



A REPORT  
TO THE  
**ARIZONA LEGISLATURE**

Financial Audit Division

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Financial Audit

## **Department of Corrections**

Arizona Correctional Industries

Year Ended June 30, 2001

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**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, 2001

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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

Terry L. Stewart, Director  
Department of Corrections

We have audited the accompanying financial statements of the State of Arizona, Department of Corrections—Arizona Correctional Industries (ACI) as of and for the year ended June 30, 2001, 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 financial statements present only the Department of Corrections' Enterprise Fund, and are not intended to present fairly the financial position of the Proprietary Fund Types—Enterprise Funds of the State of Arizona, and the results of their operations and cash flows 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 as of June 30, 2001, and the results of its operations and cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Debbie Davenport  
Auditor General

May 30, 2002

**State of Arizona**  
**Department of Corrections**  
**Arizona Correctional Industries**  
**Balance Sheet—Enterprise Fund**  
**June 30, 2001**

Assets	
Current assets:	
Cash in bank and on hand	\$ 20,650
Cash on deposit with State Treasurer	6,986,476
Receivables:	
Accounts (net of allowance for uncollectibles of \$33,000)	2,676,310
Accrued interest	44,605
Inventories	2,205,250
Prepaid expenses	50,322
Total current assets	<u>11,983,613</u>
Property, plant, and equipment (net of accumulated depreciation of \$5,475,133)	<u>3,380,641</u>
Total assets	<u>\$ 15,364,254</u>
Liabilities and Fund Equity	
Current liabilities:	
Accounts payable	\$ 1,075,173
Accrued payroll and employee benefits	69,468
Accrued compensated absences	209,861
Other accrued liabilities	425,706
Total current liabilities	<u>1,780,208</u>
Fund equity:	
Contributed capital	2,456,045
Contributed land and buildings	732,707
Retained earnings:	
Reserved for future payments to the State's Corrections Fund	1,000,000
Unreserved	9,395,294
Total fund equity	<u>13,584,046</u>
Total liabilities and fund equity	<u>\$ 15,364,254</u>

See accompanying notes to financial statements.

**State of Arizona**  
**Department of Corrections**  
**Arizona Correctional Industries**  
**Statement of Operations and Changes in**  
**Fund Equity—Enterprise Fund**  
**Year Ended June 30, 2001**

Sales	\$ 17,898,318
Cost of goods sold	<u>15,639,956</u>
Gross profit	<u>2,258,362</u>
Operating expenses:	
Selling	408,224
General and administrative	<u>1,062,612</u>
Total operating expenses	<u>1,470,836</u>
Operating income	787,526
Nonoperating revenues (expenses):	
Investment income	389,528
Loss on disposal of equipment	(2,642)
Depreciation expense on discontinued operations	<u>(1,461)</u>
Net nonoperating revenues	<u>385,425</u>
Net income	1,172,951
Fund equity, July 1, 2000	13,402,229
Increase in contributed capital—donated equipment	8,866
Residual equity transfer out to State General Fund	<u>(1,000,000)</u>
Fund equity, June 30, 2001	<u>\$ 13,584,046</u>

See accompanying notes to financial statements.

**State of Arizona  
Department of Corrections  
Arizona Correctional Industries  
Statement of Cash Flows—Enterprise Fund  
Year Ended June 30, 2001**

Cash flows from operating activities:	
Operating income	\$ 787,526
Adjustments to reconcile operating income to net cash provided by operating activities:	
Depreciation	734,255
Changes in assets and liabilities:	
Increase in:	
Accounts receivable	(97,955)
Prepaid expenses	(32,547)
Accrued payroll and employee benefits	8,375
Accrued compensated absences	27,746
Other accrued liabilities	363,898
Decrease in:	
Inventories	343,013
Accounts payable	<u>(457,621)</u>
Net cash provided by operating activities	<u>1,676,690</u>
Cash flows from noncapital financing activities:	
Cash transfers to 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 financing activities:	
Proceeds from the sale of equipment	15,365
Acquisition of property, plant, and equipment	<u>(712,139)</u>
Net cash used for capital and related financing activities	<u>(696,774)</u>
Cash flows from investing activities:	
Interest on investments	<u>410,257</u>
Net cash provided by investing activities	<u>410,257</u>
Net increase in cash and cash equivalents	390,173
Cash and cash equivalents, July 1, 2000	<u>6,616,953</u>
Cash and cash equivalents, June 30, 2001	<u><u>\$ 7,007,126</u></u>
Noncash investing, capital, and financing activities:	
Donated equipment	\$ 8,866
Increase in contributed capital	(8,866)
Disposal of equipment	(663,695)
Deletion of related accumulated depreciation	645,688
Loss on disposal	2,642
Depreciation expense on discontinued operations	1,461

See accompanying notes to financial statements.

**State of Arizona  
Department of Corrections  
Arizona Correctional Industries  
Notes to Financial Statements  
June 30, 2001**

**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, fund equity, revenues, and expenses.

ACI's financial transactions are recorded and reported as an enterprise fund using the flow of economic resources measurement focus since its operations are financed and operated in a manner similar to private business enterprises, in which the intent of the governing body 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.

ACI applies only those applicable Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.



