A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Report on Internal Control and Compliance

University of Arizona

Year Ended June 30, 2008

Debra K. Davenport
Auditor General

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Annual Financial Report

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

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

Members of the Arizona State Legislature

The Arizona Board of Regents

We have audited the financial statements of the business-type activities and aggregate discretely presented component units of the University of Arizona as of and for the year ended June 30, 2008, which collectively comprise the University's financial statements, and have issued our report thereon dated November 25, 2008. Our report was modified to include a reference to our reliance on other auditors and as to consistency because of the implementation of Governmental Accounting Standards Board Statement Nos. 45, 48, and 50. 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 aggregate discretely presented component units, the University of Arizona Foundation, Inc., the University of Arizona Alumni Association, the Law College Association of the University of Arizona, and the Campus Research Corporation, as described in our report on the University's financial statements. The financial statements of the aggregate 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 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

In planning and performing our audit, we considered the University's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the University'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 would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we and the other auditors identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

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A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the University's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the University's financial statements that is more than inconsequential will not be prevented or detected by the University's internal control. We consider items 08-01 through 08-05 described in the accompanying Schedule of Findings and Recommendations to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the University's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the University's 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 disclosed an instance of noncompliance or other matter that is required to be reported under *Government Auditing Standards*, and which is described in the accompanying Schedule of Findings and Recommendations as item 08-01.

Managements' responses to the findings identified in our audit have been included herein. We did not audit managements' 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, the Arizona Board of Regents, the University, and management 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

November 25, 2008

University of Arizona Finding

08-01
The University should improve its internal controls over purchasing

The University purchases over $200 million each year from thousands of different vendors. To help ensure that the University receives quality goods and services at the best possible price, it needs to strictly follow its purchasing policies and procedures and comply with laws and regulations. The University is responsible for complying with the State's procurement laws as well as Arizona Board of Regents procurement policies and procedures. Also, the University has developed internal policies and procedures to help ensure that it complies with these requirements. However, we found that the University did not always follow its policies or had not developed adequate policies and procedures concerning competitive bidding, purchasing cards, and conflicts of interest.

Competitive Bidding
The Arizona Board of Regents' University Procurement Code requires competitive sealed bidding for purchases exceeding $50,000. Additionally, the University's policies and procedures require written quotations for purchases between $25,000 and $50,000. However, the University's procedures were not always followed. For example, auditors found that the University improperly renewed an expired maintenance contract exceeding $50,000 without obtaining the required competitive sealed bids. In addition, for a purchase that was between $25,000 and $50,000, the University obtained the required three written quotations. However, the University did not purchase from the vendor who provided the lowest quotation and did not maintain any documentation justifying why it was beneficial to buy the more expensive items.

Purchasing Cards
The University uses purchasing cards extensively and has detailed policies and procedures to help ensure that purchasing cards are used appropriately. The policies include transaction spending limits for cardholders and prohibitions on splitting purchases to avoid exceeding a cardholder's approved transaction limit. However, the University's controls were not always sufficient to detect whether expenditures were split when cardholders made purchases. For example, auditors noted one instance in which the cardholder made a purchase above the designated transaction spending limit because the vendor split the single purchase into two separate charges, each below the limit.

Conflicts of Interest
State law requires that the University's employees make it known when they have substantial interests, such as ownership, in vendors from which the University might purchase goods and services. In addition, university policies and procedures require employees to report any substantial interest with potential vendors by filing conflict of interest statements with the University's Procurement and Contracting Services Department. Those employees must then refrain from participating in or approving any purchases from those vendors. However, the University did not have adequate procedures to ensure that employees with substantial interests were not involved in approving or making purchases from those vendors. For example, auditors noted one employee who was allowed to make a purchase directly from a business of which he was part owner.

The University should strengthen its internal controls over purchasing. Specifically, the University should ensure that it implements and practices the following procedures.

Competitive Bidding

- Communicate existing university procurement policies and procedures by providing training to employees involved in the procurement process. Training should emphasize that competitive sealed bids are required for purchases over $50,000, and written price quotations are required for purchases between $25,000 and $50,000. Also, vendors providing the lowest quotation should be selected unless appropriate documentation is maintained supporting why another vendor was selected.

Purchasing Cards

- Reinforce existing university policies prohibiting the splitting of purchasing card purchases to avoid exceeding the purchasing card's transaction limit.
- Develop policies and procedures to monitor purchasing card activity to detect when splitting of purchasing card transactions occurs.
- Take corrective action, such as canceling or suspending the cardholder's purchasing card privileges, when the cardholder splits purchases to circumvent the spending limit.

