A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Report on Internal Control and Compliance

Arizona State University

Year Ended June 30, 2007

Debra K. Davenport
Auditor General

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Arizona State University
Report on Internal Control and Compliance
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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Members of the Arizona State Legislature

The Arizona Board of Regents

We have audited the financial statements of the business-type activities and aggregate discretely presented component units of the Arizona State University as of and for the year ended June 30, 2007, which collectively comprise the University's financial statements, and have issued our report thereon dated November 15, 2007. Our report was modified to include a reference to our reliance on other auditors. We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the aggregate discretely presented component units, the Arizona State University Foundation, the Arizona Capital Facilities Finance Corporation (ACFFC), the Arizona State University Alumni Association, the Collegiate Golf Foundation, the Mesa Student Housing, LLC, the Arizona State University Research Park, Inc., the Sun Angel Foundation, and the Sun Angel Endowment, as described in our report on the University's financial statements. The financial statements of the aggregate discretely presented component units were not audited by the other auditors in accordance with *Government Auditing Standards*. This report includes our consideration of the results of the other auditors' testing of internal control over financial reporting that are reported separately by those other auditors. However, this report, insofar as it relates to the results of the other auditors, is based solely on the reports of the other auditors.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the University's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the University's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we and the other auditors identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

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A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the University's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the University's financial statements that is more than inconsequential will not be prevented or detected by the University's internal control. We consider items 07-01 through 07-06 described in the accompanying Schedule of Findings and Recommendations to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the University's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we consider items 07-01, 07-03 and 07-04 to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the University's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Managements' responses to the findings identified in our audit have been included herein. We did not audit managements' responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the members of the Arizona State Legislature, the Arizona Board of Regents, and the University and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record, and its distribution is not limited.

Debbie Davenport
Auditor General

November 15, 2007

Arizona State University
Schedule of Findings and Recommendations
Year Ended June 30, 2007

Arizona State University Findings

None reported.

Component Unit Findings

The other auditors that audited the Arizona State University Foundation, and the Arizona Capital Facilities Finance Corporation, including several subsidiaries [Energy Management Services (Main) LLC, McAllister Academic Village LLC, Nanotechnology Research LLC, and Sun Devil Energy Center LLC], reported the following significant deficiencies and material weaknesses for those component units:

07-01
Arizona State University Foundation
Restatement due to prior year errors in the classification of net assets

As identified and corrected by Foundation management, the Foundation's 2006 financial statements required restatement due to errors in the classification of net assets. In accordance with Statement of Financial Accounting Standards (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations*, a statement of activities shall report gains and losses recognized on investment and other assets (or liabilities) as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or law. In the years prior to June 30, 2007, investment gains and losses in excess of the amounts made available for temporarily restricted spending were improperly classified as permanently restricted net assets. These amounts should have been classified as temporarily restricted net assets in accordance with the donor intentions. The effect of the restatement was to increase temporarily restricted net assets and decrease permanently restricted net assets by approximately $35,200,000. This restatement had no effect on the change in net assets for the year ended June 30, 2006.

We recommend that the Foundation review and revise, as necessary, its policies for classifying market gains and losses recognized on investments in order to prevent future misclassifications.

Management response: The material weakness mentioned above describes a prior period adjustment proposed by Foundation management to correct an error in the classification of net assets. Foundation management disagrees with the auditor's conclusion that this adjustment evidences a material weakness as of June 30, 2007.

The issue involves the decision of management during fiscal year 2007 to reclassify earnings on permanently restricted funds as temporarily restricted, rather than as permanently restricted. Prior to fiscal year 2007, the Foundation's endowment agreements described how to manage the payout from the fund to spending accounts and were silent about restrictions on the earnings. During the current fiscal year, new management revised this classification and determined that, since the agreements were silent on the subject, the earnings should be treated according to current statutory regulations and generally accepted accounting principles. During the current fiscal year, Foundation management revised the endowment agreements to specifically address the restriction class of the donations and earnings. Management prepared and proposed a prior period adjustment to rectify this situation, which was agreed to by the external auditors.

