Financial Statement Findings and State Responses
(Reformatted from the FY 2014 Report on Internal Control and Compliance)

2014-01
The Arizona Department of Administration's Data Center should strengthen their contracts with state agencies

Criteria: Information technology (IT) services that the Arizona Department of Administration's Data Center (Data Center) provides to state agencies should be well documented, complete, comprehensive, up to date, and include all parties' responsibilities. Well-documented and up-to-date services provide staff with repeatable processes and clear expectations. In addition, the Data Center should maintain a listing of state agencies it has provided services to and the services provided.

Condition and context: The Data Center's IT service contracts with state agencies are broad, not agency specific, and do not adequately address critical services, including disaster recovery. Consequently, agencies may not understand their responsibilities in the event of a disaster, including what they would need to provide (e.g., data, software, etc.) to the Data Center.

Effect: Contracts for services between the Data Center and state agencies could result in the failure to clearly communicate policies and procedures, limit staff accountability, and result in inconsistencies. For example, if a major disruption or disaster were to occur, the order in which systems were restored may not match individual state agencies' or the State's criticality or operational priorities. In addition, state agencies might incorrectly assume that the Data Center will always provide full off-site backup and disaster recovery.

Cause: The Data Center did not have sufficient policies and procedures to help ensure their contracts with state agencies, including disaster recovery services, are specific for each state agency and are updated as needed. In addition, the Data Center did not maintain a comprehensive listing of state agencies it provided services to along with the services provided.

Recommendation: To help ensure IT services provided to state agencies are well documented, complete, comprehensive, up to date, and include the specific responsibilities of all parties, the Data Center should strengthen its IT services policies and procedures. For example, an IT service contract for disaster recovery should include a comprehensive disaster recovery plan that includes all systems and infrastructure for which it is responsible, and addresses important elements such as regulatory and contractual requirements, the state agencies' overall business continuity needs, IT resource management requirements and interdependencies, an analysis of business impacts, risk assessments, emergency procedures, testing, and ongoing maintenance of its disaster recovery efforts. In addition, the Data Center should maintain a comprehensive listing of state agencies it has provided services to along with the services provided.

Agency Response: Concur

Department of Administration – Arizona Strategic Enterprise Technology Division (ADOA-ASET)
Contact persons and titles: 1. Donald L Hennington, Chief Operating Officer & Assistant Director, (602) 542-1422
2. Gary Hensley, Chief Enterprise Integration Officer & Assistant Director, (602) 771-6401
Anticipated completion date: July 1, 2016

The Agency has reviewed the audit finding and recommendation associated with the audit of the Data Center contracts with state agencies. We concur with the audit finding and recommendation. The Agency will take the following corrective actions:

- The ADOA-ASET State Data Center (SDC), with the assistance of an outside contractor, has created and finalized a comprehensive Disaster Recovery/Incident Recovery Plan (DR/IRP) document, which includes all system and infrastructure components for which it is responsible, and addressed important elements such as regulatory and contractual requirements, the Department's overall business continuity needs, IT resource management requirements and interdependencies, an analysis of business impacts, risk assessments, emergency procedures, testing, and ongoing maintenance of its disaster recovery efforts. This document is a living document which will be maintained and updated as changes occur as business needs dictate.

a. ADOA-ASET will clarify a client agency's responsibilities in the provisioning of Agency specific business recovery and disaster recovery requirements to effectuate an agency's business continuity and recovery as part of an agency's IT risk management planning.

b. ADOA-ASET will provide assistance to individual agencies to define their individual business impacts, risk assessments, emergency procedures, testing, and ongoing maintenance of an agency's disaster recovery needs.

- ADOA-ASET has prepared a full listing of State Agencies and the services provided to them. Additional development effort is being defined to refine the individual services to articulate the individual services in business terms, so that they would be readily understandable by the agency business community. In support of that effort, ADOA-ASET will define a services costing model that will be based on an agency's business requirements.

