31.

Insurance and Collateralization of Deposits

Funds on deposit in an official depository (except funds deposited with a fiscal agent for the purpose of making debt-service payments to bondholders¹⁰) must be fully secured.¹¹ This is accomplished through a combination of methods. First, government funds on deposit with a bank or a savings institution or invested in a CD issued by such an institution are insured by the Federal Deposit Insurance Corporation (FDIC). If the funds that a local unit has on deposit or invested in a CD do not exceed the maximum amount of FDIC insurance—currently \$250,000 per official custodian for interest-bearing accounts and an additional \$250,000 per official custodian for non-interest-bearing accounts—no further security is required. For purposes of FDIC regulations, the finance officer is always the official custodian.

Uninsured funds in a bank or a 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 unit’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 unit, the unit is entitled to the escrowed securities in the amount of the default less the amount of FDIC insurance coverage. Under this method, the government must execute certain forms and take certain actions to ensure that deposits are adequately collateralized. Responsibility for assuring that deposits are adequately secured under this method rests with a local unit’s finance officer, who should closely supervise the collateral-security arrangement.

Alternatively, a bank or a 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, though 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.

Reporting Requirements

A unit must notify an official depository each time it opens a new account there that the deposits are subject to the collateralization rules. To assist the depository in keeping its records current, as of June 30 each year, the unit also must provide to each depository a Form COLL-91, “Annual Notification of Accounts by Public Depositor,” which lists the current account names and numbers of all its public deposit accounts. The unit sends a duplicate of the form to the N.C. Office of State Treasurer to assist in the monitoring process. Forms are supplied to the unit by the treasurer’s State and Local Government Division.¹²

10. Moneys in the hands of a fiscal agent need not be secured if they have been remitted to the bank no more than sixty days before the bonds or notes that are being paid mature.

11. G.S. 159-31(b).

12. See N.C. Department of State Treasurer, *Collateralization of Public Deposits* (last visited Feb. 27, 2023).

Liability for Losses

If deposits are adequately and legally secured, no officer or employee of a local unit may be held liable for losses sustained by the unit because of default by the depository.¹³ Under the common law, a custodian of public funds is strictly liable for any such losses. Thus, this statute operates as an exception to the common law rule.

Finance Officer Manages Accounts in Official Depository

The finance officer of a local government unit is charged with oversight and management of all moneys collected or received by the unit and deposited into an official depository.¹⁴ The finance officer also must establish all bank accounts for the local unit.¹⁵ A manager, administrator, department head, or other officer or employee may not open an account, even if it is in an official depository.¹⁶ The finance officer may set up separate accounts within an official depository for each department, or for each project or revenue source, or the finance officer may choose to pool moneys within a single account. Even if moneys are commingled in a single bank account, they still must be accounted for and allocated to the appropriate department according to the unit's or authority's budget ordinance. Revenues that are legally earmarked only for certain purposes also must be traceable to ensure proper expenditure.

The finance officer also is mandated by statute to periodically audit the accounts of any individual or department that collects or receives money. It must be done at least once per year. The statute does not prescribe the form or substance of this internal review. A finance officer is free to develop his or her own metrics to ensure that moneys are being accounted for appropriately. The metrics should be designed to test the sufficiency of internal controls within the department and also to verify that the amount that should be collected or received is actually accounted for in the actual deposits. A finance officer may want to have at least one unannounced spot check as well as regular scheduled reviews of departmental procedures, cash draws, and accounts.

Investments

It would be fiducially irresponsible for local units 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 prescribes allowable investment options for local units. It also makes the finance officer responsible for managing investments, subject to policy directions and restrictions that the unit's governing board may impose.

13. G.S. 159-31(b).

14. G.S. 159-25.

15. G.S. 159-25.

16. As discussed below, however, a unit's governing board may designate other employees or officials as deputy finance officers with authorization to disburse moneys from an account in an official depository. See G.S. 159-28.

Authorized Investments

Among the securities and instruments in which local units invest are CDs or other forms of time deposits approved by the Local Government Commission (LGC) that are offered by banks, savings institutions, and trust companies located in North Carolina.¹⁷ A bank-issued CD has traditionally been the most widely used investment instrument, especially by small- and medium-sized local governments.¹⁸ Other investments authorized by G.S. 159-30(c) are listed below. The available options reflect a policy decision by the legislature to prioritize liquidity and low-risk investments over those with higher potential yields. A local unit is directed to adopt an investment program that is managed such that “investments and deposits can be converted into cash when needed.”¹⁹

1. United States Treasury obligations (bills, notes, and bonds)—called Treasuries—and United States 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 local units. As a result, short-term Treasuries are usually lower yielding than alternative investment securities. Long-term Treasuries and Government National Mortgage Association securities (fully guaranteed by the U.S. government) can experience significant price variations, a characteristic of long-term securities in general; therefore, such securities should be carefully evaluated and 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

Among the agencies that issue this form of investment 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 a very low credit risk, though economic conditions that adversely affect an economic sector heavily financed by the agency (e.g., housing) can create some risk for local units or for others who invest in a local unit’s securities. Some securities provided by these agencies are not direct debt and therefore are not eligible investments for North Carolina governments. Moreover, even though longer-term direct debt of these agencies carries low credit risk, it can experience significant price fluctuations before maturity.

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 LGC

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 local units. However, should

17. G.S. 159-30(b), -30c(5).

18. If a local unit is using a CD as an investment vehicle under G.S. 159-30, the unit is not required to invest in a CD of an official depository.

19. G.S. 159-30(a).

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 to local units as investment instruments.

4. Top-rated commercial paper issued by domestic United States 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, though maturities from 30 to 90 days are most common. For any local unit 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 local units 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 continue to hold the investment to maturity, as the risk of loss is typically low. As long as a commercial paper issuer is top-rated and a local unit's finance officer closely monitors its ratings, the risk for this type of investment is small. Officials should understand, however, 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 United States 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 usually are 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. Local units 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 a non-North Carolina U.S. bank, 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, the bank must receive the highest rating given by each.

