



A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Report on Internal Control and Compliance

State of Arizona

Year Ended June 30, 2012



Debra K. Davenport
Auditor General

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State of Arizona
Report on Internal Control and Compliance
Year Ended June 30, 2012

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DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

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**Independent Auditors' Report on Internal Control over Financial Reporting
and on Compliance and Other Matters Based on an Audit of Basic Financial
Statements Performed in Accordance with *Government Auditing Standards***

The Honorable Janice K. Brewer, Governor
State of Arizona

The Honorable Andy Biggs, President
Arizona State Senate

The Honorable Andy Tobin, Speaker
Arizona House of Representatives

The Honorable Rebecca White Berch, Chief Justice
Arizona Supreme Court

We have audited the financial statements of the governmental activities, business-type activities, aggregate discretely presented component units, each major fund, and aggregate remaining fund information of the State of Arizona as of and for the year ended June 30, 2012, which collectively comprise the State's basic financial statements, and have issued our report thereon dated January 14, 2013. Our report was modified to include a reference to our reliance on other auditors, for emphasis of a matter relating to the Rio Nuevo Multipurpose Facilities District, and as to consistency because of a change in reporting entity. We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the Arizona Department of Transportation, the Arizona Health Care Cost Containment System, the Arizona State Lottery, the Arizona State Retirement System, the Public Safety Personnel Retirement System, the Corrections Officer Retirement Plan, the Elected Officials' Retirement Plan, the Early Childhood Development and Health Board, the Arizona Correctional Industries, and the discretely presented component units, as described in our report on the State's financial statements. The financial statements of the Arizona Power Authority, the University of Arizona Health Network, and the Universities-Affiliated Component Units, except for those of the University Public Schools, Inc., which were reported as discretely presented component units, were not audited by the other auditors in accordance with *Government Auditing Standards*. This report includes our consideration of the results of the other auditors' testing of internal control over financial reporting and compliance and other matters that are reported on separately by those other auditors. However, this report, insofar as it relates to the results of the other auditors, is based solely on the reports of the other auditors.

Internal Control over Financial Reporting

The State's management is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the State's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our

opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses, and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying Schedule of Findings and Recommendations, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses, and we and the other auditors identified other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the State's basic financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the deficiencies described in the accompanying Schedule of Findings and Recommendations as items 12-01 and 12-02 to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying Schedule of Findings and Recommendations as items 12-03 through 12-06 to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State's basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests and those of the other auditors disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The State's responses to the findings identified in our audit are presented on pages 9 through 11. There is no response for the finding noted by the other auditors identified as item 12-06. We did not audit the State's responses, and accordingly, we express no opinion on them.

This report is intended solely for the information and use of the members of the Arizona State Legislature, management of state agencies, others within the State, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record, and its distribution is not limited.

Debbie Davenport
Auditor General

January 14, 2013

State of Arizona
Schedule of Findings and Recommendations
Year Ended June 30, 2012

12-01

The Department of Administration should issue accurate and timely financial statements

Criteria: The Department of Administration should issue accurate and timely financial statements for the State to satisfy the audit requirements imposed by federal and state laws and regulations, grant contracts, and long-term debt agreements.

Condition and context: The Department of Administration is responsible for establishing internal controls over financial reporting to help ensure that the State's Comprehensive Annual Financial Report (CAFR) is prepared in accordance with generally accepted accounting principles and is issued in a timely manner. In accordance with Arizona Revised Statutes (A.R.S.) §41-703, the director has the authority to adopt rules, regulations, and procedures to carry out his responsibilities. Further, A.R.S. §35-131(l) requires state agencies and other organizations included in the State's reporting entity to submit all necessary financial information to the Department in accordance with its policies and procedures. However, those statutes do not include provisions to enforce compliance, and as a result, state agencies and other organizations did not always comply with the established deadlines. To illustrate, state agencies and other organizations audited by contract auditors had a November 13, 2012, deadline to submit their audited financial statements, and only 8 of 16 met this deadline, while one failed to submit audited statements by the report date. Further, auditors identified two significant compilation errors that the Department did not detect during its initial review process. Specifically, the Department inadvertently transposed an amount when combining the assets and liabilities of the Arizona Health Care Cost Containment System with the State's General Fund. Also, the Department incorrectly adjusted revenue and expenditure line items within the State's General Fund. These errors misstated four financial statement line items within the General Fund, however, the State's financial statements were adjusted for these significant errors prior to the compilation of the final financial statements.