- ADOA-ASET will improve the contractual language of State Data Center service contracts to ensure clarity of services provided and specific responsibilities of all parties. The current Inter-Agency Services Agreement (ISA) is being reviewed by ADOA legal, and recommendations from that review process will be incorporated into a new agreement with clarified terms and conditions that are specific to the requesting agency.

2014-02
The State of Arizona should strengthen its internal controls over purchasing cards

Criteria: The State's General Accounting Office (GAO) Technical Bulletin 08-1, Statewide Purchasing Card (P-Card) Policies and Procedures, requires state agencies to establish policies, procedures, and documentation requirements for p-card transactions that conform to the State's policies and procedures. These agency-specific policies and procedures should include requiring all employees who are issued a p-card to sign an agreement acknowledging their cardholder responsibilities that are approved by appropriate agency personnel, a supervisory review of all p-card transactions, and a reconciliation of posted transactions against purchasing activity. The agencies should also establish systemic controls restricting the use of the p-cards, such as single transaction limits, monthly spending limits, and category blocks such as prohibiting travel purchases or other unallowed transactions.

Condition and context: During fiscal year 2014, state agencies used p-cards to help facilitate the purchase of over $13.3 million in goods and certain services. However, the State did not ensure its agencies had adequate internal controls over the use of p-cards. Specifically, auditors reviewed the policies and procedures, cardholder agreements, and a sample of 114 p-card transactions for 10 of the 93 state agencies that had p-card purchases and noted the following deficiencies:

- An employee at the Department of Health Services used a p-card to purchase gift cards for patients of the Arizona State Hospital during the month of December. The Department indicated the gift cards were purchased to be used as rewards for patient behavior; however, it was unable to provide evidence that the cards were actually given to the patients or used for that purpose.

- Employees at the Game and Fish Department, the Department of Emergency and Military Affairs, and the Department of Education used p-cards for travel-related activities, including hotel stays and rental cars, which the State's p-card policies prohibit. Further, the transactions for the rental cars at the Department of Emergency and Military Affairs included a luxury vehicle rental, liability insurance, and prepaid gas, which are not allowable expenditures under the State's policy for travel-related expenses.

- The Department of Education did not always have their p-card transactions independently reviewed by the cardholder's supervisor or the p-card administrator. Further, some of the transaction receipts for the Department of Revenue's p-card transactions were retained by the cardholder and not submitted with the monthly reconciliation for retention with all the p-card documentation. As a result, the p-card administrator may not have always had sufficient details available in order to properly approve the transactions.

- Employees at the Department of Education had single transaction limits for p-card purchases. However, auditors determined two employees split their purchases into separate transactions to circumvent the Department's p-card limits.

- The Department of Administration and the Department of Revenue did not have current agency-specific policies and procedures in place for p-card transactions.

- The Department of Administration did not retain all the p-card agreements that employees signed acknowledging their responsibilities for the use of the p-card. Further, the Department of Education did not have the appropriate department personnel approve and sign the p-card agreement.

- The Department of Emergency and Military Affairs' procedures included a requirement for the p-card transactions to be reviewed by the procurement area. However, auditors determined this review was not always performed on a timely basis.

Effect: The State may have an increased risk of misuse, waste, or theft of public monies related to p-card transactions.

Cause: The State relies on the management of the individual state agencies to implement their own p-card policies and procedures that conform to its p-card policies and procedures. However, the State does not ensure the agencies have implemented policies and procedures and does not always monitor compliance with established policies and procedures.

Recommendation: The State should establish monitoring and oversight procedures to help ensure that individual state agencies have properly implemented p-card policies and procedures, as directed by the State's General Accounting Office (GAO) Technical Bulletin 08-1, *Statewide Purchasing Card (P-Card) Policies and Procedures*, to help prevent and detect potential fraud, waste, and abuse related to p-card transactions.

Agency Response: Concur

Agency: Department of Administration
Contact person and title: Clark Partridge, State Comptroller
Anticipated completion date: June 30, 2016

The State understands the importance of internal controls over purchasing cards. We will review and update policies and procedures as appropriate.