Conflicts of Interest

- Require all current employees, at least annually, to review the conflict of interest statement form to determine if their current circumstances require them to revise their prior disclosure or disclose a substantial interest for the first time.
- Create a comprehensive and easily accessible list of employees who have disclosed a substantial interest in a potential vendor.
- Communicate to employees with substantial interests in potential vendors that they are required to remove themselves from any purchasing decisions or approvals with those vendors.
- Develop policies and procedures to monitor that employees were appropriately involved in the purchasing process.

Component Unit Findings

The other auditors who audited the Law College Association of the University of Arizona, the Campus Research Corporation, and the University of Arizona Alumni Association reported the following significant deficiencies for those component units.

08-02
Law College Association
Audit Adjustments

For the year audited, audit adjustments were required for the financial statements to be materially correct at year-end. Although auditors are permitted to draft an organization's financial statements, the preparation of the underlying general ledger, which is used to prepare the financial statements, including the footnotes, is the responsibility of management. The unadjusted general ledger was not materially correct under generally accepted accounting principles. We recommend that the Association have appropriate processes in place to properly reconcile the general ledger throughout the year and especially at year-end, prior to audit fieldwork, as part of the year-end closing process.

Management response: There were seven journal entries made during the audit process, four of which were reclassification entries. The reclassification entries that were made have in years past been prepared during the audit process. Management will make an effort to prepare these entries prior to the auditors beginning field work in the future. Of the three remaining entries made, one was an accounts payable accrual, one relates to the cutoff question discussed in point two below, and one was due to a $7,500 error in management's calculation of the discount on pledges receivables, which totaled $9,490,073. Management is in the process of revising its procedures for accounts payable so that the accounting system captures the payables as invoices are received. This will eliminate the need to make an accrual for accounts payable at year end.

08-03
Law College Association
Cutoff

At the end of the fiscal year, the Association cut many significant cash disbursement checks and held the checks until funds were available to cover the checks, which was not until after the end of the fiscal year. The Association also recorded numerous cash receipts received subsequent to year-end as deposits in transit as of the end of the fiscal year. Under generally accepted accounting principles, cash receipts are only to be recorded if they have either been deposited or have been received but not yet deposited. Likewise, cash disbursements are only to be recorded when they have been cut and disbursed to the payees. We recommend that the Association set a process in place that will ensure that deposits in transit only reflect actual receipts and that checks only be cut as funds are available. Due to the Association having an improper cutoff during the year, a material audit adjustment had to be recorded to the cash account.

Management response: The Association followed the same cutoff procedures this year in recording deposits as in prior years. However, this year there were some large payments made against pledges receivable where the checks were dated prior to but received after the last day of the fiscal year. In the case of one large donation in particular, the Association was in contact with the donor, who sent a fax copy of the check prior to year end and mailed the check, which was dated May 29, 2008, to the Association via a courier service. Since the last day of the fiscal year fell on a weekend, management believed that they had constructive receipt of the gift, which was received on the second day (Monday) of the new fiscal year and deposited on the third (Tuesday). Having made this determination, management prepared checks to transfer funds from this gift to The University of Arizona. The auditors determined that this practice was contrary to generally accepted accounting principles. Based on this determination, the Association reclassified the major cash receipts as pledge receivables, reversed the small amount of gifts recorded and reversed the cash disbursement transfers. These items will be recorded in the new fiscal year. In the future, the Association will only record funds actually received by the last day of the fiscal year and will cut and disburse checks as funds are available.

08-04
Campus Research Corporation
Financial Statement Preparation

Campus Research Corporation, like many nonprofit organizations, has historically relied upon its auditors to draft its annual financial statements and required disclosures as part of the year-end audit process. Upon completion of audit fieldwork management has reviewed and approved any adjustments made to the general ledger, and then the audited financial statements have been subjected to review and approval by management and the organization’s Audit Committee prior to issuance.

U.S. generally accepted auditing standards require management be responsible for the preparation of an organization’s financial statements and all required disclosures in accordance with U.S. generally accepted accounting principles (GAAP). Accordingly, to comply with these standards an organization must not only have accounting personnel that have expertise in the area of financial reporting standards, but a system in place that ensures on-going training for its personnel in the area of financial reporting and the necessary reference materials or other resources to ensure compliance with financial reporting standards.

While the Organization’s accounting personnel possess the level of skill necessary to produce the basic financial statements, they lack the technical expertise needed to ensure compliance with the current reporting standards promulgated in GAAP. Further, the organization does not have the necessary technical reference materials and resources needed to ensure the propriety and completeness of all of the required financial disclosures applicable to its financial statements. We believe these resource limitations would limit the organization’s ability to comply with the requirements as outlined and as such would be deemed an internal control deficiency with respect to the financial reporting control.

We acknowledge that this is an element of internal control embodied in the new standards that may be difficult for some organizations to overcome. For many organizations like Campus Research Corporation, financial constraints make it more cost effective to rely on its auditors for this technical expertise. This item was communicated in the 2007 audit.