The Statement of Auditing Standards No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, that was issued in May 2006 states that a control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. It further states that a strong indicator of material weakness in internal control is a restatement of previously issued financial statements to reflect the correction of a material misstatement. Our external audit firm's policy interprets this to mean that all prior period adjustments are material weaknesses in internal control.

It is management's observation that, during 2007, new management reviewed and reinterpreted the language in the endowment agreements. Based on this review, management identified the situation that led to the adjustment, prepared a prior period adjustment, and proposed this adjustment to the external auditors. Based on these facts, management believes that sufficient controls existed during 2007, and that these controls allowed current management to detect this situation in a timely manner. Management also revised the language in the endowment agreements during 2007 to clarify the accounting treatment and prevent this situation in the future.

Management believes that, if material weakness exists, management must have some way to remediate this deficiency. Given that, during 2007, current management detected the situation and revised the language in the endowment agreements to prevent this situation from occurring in the future, any control deficiency that existed in prior years was effectively remediated during 2007. Therefore, management respectfully disagrees with the assertion that a material weakness existed as of June 30, 2007.

07-02
Arizona State University Foundation
Year-end audit adjustments

Based on the nature of the year-end adjustments, the Foundation's interim combined financial statements did not include all of the necessary adjustments to provide combined financial statements comparable to the audited combined financial statements distributed to outside users. Specifically, the interim combined financial statements did not recognize certain contributions in accordance with Statement of Financial Accounting Standards (SFAS) No. 116, *Accounting for Contributions Received and Contributions Made*. Additionally, the discount rate used by management to calculate the present value on long-term pledges receivable should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently. The effect of these year-end audit adjustments was to increase contribution revenue by $3,100,000, increase pledges receivable by $10,200,000, increase the present value discount on long-term pledges receivables by $7,700,000 and decrease accounts payable by $600,000. In order for decision makers and other users of the combined financial statements to make informed decisions regarding the Foundation, its financial position and its changes in net assets, the Foundation's interim combined financial statements should be prepared on a consistent basis with the year end audited combined financial statements.

We recommend that the Foundation review the content of the audit adjustments made to the year-end combined financial statements and develop appropriate policies and procedures to ensure that these items are appropriately considered in the monthly closing process.

Management response: The significant deficiency described by the auditors above relates to the recording of gifts and the calculation of the discount on future pledge payments. In a prior year, the Foundation received two pledges: a conditional pledge from a private foundation of $20 million, due when the condition was met, and a pledge of $10 million, due after the condition was met and at the death of the donor. During 2007, the private foundation removed the condition on the $20 million pledge and provided a new payment schedule for the payment of these funds. While the $20 million pledge was accurately recorded on the Foundation's books, the second pledge of $10 million was not recorded properly at June 30, 2007. The $10 million dollar pledge also became recordable when the condition was removed and has an expected payment date according to actuarial tables of more than 10 years from now. Recording this second pledge significantly altered the pledge discount value.

In addition to the above pledge recording, another item impacted the calculation of the pledge discount. The rates used in prior years to calculate the present value of the expected cash flow streams for pledges were estimated using rates that management at that time determined to be reasonable estimates of the risk-free rate at the time of the gift. During this year, management determined that the applicable federal rate (AFR) was a more easily documented estimate of the risk-free rate and management applied the AFR to pledges received in prior years as well as to new pledges received in the current year. The accounting standards state that the discount rate determined at the time of the initial pledge should not be revised in subsequent years. Although both rates are reasonable estimates of the risk-free rate, management concurs that the application of the AFR to prior years' calculations is not supported by generally accepted accounting principles. The revision of these rates and recalculation resulted in an additional adjustment to the discount value.

07-03
Arizona Capital Facilities Finance Corporation's subsidiaries:
Energy Management Services (Main) LLC
McAllister Academic Village LLC
Nanotechnology Research LLC
Sun Devil Energy Center LLC
Financial statement preparation – operating effectiveness

The COSO framework for effective internal control over financial reporting states that control activities should be selected and developed to mitigate risks to the achievement of financial reporting objectives, which would include appropriate disclosures required by generally accepted accounting principles (GAAP). Management, including the accounting staff, does not have sufficient knowledge of current GAAP in order to determine the completeness of financial statement information and disclosures. As a result of this operating deficiency, material disclosure and classification misstatements could not be prevented or detected prior to our audit.

