

REPORT HIGHLIGHTS FINANCIAL AND SINGLE AUDITS

Subject

The State of Arizona issues a Comprehensive Annual Financial Report. The State is responsible for preparing financial statements, maintaining strong internal controls, demonstrating accountability for its use of public monies, and complying with federal program requirements. As the auditors, our job is to determine whether the State has met its responsibilities.

Our Conclusion

The information in the State's financial statements is fairly stated in all material respects and the financial statements can be relied on. However, auditors identified 36 deficiencies in internal control over financial reporting, including 10 material weaknesses. In addition, the State maintained adequate internal controls over, and complied with, the federal compliance requirements for 2 of the 29 federal programs tested. However, for 27 federal programs tested, auditors found that the State did not maintain adequate internal controls or comply with one or more of the compliance requirements. See pages 3 and 4 for further information.



2008

Year Ended June 30, 2008

General Fund Financial Condition Declines

During fiscal year 2008, General Fund revenues and other financing sources totaled approximately \$20 billion, and expenditures and other financing uses totaled approximately \$21.6 billion.

Revenues and other financing sources increased \$436 million from fiscal year 2007, but the increase was not large enough to offset the \$1.7 billion increase in expenditures and other financing uses. As a result, the fund balance of the State's General Fund declined \$1.6 billion from the prior fiscal year. This represents a decrease of approximately 81 percent.

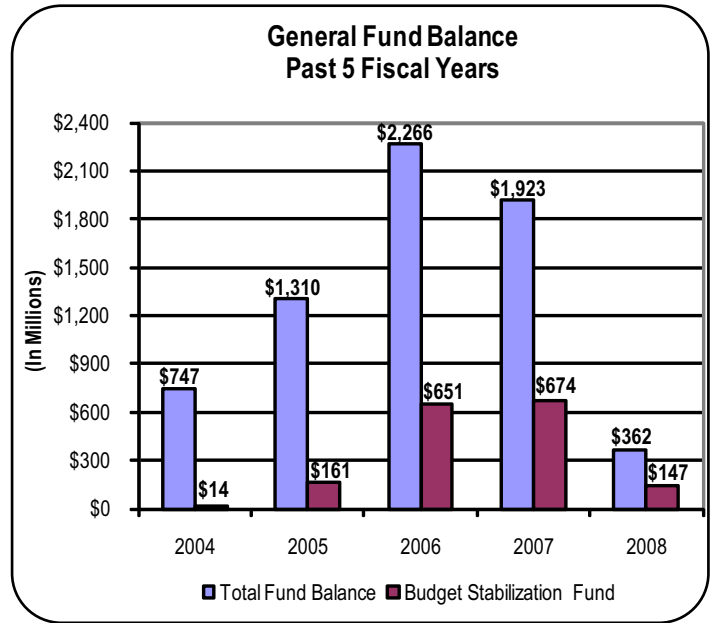
General Fund revenues and other financing sources increased \$436 million, or 2.2 percent, between fiscal years 2007 and 2008, primarily as a result of the following:

- Intergovernmental revenues increased \$999 million, or 12.7 percent, because of an increase in monies received for health and welfare programs from the federal and local governments.
- Sales tax revenues decreased \$217 million, or 3.8 percent because of the economic downturn. Sales taxes paid by retail stores and construction contractors decreased by \$120 million and \$112 million, respectively, when compared to fiscal year 2007 sales tax receipts. Overall, collections in other sales tax categories increased slightly.
- Income tax revenues decreased \$454 million, or 9.8 percent. This decrease was due to a gradual reduction in the individual income tax rates, a new formula used to compute the tax liability for multi-state corporations and a decline in Arizona's economy.