6. Participating shares in the North Carolina Capital Management Trust (NCCMT)

The NCCMT is a money market mutual fund established specifically for investments by North Carolina local governments and public authorities. It is certified and regulated by the LGC, and unlike other state-sponsored investment pools for public

entity investments, it is registered with the U.S. Securities and Exchange Commission, which imposes extensive requirements on the fund to ensure the safety of moneys invested. The NCCMT currently manages the Government Portfolio, which was started in 1982 and is intended for the investment of operating cash balances and debt proceeds. The principal value of moneys invested in a share in this portfolio remains fixed at \$1. Funds invested in the NCCMT may be withdrawn on the same day of notice; however, the managers of the portfolios do request that local governments provide one day's advance notice if large withdrawals will be made. The Government Portfolio may invest only in U.S. Treasury securities and U.S. government agency securities which are authorized under G.S. 159-30(c). The Government Portfolio maintains "AAA" ratings from Moody's and Standard & Poor's.

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) authorizes local units to invest in repurchase agreements but only under very limited conditions.²⁰ These conditions have greatly reduced the cost-effectiveness of local government investments in these instruments.

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 can be useful investment vehicles 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-coupon securities have long maturities, they are subject to considerable price

20. The following restrictions apply to local government investments in repurchase agreements: (1) the underlying security acquired with a repurchase agreement must be a direct obligation of the United States or fully guaranteed by the United States; (2) the repurchase agreement must be sold by a broker or a dealer recognized as a primary dealer by a Federal Reserve Bank or by a commercial bank, a trust company, or a national bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC); (3) the security underlying the agreement must be delivered in physical or in electronic book-entry form to the local unit or its third-party agent; (4) the value of the underlying security must be determined daily and must be maintained, at least, at 100 percent of the repurchase price; (5) the local unit must have a valid and perfected first security interest in the underlying security. This can be achieved through delivery of the security to the local unit or its third-party safekeeping agent under a written agreement; (6) the underlying security acquired in the repurchase agreement must be free of any lien or third-party claim.

fluctuations before maturity and should not be used for the investment of general county funds. If investments are made in these securities and market interest rates later rise substantially, a county that has to cash in the investment before maturity may lose a significant portion of the principal invested in the securities.

9. Certain mutual funds for moneys held by either a county or a municipality 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, under strict procedures, in tax-exempt and taxable mutual funds. 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 they may be eligible investments if they are otherwise authorized in G.S. 159-30(c). The term *derivatives* refers 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 U.S. 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 chapter to explain these different types of derivatives. It suffices 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, municipal, and other local government finance officers. Many derivatives are not legal investment instruments for North Carolina 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 U.S. government are usually legal investments. However, many if not most of them are inappropriate as investment vehicles for counties or municipalities 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 local unit's moneys 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.

Custody of Investment Securities

The LGBFCA requires that “[s]ecurities and deposit certificates shall be in the custody of the finance officer [of a local government unit] who shall be responsible for their safekeeping.”²¹ Investment securities come in two forms: certificated and noncertificated. Ownership of certificated investments is represented by an actual physical security. Some CDs and certain other securities are issued in certificated form. To obtain proper custody of certificated securities, a finance officer should hold the securities or the certificates in the local unit’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—U.S. 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 maintained by the Federal Reserve System for banks and certain other financial institutions and by the financial institutions themselves. In addition, for certain other securities, the Depository Trust Co. in New York maintains the electronic records of ownership. When a local unit 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 authorized to conduct trust business in North Carolina. Local units 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 local unit 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 local unit or its 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.

Distribution of Investment Proceeds

Interest earned by a local government unit on deposits and investments must be credited to the fund in which cash is deposited or invested.²² This is true even if moneys from different funds are pooled for investment purposes. In that case, a prorated share of the investment income must be allocated to each fund from which the moneys derived.

21. G.S. 159-30(d).

22. G.S. 159-30(e).

Finance Officer Responsible for Investments

A local unit's finance officer is statutorily charged with managing the unit's investments.²³ In conducting an investment program, a finance officer must forecast cash resources and needs, thus determining how much is available for investment and for how long. A finance officer also must investigate what types of investment securities are authorized by law and by the unit's 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.

A governing board, however, should establish general investment policies and restrictions for its finance officer 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 above); and make clear that safety and liquidity should take precedence over yield in the county's or the municipality's investment program. A growing number of local governing boards are adopting such investment policies.

Guidelines for Investing Public Funds

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

1. An investment program should put safety and liquidity before yield.

A local unit should not put its investment funds at risk of loss in the interest of obtaining higher investment earnings. The temptation to sacrifice safety for yield is particularly great when interest rates are falling and local government officials are attempting to maintain investment earnings and revenues. Any local unit should always have funds available to meet payment obligations as they come 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 its finance officer understands.

Many investment vehicles, including most derivatives, are extremely complex. Before purchasing a security, a finance officer should thoroughly understand all of its components—especially how its value is likely to increase or decrease with changes in market interest rates. A finance officer who is considering investing in a type of security that has not been used before should obtain and study the prospectus or equivalent information for the security and talk to LGC staff and other informed, disinterested parties about the nature and risks of that security.

23. See G.S. 159-30(a), -25(a).

3. A finance officer and other officials involved in investing a local government 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 easily be lost or “misplaced” in such an environment. To protect the local government, 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 generally accepted accounting principles (GAAP) also refers to the importance of knowing one's brokers or dealers. A finance officer should obtain a list of the North Carolina local government clients of any firm or person attempting to sell investment securities and obtain references from these officials. 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 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. A county's or municipality's finance officer should ensure that the local unit 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.

Insurance and collateralization must be in accordance with statutory requirements.

5. A local government's investment program should be conducted pursuant to the cash management and investment policy approved by its governing board.

Such a policy should be based on G.S. 159-30 and related statutes. It should set forth the governing board's directions and expectations about which investments will be made and how they will be made and should establish general parameters for the receipt, disbursement, and management of moneys.

6. A local government finance officer should report periodically to the governing board on the status of the unit's investment program.

Such a report should be made at least semiannually—preferably quarterly or monthly—and should show the securities in the local government's investment portfolio, the terms or maturities of those investments, and their yields. If possible, average investment maturity and yield also should be calculated and shown in this report.

