Financial Statement Findings and State Responses
(Reformatted from FY 2010 Single Audit Report)

10-01
The Department of Administration should prepare accurate financial statements in a timely manner

Finding

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 Director of the Department is responsible for establishing and maintaining the State's accounting systems and preparing accurate and timely financial reports, including the State's Comprehensive Annual Financial Report (CAFR). In accordance with Arizona Revised Statutes (A.R.S.) §41-703, the Director has the authority to promulgate rules, regulations, and procedures to carry out his responsibilities. Further, A.R.S. §35-131(I), 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 did 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 29, 2010, deadline to submit their audited financial statements; only four met this deadline, and the other eight submitted their audited financial statements from December 1, 2010 to February 17, 2011.

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, 2010, deadline. Delays in financial reporting may result in rating agencies lowering the State's ratings for bonds and certificates of participation. This finding is a significant deficiency in internal control over financial reporting.

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.

Recommendation: To help ensure that the Department receives financial information necessary for timely issuance of the State's CAFR, the Department should:

- Seek the authority to enforce rules, regulations, and procedures over financial reporting.
- Establish enforcement actions for agencies' and other organizations' who fail to submit such information by the required deadlines.

This finding is similar to a prior-year finding.

Agency Response: Concur

Agency Corrective Action Plan: Timeliness is one of the fundamental thresholds of 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 past few years. The FY 2007, FY 2008, FY 2009, and FY 2010 CAFRs were issued June 16, 2008, May 26, 2009, May 7, 2010, and March 4, 2011, respectively. Further, despite the on-going challenges of additional reporting requirements amid limited resources, we expect to continue to improve our timeliness.

10-02
The Department of Economic Security should prepare accurate financial statements

Finding

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

Condition and context: The unemployment insurance fund's financial statements and detailed supporting schedules were not always accurate and complete. While testing the amounts reported on the financial statements, auditors noted the Department did not properly classify accrued liabilities and employers' unemployment insurance contributions revenues, and overstated other revenues and other expenses. Additionally, the Department understated accounts receivable and overstated cost of sales and benefits. Specifically, when a Federal Additional Compensation (FAC) program overpayment is identified the Department is required to record an accounts receivable and reduce the claimant's future benefits. However, the Department did not record the accounts receivable and reduce the cost of sales and benefits expenses to properly account for FAC program overpayments.

Effect: The errors caused the following misstatements in the unemployment insurance fund's financial statements:

- Accrued liabilities were overstated and employers' unemployment insurance contributions were understated by $1,409,000.

- Other revenues and other expenses were overstated by $106,931,000.

- Accounts receivable and unemployment benefits payable was overstated by $1,789,000.

- Accounts receivable was understated and cost of sales and benefits was overstated by $6,713,291.

The Department adjusted the financial statements for the errors noted above. This finding is a material weakness in internal control over financial reporting.

Cause: The Department did not identify that the financial accounting system incorrectly rejected a report and established an accrued liability for an employer's payment of $1,409,000. The $106,931,000 misstatement was caused by an adjustment based on information not readily available from the accounting system that was posted in error. Finally, the unemployment insurance benefits payment system did not have the capability to establish, track or report FAC overpayments causing the other misstatements.

Recommendation: To help ensure that financial statements of the unemployment insurance fund are accurate and complete, the Department should perform the following procedures:

- Strengthen and follow written procedures for compiling the information and preparing the financial statements and accompanying notes. These procedures should include detailed instructions for obtaining information from the unemployment insurance accounting systems, as well as obtaining information not readily available from the accounting system but necessary for financial statement preparation.

- Develop a method to establish, track, and report FAC overpayments.

Agency Response: Concur

Agency Corrective Action Plan: The DES Division of Business and Finance (DBF) and the Division of Employment and Rehabilitation Services (DERS) are working together to improve the financial statement preparation process with the goal of eliminating any future financial statement errors. The improvements include the following:

- DBF and DERS will hold divisional meetings before and during the financial statement preparation process to ensure any changes to the Unemployment Insurance (UI) Program from the prior year are communicated to DBF and the Accounting Office. The anticipated date of the first meeting is July 6, 2011.

- DBF and DERS will meet to review the draft of the financial statements. The anticipated date of this meeting is September 14, 2011.