Effect: Since various state agencies and other organizations did not comply with state statutes or department rules and regulations, the State did not issue its CAFR by its December 31, 2012, deadline. Delays in financial reporting may result in rating agencies lowering the State's ratings for bonds and certificates of participation. Additionally, in the preliminary financial statements, the General Fund's due from U.S. government and unavailable deferred revenue line items were overstated by \$27 million, or by 1.07 percent of total assets and total liabilities and fund balance, and the sales tax revenue and intergovernmental revenue sharing line items were understated by more than \$958 million, or by 4.44 percent of revenues and 4.58 percent of expenditures.

Cause: State statutes do not provide the director with enforcement power to ensure that state agencies and other organizations comply with department rules, regulations, and procedures for financial reporting. Further, in an effort to prepare financial statements and issue them earlier than in the prior year, the Department reduced its time frame for preparing and reviewing the State's CAFR, thereby increasing the risk that errors made while compiling the statements could go undetected.

Recommendation: To help ensure that the Department prepares accurate financial statements and issues the State's CAFR in a timely manner, the Department should:

- Seek the authority to enforce rules, regulations, and procedures over financial reporting.

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Schedule of Findings and Recommendations
Year Ended June 30, 2012

- Establish enforcement actions for agencies and other organizations that fail to submit such information by the required deadlines.
- Prepare and review compilation schedules more carefully during the initial review process.
- Perform a comparative analysis of current year and prior year financial statement line items during the initial review process.

The timeliness aspect of this finding is similar to a prior-year finding.

12-02

The Department of Economic Security should prepare accurate financial statements

Criteria: The Department of Economic Security should have adequate internal controls to help ensure that amounts reported in its financial statements are accurate and properly classified in accordance with generally accepted accounting principles.

Condition and context: The Department's General Fund and the Unemployment Insurance (UI) Fund financial statements and supporting schedules were not always complete and accurate. While testing the amounts reported on the financial statements, auditors noted that negative restricted fund balance in five individual funds within the General Fund had been improperly reclassified to unassigned fund balance. In addition, the accounts receivable and cost of sales and benefits were not accurately reported in the UI Fund.

Effect: The errors caused the following misstatements in the financial statements:

- General Fund restricted fund balance was overstated, and unassigned fund balance was understated by \$32,945,685.
- UI Fund accounts receivable was overstated, and the cost of sales and benefits was understated by \$8,301,662.

The Department adjusted its financial statements for the errors noted above.

Cause: The Division of Business and Finance did not have written procedures to properly classify fund balances for reporting purposes or to ensure that a detailed management review of the General Fund financial statements was performed. Furthermore, the Division of Employment and Rehabilitation Services could not provide the Division of Business and Finance with accurate UI Fund accounts receivable information since the UI benefits payment system did not have the capability to establish, track, or report all Federal Additional Compensation program overpayments accurately or calculate an aging amount for interest on UI overpayments.

Recommendation: To help ensure that financial statements are accurate and complete, the Department should establish and follow written procedures for compiling the required information for preparing the financial statements and accompanying notes. These procedures should include detailed instructions for

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obtaining information from the unemployment insurance accounting systems, as well as obtaining information not readily available from the accounting systems but necessary for financial statement preparation.

12-03

The Department of Revenue should continue to strengthen its procedures for processing income tax revenues

Criteria: The Department should improve procedures to ensure that it records and reports all tax revenues of the State.

Condition and context: The Department is responsible for collecting, recording, and reporting income taxes owed to the State. While testing procedures for income tax revenues, auditors noted additional procedures that the Department should perform. Because this finding is of a sensitive nature, its specific details, including detailed recommendations, were verbally communicated to those officials directly responsible for implementing corrective action.

Effect: The State may not receive the proper amount of individual income taxes.

Cause: The computer system did not have the functionality to perform the identified omitted procedures.

Recommendation: The Department should implement additional procedures necessary to compensate for the omitted procedures.

This finding is similar to a prior-year finding.

12-04

The Industrial Commission of Arizona should strengthen change management controls for its computerized accounting system

Criteria: The Industrial Commission of Arizona uses its computerized accounting system to record detailed financial transactions and generate monthly and year-end summary reports to support amounts reported in the financial statements. Therefore, it is essential that changes to the system and data be documented, reviewed, and approved.

Condition and context: When users made changes to system data, the changes were documented in the system; however, if the database administrator made changes to the system database, the changes would not be documented in the system.

Effect: Unauthorized changes could be made to the system or data without detection.

Cause: The Commission did not have effective controls over system and data changes because it plans to replace its computer system. Therefore, it has chosen not to invest additional time or resources into an outdated system.