7. A local government should understand that the use of investment managers does not relieve its finance officer of the responsibility of safeguarding public funds.

A few counties and municipalities 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 a county/municipal finance officer to

have direct control of investments even though he or she has responsibility for them. Also, because of legal restrictions on the types of investments local governments can make, the return an investment manager can earn for the unit after management fees have been deducted may be lower than the return the unit can earn on its own. It also should be noted that local legislation may be required in order for an entity to engage an outside investment manager. 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.

Obligating and Disbursing Public Funds

Article V, Section 7(2) of the North Carolina Constitution provides that “[n]o money shall be drawn from the treasury of any county, city or town, or other unit of local government except by authority of law.” The LGBFCA establishes the requirements regarding disbursement of public funds. Through both the budget ordinance and project ordinances, a governing board authorizes a local unit to undertake programs or projects and to spend moneys.²⁴ G.S. 159-8 directs that no local unit “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 the budget ordinance and any project ordinances. For example, budget and project ordinances are required by law to be balanced. If a unit complies with these directives, deficit spending should not occur and the board’s policies and priorities will be carried out.

The principal legal mechanisms for ensuring a local unit’s compliance with the budget ordinance and each project ordinance are the *preaudit* and *disbursement* processes prescribed by the LGBFCA. Both processes are set forth in G.S. 159-28. The statute also specifies the forms of payment that a local unit may use to satisfy its obligations.

Preaudit Requirement

G.S. 159-28(a), (a1), and (a2), collectively referred to as the preaudit requirement, state as follows:

- (a) Incurring Obligations.—No obligation may be incurred in a program, function, or activity accounted for in a fund included in the budget ordinance unless the budget ordinance includes an appropriation authorizing the obligation and an unencumbered balance remains in the appropriation sufficient to pay in the current fiscal year the sums obligated by the transaction for the current fiscal year. No obligation may be incurred for a capital project or a grant project authorized by a project ordinance unless that project ordinance includes an appropriation authorizing the obligation and an unencumbered balance remains in the appropriation sufficient to pay the sums obligated by the transaction. Nothing in this section shall require a contract to be reduced to writing.

24. For information on the annual budget ordinance and project ordinances, see Chapter 3, “Budgeting for Operating and Capital Expenditures.”

- (a1) Preaudit Requirement.—If an obligation is reduced to a written contract or written agreement requiring the payment of money, or is evidenced by a written purchase order for supplies and materials, the written contract, agreement, or purchase order shall include on its face a certificate stating that the instrument has been preaudited to assure compliance with subsection (a) of this section. The certificate, which shall be signed by the finance officer, or any deputy finance officer approved for this purpose by the governing board, shall take substantially the following form:

“This instrument has been preaudited in the manner required by the Local Government Budget and Fiscal Control Act.

(Signature of finance officer [or deputy finance officer]).”

- (a2) Failure to Preaudit.—An obligation incurred in violation of subsection (a) or (a1) of this section is invalid and may not be enforced. The finance officer shall establish procedures to assure compliance with this section, in accordance with any rules adopted by the Local Government Commission.

To fully understand the preaudit requirement, it is helpful to break the analysis down into three parts—(1) determining when the statutory provisions apply, (2) determining what the statute requires, and (3) determining what happens if the requirements are not met.

When Does G.S. 159-28(a) Apply?

G.S. 159-28(a) applies when a local unit incurs an obligation that is accounted for in the budget ordinance or in a project ordinance. An obligation is incurred when a unit commits itself to pay money to another entity. Examples include placing orders for supplies and equipment, entering into contracts for services, and even hiring an employee. There is no minimum threshold amount to trigger the requirement. If a contract, purchase order, or other agreement commits the unit to an expenditure of any amount of money, an obligation is incurred. It also does not matter if the liability is uncertain.²⁵ An obligation is incurred, for example, when a unit engages a law firm and agrees to pay an hourly fee for work that will be performed during the fiscal year, even though the total number of hours likely will not be known at the outset of the agreement. The form of the obligation also is irrelevant. A local unit may incur an obligation by executing a construction contract, issuing an electronic purchase order for goods, or verbally committing to pay a salary to a newly hired at-will employee.

25. *See, e.g.,* Transp. Servs. of N.C., Inc. v. Wake Cnty. Bd. of Educ., 198 N.C. App. 590 (2009) (holding that contract in which school board agreed to compensate transportation services provider for services on per-student-assigned basis was subject to preaudit requirement under analogous provision to G.S. 159-28); Watauga Cnty. Bd. of Educ. v. Town of Boone, 106 N.C. App. 270 (1992) (declaring that resolution passed by town requiring that 18 percent of profits of town’s ABC store be given to school system was subject to preaudit requirement).

Specific Performance Obligations

A preaudit is not required, however, if a unit enters into a contract or agreement that does not commit the unit to pay money. An example is an agreement by a municipality to provide water to a commercial entity located outside its borders. Such a contract commits the unit to perform a specific task; it does not, however, commit the unit to pay money. This type of arrangement is often referred to as a contract for specific performance, and it does not trigger the preaudit requirement.²⁶

Continuing (Multi-Year) Contracts

What about continuing contracts—contracts that extend for more than one fiscal year? Whether or not the preaudit is triggered depends in part on whether the appropriation authorizing the obligation is accounted for in the annual budget ordinance or in a project ordinance.