Management response: The response of ACFFC to the auditors' findings and recommendations in conjunction with the audit of Arizona State University for the year ended June 30, 2007 is as follows: This response was prepared subsequent to the ACFFC audit and has been shared with the ACFFC auditors. This response is for the Auditor General's findings 07-03 through 07-06.

The Arizona Capital Facilities Finance Corporation (ACFFC) uses a contract accountant to perform certain accounting duties including monthly bookkeeping, preparation of year-end entries and preparation of the annual financial statements for certain ACFFC subsidiaries. At the ACFFC's September, 2007 Board meeting, prior to the issuance of the Auditors' findings, a decision was made to consider options to improve the accounting for ACFFC.

At the ACFFC's December, 2007 Board meeting, a decision was made to appoint a new contract accountant who is a licensed Arizona CPA to take over the duties of the former contract accountant. Further, the current ACFFC Board President, who is an Arizona licensed CPA and experienced in financial statement reporting, will assume increased oversight responsibilities for the ongoing accounting and financial reporting of ACFFC and will work closely with the new contract accountant.

07-04
Arizona Capital Facilities Finance Corporation's subsidiary:
McAllister Academic Village LLC
Inadequate design and operation of accounting process

Inadequate design and operation of internal controls over the entire accounting/bookkeeping process was identified. This inadequacy occurs not only when there is only one individual responsible for the entire accounting process of the entity, but when the necessary accounting for the entity is beyond the overall capabilities of the employee. This deficiency is also a result of lack of internal communication between the employee, internal management and third party management. The overall result is a failure to provide complete, accurate and timely accounting information for the entity.

Management response: The response of ACFFC to the auditors' findings and recommendations in conjunction with the audit of Arizona State University for the year ended June 30, 2007 is as follows: This response was prepared subsequent to the ACFFC audit and has been shared with the ACFFC auditors. This response is for the Auditor General's findings 07-03 through 07-06.

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07-05
Arizona Capital Facilities Finance Corporation's subsidiary:
Nanotechnology Research LLC
Financial statement misstatement

The following adjustment was not prevented or detected by internal controls:

Lease receivable and unearned revenue should have been adjusted to their actual amounts at June 30, 2007. The net investment in direct financing lease is stated at the sum of the minimum lease payments less unearned revenues. The minimum lease payments are based on a variable interest rate determined on a weekly basis. The lease receivable and unearned revenue should have been reevaluated at year end based on the current rates of 3.73% for tax exempt bonds and 5.35% for the taxable bonds.

Management response: The response of ACFFC to the auditors' findings and recommendations in conjunction with the audit of Arizona State University for the year ended June 30, 2007 is as follows: This response was prepared subsequent to the ACFFC audit and has been shared with the ACFFC auditors. This response is for the Auditor General's findings 07-03 through 07-06.

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07-06
Arizona Capital Facilities Finance Corporation's subsidiary:
Sun Devil Energy Center LLC
Financial statement misstatement

The following adjustment was not prevented or detected by internal controls:

Derivative instruments are valued at fair value. The entity posted an adjusting entry at year end to reflect the swap instrument at fair value. The entity used a specialist, the PFM Group in Philadelphia, PA, to perform the year-end valuations of the swap agreements. The report provided by the specialist included a valuation for an ASU swap unrelated to the entity. The adjustment posted by the entity at year end included the fair value of the ASU swap. The controls over financial reporting did not detect a misstatement caused by this error.

Management response: The response of ACFFC to the auditors' findings and recommendations in conjunction with the audit of Arizona State University for the year ended June 30, 2007 is as follows: This response was prepared subsequent to the ACFFC audit and has been shared with the ACFFC auditors. This response is for the Auditor General's findings 07-03 through 07-06.

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