



A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Financial Statement Audit

Department of Corrections

Arizona Correctional Industries
Year Ended June 30, 2004



Debra K. Davenport
Auditor General

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State of Arizona
Department of Corrections
Arizona Correctional Industries
Report on Audit of Financial Statements
June 30, 2004

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DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

**STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL**

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

Independent Auditors' Report

Members of the Arizona State Legislature

Dora Schriro, Director
Department of Corrections

We have audited the accompanying financial statements of the State of Arizona, Department of Corrections—Arizona Correctional Industries (ACI) Enterprise Fund as of and for the year ended June 30, 2004, as listed in the table of contents. These financial statements are the responsibility of ACI's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the Department of Corrections—Arizona Correctional Industries Enterprise Fund's financial statements are intended to present the financial position, and the changes in financial position and cash flows of only that portion of the business-type activities and aggregate remaining fund information of the State of Arizona that is attributable to the transactions of the Arizona Correctional Industries Enterprise Fund. They do not purport to, and do not, present fairly the financial position of the State of Arizona as of June 30, 2004, and the changes in its financial position and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department of Corrections—Arizona Correctional Industries Enterprise Fund as of June 30, 2004, and the respective changes in financial position and cash flows thereof for the year then ended in conformity with U.S. generally accepted accounting principles.

Debbie Davenport
Auditor General

July 20, 2005

State of Arizona
Department of Corrections
Arizona Correctional Industries
Statement of Net Assets—Enterprise Fund
June 30, 2004

Assets

Current assets:

Cash in bank and on hand	\$ 44,491
Cash on deposit with State Treasurer	3,241,734
Receivables:	
Accounts (net of allowance for uncollectibles of \$20,000)	2,509,872
Accrued interest	14,639
Inventories	3,299,881
Prepaid expenses	<u>126,672</u>
Total current assets	<u>9,237,289</u>

Noncurrent assets:

Capital assets, not being depreciated	862,059
Capital assets, being depreciated, net	<u>1,589,714</u>
Total noncurrent assets	<u>2,451,773</u>
Total assets	<u>11,689,062</u>

Liabilities

Current liabilities:

Accounts payable	428,789
Accrued payroll and employee benefits	194,522
Accrued compensated absences	233,375
Other accrued liabilities	<u>540,973</u>
Total current liabilities	<u>1,397,659</u>

Net Assets:

Invested in capital assets	2,451,773
Unrestricted	<u>7,839,630</u>
Total net assets	<u>\$ 10,291,403</u>

See accompanying notes to financial statements.

State of Arizona
Department of Corrections
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Statement of Revenues, Expenses, and Changes in
Fund Net Assets—Enterprise Fund
Year Ended June 30, 2004

Sales	\$ 19,928,145
Cost of goods sold	<u>17,149,328</u>
Gross profit	<u>2,778,817</u>
Operating expenses:	
Selling	490,166
General and administrative	<u>1,894,817</u>
Total operating expenses	<u>2,384,983</u>
Operating income	393,834
Nonoperating revenues:	
Investment income	72,090
Net gain on disposal of equipment	<u>18,092</u>
Net nonoperating revenues	<u>90,182</u>
Income before transfers	484,016
Transfers out to the State General Fund	<u>(1,000,000)</u>
Decrease in net assets	(515,984)
Total net assets, July 1, 2003	<u>10,807,387</u>
Total net assets, June 30, 2004	<u><u>\$ 10,291,403</u></u>

See accompanying notes to financial statements.