Annual Budget Ordinance Appropriations

If the appropriation authorizing the obligation is accounted for in the budget ordinance and it is certain that the unit will have to expend money under the contract in the fiscal year in which it is entered into, an obligation is incurred for purposes of G.S. 159-28(a). If, however, a local unit does not expect to expend money in the current fiscal year, or if it is certain that the unit will not have to expend money in the current fiscal year, things get a little murkier. There are a couple of court of appeals cases suggesting that if there is a good chance that no resources will be expended in the year in which the contract or agreement is entered into, then a preaudit is not needed. In *Myers v. Town of Plymouth*,²⁷ the town entered into an employment contract with the town manager in March 1997 (fiscal year 1996–97), whereby the manager agreed to work for the town for four years. Both the town and the manager reserved the right to terminate the employment relationship with thirty days' notice. The contract provided the manager with a severance package if he was terminated by the town for any reason except felonious criminal conduct or a failure of performance that the manager failed to rectify after appropriate notice. The following December (fiscal year 1997–98) a new town council was seated, and within a few months the new council terminated the manager and refused to pay the severance package. The manager sued. Among other defenses, the town argued that the employment contract was void because it lacked a preaudit certificate (one of the requirements of G.S. 159-28(a)). The court disagreed, holding that no preaudit was needed because it was highly improbable that the town would have been required to pay the severance package in the fiscal year in which the contract

26. Compare *Lee v. Wake Cnty.*, 165 N.C. App. 154 (2004) (holding that an agreement to enter into a formal settlement agreement did not require a preaudit because it was “an action for specific performance, not for the payment of money”), and *Moss v. Town of Kernersville*, 150 N.C. App. 713 (2002) (holding that a consent agreement, whereby the town agreed to make certain repairs to a dam, did not require a preaudit certificate because it was a contract for specific performance, not a contract requiring the payment of money), with *Cabarrus Cnty. v. Systel Bus. Equip. Co.*, 171 N.C. App. 423 (2005) (holding that the settlement agreement at issue, which required the county to pay a specified amount of money, required a preaudit).

27. 135 N.C. App. 707 (1999); see also *M Series Rebuild, LLC v. Town of Mount Pleasant*, 222 N.C. App. 59, review denied, 366 N.C. 413 (2012) (noting that a preaudit was required of a “contract and obligation to pay [that were] both created in the same fiscal year.”); *Davis v. City of Greensboro*, 770 F.3d 278 (4th Cir. 2014) (holding that a preaudit certificate was not required on law enforcement and firefighter longevity pay contracts, where no payments came due during the fiscal year in which the contracts were entered into).

was signed. (And, in fact, the town was not required to pay the severance package in the fiscal year in which the contract was signed.)

It is not entirely clear how broadly to read *Myers*. The holding may be limited to the unique factual scenario presented by this one case. Even if it is meant to be applied more broadly, the holding leaves many unanswered questions. For example, it is not clear how low the probability or possibility of incurring an obligation in the current fiscal year must be for the preaudit requirement not to apply. Given this ambiguity, it may be safer for a unit to comply with G.S. 159-28(a) if there is any chance it will have to expend funds under a contract, agreement, or purchase order in the current fiscal year.

If a preaudit is required for a multi-year contract, the finance officer or deputy finance officer of a local unit will only be attesting that there is a budget appropriation for the amount expected to come due in the current fiscal year. The unit is not required to re-preaudit the contract in future fiscal years. However, G.S. 159-13 generally requires a governing board to appropriate sufficient moneys each year to cover the amounts due that year under continuing contracts.

Project Ordinance Appropriations

If an appropriation authorizing an obligation is accounted for in a capital- or grant-project ordinance, the preaudit is triggered regardless of whether any amounts are expected to come due in the fiscal year in which the obligation is incurred. A project ordinance is effective for the life of the project. It does not expire at the end of each fiscal year.²⁸ The preaudit will be for the full amount of the obligation.

Electronic Transactions

Finally, what about when a unit places an Internet order for park equipment and pays for the equipment with a credit card? Or when a unit makes a p-card (purchase card) purchase from a local vendor for water treatment chemicals? Or when an ambulance crew member uses a fuel card at a local gas station? Do electronic payment transactions such as these require a preaudit?

A preaudit is required if

1. a unit enters into a contract or agreement or places an order for goods or services that are accounted for in the budget ordinance or a project ordinance *and*
2. the unit is obligated to pay money by the terms of the contract/agreement/order *and*
3. if the obligation is accounted for in the annual budget ordinance, the unit anticipates paying at least some of the money in the fiscal year in which the contract/agreement/order is entered into.

The answer is “yes”; the preaudit requirements do apply to these transactions. An obligation is incurred for purposes of the preaudit statute in a credit card transaction when a unit uses the credit card, p-card, or fuel card to pay for goods or services. That is when the unit is authorizing the issuing company to pay the vendor or contracting party and thereby committing the unit to

28. See G.S. 159-13.2.

pay money (to the issuing company) to cover the costs of the expenditure. When the General Assembly authorized local units to make “electronic payments” (defined as payment by charge card, credit card, debit card, or by electronic funds transfer), it specified that each electronic payment “shall be subject to the preaudit process. . . .”²⁹ As discussed below, a local unit must comply with any rules adopted by the Local Government Commission (LGC) in executing electronic payments.³⁰

The text box above summarizes when the preaudit is triggered.

What Does G.S. 159-28(a) Require?

Before a local unit incurs an obligation subject to the preaudit, its finance officer (or a deputy finance officer approved by the unit’s governing board for this purpose) must take the following actions.

1. *Ensure that there is a budget or a project ordinance appropriation authorizing the obligation.* This typically is not much of a hurdle because the budget ordinance and project ordinances often are adopted at a very general level of legal control. In fact, units are authorized to make budget appropriations only by department, function, or project.³¹ (A preaudit is not performed on line-item appropriations in the unit’s “working budget.”)
2. *Ensure that sufficient funds will remain in the appropriation to pay the amounts that are expected to come due.* If the obligation is accounted for in the annual budget ordinance, the appropriation need cover only the amount that is expected to come due in the current fiscal year. However, if the obligation is accounted for in a project ordinance, the appropriation must be for the full amount due under the contract.
3. *If the order, contract, or agreement is in writing, affix and sign a preaudit certificate to the “writing.”* If the order, contract, or agreement is not in writing—such as a telephone order or other verbal agreement—a preaudit certificate is not required.³² In addition, as discussed below, a few types of transactions may be exempt from the preaudit certificate requirement even if they are in writing.

29. G.S. 159-28(d2).

30. The LGC rules ensure that the local unit properly performs the preaudit process before undertaking an electronic transaction.