The Department of Health Services has instituted procedures that require documentation be maintained with the Business Office at the Arizona State Hospital identifying patients that receive gift cards as a reward for appropriate behavior and are used as therapy for community reintegration. The documentation will be in either hardcopy or electronic form, include signatures by the patient verifying receipt of the gift card, and will be maintained as part of our records for five years past the end of the fiscal year of the purchase.

The Game and Fish Department has added information to existing training to distinguish between use of a purchasing card and the travel card or Central Travel Account. Additionally, this training is being converted into a computer based training in order to increase accessibility to card program policies and procedures.

The Department of Emergency and Military Affairs will use the Central Travel Account for emergency travel purposes and will be managed and maintained by the Deputy Director.

The Department of Education will continue to utilize existing controls to help ensure that all purchasing card rules are followed and all transactions are appropriate and allowable. Each purchasing card transaction is approved by a Procurement Department member. The Procurement Department within the Department of Education gives all Department of Education staff the opportunity to refresh their procurement knowledge at quarterly procurement training sessions.

The Department of Revenue agrees that not all transaction receipts are submitted with the monthly reconciliation, but all transactions are reviewed to ensure the purchase was appropriate and for a public purpose. If a transaction is questionable or more information is needed, the purchasing card holder is contacted. The Department of Revenue will update policies and procedures for purchasing card transactions, including requiring all receipts be submitted with monthly purchasing card reconciliation statement and require the reconciliation review to include a comparison of each transaction to its receipt.

The Department of Administration has updated the purchasing card policies and procedures. Additionally the Department of Administration has obtained signed purchasing card agreement forms from all current

2014-03
The Department of Revenue should continue to strengthen its procedures for processing income tax revenues

Criteria: The Department of Revenue (Department) should improve procedures to ensure that it collects and reports all state income tax revenues.

Condition and context: The Department is responsible for collecting and reporting state income taxes. While testing procedures for income tax revenues, auditors noted additional procedures that the Department should perform to help ensure it achieves this. 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 income taxes.

Cause: The Department's information 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: Department of Revenue
Contact person and title: Francis Becker, Senior Internal Auditor, (602) 716-6156
Anticipated completion date: Unknown

The Department has instituted and continues to research compensating controls to minimize risks to tax revenue.

2014-04
The Northern Arizona University must ensure all deposits are fully collateralized as required by state statute

Criteria: To protect public monies from potential loss, Arizona Revised Statutes (A.R.S.) §15-1668 requires that eligible banks, before receiving a deposit in excess of the federally insured amount, pledge collateral equal at all times to the amount of the deposits. Further, U.S. generally accepted accounting principles (GAAP) requires the Northern Arizona University (University) to disclose the amount of its bank balance that is uninsured and uncollateralized at the end of the period.

Condition and context: During the fiscal year, the University switched servicing banks for its depository accounts and failed to have a collateral agreement on file with the new servicing bank. As a result, $41.5 million of the University's bank balance was uninsured and uncollateralized at June 30, 2014. In addition, the University improperly reported the deposits as uninsured and collateralized by the servicing bank in its notes to the financial statements.

Effect: Cash deposits exceeding the Federal Deposit Insurance Corporation coverage of $250,000 are at risk of being lost if the bank becomes insolvent. No loss of public monies resulted from these uninsured and uncollateralized deposits. In addition, the University did not properly report the amount of deposits as uninsured and uncollateralized at the end of the period. The University revised its notes to the financial statements to correct this error.

Cause: The collateral was not pledged by the servicing bank, and the University improperly reported the deposits as collateralized due to a miscommunication between university management and its servicing bank.

Recommendation: To help protect public monies from potential loss and to comply with state statutes, the University must ensure that all deposits not covered by federal depository insurance are collateralized in accordance with A.R.S. §15-1668. In addition, the University should properly disclose the amount of its bank balance that is uninsured and uncollateralized at the end of the period to comply with GAAP.