Management response: We have an extremely small and limited staff at Campus Research Corporation, but we do provide Management monthly and year-end financial reports. Our annual audited financial statements and footnotes are outsourced to our auditors because of the cost/benefit standpoint and our auditors have direct knowledge that aids in preparing the annual audited financial statement package. Our trial balance and financial package is used for basis in the preparation of annual audited financial statement package.

08-05
Alumni Association
Travel or Entertainment Expenses

The Association's documented procedures require purchases for travel or entertainment to be authorized by the Association's President. During our testing of cash disbursement procedures for travel or entertainment, we noted some travel and entertainment purchases were not properly authorized. We recommend that the Association continue to train employees and management in the importance of following these approval procedures.

Management response: Management will take appropriate steps to ensure that all business travel is approved in advance by the Association's President, including, but not limited to, randomly testing these procedures internally.

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December 10, 2008

Ms. Debbie Davenport
Auditor General, State of Arizona
2910 North 44th Street, Suite 410
Phoenix, AZ 85018

Dear Ms. Davenport;

The following is the University of Arizona's response to the significant deficiency described in the Schedule of Findings and Recommendations, item 08-01.

Title of Finding: 08-01 The University should improve its internal controls over purchasing

Response:

We Concur. Please find attached the University's corrective action plan.

I would like to emphasize that we have not responded to items 08-02 through 08-05. These items relate to certain of our component units, which are discreetly presented in the Annual Financial Report of the University. The component units are made up of separate, legal entities that are not subject to management by the University. As such, it would not be appropriate for us to respond to issues pertaining to these entities.

If you have any questions, you may contact me at (520) 626-1677.

Sincerely,

Mark McGurk
Comptroller

University of Arizona
Corrective Action Plan
Year Ended June 30, 2008

08-01
The University should improve its internal controls over purchasing
Contact Person: Kirk Ketcham, Procurement and Contracting Services Director
Anticipated Completion Date: December 2008 for Competitive Bidding and Purchasing Card
March 2009 for Conflict of Interest

Competitive Bidding

We concur with the audit recommendation and will take appropriate action to ensure compliance with all State and ABOR procurement laws and regulations. Procurement and Contracting Services (PACS) has policies and procedures in place for all purchase order awards that require a competitive solicitation. PACS Administrators will reiterate existing University Procurement policies and procedures to all employees involved in the procurement process. During our monthly Buyer Meetings, PACS Administrators will emphasize the importance of retaining proper written documentation to support vendor selection when choosing to purchase items from higher priced entities. PACS Administrators will also highlight the policy on formal written competitive sealed bids which are required for purchases greater than $50,000, unless a sole source or emergency exists. An emphasis will be placed on documentation requirements for informal price quotes (via phone, fax or email) for purchases between $25,000 and $50,000.

Purchasing Card

We concur with the audit recommendation and will actively use the “Declines Report” data to flag possible misuse. This report checks for spending patterns to detect if cardholders are attempting to make purchases over $5,000 and/or attempting to make unauthorized purchases. This should assist PACS in determining whether any splitting, fragmenting, and/or pyramiding have occurred. When a transaction is flagged through this process PACS requires that a “Possible Non-Compliance” form be sent to the Department Liaison requesting justification and documentation for the transactions in question. The form must also be reviewed and signed by the Director or Department Head.

Once all documentation is compiled it is reviewed by a PCard Administrator and Assistant Director of Procurement and Contracting Services in order to determine if an actual violation has taken place. If it is determined that a violation has occurred the card will be suspended for 90 days. Notification of card suspension is sent to Department Liaison and the Dean, Director or Department Head.

Conflict of Interest

We concur with the audit recommendations and will take appropriate action to address these issues. On an annual basis, PACS will send an email to all current University employees to inform them of their responsibility to review the Purchasing Policy on Conflict of Interest (Policy 1.4). This policy requires that employees file a disclosure of substantial interest and/or update any existing disclosures.

The Disclosure of Conflict of Interest form has been revised. The signed statement is an attestation requiring that the employee not be involved in any purchasing decisions and/or approvals related to the listed vendor. Once the form has gone through a formal review process, the employee is notified whether or not a Conflict of Interest exists.

PACS has also implemented procedures to ensure that a comprehensive Conflict of Interest listing is maintained and kept current. The listing will be disclosed on the Procurement and Contracting Services web site.

PACS internal procedures have been revised to include Conflict of Interest flags within the FRS Vendor File (either substantial or remote). When processing requisitions, Buyers are responsible for securing a vendor number from the Vendor File. At that point in time, the Buyer will identify whether the vendor has a Conflict of Interest designation. Should purchasing from a particular vendor be a Conflict of Interest, the Buyer will notify the department to ensure that the employee is not involved in the purchasing decision.