31. For more information on the budgeting process, see Chapter 3, “Budgeting for Operating and Capital Expenditures.”

32. Note, however, that other provisions of law may require a particular contract or agreement to be in writing. For example, all contracts entered into by a municipality must be in writing, though the governing board of the municipality may ratify a contract that violates this provision. G.S. 160A-16. All contracts involving the sale of “goods” for the price of \$500 or more must be in writing. G.S. 25-2-201. And contracts for purchases and construction or repair subject to formal bidding requirements must be in writing. G.S. 143-129(c).

Complying with Preaudit Requirement

The statute envisions that all of these steps be performed before the obligation is incurred—that is, before the goods are ordered or before the contract is executed. It is not sufficient to perform the preaudit process after a contract is executed.³³ As numerous finance officers have attested, though, complying with these requirements can be very difficult.

G.S. 159-28 directs a unit’s finance officer to “establish procedures to assure compliance” with the statute. Thus, a finance officer has a great deal of flexibility to design ordering and contracting processes that comply with the statute (or at least come close). The processes likely will vary depending on the size of the unit, the number of personnel, and the various needs of the departments within the unit.

One important tool that often is overlooked by units is statutory authority for the governing board to appoint one or more deputy finance officers to perform the preaudit process.³⁴ To the extent that individual departments in a unit need to order goods or enter into service contracts, the governing board can appoint one or more department heads (or other department employees) as deputy finance officers. The deputy finance officers then would be authorized to enter into obligations consistent with their department budget appropriations.

Even if all ordering/contracting is centralized within a unit’s finance office, it may be impossible for the finance officer to actually perform the preaudit process for each obligation. Again, the governing board could appoint other finance office employees as deputy finance officers to perform the preaudit. The finance officer also could delegate the ministerial job of performing the preaudit process, including affixing the finance officer’s signature to the preaudit certificate. Under the latter approach, though, it is important that the finance officer trust that the preaudit process will be performed properly because the finance officer could be held liable for any statutory violations.

Exemptions from Preaudit Certificate Requirement

Recognizing these practical difficulties, the legislature has exempted certain transactions from the preaudit certificate requirement, even if the order, contract, or agreement is in writing. There are three categories of exempt transactions. The first two apply automatically. The third applies only if the LGC adopts certain rules and the local unit follows those rules. The fourth applies only if the LGC certifies that a local government’s accounting system meets statutory requirements. (It is worth emphasizing that all of these exemptions apply only to the preaudit certificate requirement. A unit still must perform the other preaudit steps before incurring an obligation pursuant to one or more of the exempt transactions.)

Exemption 1: Any obligation or document that has been approved by the LGC.³⁵

This exemption from the preaudit certificate requirement applies to loan agreements, debt issuances, and other leases and financial transactions that are subject to LGC

33. A trial court judge invalidated an interlocal agreement between a city and a county because the preaudit certificate had been affixed to the contract after the contract was executed (that is, after it was signed by both parties). See Jon Hawley, “Judge Voids Water Contract,” *DailyAdvance.com*, Apr. 12, 2016.

34. See G.S. 159-28(a1).

35. G.S. 159-28(f)(1).

approval and have, in fact, been so approved.³⁶ It also likely applies to audit contracts, which must be approved by the LGC pursuant to G.S. 159-34.

Exemption 2: Payroll expenditures, including all benefits for employees of the local unit.³⁷

This exemption ensures that salary and benefit changes for current employees, even if in writing, do not need to include a preaudit certificate.

Exemption 3: Electronic payments, defined as payments made by charge card, credit card, debit card, gas card, or procurement card.³⁸

Electronic payments often are the most difficult to preaudit. The point of transaction often occurs off-site or on the vendor's proprietary software. A local unit, therefore, is not easily able to include a signed preaudit certificate. This exemption eliminates the problem. It only applies, however, if the local unit follows the rules adopted by the LGC. The LGC rules are considered a safe harbor. In other words, the law presumes compliance with the statutory preaudit requirements if a finance officer or deputy finance officer follows the LGC rules. The rules must ensure that a local unit properly performs the other steps in the preaudit process before undertaking an electronic transaction.³⁹

The LGC rules are part of the North Carolina Administrative Code (Title 20, Chapter 03, Section .0409). These rules require the following:

Resolution

A local unit's governing board must adopt a resolution authorizing the unit to engage in electronic transactions. That resolution authorizes the unit's employees and officials to use p-cards, credit cards, and/or fuel cards, and it either incorporates (by reference) the unit's written policies related to the use of those cards or authorizes the finance officer to prepare those policies.

Encumbrance System

State law requires that certain local units that meet certain population thresholds (municipalities with a population over 10,000 and counties with a population over 50,000) incorporate encumbrance systems into their accounting systems. In order to comply with the new LGC regulations, all units will need to implement encumbrance systems. For units under the population thresholds listed above, the encumbrance system does not have to be incorporated into the unit's accounting system. In fact, for small units, it can be as simple as tracking expenditures against budget appropriations in a spreadsheet or even on index cards. To facilitate individual transactions, though, a unit might want to create a shared electronic document that can be accessed by anyone authorized to make purchases.

36. To determine the types of contracts that are subject to LGC approval, see Kara Millonzi, "Local Government Commission (LGC) Approval of Contracts, Leases, and Other (Non-Debt) Financing Agreements," *Coates' Canons: NC Local Government Law* blog (Aug. 9, 2012).

37. G.S. 159-28(f)(2).

38. G.S. 159-28(f)(3).

39. G.S. 159-28(d2).

Policies and Procedures

A local unit's governing board or finance officer must adopt written policies that outline the unit's procedures for using p-cards, credit cards, and/or fuel cards. At a minimum, the policies need to provide a process to ensure that *before each transaction is made*, the individual making the transaction

1. ensures that there is an appropriate budget ordinance or project/grant ordinance appropriation authorizing the obligation (for school units, the reference should be to the budget resolution);
2. ensures that sufficient moneys remain in the appropriation to cover the amount expected to be paid out in the current fiscal year (if the expenditure is accounted for in the budget ordinance/resolution) or the entire amount (if the expenditure is accounted for in a project/grant ordinance);
3. records the amount of the transaction in the unit's encumbrance system or reports the amount to another individual (either within the individual's department or within the finance department) to encumber; as stated above, in order to comply with this requirement, each unit must have an encumbrance system.