Agency Response: Concur

Agency: Northern Arizona University
Contact person and title: Robert G. Norton, Associate Vice President and Comptroller, (928) 523-6054
Anticipated completion date: Corrected

The University has reviewed the audit finding and recommendation associated with the annual audit of the University's Annual Financial Report for the year ended June 30, 2014. We concur with the audit finding and recommendation. The University switched servicing banks during the fiscal year and for a period of 69 days from April to June 30, 2014 the deposits were uncollateralized although this requirement is stipulated in the University Request for Proposal (RFP) for banking services. Beginning July 1, 2014 the State Treasurer began administering collateral for all University deposits and since July 1, 2014 all deposits are properly collateralized and the University receives monthly confirmation of the collateralized amounts. As noted in the finding, no loss of public monies resulted from the uninsured, uncollateralized deposits. There was no malfeasance or theft related to the finding. In addition the University will reemphasize in its fiscal year end procedures to verify proper collateralization of deposits before preparing the University footnote for Cash and Investments.

2014-05
The Department of Economic Security should update and test its disaster recovery plan over its information technology systems

Criteria: It is critical that the Department of Economic Security (Department) have a comprehensive, up-to-date disaster recovery plan for its information technology (IT) systems to provide for the continuity of operations and to ensure that it can recover information and data in the event of a system or equipment failure or other system interruption. Also, the plan should be evaluated, tested, and updated annually.

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Condition and context: The Department had a disaster recovery plan for its IT systems; however, the Department did not evaluate or test its plan annually.

Effect: Inadequate disaster recovery controls subject the Department to risks that can result in inaccurate or incomplete financial, federal program, or management information; expensive recovery efforts; and financial losses. In addition, the disruption of services in the event of a system or equipment failure or other system interruption could result in significant harm or inconvenience to the State and its citizens.

Cause: The Department did not follow its policies and procedures to ensure its disaster recovery plan is sufficiently tested and evaluated annually.

Recommendation: To help ensure the continuity of the Department's operations and to help ensure that electronic information and data are not lost in the event of a system or equipment failure or other system interruption, the Department should evaluate, test, and update its disaster recovery plan annually and retain documentation of all disaster recovery plan tests and those tests' results.

This finding is also reported as a federal finding. See finding 2014-109.

Other auditors' findings:

The other auditors who audited the Water Infrastructure Finance Authority and the Arizona State Lottery, which are departments of the State, reported the following findings.

Agency Response: Concur

Agency: Department of Economic Security
Contact person and title: Josephine Wilt, Project Manager
Anticipated completion date: June 30, 2017

Contingency Planning is comprised of both a Continuity of Operations Plan (COOP) focused on process continuity and a Disaster Recovery Plan (DRP) focused on the supporting technology. This Corrective Action Plan addresses the disaster recovery findings of the OAG audit. The current DES Disaster Recovery Plan has been in place since 1999. There was a formal review of the Plan in 2006 and it was last updated in 2011. The last failover test was completed in 2010 and included a failover to an IBM mainframe located in Boulder, Colorado. Currently data from the mainframe is simultaneously stored in a secondary secured location. The backup tapes from the mainframe are stored off-site at a facility specifically designed for storing data. For SFY 2015, DES received funding for moving the DES Data Center into a purpose built, Tier III data center operated by a third party. The facility risk of outages is anticipated to be greatly reduced by this move.

Milestones	Anticipated Completion Date	
	SFY16	SFY17
A. Migrate the data center to new location	✓	
B. Review and modify Recovery Plan	✓	
C. Perform annual test	✓	
D. Document overall testing strategies, testing frequencies, and test results		✓
E. Implement technology appropriate to ensure continuity of operations		✓

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2014-06
Year End Financial Statement Preparation

Criteria: The Water Infrastructure Finance Authority's (WIFA) management is responsible for the preparation and fair presentation of its financial statements in accordance with accounting principles generally accepted in the United States of America. The audit firm may advise management about appropriate accounting principles and their application and may assist in the preparation of the financial statements, but management remains responsible for the financial statements. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to error or fraud. This responsibility includes the maintenance of adequate records and the selection and application of accounting principles.