**State of Arizona  
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Notes to Financial Statements  
June 30, 2001**

**C. Basis of Accounting**

Basis of accounting relates to the timing of measurements made, regardless of the measurement focus applied, and determines when revenues and expenses are recognized in the accounts and reported in the financial statements. The financial statements of ACI are presented on the accrual basis of accounting. Revenues are recognized when they are earned, and expenses are recognized when they are incurred.

**D. Inventories**

Inventories consist of raw materials, work-in-process, finished goods, and crops. Inventories are recorded as assets when purchased and expensed when consumed. Inventories are stated at approximate costs determined on the first-in first-out basis.

**E. Property, Plant, and Equipment**

Purchased property, plant, and equipment are capitalized at cost. Donated property, plant, and equipment are capitalized at their estimated fair market value at the time received. Depreciation of such assets is 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	5 to 10 years
Computer equipment	5 years

**F. 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, but any unused vacation hours in excess of the maximum amount 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.

**State of Arizona**  
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**June 30, 2001**

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. Because sick leave benefits do not vest with employees, a liability for sick leave benefits is not accrued in the financial statements. 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 - Cash and Investments

*Cash in bank and on hand*—At June 30, 2001, cash on hand was \$700, the carrying amount of cash in bank was \$19,950, and the bank balance was \$16,910. 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. Deposits of the State 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.

*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 accounts 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.

**State of Arizona  
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Notes to Financial Statements  
June 30, 2001**

**Note 3 - Property, Plant, and Equipment**

At June 30, 2001, property, plant, and equipment consisted of the following:

Land	\$ 692,438
Land improvements	248,307
Buildings	836,333
Building improvements	557,502
Equipment	6,443,154
Construction in progress	<u>78,040</u>
	8,855,774
Less accumulated depreciation	<u>5,475,133</u>
Net property, plant, and equipment	<u><u>\$3,380,641</u></u>

**Note 4 - Residual Equity Transfer**

Laws 1999, 1<sup>st</sup> Special Session, Chapter 6, §§23, 24, 26, and 28 directed ACI to transfer \$3 million to State General Fund for the purpose of providing support and maintenance for other state agencies. Transfers of \$1 million were made during each of the years ended June 30, 1999, 2000, and 2001. In addition, the Law requires ACI to transfer \$1 million to the State's Corrections Fund during the year ending June 30, 2002. 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, 2001, approximately \$5.0 million, \$2.1 million and \$530,000 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, 2001, ACI's accounts receivable balance included \$875,985, \$39,373, and \$141,682 due from ADC, ADOT, and other state agencies, respectively. ACI purchased approximately \$5.2 million of goods and inmate services from ADC, \$18,919 of goods and services from ADOT, and \$159,049 of goods and services from other state agencies, respectively, during the year ended June 30, 2001. ACI's accounts payable at June 30, 2001, included \$494,889 due to ADC.

**State of Arizona**  
**Department of Corrections**  
**Arizona Correctional Industries**  
**Notes to Financial Statements**  
**June 30, 2001**

## 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*.

## Note 7 - Retirement Plans

**Plan Descriptions**—ACI contributes to the two plans described below. Benefits are established by state statute and generally provide retirement, death, long-term disability, survivor, and health insurance premium benefits.

The *Arizona State Retirement System* (ASRS) administers a cost-sharing multiple-employer defined benefit pension plan that covers general employees of ACI. The ASRS is governed by the Arizona State Retirement System Board according to the provisions of A.R.S. Title 38, Chapter 5, Article 2.

The *Corrections Officer Retirement Plan* (CORP) is an agent multiple-employer defined benefit pension plan that covers certain employees of the State of Arizona, Departments of Corrections and Juvenile Corrections, and County employees whose primary duties require direct inmate contact. The CORP is governed by the Fund Manager of the Public Safety Personnel Retirement System and 12 local boards according to the provisions of A.R.S. Title 38, Chapter 5, Article 6.

Each plan issues a publicly available annual financial report that includes its financial statements and required supplementary information. A report may be obtained by writing or calling the applicable plan.

State of Arizona  
Department of Corrections  
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Notes to Financial Statements  
June 30, 2001

**ASRS**

3300 North Central Avenue  
P.O. Box 33910  
Phoenix, AZ 85067-3910

(602) 240-2000 or (800) 621-3778

**CORP**

1020 East Missouri Avenue  
Phoenix, AZ 85014

(602) 255-5575

**Funding Policy**—The Arizona State Legislature establishes and may amend active plan members' and ACI's contribution rates.

*ASRS*—For the year ended June 30, 2001, active ASRS members and ACI were each required by statute to contribute at the actuarially determined rate of 2.66 percent (2.17 percent retirement and 0.49 percent long-term disability) of the members' annual covered payroll. ACI's contributions to ASRS for the years ended June 30, 2001, 2000, and 1999, were \$38,379, \$37,270, and \$44,939, respectively, which were equal to the required contributions for the year.

*CORP*—For the year ended June 30, 2001, active CORP members were required by statute to contribute 8.5 percent of the members' annual covered payroll, and ACI was required to contribute at the actuarially determined rate of 5 percent.

The CORP does not provide separately calculated annual pension cost, trend, and funding progress information for ACI. Consequently, this information is not available for presentation in ACI's financial statements. Annual pension cost, trend, and funding progress information for all State of Arizona employees covered by CORP is presented in the *State of Arizona Comprehensive Annual Financial Report* for the year ended June 30, 2001.