In addition to these requirements, a unit's p-card, credit card, and/or fuel card policies should address who has custody of the cards, who has access to the cards, what dollar limits are placed on the cards and individual transactions, what expenditure category limits are placed on the cards, and how transactions must be documented for reconciliation with the monthly bills. They should also state the consequences for failure to comply with these policies. The local unit's finance officer is responsible for overseeing all electronic payments, and the policies must build in sufficient controls to allow the finance officer to carry out his or her duties.

Policies will vary significantly by local unit and by type of transaction. They need to address all the different ways in which p-card, credit card, or fuel card transactions may occur and be detailed enough to inform individual employees and officials of the exact steps they must take (and how to take them) before initiating a p-card, credit card, or fuel card transaction. At the same time, they need to be flexible enough to allow local officials to carry out their day-to-day responsibilities effectively. Finance officers may be well advised to consult with department heads and others in their units and formulate policies that track existing business practices as much as possible.

These new rules do not supplant the preaudit process in its entirety. They merely provide a workable alternative to affixing the preaudit certificate to an electronic payment. And these policies, alone, may not provide sufficient internal controls. Finance officers are well advised to implement additional controls in areas where misappropriations are more likely to occur.

Training

Once the policies are enacted, the local unit must provide training to all personnel about the policies and procedures to be followed before using a p-card, credit card, or fuel card. Training should be repeated at regular intervals and presented to all new employees and officials early in their tenures. And the local unit's governing board needs to set an expectation of full compliance with the preaudit policies by all employees and officials.

Quarterly Reports

A local unit's staff must prepare and present to the unit's governing board a budget-to-actual statement by fund at least quarterly. The statement needs to include budgeted accounts, actual payments made, amounts encumbered, and the amount of the budget that is unobligated. It is incumbent on the board to gain sufficient training on how to properly interpret these reports in order to carry out the board's fiduciary responsibility to the unit.

If a local government unit uses p-cards, credit cards, and/or fuel cards it must follow the new regulations. The reason is that it is impossible to affix the signed preaudit certificate to p-card, credit card, or fuel card transactions. It is not sufficient to perform the preaudit after the transaction is completed. Because a transaction is void if the preaudit is not followed, a local unit will need to follow the new rules to come into legal compliance.

Exemption 4: Automated accounting system.

A local unit may perform its preaudit process using an automated accounting system.⁴⁰ The system must do all of the following:

1. embed functionality that determines that there is an appropriation to the department, function code, or project in which the transaction appropriately falls;
2. ensure that unencumbered funds remain in the appropriation to pay out any amounts that are expected to come due during the budgeting period; and
3. provide real-time visibility to budget compliance, alert threshold notifications, and rules-based compliance measures and enforcement.⁴¹

If a local unit's accounting system performs these functions, the unit is not required to include a signed preaudit certificate on any contract, agreement, purchase order, or other writing evidencing a transaction subject to the preaudit requirement. Within thirty days of the start of each fiscal year, a local unit's finance officer must certify to the LGC that the unit's accounting system meets these requirements.⁴² The LGC's Secretary may reject or revoke the finance officer's certification if the prior year's annual audit includes a finding of budgetary noncompliance or if the LGC's Secretary determines that the automated financial computer system fails to meet the statutory requirements.⁴³

It is worth emphasizing that all of these exemptions apply only to the preaudit certificate requirement. A unit still must perform the other preaudit steps before incurring an obligation pursuant to one or more of the exempt transactions.

What Happens if a Unit Does Not Comply with the Preaudit Requirements?

As the statute makes clear, failure to perform any of the applicable preaudit requirements makes a contract, agreement, or purchase order connected with a local government transaction void.⁴⁴ That is the equivalent of saying that it was never entered into to begin with. It does not matter

40. G.S. 159-28(a3).

41. G.S. 159-28(a3).

42. G.S. 159-28(a4). The certification form is available from the N.C. Department of State Treasurer.

43. G.S. 159-28(a4).

44. See, e.g., *L&S Leasing, Inc. v. City of Winston-Salem*, 122 N.C. App. 619 (1996); *Cincinnati Thermal Spray, Inc. v. Pender Cnty.*, 101 N.C. App. 405 (1991).

if either or both parties have performed under the contract. The court of appeals has further held that parties may not recover against government entities under a theory of estoppel when a contract is deemed invalid for lack of compliance with the preaudit requirements.⁴⁵

The statute also provides that if “an officer or employee [of a local unit] incurs an obligation or pays out or causes to be paid out any funds in violation of [the preaudit statute], he [or she] and the sureties on his [or her] official bond are liable for any sums so committed or disbursed.”⁴⁶ This means that if any officer or employee orders goods or enters into a contract or agreement subject to a preaudit before the process is completed, he or she could be held personally liable by the unit’s governing board for the amounts obligated, even if the unit never actually incurs the expense.

If a finance officer or a deputy finance officer gives a false certificate, he or she also may be held liable for the sums illegally committed or disbursed. It is a Class 3 misdemeanor, and may result in forfeiture of office, if a finance officer, or a deputy finance officer, knowingly gives a false certificate.⁴⁷

Disbursement Requirement

When a unit receives an invoice, bill, or other claim, it must perform a disbursement process before making payment. Specifically, G.S. 159-28(b) requires that

[w]hen a bill, invoice, or other claim against a local government or public authority is presented, the finance officer shall either approve or disapprove the necessary disbursement. If the claim involves a program, function, or activity accounted for in a fund included in the budget ordinance or a capital project or a grant project authorized by a project ordinance, the finance officer may approve the claim only if both of the following apply:

- (1) The finance officer determines the amount to be payable.
- (2) The budget ordinance or a project ordinance includes an appropriation authorizing the expenditure and either (i) an encumbrance has been previously created for the transaction or (ii) an unencumbered balance remains in the appropriation sufficient to pay the amount to be disbursed.