- DBF and DERS will develop and require use of clearer terminology in written procedures used for compiling the data and preparing the financial statements. This will be completed and in place by July 31, 2011.

- DBF and DERS will develop and use detailed instructions for obtaining information from the Unemployment Insurance accounting systems and other information not readily available from the accounting systems, but necessary for the financial statement preparation. The anticipated completion date for this item is July 31, 2011.

In addition, DERS is working to ensure that rejected TAX and Wage Reports are resolved as soon as possible. The UI Tax Unit will strengthen written procedures used by the Employer Accounting and the Employer Registration Units. This will include using current reporting capabilities to begin tracking rejected Tax and Wage Reports, and developing procedures for researching employer accounts with significant payable amounts to determine if rejected Tax and Wage Reports exist for a particular account. The anticipated completion date is April 24, 2011.

DERS is in the process of developing a method to establish, track, and report Federal Additional Compensation (FAC) overpayments. The new process will establish FAC overpayments and any future overpayments that are created. The FAC overpayments will be tracked and reported in the same manner in which the regular benefit overpayments are currently tracked. The projected implementation date of the new method is April 24, 2011.

- Strengthen and follow written procedures for compiling the information and preparing the financial statements and accompanying notes. These procedures should include detailed instructions for obtaining information from the unemployment insurance accounting systems, as well as obtaining information not readily available from the accounting system but necessary for financial statement preparation.

- Develop a method to establish, track, and report FAC overpayments.

Financial Statement Findings and State Responses
(Reformatted from FY 2010 Single Audit Report)

10-03
The Industrial Commission of Arizona should maintain a record of all changes to its computer system

Finding
Criteria: The Industrial Commission of Arizona uses its computer 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 reviewed and documented.

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. Additionally, any changes to key computer equipment, such as firewalls, routers, or switches, were made by the chief information officer, but were not reviewed or authorized by another employee.

Effect: Unauthorized changes could be made to the system or data without detection. This finding is a significant deficiency in internal control over financial reporting.

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

Recommendation: To help strengthen controls over system and data changes to its computer system, the Commission should:

- Maintain a record of all system and data changes, including changes made to the system database, to help monitor changes.

- Have an independent employee review and authorize all major changes to computer equipment.

This finding is similar to a prior-year finding.

Agency Response: Concur

Agency Corrective Action Plan: Per a meeting with the auditors, finding 10-03 requires that the PACE application log all system level database changes that could be made directly to the database by the PACE administrator. The PACE system was developed at a time when this was not a requirement and the system as currently in place does not have a means to log direct database administrator changes and the Commission does not have a mean to modify the code to correct this issue.
The Commission is currently developing a new Special Fund Accounting application to replace the Legacy PACE system, which is scheduled to be deployed in July 2011 to resolve this problem.

10-04
The Department of Revenue's computer access controls should continue to be strengthened

Finding
Criteria: The Department of Revenue should have effective computer access controls to prevent and detect unauthorized use, damage, loss, or modification of programs and data, and misuse of sensitive or confidential information.

Condition and context: While performing test work over access controls to the Department's computerized financial information systems, auditors noted the Department did not always retain documentation to support its review and approval of users' access rights. For example, for 2 of 14 employees selected for test work, the Department was unable to provide documentation authorizing the employees' access and approval of those rights by a supervisor. Also, the Department did not remove two users' access rights after the employees separated from the Department as required by the Department's policies and procedures. In addition, the Department did not actively monitor database administrators with elevated user access privileges.

Effect: There is an increased risk of theft, manipulation, or misuse of sensitive or confidential data by unauthorized users or by users who were not being properly monitored. This finding is a significant deficiency in internal control over financial reporting.

Cause: The Department did not commit sufficient resources to ensure appropriate documentation of supervisory approval of employee access rights. In addition, the Department did not have policies and procedures in place to independently monitor and review the activities of database administrators with elevated system access.

Recommendation: To help ensure the integrity of the Department's computerized financial information systems, the Department should follow its policies and procedures, which require documentation of supervisory approval on all requests for system access, and prompt termination of user access when an employee leaves employment or changes job responsibilities within the Department. In addition, the Department should develop policies and procedures that require the activities of database administrators with elevated user access privileges to be independently monitored and reviewed for propriety.

This finding is similar to a prior-year finding.