State of Arizona
Department of Corrections
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Statement of Cash Flows—Enterprise Fund
Year Ended June 30, 2004

Cash flows from operating activities:	
Receipts from customers	\$ 20,161,952
Payments to suppliers for goods and services	(9,367,069)
Payments to employees	(5,144,702)
Payments to inmates	<u>(5,701,982)</u>
Net cash used for operating activities	<u>(51,801)</u>
Cash flows from noncapital financing activities:	
Cash transfers to the State General Fund	<u>(1,000,000)</u>
Net cash used for noncapital financing activities	<u>(1,000,000)</u>
Cash flows from capital and related financial activities:	
Proceeds from sale of capital assets	19,238
Purchases of capital assets	<u>(228,052)</u>
Net cash used for capital and related financing activities	<u>(208,814)</u>
Cash flows from investing activities:	
Interest received on investments	<u>74,987</u>
Net cash provided by investing activities	<u>74,987</u>
Net decrease in cash and cash equivalents	(1,185,628)
Cash and cash equivalents, July 1, 2003	<u>4,471,853</u>
Cash and cash equivalents, June 30, 2004	<u><u>\$ 3,286,225</u></u>

(Continued)

See accompanying notes to financial statements.

State of Arizona
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Statement of Cash Flows—Enterprise Fund
Year Ended June 30, 2004
(Continued)

Reconciliation of operating income to net cash used for operating activities:	
Operating income	\$ 393,834
Adjustments to reconcile operating income to net cash used for operating activities:	
Depreciation	453,788
Changes in assets and liabilities:	
Increase in:	
Accounts receivable	(233,990)
Inventories	(415,183)
Prepaid expenses	(59,708)
Accrued payroll and employee benefits	59,604
Other accrued liabilities	467,797
Decrease in:	
Accounts payable	(702,970)
Accrued compensated absences	<u>(14,973)</u>
Net cash used for operating activities	<u>\$ (51,801)</u>

See accompanying notes to financial statements.

State of Arizona
Department of Corrections
Arizona Correctional Industries
Notes to Financial Statements
June 30, 2004

Note 1 - Summary of Significant Accounting Policies

The accounting policies of the Department of Corrections—Arizona Correctional Industries (ACI) conform to generally accepted accounting principles applicable to governmental units adopted by the Governmental Accounting Standards Board (GASB). A summary of ACI's more significant accounting policies follows.

A. Reporting Entity

ACI is accounted for as an enterprise fund of the State of Arizona that is controlled by the Department of Corrections. However, ultimate fiscal responsibility for ACI remains with the State of Arizona.

B. Fund Accounting

ACI's accounts are maintained in accordance with the principles of fund accounting to ensure that limitations and restrictions on ACI's available resources are observed. The principles of fund accounting require that resources be classified for accounting and reporting purposes into funds in accordance with the activities or objectives specified for those resources. Each fund is considered a separate accounting entity, and its operations are accounted for in a separate set of self-balancing accounts that comprise its assets, liabilities, net assets, revenues, and expenses.

ACI's financial transactions are recorded and reported as an enterprise fund, since its operations are financed and operated in a manner similar to private business enterprises, in which the governing body's intent is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges.

C. Basis of Presentation and Accounting

The financial statements include a statement of net assets; a statement of revenues, expenses, and changes in fund net assets; and a statement of cash flows.

A statement of net assets provides information about the assets, liabilities, and net assets of ACI at the end of the year. Assets and liabilities are classified as either current or noncurrent. Net assets are classified according to external restrictions or availability of assets to satisfy ACI's obligations. Invested in capital assets represents the value of capital assets, net of accumulated depreciation. Unrestricted net assets include all other net assets, including those that have been designated by management to be used for other than general operating purposes.

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A statement of revenues, expenses, and changes in fund net assets provides information about ACI's financial activities during the year. Revenues and expenses are classified as either operating or nonoperating, and all changes in net assets are reported, including capital contributions and transfers. Operating revenues and expenses generally result from providing services, producing goods, and delivering goods in connection with ACI's ongoing operations. Other revenues used for operations, such as investment income, are not generated from operations and are considered to be nonoperating revenues. Operating expenses include the costs of sales and services, administrative expenses, and depreciation on capital assets.

A statement of cash flows provides information about ACI's sources and uses of cash and cash equivalents during the year. Increases and decreases in cash and cash equivalents are classified as either operating, noncapital financing, capital financing, or investing.

The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place.