The finance officer may approve a bill, invoice, or other claim requiring disbursement from an intragovernmental service fund or trust or agency fund not included in the budget ordinance, only if the amount claimed is determined to be payable.

45. *See, e.g.,* Transp. Servs. of N.C., Inc. v. Wake Cnty. Bd. of Educ., 198 N.C. App. 590 (refusing to allow claim against school based on estoppel in absence of valid contractual agreement because of lack of preaudit certificate); *Finger v. Gaston Cnty.*, 178 N.C. App. 367 (2006) (“To permit a party to use estoppel to render a county contractually bound despite the absence of the [preaudit] certificate would effectively negate N.C. Gen. Stat. Sect. 159-28(a).”); *Data Gen. Corp. v. Cnty. of Durham*, 143 N.C. App. 97 (2001) (“[T]he preaudit certificate requirement is a matter of public record . . . and parties contracting with a county within this state are presumed to be aware of, and may not rely upon estoppel to circumvent, such requirements.”).

46. G.S. 159-28(e). The governing board must “determine, by resolution, if payment from the official bond shall be sought and if the governing board will seek a judgment from the finance officer or duly appointed deputy finance officer for any deficiencies in the amount.” *Id.*

47. G.S. 159-181.

A bill, invoice, or other claim may not be paid unless it has been approved by the finance officer or, under subsection (c) of this section, by the governing board. The finance officer shall establish procedures to assure compliance with this subsection, in accordance with any rules adopted by the Local Government Commission.

G.S. 159-28(d1) further provides,

Except as provided in this section, each check or draft on an official depository shall bear on its face a certificate signed by the finance officer or a deputy finance officer approved for this purpose by the governing board (or signed by the chairman or some other member of the board pursuant to subsection (c) of this section). The certificate shall take substantially the following form:

“This disbursement has been approved as required by the Local Government Budget and Fiscal Control Act.

(Signature of finance officer).”

The disbursement requirement is often confused (or conflated) with the preaudit requirement. Although the processes appear similar, they are not interchangeable. G.S. 159-28 envisions that most obligations will be subject to both the preaudit and the disbursement process. The disbursement process occurs when a local unit actually disburses public funds, that is, when the unit pays for the goods or services. (By contrast, the preaudit process is triggered when the goods are ordered or a contract is entered into.)

Complying with the Disbursement Process

The law requires a local unit’s finance officer (or a deputy finance officer designated by the unit’s governing board for this purpose) to do the following before paying a bill, invoice, or other claim that is accounted for in the budget ordinance or in a project ordinance:

1. Verify that the amount is due and owing. If the amount claimed is not due and owing because, for example, the goods did not arrive or the services were not performed, then the finance officer or deputy finance officer may not authorize the disbursement. (Part of performing this process requires that the officer verify that the preaudit process was properly performed when the obligation was incurred. G.S. 159-181 makes it a Class 3 misdemeanor for any officer or employee to approve a claim or bill knowing it to be invalid.)⁴⁸
2. Make sure that there is (still) an appropriation authorizing the expenditure.
3. Make sure that sufficient funds remain in the appropriation to pay the amount due. If there is no budget appropriation for the expenditure, or more commonly, if sufficient unencumbered funds do not remain in the appropriation, the finance officer or deputy finance officer may not authorize the disbursement. The governing board must first amend the budget (or project/grant) ordinance to make (or increase) the appropriation.

48. See G.S. 159-181. It could result also in forfeiture of office and a statutory fine.

4. Include a signed disbursement certificate on the face of the check or draft.⁴⁹ Note that the text of the disbursement certificate varies slightly from the text of the preaudit certificate. It states “This disbursement has been approved as required by the Local Government Budget and Fiscal Control Act.” This is yet another reminder that these are two separate processes.

Exemptions from Disbursement Certificate Requirement

Certain transactions may be exempt from the disbursement certificate requirement. There are three categories of exempt transactions. The first two apply automatically. The third applies only if the LGC adopts certain rules and the local unit follows those rules.

1. Any disbursement related to an obligation that has been approved by the LGC

This exemption from the disbursement certificate requirement applies to any payments related to loan agreements, debt issuances, and other leases and financial transactions that are subject to LGC approval and have, in fact, been so approved.⁵⁰ It also likely applies to audit contract payments.

2. Any disbursement related to payroll or other employee benefits

This exemption applies to payroll checks or payroll direct deposits. It also exempts any payments related to employee benefits, whether disbursed to the employee directly or to another entity on behalf of an employee.

3. Any disbursement done by electronic funds transfer, as long as the local unit follows rules adopted by the LGC

An electronic funds transfer is defined as “a transfer of funds initiated by using an electronic terminal, a telephone, a computer, or magnetic tape to instruct or authorize a financial institution or its agent to credit or debit an account.”⁵¹ A local unit is not easily able to include a signed disbursement certificate on its electronic funds transfers. This exemption would eliminate the problem. It only applies, however, if the local unit follows rules adopted by the LGC governing electronic payments. The rules must ensure that the unit’s finance officer or a deputy finance officer has performed the other steps in the preaudit process before the transaction occurs. Following the LGC rules is considered a safe harbor. In other words, the law presumes compliance with the statutory disbursement requirements if a finance officer or deputy finance officer follows the LGC rules.

The LGC rules became effective on November 1, 2017, and are part of the North Carolina Administrative Code (Title 20, Chapter 03, Section .0410). They require the following:

Resolution

A local unit’s governing board must adopt a resolution authorizing the unit to engage in electronic funds transfer, defined in G.S. 159-28(g) as “[a] transfer of funds initiated by using an electronic terminal, a telephone, a computer, or magnetic tape to instruct or authorize a

49. A disbursement certificate is not required for certain electronic funds transfers.

50. To determine the types of contracts that are subject to LGC approval, see Millonzi, note 36 above.

51. G.S. 159-28(d2).

financial institution or its agent to credit or debit an account.” A common means of making an electronic funds transfer is through an ACH (automated clearinghouse) payment. ACH payments occur when a local government gives an originating institution, corporation, or other originator authorization to debit directly from the local unit’s bank account for purposes of bill payment. The resolution should incorporate written policies for making electronic fund transfers or delegate the responsibility for creating such policies to the unit’s finance officer.

