



A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Financial Audit

Department of Corrections

Arizona Correctional Industries
Year Ended June 30, 2002



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, 2002

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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, 2002, 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 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, 2002, and changes in its financial position and 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, 2002, and the changes in financial position and cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

As described in Note 1, the State of Arizona adopted the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, for the year ended June 30, 2002, to implement a new financial reporting model.

Debbie Davenport
Auditor General

May 28, 2003

State of Arizona
Department of Corrections
Arizona Correctional Industries
Statement of Net Assets—Enterprise Fund
June 30, 2002

Assets

Current assets:

Cash in bank and on hand	\$ 49,576
Cash on deposit with State Treasurer	4,741,327
Receivables:	
Accounts (net of allowance for uncollectibles of \$32,603)	2,260,051
Accrued interest	28,661
Inventories	2,631,839
Prepaid expenses	<u>125,408</u>
Total current assets	<u>9,836,862</u>

Noncurrent assets:

Capital assets, not being depreciated	692,438
Capital assets, being depreciated, net	<u>2,212,632</u>
Total noncurrent assets	<u>2,905,070</u>
Total assets	<u>12,741,932</u>

Liabilities

Current liabilities:

Accounts payable	170,193
Accrued payroll and employee benefits	126,305
Accrued compensated absences	231,663
Other accrued liabilities	<u>267,498</u>
Total current liabilities	<u>795,659</u>

Net Assets:

Invested in capital assets	2,905,070
Unrestricted	<u>9,041,203</u>
Total net assets	<u>\$ 11,946,273</u>

See accompanying notes to financial statements.

State of Arizona
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Statement of Revenues, Expenses, and Changes in
Fund Net Assets—Enterprise Fund
Year Ended June 30, 2002

Sales	\$ 17,194,992
Cost of goods sold	<u>15,457,044</u>
Gross profit	<u>1,737,948</u>
Operating expenses:	
Selling	457,748
General and administrative	<u>1,122,231</u>
Total operating expenses	<u>1,579,979</u>
Operating income	157,969
Nonoperating revenues (expenses):	
Investment income	224,762
Net loss on disposal of equipment	(4,312)
Depreciation expense on discontinued operations	<u>(2,571)</u>
Net nonoperating revenues	<u>217,879</u>
Net income	375,848
Capital contributions	8,455
Transfers out to other state funds	<u>(2,022,076)</u>
Decrease in net assets	(1,637,773)
Total net assets, July 1, 2001	<u>13,584,046</u>
Total net assets, June 30, 2002	<u>\$ 11,946,273</u>

See accompanying notes to financial statements.

State of Arizona
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Statement of Cash Flows—Enterprise Fund
Year Ended June 30, 2002

Cash flows from operating activities:	
Receipts from customers	\$ 17,453,043
Payments to suppliers for goods and services	(8,364,680)
Payments to employees	(4,262,668)
Payments to inmates	<u>(4,988,521)</u>
Net cash used for operating activities	<u>(162,826)</u>
Cash flows from noncapital financing activities:	
Cash transfers to other state funds	<u>(2,000,000)</u>
Net cash used for noncapital financing activities	<u>(2,000,000)</u>
Cash flows from capital and related financial activities:	
Proceeds from sale of capital assets	5,575
Purchases of capital assets	<u>(299,678)</u>
Net cash used for capital and related financing activities	<u>(294,103)</u>
Cash flows from investing activities:	
Interest received on investments	<u>240,706</u>
Net cash provided by investing activities	<u>240,706</u>
Net decrease in cash and cash equivalents	(2,216,223)
Cash and cash equivalents, July 1, 2001	<u>7,007,126</u>
Cash and cash equivalents, June 30, 2002	<u>\$ 4,790,903</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, 2002
(Continued)

Reconciliation of operating income to net cash used for operating activities:	
Operating income	\$ 157,969
Adjustments to reconcile operating income to net cash used for operating activities:	
Depreciation	673,237
Net changes in assets and liabilities:	
Accounts receivable	416,259
Inventories	(426,589)
Prepaid expenses	847
Accounts payable	(904,980)
Accrued payroll and employee benefits	56,837
Accrued compensated absences	21,802
Other accrued liabilities	<u>(158,208)</u>
Net cash used for operating activities	<u>\$ (162,826)</u>

The following noncash transactions occurred during the year ended June 30, 2002:

Donated equipment	\$ 8,455
Capital contributions	(8,455)
Capital assets, net of accumulated depreciation	(22,076)
Equipment transfer out to Department of Corrections	22,076
Building improvements	9,379
Construction in progress completed	(9,379)
Depreciation expense for discontinued operations	2,571
Accumulated depreciation related to discontinued operations	(2,571)
Capital assets, net of accumulated depreciation	(9,887)
Loss on disposal of equipment	9,887

See accompanying notes to financial statements.

