A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Management Letter

Department of Corrections

Arizona Correctional Industries

Year Ended June 30, 2002

Debra K. Davenport
Auditor General

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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

August 8, 2003

Dora Schriro, Director
State of Arizona
Department of Corrections
1601 West Jefferson Street
Phoenix, AZ 85007

Dear Ms. Schriro:

In planning and conducting our audit of the State of Arizona, Department of Corrections—Arizona Correctional Industries (ACI) for the year ended June 30, 2002, we considered ACI's internal controls over financial reporting and tested its compliance with laws and regulations that could have a direct and material effect on ACI's financial statements as required by U.S. generally accepted auditing standards.

We noted no internal control weaknesses or instances of noncompliance that we consider to be material to the financial statements. However, our audit disclosed other matters involving internal controls that management should correct to ensure that it fulfills its responsibility to establish and maintain adequate internal controls. Our recommendations are described in the accompanying summary.

This letter is intended solely for the information of the Department of Corrections and is not intended to be and should not be used by anyone other than the specified party. However, this letter is a matter of public record, and its distribution is not limited.

Should you have any questions concerning its contents, please let us know.

Sincerely,

Dennis L. Mattheisen, CPA
Financial Audit Director

2910 NORTH 44th STREET • SUITE 410 • PHOENIX, ARIZONA 85018 • (602) 553-0333 • FAX (602) 553-0051

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ACI should ensure inventories and cost of goods sold are properly valued

ACI's management depends on complete and accurate information to value its inventories and to appropriately price goods produced for sale. To achieve this objective, management should have appropriate procedures to value its inventory. ACI records inventories and cost of goods sold using standard costing techniques. Generally Accepted Accounting Principles allows inventory to be valued using standard costs if adjustments are made at reasonable intervals to reflect the actual costs. However, ACI did not adjust its accounting records for actual labor and material costs incurred.

To help ensure that inventories are properly valued and costs of goods sold are accurately reported, ACI should develop and implement policies and procedures to compare actual costs to standard costs on a regular basis and record any necessary adjusting entries. Specifically:

- Determine actual material usage and labor hours.
- Compare actual costs and usage of materials and labor to standards, noting any variances.
- Monitor variances to determine if standard costs should be adjusted because of large variances.
- Record differences between standard and actual cost accounts to the appropriate inventory and cost of goods sold accounts.

ACI should reconcile the subsidiary ledgers to the general ledger

ACI's management is responsible for ensuring that its accounting records are complete and accurate. However, ACI did not follow its established reconciliation procedures and did not reconcile its detailed subsidiary ledgers to the general ledger which was the source of its financial statements. As a result, differences existed between the accounts receivable, accounts payable, and capital assets subsidiary ledgers and the general ledger that could not be explained.

To help ensure the completeness and accuracy of its accounting records, ACI management should follow its established procedures to reconcile the general ledger to the detailed subsidiary ledgers at least monthly to ensure that all transactions have been recorded, and investigate and resolve all discrepancies.

ACI should improve its recordkeeping procedures over its capital assets

ACI uses a construction in progress account to accumulate the costs associated with capital asset construction projects. ACI has a responsibility to properly account for these projects' costs. Doing so ensures that ACI accurately reflects its operating and capital costs on its financial statements. However, ACI did not accurately account for these projects. None of the $226,000 of construction in progress recorded in its general ledger as of June 30, 2002, should have been recorded as such. Some of these costs should have been expensed and costs related to completed projects should have been transferred to capital assets accounts. Audit adjustments were recorded to properly report these costs in ACI's financial statements.

To help ensure the propriety and accuracy of ACI's capital assets records and ensure that capital assets and expenses are properly reported in the financial statements, ACI should revise its policies and procedures to include the following:

- Analyze all construction projects and determine which costs should be capitalized and which ones should be expensed.
- Transfer costs of completed projects to the appropriate capital assets accounts.
- Retain all supporting documentation for all charges to the construction in progress account.

July 29, 2003

Debra Davenport, CPA
Auditor General
Office of the Auditor General
2910 N. 44th Street, Suite 410
Phoenix, AZ 85018

Dear Ms. Davenport:

Arizona Correctional Industries (ACI) appreciates the insights shared in the Management Letter from your certified audit performed on our division for the year ending June 30, 2002. Attached is our response to your audit findings and related recommendations.

If you have any questions, please contact me at 272-7600 or Dale Beatty the ACI controller.

Sincerely,

John J. Spearman
Assistant Director

JJS:cs

Attachment

ARIZONA CORRECTIONAL INDUSTRIES
AUDITOR GENERAL RESPONSE
FOR THE YEAR ENDED JUNE 30, 2002

RECOMMENDATION 1: ACI should ensure inventories and cost of goods sold are properly valued.

We concur. A critical component in establishing costs of goods sold are inventory balances. In reviewing the FY 2002 inventory valuation it is important to note that no less than 73% of the inventory balance is raw material which had not entered into the production process and is based on standard costs updated frequently. To our knowledge the auditor general is satisfied with this process. Regarding the valuation of finished goods, it is important to note that these amounts are comprised of material, labor, and overhead. The majority of the products are in the two sewing divisions and bedding. These are generally standard products that sell for less than $10 each.

All standard product costs of manufacture are reviewed semi-annually and more often if necessary and adjusted as required. All non standard products have a developed cost of manufacture before they are produced. For most of the divisions, labor and overhead are allocated to inventory based on a standard shop rate. This rate is tested against the actual financials on a quarterly basis and adjusted as necessary. ACI believes in aggregate the inventories are substantially accurate and will continue to practice procedures that clearly support the expressed inventory balances.

RECOMMENDATION 2: ACI should reconcile the subsidiary ledgers to the general ledger.

We concur. An integral discipline associated with the preparation of accurate financial statements includes the reconciliation of the general ledger to its subsidiary ledgers. Our policy requires the reconciliation of both monthly and year-end ACI financial statements. The largest of the errors resulting in this recommendation occurred when ACI's computer system failed while amounts were being posted to their respective accounts thus causing an out-of-balance subsidiary ledger. An inadequate attempt by staff to correct the balance resulted in our accounts receivables being out of balance by $23,000 at year-end. This failure has been corrected without impacting the statement of operations. ACI will more closely adhere to its policy to ensure accurate reconciliation is completed on a monthly basis.

COMMENDATION 3: ACI should improve its recordkeeping procedures over its assets.

We concur. The Construction-In-Progress (CIP) account is intended to capture costs related to large projects. These costs are accumulated, analyzed, and distributed to their proper accounts at the completion of the project. Most of the costs are capitalized into their respective fixed asset accounts. For Fiscal Year 2002, some costs associated with ACI's move to its new building were accumulated in the CIP account and were not subsequently moved to the appropriate fixed asset account. As a result, the costs were incorrectly left in the CIP account. Approximately $40,000, of these costs, should have been expensed. Appropriate adjustments correcting the accounts were made in accordance with instructions from staff of the Auditor General's Office. It should be noted that depreciation for the assets was properly recorded in FY 2002.