Condition: During our audit procedures, we noted several audit adjustments that were necessary to properly classify balances and transactions within the financial statements and meet required footnote disclosures. Audit adjustments were necessary to properly implement *GASB 65* Items *Previously Reported as Assets and Liabilities* for bond issuance costs, to properly classify deferred loss on bond refundings as a deferred outflow of resources, and meet required footnote disclosure requirements. Reclassifications were made to report amounts on deposit in trustee accounts for purposes of satisfying certain bond master trust indenture provisions as restricted net position. Finally, after further consideration of the level of constraint placed on WIFA's resources by the Environmental Protection Agency in carrying out its revolving loan programs, management determined that a more transparent reporting resulted in all of its resources classified as restricted net position.

Effect: There was no net effect to the total net position reported or the change in net position. A reclassification was required to properly report the balance of prior year gains and losses on bond refundings into the GASB 65 required account titled deferred outflows. In addition, a reclassification was made among the net position accounts that resulted in all ending net position reporting as restricted.

Cause: Management switched audit firms during the last fiscal year. In the transition, management did not hear about the requirements of the new standard, GASB 65, and did not learn about the implementation requirements from other sources. As to the reporting of net position, management applied a narrower focus on the more accurate reporting the corpus of its loan program resources from EPA capitalization grants as restricted, instead of applying the classification criteria on a broader scale to all of WIFA's resources.

Recommendation: There are a number of governmental accounting standards update continuing education sessions available through the American Institute of Certified Public Accountants, the Government Finance Officers Association, Arizona specific governmental conferences, and Moss Adams has a number of webcasts that we make available to our clients. We recommend that WIFA provide opportunities for staff responsible for external reporting to attend these training courses.

Agency Response: Concur

Agency: Water Infrastructure Finance Authority
Contact person and title: Sandra Sutton, Executive Director (602) 364-1310

I have reviewed and concur with the audit finding recommendation. WIFA staff will continue to schedule and attend training courses on Accounting subjects.

2014-07
Accounting and Reporting Components of Net Position

Criteria: For the Arizona State Lottery (Lottery), we believe that paragraph 12.123 of the American Institute of Certified Public Accountants, (AICPA) State and Local Government Audit and Accounting Guide provides the relevant accounting guidance for liabilities for prizes and forfeitures of unclaimed prizes. Forfeitures of unclaimed prizes should be recognized as a gain (net against prize expense) as of the date the claim is forfeited according to the provisions of a State's stated regulations. Many States have regulations with regard to how forfeited unclaimed prizes must be utilized. For example some States require all forfeited unclaimed prizes be transferred to another State fund or agency having a different mission. Arizona Revised Statutes 5-568 states the following:

> Disposition of unclaimed prize money
> Unclaimed prize money for the prize on a winning ticket or share shall be retained for the person entitled to the prize for one hundred eighty days after the drawing in which the prize was won in the case of a drawing prize and for one hundred eighty days after the announced end of the game in question in the case of a prize determined in any manner other than by means of a drawing. If a claim is not made for the money within the applicable period, seventy per cent of the prize money shall be held in the state lottery prize fund for use as additional prizes in future games and thirty per cent shall be transferred monthly to the court appointed special advocate fund established by section 8-524.

We believe the State's statute places a restriction on the use of forfeited prizes. Restricted net position should be reported when constraints placed on net position are either externally imposed by grantors, creditors, contributors, or by laws or enabling legislation. The restriction to use unclaimed prizes that are forfeited represents a specific purpose, does not represent a liability in our view, rather it is the underlying transaction exchange transaction resulting from the sale of lottery tickets for games in progress that creates a liability, defined by GASB's Concept Statement No. 4, *Elements of Financial Statements*, as the present obligation to sacrifice resources.