State of Arizona
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Notes to Financial Statements
June 30, 2002

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). For the year ended June 30, 2002, the State of Arizona Implemented GASB Statement No. 34, as amended by GASB Statement No. 37, which prescribes a new reporting model for state and local governments. As a result, ACI adopted the reporting requirements for business-type activities specified by the pronouncement. The State of Arizona also implemented GASB Statement No. 38, which prescribes new and revised note disclosures. 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 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.

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.

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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 net of related debt represents the value of capital assets, net of accumulated depreciation less any outstanding debt incurred to acquire or construct the asset. 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.

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 assets are reported, including capital contributions and transfers. Generally, sales of goods and services are considered to be operating revenues. Other revenues used for operations, such as investment income, are not generated from operations and are considered to be nonoperating revenues.

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.

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.

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F. 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.

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 building improvements, equipment, and computer equipment. 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	3 to 5 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. 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.

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Note 2 - Accounting Changes

As a result of the implementing GASB Statement No. 34, ACI made several accounting and reporting changes. The most significant change is that fund equity has been relabeled as net assets, and its components have changed as described in Note 1.

Note 3 - Cash and Investments

Cash in bank and on hand—At June 30, 2002, cash on hand was \$600, the carrying amount of cash in bank was \$48,976, and the bank balance was \$48,555. 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.

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Note 4 - Capital Assets

Capital asset activity for the year ended June 30, 2002, was as follows:

	Balance July 1, 2001, as restated	Increases	Decreases	Balance June 30, 2002
Capital assets, not being depreciated:				
Land	\$ 692,438			\$ 692,438
Construction in progress	<u>2,107</u>	\$ 7,272	\$ (9,379)	<u> </u>
Total capital assets, not being depreciated	<u>694,545</u>	<u>7,272</u>	<u>(9,379)</u>	<u>692,438</u>
Capital assets, being depreciated:				
Land improvements	248,307		(6,219)	242,088
Buildings	836,333		(31,751)	804,582
Building improvements	557,502	63,223	(15,829)	604,896
Equipment	<u>6,443,154</u>	<u>247,017</u>	<u>(247,450)</u>	<u>6,442,721</u>
Total capital assets, being depreciated	<u>8,085,296</u>	<u>310,240</u>	<u>(301,249)</u>	<u>8,094,287</u>
Less accumulated depreciation for:				
Land improvements	(229,118)	(5,716)	(6,093)	(228,741)
Buildings	(148,067)	(43,076)	(14,345)	(176,798)
Building improvements	(348,986)	(43,097)	(11,159)	(380,924)
Equipment	<u>(4,748,962)</u>	<u>(583,919)</u>	<u>(237,689)</u>	<u>(5,095,192)</u>
Total accumulated depreciation	<u>(5,475,133)</u>	<u>(675,808)</u>	<u>(269,286)</u>	<u>(5,881,655)</u>
Total capital assets, being depreciated, net	<u>2,610,163</u>	<u>(365,568)</u>	<u>(31,963)</u>	<u>2,212,632</u>
Capital assets, net	<u>\$ 3,304,708</u>	<u>\$(358,296)</u>	<u>\$ (41,342)</u>	<u>\$ 2,905,070</u>

During the year ended June 30, 2002, ACI reclassified \$75,933 of prepaid expenses incorrectly reported as construction in progress at June 30, 2001.

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Note 5 - Transfers to other State Funds

Laws 1999, 1st Special Session, Chapter 6, §28 directed ACI to transfer \$1 million to the State Corrections Fund during the year ended June 30, 2002. In addition, the State Department of Corrections transferred \$1 million from ACI for inmate programming activities during the year ended June 30, 2002, as allowed by Laws 2001 2nd Special Session, Chapter 2, §21. Further, Laws 2002, 6th Special Session, Chapter 1, §61 requires ACI to transfer \$1 million to the State General Fund during the year ending June 30, 2003. 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 6 - 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, 2002, approximately \$3.3 million, \$2.4 million and \$758,000 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, 2002, ACI's accounts receivable balance included \$370,301, \$80,741, and \$170,510 due from ADC, ADOT, and other state agencies, respectively. ACI purchased approximately \$5.5 million of goods and inmate services from ADC, \$5,477 of goods and services from ADOT, and \$1.2 million of goods and services from other state agencies, respectively, during the year ended June 30, 2002.

Note 7 - 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 8 - 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 23 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.

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, 2002, active ASRS members and ACI were each required by statute to contribute at the actuarially determined rate of 2.49 percent (2.00 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, 2002, 2001, and 2000, were \$37,119, \$38,379, and \$37,270, respectively, which were equal to the required contributions for the year.

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CORP—For the year ended June 30, 2002, 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 2 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, 2002.