General Fund expenditures and other financing uses increased \$1.7 billion, or 8.3 percent, between fiscal years 2007 and 2008, primarily as a result of the following:

- Education expenditures increased \$310 million, or 5.9 percent, compared to fiscal year 2007. The increase can be primarily attributed to additional state assistance for kindergarten through 12th grade operating expenditures to support a student enrollment increase of 26,756 and a 2 percent inflation adjustment. Furthermore, the fiscal year 2008 budget provided for an additional \$80 million in a new Kindergarten "Group B" Weight funding for the second year of a 2-year phase-in. Additionally, programs supported by federal grant monies increased approximately \$27 million during the fiscal year.
- Health and welfare expenditures increased \$1.2 billion, or 13.1 percent, because of increased enrollment in the Arizona Health Care Cost Containment System's (AHCCCS) programs and associated provider reimbursement increases. Overall program enrollment in the various AHCCCS programs increased 5.1 percent, primarily because of growth in the Social Security Act Title XIX Waiver Group childless adults, Title XIX families and children, and long-term care program populations. Also, capitation rates were increased by a weighted average of 6.7 percent for the contract period of October 2007 to September 2008.

The graph to the right shows the General Fund's fund balance had increased from 2004 through 2006 by approximately \$1.5 billion. However, the fund balance has decreased the past 2 years by \$1.9 billion, ending with an unreserved fund balance of \$109 million and a reserved fund balance of \$253 million. Included in the \$253 million reserved fund balance is \$147 million for the Budget Stabilization Fund. The Budget Stabilization Fund is a form of "Rainy Day Fund" the Legislature established in 1991.

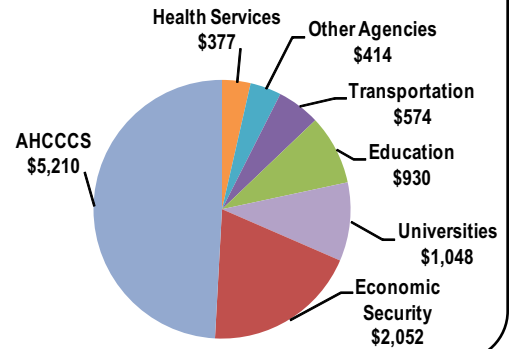


Expenditures of Federal Monies Increased by \$873 Million

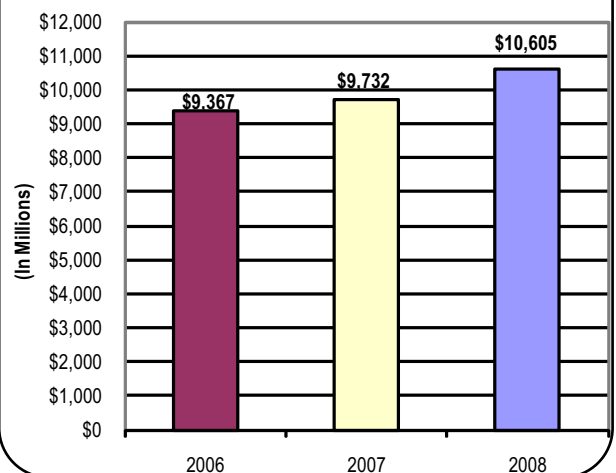
During fiscal year 2008, the State spent \$10.6 billion of federal monies. As shown in the chart to the right, six entities administered 96 percent of these monies.

Overall, expenditures increased \$873 million, or 9 percent, from the \$9.7 billion expended in fiscal year 2007. The largest increase occurred in the Unemployment Insurance program and the Medicaid, Child Nutrition, Food Stamp, and Highway Planning and Construction Clusters. Combined expenditures for these programs increased by \$856 million. This increase was attributable to inflationary increases in healthcare costs, enrollment increases in healthcare and child nutrition programs, accelerated highway construction, and increases in unemployment payments because of the economic downturn. The largest increase, \$452 million, occurred in federal monies expended for the Medicaid Cluster by the AHCCCS. As shown in the graph to the right, expenditures of federal monies have increased \$1.2 billion between fiscal years 2006 and 2008. Expenditures for the Unemployment Insurance program and the Medicaid, Child Nutrition, Food Stamp, and Highway Planning and Construction Clusters accounted for all but \$63 million of the increase.