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Recommendation: To help strengthen controls over system and data changes to its computerized accounting system, the Commission should maintain a record of all system and data changes, including changes made directly to the system. Additionally, the Commission should regularly monitor these changes.

This finding is similar to a prior-year finding.

12-05

The University of Arizona should strengthen access controls for its general ledger system

Criteria: The University should have effective system access controls to help prevent and detect unauthorized use, damage, loss, or modification of programs and data, including sensitive and confidential information.

Condition and context: The University did not have a comprehensive process in place to centrally monitor and review user roles, groups, and permissions. This is important because the University used business rules that relied primarily on these user roles, groups, and permissions to enforce access controls and adequately segregate responsibilities. In addition, certain access controls were decentralized, and the University's policies and procedures did not provide sufficient guidance requiring individual departments to monitor and review user access. Consequently, the University could not generate for auditors a complete listing of system users that included all roles, groups, and permissions associated with each user. When testing the user information that was provided, auditors identified numerous users with the ability to initiate and approve their own fiscal year-end closing entries and other financial statement adjustments. In some cases, these users could approve their own system access based on the roles, groups, or permissions they were assigned at the department or college level. Furthermore, auditors found that the University did not always terminate employees nor their related system access in a timely manner and did not adequately monitor access logs or other changes to the underlying database.

Effect: There is an increased risk of misstatement or misuse of financial or confidential information by unauthorized users or by users who were not properly monitored.

Cause: The University implemented a new general ledger system during the fiscal year. The policies and procedures implemented were not sufficiently comprehensive to establish a process for monitoring and reviewing system access.

Recommendation: The University should strengthen access controls by strengthening policies and procedures that include the following:

- Develop a comprehensive process for reviewing user roles, groups, and permissions to help ensure that the appropriate level of system access is granted and communicate this review process to the departments responsible for decentralized access controls.
- Perform a comprehensive review of all existing system users annually to help ensure that access granted is compatible with their job responsibilities.

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- Improve communication among university departments to ensure that system access is removed for terminated employees immediately.
- Proactively monitor system access logs for unusual or suspicious activity.
- Establish logging techniques, proactive monitoring, or other triggers for direct changes to the database and investigate and resolve them.

Other auditors' findings:

The other auditors who audited the University of Arizona Health Network reported the following significant deficiency:

12-06

Revenue Cutoff

We reviewed the charges that related to services performed in the year ended June 30, 2012, that were not billed by the Corporation until fiscal year 2013. We noted that there was approximately \$2.9 million of net patient services related to 2012 that was not recorded until 2013. This resulted in an audit adjustment to record the revenue in fiscal year 2012. This was a result of management's financial statement close process being shorter than the process of billing some charges.

We recommend that the Corporation refine an estimation process to ensure that charges are recorded in the proper period.

State of Arizona
Corrective Action Plan
Year Ended June 30, 2012

12-01

The Department of Administration should issue accurate and timely financial statements

Agency: Department of Administration

Contact person: Clark Partridge, State Comptroller, (602) 542-5405

Anticipated completion date: December 31, 2013

Agency Response: We concur. As part of our efforts to prepare and issue timely financial statements, we share information with the auditors upon the initial compilation even though we had not completed our entire review process. Although individual controls in the initial preparation process did not detect the error, subsequent analytical analysis and controls are designed to address these issues and would have identified any significant items and corrected them before the financial statements were finalized.

Agency Corrective Action Plan: Timeliness is one of the fundamental characteristics to effective financial reporting and the timely issuance of the CAFR is vital to other reporting requirements and deadlines. A.R.S. §35-131 clearly requires state agencies and other organizations that are part of the State's reporting entity to submit all necessary financial statements and other information in accordance with the policies and procedures of the Arizona Department of Administration, General Accounting Office. This includes adherence to established time frames and deadlines. However, there are no specific provisions in the law for actions that may be taken to enforce such compliance. We are continuing to explore potential options for enforcement actions and will continue to work with state agencies to effectively resolve the issue of timely submission of financial information.

Administratively, we have addressed the specific issues resulting in delays with various state agencies and other organizations, and through these collective efforts have seen significant results in the last 6 years. The FY 2007, FY 2008, FY 2009, FY 2010, FY 2011, and FY 2012 CAFRs were issued June 16, 2008; May 26, 2009; May 7, 2010; March 4, 2011; February 10, 2012; and January 14, 2013, respectively. Further, of the eight agencies that missed the deadline, four submitted their information within 6 days of this date. The organization that failed to submit audited financial statements by the report date is a discretely presented component unit. This component unit is not material to the State and did not warrant further delay in issuing the State's financial statements. Despite the ongoing challenges of additional reporting requirements amid limited resources, we expect to continue to improve our timeliness and intend to issue the FY 2013 CAFR by December 31, 2013.