Policies and Procedures

A local unit’s governing board or finance officer must adopt written policies that outline the procedures for making electronic fund transfers to disburse public funds. At a minimum, the policies need to

1. ensure that the amount claimed is payable;
2. ensure that there is a budget ordinance or project/grant ordinance appropriation authorizing the expenditures;
3. ensure that sufficient moneys remain in the appropriation to cover the amount that is due to be paid out;
4. ensure that the unit has sufficient cash to cover the payment.

The first three steps mirror those laid out in the statute itself (G.S. 159-28(b)). The last step simply makes sure that the local unit does not “bounce a check,” so to speak. There must be sufficient cash in the account to transfer out to cover the payment.

These exemptions apply only to the disbursement certificate requirement. A unit still must perform the other disbursement process steps before disbursing funds for (or by) one or more of the exempt transactions.

What Happens if a Unit Does Not Comply with the Disbursement Requirements?

As with the preaudit, “if an officer or employee . . . pays out or causes to be paid out any funds in violation [of G.S. 159-28], he and the sureties on his official bond are liable for any sums . . . so disbursed.”⁵² Moreover, if a finance officer or a deputy finance officer gives a false disbursement certificate, he or she also may be held liable for the sums illegally committed or disbursed. It is a Class 3 misdemeanor, and may result in forfeiture of office, if the officer knowingly gives a false certificate.⁵³

Governing Board Override

If a local unit’s finance officer or deputy finance officer disapproves a bill, invoice, or other claim, the unit’s governing board may step in to approve payment.⁵⁴ The board may not approve payment, however, if there is not an appropriation in the budget ordinance or in a project ordinance or if sufficient funds do not remain in the appropriation to pay the amount due. The

52. G.S. 159-28(e). The governing board must “determine, by resolution, if payment from the official bond shall be sought and if the governing board will seek a judgment from the finance officer or duly appointed deputy finance officer for any deficiencies in the amount.” *Id.*

53. G.S. 159-181.

54. See G.S. 159-28(c).

board must adopt a resolution approving the payment, which must be entered in the board's meeting minutes along with the names of the members voting in the affirmative. The board's chairperson, or designated member, may sign the disbursement certificate.

If the board approves payment and it results in a violation of law, each member of the board voting to allow payment is jointly and severally liable for the full amount of the check or draft.

Forms of Payment

G.S. 159-28(d) directs that all bills, invoices, salaries, or other claims be paid by check or draft on an official depository, bank wire transfer from an official depository, electronic payment or electronic funds transfer, or cash. 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 (ACH) 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. A local unit may pay with cash only if its governing board has adopted an ordinance authorizing it as a payment option and specifying when it is allowed.⁵⁵

Dual Signature Requirement on Disbursements

G.S. 159-25(b) requires each check or draft from a local unit 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 [unit’s] governing board.” The finance officer’s (or deputy finance officer’s) signature attests to completion of review and accompanies the disbursement certificate described above. The second signature may be by the chair of the board of commissioners, the mayor of the municipality, the manager, or some other official. (If the governing board does not expressly designate the countersigner, G.S. 159-25(b) directs that for counties it should be the board chair or the chief executive officer (i.e., the manager, administrator, or director of the unit).)

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 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 a local unit’s 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.”

55. G.S. 159-28(d)(4).

Electronic 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 local units all across North Carolina. To do so, a unit's 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. A unit's 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).

Local Internal Controls

As stated in the introduction to this chapter, the LGBFCA provides a minimum set of procedures that local units must follow in depositing, investing, obligating, and disbursing public funds. Local units also must establish additional internal controls to ensure proper management of these moneys.

One of the reasons that the LGBFCA need not provide for all aspects of accounting for and managing of cash and other assets is because it commits to the Local Government Commission (LGC) broad powers over these functions. G.S. 159-25(c) authorizes the LGC to issue "rules and regulations having the force of law governing procedures for the receipt, deposit, investment, transfer, and disbursement of money and other assets." Thus, if necessary, any gaps in the act can be filled by commission regulations. In addition, the same section authorizes the commission to look into the internal control procedures of particular units or authorities and to require any modifications to those procedures that it finds to be "necessary or desirable to prevent embezzlement or mishandling of public moneys."

Within a local unit, the finance officer is charged with supervising the receipt and deposit of money that belongs to the unit.⁵⁶ He or she prescribes the form and detail of the accounts for each officer or employee who collects money and may audit those accounts at any time.⁵⁷ The finance officer establishes the policies and procedures for carrying out the preaudit and disbursement processes.⁵⁸ In addition to the statutory duties, the finance officer also should devise and implement organizational plans and operating procedures to maintain adequate controls. For example, duties may be divided so that whoever collects cash does not record collections in the accounting system. Pre-numbered receipts may be used for collections. Employees handling public funds may be required to periodically rotate duties.

The above are just a few examples. What internal controls are sufficient will vary by unit and may change over time. Finance officers must continually evaluate and adjust to changing situations.⁵⁹

56. G.S. 159-25(a)(4).

57. G.S. 159-32.

58. G.S. 159-28.

59. See Chapter 9, "Internal Control in Financial Management."

Governing Board Oversight

Finally, it is important to note that the governing board of a local unit plays a critical role in overseeing compliance with all financial laws and internal policies. In addition to the roles specifically assigned to it by the LGBFCA, such as adopting the budget; selecting the official depository or depositories; setting the amount of, and paying for, performance bonds; and hiring the independent auditor/receiving the audit report, the board is charged generally with the proper stewardship of public funds. The board must set the expectation that all employees and officials of the unit are to follow both statutory and other internal rules related to the collection, management, and disbursement of public funds. In some cases, the board may need to be more involved in developing internal control policies and practices and in compelling compliance by all employees or officials by instituting meaningful consequences for nonconformance. And, of course, proper board member training on how to read and interpret budgets, financial statements, audits, and other financial documents is essential to allow the board to carry out its fiduciary duty effectively.