Agency Response: Concur

Agency Corrective Action Plan:

User Access

During FY 2010, the Department took immediate action to ensure that all employees with system access had required documentation to support their access rights. This updated process requires each individual business unit to maintain documentation to support user's access rights within their respective unit. The Department is currently implementing an additional control, with centralized oversight to ensure each business unit has and maintains this documentation. The Department anticipates this additional control will be implemented no later than June 30th, 2011.

User Accounts

The Department currently has 3 procedures/controls in place to identify and disable user accounts. The Department is currently implementing an additional process with centralized controls to replace one or more of the existing controls to ensure timely removal of user access rights once employment has been discontinued. The Department anticipates this additional control will be implemented no later than June 30th, 2011.

DBA Privileges

The Department captures and retains activity logs for database administrators with elevated user access, which currently requires significant manual effort to actively monitor. The Department has however, initiated a project, which is currently in the pilot phase, to address this. The anticipated completion date, as in the Department's FY2009 response, is June 30th, 2011.

Financial Statement Findings and State Responses
(Reformatted from FY 2010 Single Audit Report)

10-05
The Department of Revenue should continue to strengthen its procedures for processing income tax revenues

Finding
Criteria: The Department of Revenue should have effective controls to record and report all income tax revenue of the State.

Condition and context: The Department is responsible for collecting, recording, and reporting all income taxes owed to the State. While testing procedures for income tax revenues, auditors noted additional procedures that should be performed. Because of the nature of this finding, the specific details of this finding, 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 income taxes. This finding is a significant deficiency in internal control over financial reporting.

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.

Agency Response: Concur

Agency Corrective Action Plan: The Department understands and has prioritized the continual improvement of its operations including all departmental procedures and controls and will continue to do so. Where constrained by limited resources, the Department has instituted compensating controls to help minimize risks to tax revenues.

10-06
The Department of Revenue should better protect its computer network

Finding
Criteria: The Department of Revenue should have effective network security controls to prevent and detect unauthorized use, damage, loss, or modification of programs and data, and misuse of sensitive or confidential information.

Condition and context: The Department is the main tax collector for the State of Arizona, and in connection with those tax collections the Department maintains a significant amount of confidential data on its computerized information systems. However, the Department did not have adequate controls in place to help identify and resolve vulnerabilities to its network. Because of the sensitive nature of this finding, the specific details of this finding, including detailed recommendations, were verbally communicated to those officials directly responsible for implementing corrective action.

Effect: There is an increased risk for unauthorized persons to obtain confidential data or make changes to computer programs or data. This finding is a significant deficiency in internal control over financial reporting.

Cause: The Department had insufficient internal control policies and procedures to address the potential vulnerabilities.

Recommendation: The Department should implement additional policies and procedures for network security to help prevent and detect unauthorized access or misuse of confidential information.

This finding is similar to a prior-year finding.

Agency Response: Concur

Agency Corrective Action Plan: The Department took immediate short-term steps in mitigating the risk by removing the tool with vulnerabilities. Further, the Department currently has a tool in the pilot phase which, once implemented, will serve as an additional detective control over unauthorized system access. The Department is working diligently to move this tool into production, with an anticipated implementation date of June 30th, 2011.

10-07
Arizona State University should strengthen controls over payroll expenses

Finding
Criteria: The University needs to have strong internal controls over payroll expenses to help ensure employees are accurately paid and to accurately record and report payroll expenses. Further, since payroll processing functions are decentralized at the University, the internal controls should include adequate monitoring and training to ensure compliance with established policies and procedures.

Condition and context: The University's payroll and related expenses comprise over $881 million, or approximately 58 percent, of its total expenses. Payroll processing at the University is decentralized since some key internal control functions are performed by university departments. During fiscal year 2010, the University improved existing policies and procedures for processing, monitoring, and verifying payroll expenses. However, when obtaining an understanding of the University's internal control over payroll expenses and testing those controls, auditors noted the following deficiencies:

- For 8 of 71 university departments where employees were selected for test work, the departments either did not prepare a monthly detailed reconciliation of payroll expenses for each employee or did not correctly prepare the reconciliation in accordance with the University's policies. In addition, four of these departments did not ensure that amounts paid to employees agreed to the employment contracts.

- For 5 of 92 employees selected for test work, the employee was paid or reimbursed for employment-related expenses in excess of the amount specified in the employment contract, offer letter, or other official documentation maintained in the personnel file. Further, these overpayments were not identified by the University and were not included in the listing used to monitor overpayments.