ACI follows Financial Accounting Standards Board Statements and Interpretations issued on or before November 30, 1989; Accounting Principles Board Opinions; and Accounting Research Bulletins, unless those pronouncements conflict with or contradict GASB pronouncements. ACI has chosen the option not to follow FASB Statements and Interpretations issued after November 30, 1989.

D. Cash and Investments

For purposes of its statement of cash flows, ACI considers cash on hand, demand deposits, and cash on deposit with State Treasurer to be cash and cash equivalents.

E. Accounts Receivable

Accounts receivable are due from a variety of governmental and nongovernmental customers. The allowance for uncollectible accounts is based upon management's evaluation of the collectibility of the accounts.

F. Inventories

Inventories consist of raw materials, work-in-process, finished goods, and crops. Inventories are recorded as assets when purchased along with the costs of manufacturing the merchandise intended for sale to customers and expensed when sold. Inventories are stated at cost using the first-in, first-out method.

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G. Capital Assets

Capital assets are reported at actual cost. Donated assets are reported at fair value at the time received. The capitalization thresholds are \$300 for all capital assets. Depreciation of such assets is generally charged as an expense against operations. These assets are depreciated over their estimated useful lives using the straight-line method. The estimated useful lives are as follows:

Land improvements and buildings	20 to 40 years
Building improvements	7.5 to 20 years
Equipment	3 to 10 years

H. Compensated Absences

Compensated absences consist of vacation leave earned by employees based on services already rendered. Employees may accumulate up to 320 hours of vacation if salaried or 240 hours if hourly depending on years of service, but any vacation hours in excess of the maximum amount that are unused at year-end are forfeited. Upon termination of employment, all unused and unforfeited vacation benefits are paid to employees. Accordingly, vacation benefits are accrued as a liability in the financial statements.

Employees may accumulate an unlimited number of sick leave hours. Generally, sick leave benefits provide for ordinary sick pay and are cumulative but are forfeited upon termination of employment. However upon retirement, employees who have accumulated at least 500 hours of sick leave receive some benefit payments. Benefit payments vary based upon the number of sick hours accumulated, but cannot exceed \$30,000. ACI makes contributions to the State's Retiree Accumulated Sick Leave Fund for each employee, and the State makes benefit payments directly to the retired employees. Consequently, ACI has not accrued a liability for these sick leave benefits.

Note 2 - Deposits and Investments

Cash in bank and on hand—At June 30, 2004, cash on hand was \$700, the carrying amount of cash in bank was \$43,791, and the bank balance was \$44,032. Arizona Revised Statutes (A.R.S.) stipulate that collateral is required for demand deposits and repurchase agreements at 102 percent of all deposits not covered by federal depository insurance. ACI's bank accounts are included in the Arizona State Treasurer's State Servicing Bank Agreement. State deposits under this agreement in excess of amounts covered by federal depository insurance were collateralized by securities held by the bank's trust division or agent in the Treasurer's name in book-entry form.

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Cash on deposit with State Treasurer—Cash on deposit with the State Treasurer is pooled and invested. Interest earned from investments purchased with such pooled monies is generally deposited in the State General Fund. However, if authorized by statute and requested by the depositor, the State Treasurer will invest the monies in a separate pool. ACI separately invested monies with the State Treasurer, and interest earned from these separately invested monies is allocated monthly to ACI based upon the account's average daily balance. The fair value of ACI's position in the pool approximates the value of ACI's pool shares. Those shares are not identified with specific investments and are not subject to custodial credit risk.

Note 3 - Capital Assets

Capital asset activity for the year ended June 30, 2004, was as follows:

	Balance July 1, 2003	Increases	Decreases	Balance June 30, 2004
Capital assets, not being depreciated:				
Land	\$ 692,438			\$ 692,438
Construction in progress (estimated cost to complete \$228,000)	<u>15,830</u>	<u>\$ 153,791</u>		<u>169,621</u>
Total capital assets, not being depreciated	<u>708,268</u>	<u>153,791</u>		<u>862,059</u>
Capital assets, being depreciated:				
Land improvements	240,438			240,438
Buildings	804,582			804,582
Building improvements	610,007	4,599		614,606
Equipment	<u>6,602,103</u>	<u>69,662</u>	<u>\$218,473</u>	<u>6,453,292</u>
Total capital assets, being depreciated	<u>8,257,130</u>	<u>74,261</u>	<u>218,473</u>	<u>8,112,918</u>
Less accumulated depreciation for:				
Land improvements	234,098	3,899		237,997
Buildings	217,429	39,465		256,894
Building improvements	398,893	58,212		457,105
Equipment	<u>5,436,323</u>	<u>352,212</u>	<u>217,327</u>	<u>5,571,208</u>
Total accumulated depreciation	<u>6,286,743</u>	<u>453,788</u>	<u>217,327</u>	<u>6,523,204</u>
Total capital assets, being depreciated, net	<u>1,970,387</u>	<u>(379,527)</u>	<u>1,146</u>	<u>1,589,714</u>
Capital assets, net	<u>\$2,678,655</u>	<u>\$(225,736)</u>	<u>\$ 1,146</u>	<u>\$2,451,773</u>

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Note 4 - Transfers to Other State Funds

Laws 2003, Chapter 262, §108 directed ACI to transfer \$1 million to the State General Fund on or before the year ended June 30, 2004. Further, Laws 2004, Chapter 275, §71 requires ACI to transfer \$500,000 to the State General Fund during the year ending June 30, 2005. ACI management does not believe these transfers will have a significant impact on ACI's ability to maintain working capital requirements; however, ACI management does believe that it will affect its ability to expand operations.

Note 5 - Related Party Transactions

ACI employs inmates in its manufacturing, service, and agricultural operations for the sale of goods and services primarily to other state agencies and political subdivisions. During the year ended June 30, 2004, approximately \$3.5 million, \$3.2 million, and \$500,000 of goods and services were sold to the Arizona Department of Corrections (ADC), Arizona Department of Transportation (ADOT), and all other state agencies, respectively. At June 30, 2004, ACI's accounts receivable balance included \$281,721, \$174,205, and \$41,795 due from ADC, ADOT, and other state agencies, respectively. ACI purchased approximately \$6 million of goods and inmate services from ADC, \$3,796 of goods and services from ADOT, and \$246,153 of goods and services from other state agencies, respectively, during the year ended June 30, 2004.

Note 6 - Risk Management

ACI is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees and others; and natural disasters. ACI is a participant in the State's self-insurance program covering property, environmental liability, and workers' compensation losses. In the opinion of ACI's management, any unfavorable outcomes from these risks would be covered by the State's self-insurance program. Accordingly, ACI has no risk of loss beyond adjustments to future years' premium payments to the State's self-insurance program. All estimated losses for unsettled claims and actions of the State are determined on an actuarial basis and are included in the *State of Arizona Comprehensive Annual Financial Report*.

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Note 7 - Retirement Plan

Plan Description—ACI contributes to a cost-sharing multiple-employer defined benefit pension plan that covers general employees of ACI administered by the Arizona State Retirement System. Benefits are established by state statute and generally provide retirement, death, long-term disability, survivor, and health insurance premium benefits.

The System is governed by the Arizona State Retirement System Board according to the provisions of A.R.S. Title 38, Chapter 5, Article 2.

The System issues a comprehensive annual financial report that includes its financial statements and required supplementary information. A report may be obtained by writing to the Arizona Retirement System, 3300 North Central Avenue, PO Box 33910, Phoenix, AZ 85067-3910, or calling (602) 240-2000 or (800) 621-3778.

Funding Policy—The Arizona State Legislature establishes and may amend active plan members' and ACI's contribution rates. For the year ended June 30, 2004, active ASRS members and ACI were each required by statute to contribute at the actuarially determined rate of 5.7 percent (5.2 percent retirement and 0.5 percent long-term disability) of the members' annual covered payroll. ACI's contributions to the ASRS for the years ended June 30, 2004, 2003, and 2002, were \$86,542, \$40,770, and \$37,119, respectively, which were equal to the required contributions for the year.