In regard to the prevention of errors, we continue to take great care to ensure that accuracy in the preparation of the CAFR is not compromised by our efforts to improve timeliness. Existing individual controls in compilation processes will be reviewed to evaluate their effectiveness in identifying errors. Further, as an added measure to detect significant compilation errors early in our preparation process, a comparative analysis of financial statement line items from current year to prior year will be performed and significant changes will be researched for reasonableness before draft financial statements are submitted to our auditors. Also, we'll continue to develop staff on the efficient use of practices that will improve work accuracy in the preparation and review of the CAFR.

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12-02

The Department of Economic Security should prepare accurate financial statements

Agency: Department of Economic Security

Contact persons: Tim Newton, DBF Accounting Administrator, (602) 364-2350, and
Mark Darmer, DERS Deputy Assistant Director, (602) 542-4910

Anticipated completion date: June 2013

Agency Response: Concur

Agency Corrective Action Plan: The DES Division of Business and Finance (DBF) will modify its current fund balance classification procedures to include the proper classification of the Governmental Fund balances for the Statewide CAFR reporting purposes. In addition, DBF will create a formal process to document that a detailed and complete management review of the fund-based and entity-wide financial statements has been performed.

DBF and the Division of Employment and Rehabilitation Services (DERS) will continue to work together to develop and use detailed instructions for obtaining information that is not readily available, but necessary for the financial statement preparation, from the Unemployment Insurance (UI) accounting systems. DERS has established a process for capturing Federal Additional Compensation (FAC) overpayments from UI recipient federal tax refunds. DERS will design a process to retrieve aging amounts of interest on regular UI benefits, Emergency Unemployment Compensation (EUC), and Extended Benefits (EB) so that DBF will be able to prepare accurate and complete UI financial statements.

12-03

The Department of Revenue should continue to strengthen its procedures for processing income tax revenues

Agency: Department of Revenue

Contact person: Francis Becker, Senior Internal Auditor, (602) 716-6156

Anticipated completion date: Unknown

Agency Response: Concur

Agency Corrective Action Plan: The Department understands the need for improved procedures concerning the recording and reporting of tax revenues for the State. Staff reductions, imperative IT projects and other resource limitations have required the Department to carefully prioritize proposed improvements. As the Department works through the implementation of improvements to systems and procedures, it has instituted and continues to research compensating controls to minimize risks to tax revenue.

12-04

The Industrial Commission of Arizona should strengthen change management controls for its computerized accounting system

Agency: Industrial Commission of Arizona

Contact person: Michael Hawthorne, CFO, (602) 542-5380

Anticipated completion date: Various, for anticipated completion dates see corrective action plan below.

Agency Response: Concur

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Agency Corrective Action Plan: The Industrial Commission of Arizona (the "Commission") has been dependent on a 30-year-old WANG PACE accounting application to provide financial transactions and reporting. The antiquated nature of the system did not provide logging of database administrator changes made at the database layer. With no industry support for the WANG PACE system or in-house development staff, it was not feasible for the Commission to modify the application.

However, in early fiscal year 2013, the Commission implemented Voyager, a new Special Fund Accounting .NET application and Microsoft SQL Server 2008 database. Voyager provides the ability to perform system level logging for database administrator changes to the database. The Commission will implement this new SQL logging solution and develop a review process based on industry "best practices" of SQL log activity, to be completed by the third quarter of fiscal year 2013.

It should be noted that although the WANG PACE system did not provide system-level logging of database changes, the Commission still employed a change management process that required CIO authorization and approval prior to any direct access to the PACE databases or system-level database changes.

12-05

The University of Arizona should strengthen access controls for its general ledger system

Agency: University of Arizona

Contact person: Duc Ma, Assistant Vice President, Financial Services, (520) 626-1188

Anticipated completion date: May 1, 2013

Agency Response: Concur

Agency Corrective Action Plan: The University will take the following steps to remediate the finding:

- A policy and procedure will be added to the Financial Services Manual regarding the creation, addition and review of groups/roles/permissions. Additionally, a tool will be developed for departments to review their groups/roles/permissions.
- An annual review of all UAccess Financial groups/roles/permissions will be performed.
- Communications will be made through a minimum of two outlets to Campus regarding timeliness of terminations; additionally revision of the termination procedures to efficiently reduce risk will be considered.
- Automated and manual options for proactive detection of unusual or suspicious activity and detection of direct changes to the database will be assessed. In the interim, logs are maintained detailing activity and will be reviewed if an issue is detected.