State Agencies that Administer Federal Awards (In Millions)



Federal Programs Expenditures Fiscal Years 2006-2008



The State Did Not Always Comply with Federal Program Requirements

Auditors identified and tested 29 federal programs, including 11 program clusters, under the guidelines established by the Single Audit Act. Audit tests included evaluating the State's compliance with each program's federal regulations generally related to expending, monitoring, matching, and reporting federal awards. Auditors noted internal control weaknesses or instances of noncompliance with program requirements for 27 of the programs tested. For 11 of the 27, the internal control weaknesses and instances of noncompliance with program requirements

were considered to be material. As a result, our audit opinion on federal compliance was modified because of noncompliance with federal requirements for the following programs or clusters: Food Stamp Cluster, Child Nutrition Cluster, Cooperative Forestry Assistance, WIA Cluster, Education and Human Resources, Migrant Education—State Grant Program, Rehabilitation Services—Vocational Rehabilitation Grants to States, Temporary Assistance for Needy Families, Child Support Enforcement, Homeland Security Cluster, and Research and Development Cluster.

The Department of Economic Security Did Not Materially Comply with Program Requirements for Five Programs

The Arizona Department of Economic Security receives federal monies to help administer assistance programs to recipients throughout the State of Arizona. For the period July 1, 2007 through June 30, 2008, the Department received almost \$2.1 billion in federal financial assistance. However, for the audit period, the Department did not materially comply with federal requirements for five of its programs. Our report indicates that the following programs had material internal control weaknesses and material instances of noncompliance with federal requirements.

- The Division of Benefits and Medical Eligibility, Family Assistance Administration offices did not materially comply with federal requirements applicable to the Food Stamp Cluster and the Temporary Assistance for Needy Families (TANF) program, since they did not always follow the internal control policies and procedures for activating and issuing electronic benefits transfer (EBT) cards. In addition, three employees manipulated the eligibility computer system to issue EBT cards for personal use. This resulted in unallowable costs of \$265 in food stamp benefits and \$10,010 in TANF support service payments. The Department referred these matters to the Office of the Attorney General for further investigation and prosecution.
- The Division of Benefits and Medical Eligibility, Family Assistance Administration offices did not materially comply with federal requirements applicable to the TANF program, since they did not always retain documents supporting the verification of wage and unemployment compensation through the data exchange process or document the effect of its verification on eligibility and benefit determinations from its review.
- The Division of Employment and Rehabilitation Services, Rehabilitation Services Administration did not materially comply with federal requirements for the Rehabilitation Services—Vocational Rehabilitation Grants to States program because it did not always determine if applicants were eligible within the specified time period.
- The Division of Child Support Enforcement did not materially comply with federal requirements applicable to the Child Support Enforcement program for establishing support obligations, enforcing medical support obligations and interstate services, and establishing new cases.
- The Division of Employment and Rehabilitation Services did not materially comply with federal reporting and monitoring requirements for the WIA Cluster.

Ten Material Weaknesses Were Identified in Internal Control over Financial Reporting

Auditors identified 36 deficiencies in internal control over financial reporting. Ten of these deficiencies were material weaknesses. A material weakness is a weakness in internal controls that could lead to a material misstatement of the State's financial statements. The more significant material weaknesses were as follows:

- The Department of Administration's Director lacked the authority to enforce rules over financial reporting.
- The Department of Economic Security's Division of Developmental Disabilities did not ensure its financial statements were accurate and did not follow the AHCCCS-approved method to estimate its accrued long-term care costs.
- Arizona State University did not have adequate controls over payroll expenses and its new human resources and payroll computer system.
- Arizona State University did not have effective access, program change, and disaster recovery controls for its financial accounting system. It also did not have effective security, access, and change management controls for its new student information and human resources and payroll computer systems.
- Northern Arizona University did not have adequate controls over access and application software changes for its computer systems.

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(602) 553-0333



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our Web site at:
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Contact person for
this report:
Rick Meyer

Single Audit Fact Sheet

- Thirty-six weaknesses in financial reporting internal controls, including 10 material weaknesses.
- Thirty-one findings identifying weaknesses in federal compliance internal controls, including 17 material weaknesses.
- Thirty-one findings identifying violations of federal program compliance requirements, including 14 material violations.
- Program costs totaling \$634,123 were questioned as a result of our audit.