- Leave requests for employees were not always reviewed and monitored at the department level. In addition, the leave requests were not always retained to support vacation and sick leave taken on time sheets.

- For 2 of 71 departments where employees were selected for test work, time sheets for hourly employees were approved by employees who did not have firsthand knowledge of the actual time worked.

- Payroll overpayments identified by departments or reported by the employees themselves were not consolidated in a timely manner and monitored centrally. As a result, the University was unable to determine recurring reasons for overpayments and identify potential internal control deficiencies.

Effect: The lack of effective internal controls over payroll expenses may result in misstating the financial statements or paying employees wrong amounts. In addition, it also increases the risk of fraudulent payroll transactions occurring and not being detected. This finding is a significant deficiency in internal control over financial reporting.

Agency Response: Concur

Agency Corrective Action Plan: All recommendations have been implemented and, as noted by the auditors, the University has made significant progress in resolving payroll-related issues. Improving overall compliance by individual university departments is ongoing and the University will continue with education and monitoring efforts.

The University agrees departments should review and reconcile payroll expenses in compliance with University policy to identify and rectify issues relating to employee pay, including pay adjustments, leave reporting, and timesheet approvals. During fiscal year 2010 most departments instituted processes to comply with the University's policy, as evidenced by the auditor's findings and University reviews performed by Financial Services. Additionally, in fiscal year 2010, a central website containing payroll and human resources-related policies and procedures was established and made available to University departments.

Responsibility for the payroll function, including management of overpayments, was transferred to the accounting area of Financial Services at the beginning of fiscal year 2011. A single comprehensive overpayment list is maintained and updated to ensure timely collection of overpayments and to identify potential control weaknesses in either University or departmental processes.

Cause: Since the payroll processing function is decentralized, individual departments did not always follow payroll policies, and the University did not effectively monitor the decentralized payroll functions.

Recommendation: To help ensure employees are accurately paid and that payroll expenses are accurately recorded and reported, the University should:

- Ensure that all departments prepare detailed monthly reconciliations of each employee's payroll expenses in accordance with the University's policies.

- Improve controls over payroll to ensure that payroll data reflected in the payroll system is supported by the contract, offer letter, or other official documentation maintained in the personnel files.

- Require departments to follow established policies and procedures to ensure that leave requests for employees are reviewed, monitored, and retained to support hours worked.

- Ensure that departments are aware of and follow guidelines for verifying and approving time recorded by employees.

- Monitor the overpayment listing centrally to help ensure accuracy, completeness, and timely collection of overpayments as well as to identify potential internal control weaknesses.

- Ensure all departmental personnel responsible for payroll functions are instructed as to the University's current policies and procedures.

This finding is similar to a prior-year finding.

Other auditors' findings:

The other auditors who audited the Water Infrastructure Finance Authority reported the following material weakness.

10-08
Closing Procedures for the End of Year

Finding
Criteria: The design and operation of the components of internal control over financial reporting should reduce to a relatively low level the risk that misstatements caused by error in the amounts that would be material to the financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Condition and context: Significant audit adjustments were required relating to loans receivable and interest payable.

Effect: Assets were understated, liabilities were overstated and expenses were overstated, resulting in two adjustments significant to the financial statements.

Cause: Controls relating to proper closing procedures and timely oversight over the process were not effective.

Recommendation: We recommend that management strengthen its policies and procedures over the year-end closing process to ensure all accounts were accurately adjusted.

Management's response: Fiscal year 2010 was only the Authority's second year operating in its new, all inclusive software program (LGTS). The software is a database, not an accounting program. The developers have tried to automate as many functions as possible. However, some functions that would be routine in a typical computer accounting system, require user entries in LTGS. This includes both accrual entries and closing entries. A bug in the program caused LGTS to ignore the fact that a new bond issue had taken place during the year when it calculated the interest payable. This has been addressed with the developers. All receivable entries must be calculated and keyed by the users. Management has instituted a checklist document to be used at the roll over from one fiscal year to the next. This will ensure that all bond issues, new and old are included in the interest payable calculation in future years. The document will also serve as a double check to ensure that all receivable entries are made and to verify the accuracy of those entries. The Authority is also continuing to work with the software developers to further automate year end and roll over transactions.