Condition: The previous balance reported as liabilities for prizes was comprised of several components of the Lottery's Prize Fund. These components consisted of unclaimed forfeited prizes, accumulated prize fund balance, accumulated investment earnings of the prize fund, and flows of the prize fund. Certain of these components do not appear related to a present obligation for prizes. The Arizona Lottery retains and reports unclaimed prizes as a liability.

Context: Management's estimate of liability attributable to only prizes is approximately $14 million. A portion of this estimate is attributable to forfeited prizes is approximately $5 million.

Effect: We believe the liability for prizes has been overstated and that components of net position are understated or other liabilities exist.

Cause: We do not believe management had fully considered the applicable accounting and financial reporting guidance for prizes or components of net position.

Recommendation: We recommend that management review the underlying nature and agreements for each significant reported balance and assess reporting restricted components of net position and review/revise its accounting policies with regard to activities of the Prize Fund. Those policies should reflect the use of resources in conformity with State statute while also considering the financial condition of the Lottery.

Agency Response: Concur

Agency: Arizona State Lottery

Management will review accounting policies for activities in the Prize Fund. The Lottery has been consistent in its reporting of prize liability since the Lottery's inception and that reporting is similar to reporting used by other state lotteries. We agree with the auditor to revise the presentation of prize liability this year and will seek to find an appropriate presentation in future years.

The Lottery also believes that forfeited prizes are properly included in prize liability. Some of those forfeited prizes are committed to prize subsidies for Scratchers games that began in FY13 and are continuing into FY14 and the balance of forfeited prizes will be used to subsidize other games before the end of FY14. The Lottery has historically subsidized Scratchers by $6 to $8 million annually. The Lottery also has an ongoing commitment to fund a $1 million jackpot for the Pick game. It is currently taking from twelve to fourteen draws to fully fund jackpot payouts from sales. Any subsidy would come from forfeited prizes.

2014-08
Regularly Review Third-Party Service Reports

Criteria: Service organizations are entities that provide outsourcing activities that are relevant to the control environments at user organizations. A Type II SSAE 16 report is an independent report on the design and operating effectiveness of key controls at a service organization. A Type II SSAE 16 provides assurance to user organizations that the control objectives relating to the services provided by their service organization are suitably designed and operating effectively throughout the examination period.

Condition and context: The Arizona State Lottery (Lottery) utilizes reports and systems of GTECH, a service organization; however GTECH does not currently provide a Type II SSAE 16 report to the Lottery.

Effect: Errors, if any, in the reports provided to the Lottery by GTECH may not be detected in a timely manner.

Cause: GTECH does not appear to have a Type II SSAE 16 report available for the Lottery.

Recommendation: We recommended that management obtain and review SSAE 16/SAS 70 annually to ensure service providers have sufficient controls in place and are operating effectively given the significance of the information provided by GTECH to the Lottery.

Agency Response: Concur

Agency: Arizona State Lottery

With the present on-line contract GTECH was required to provide, within the first year but not before six months, the Arizona Lottery with a SAS 70 report. This report was to study the controls put into place by GTECH Arizona. The Arizona Lottery was able to approve the contractor that GTECH proposed to use for the SAS 70 report. The cost associated with this project was placed on the winner of the on-line contract. It was a built in expense as it is quite expensive to produce. The Lottery is always attempting to make sure all systems and processes are followed, not only by the rules set forth by the Lottery but, also with the rules set forth under the Multi State Lottery agreement. The Lottery's internal auditing department verifies all changes made to the GTECH process and programs. These changes are reviewed and tested before they are implemented. The Arizona Security department also observers the process several times a year to ensure compliance with existing rules and processes. To start a SSAE 16/SAS 70 report outside of the contract would place an undue financial burden upon the Lottery as it is not required by contract to be performed by GTECH. If it is indeed necessary this will be made an ongoing requirement placed in the upcoming RFP for the on-line contract.