



A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Management Letter

Industrial Commission of Arizona

Year Ended June 30, 2006



Debra K. Davenport
Auditor General

The **Auditor General** is appointed by the Joint Legislative Audit Committee, a bipartisan committee composed of five senators and five representatives. Her mission is to provide independent and impartial information and specific recommendations to improve the operations of state and local government entities. To this end, she provides financial audits and accounting services to the State and political subdivisions, investigates possible misuse of public monies, and conducts performance audits of school districts, state agencies, and the programs they administer.



Copies of the Auditor General's reports are free.
You may request them by contacting us at:

Office of the Auditor General

2910 N. 44th Street, Suite 410 • Phoenix, AZ 85018 • (602) 553-0333

Additionally, many of our reports can be found in electronic format at:

www.azauditor.gov



**STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL**

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

June 11, 2007

Larry Etchechury, Director
Industrial Commission of Arizona
800 West Washington Street
Phoenix, AZ 85007

Dear Mr. Etchechury:

In planning and conducting our audit of the State of Arizona for the year ended June 30, 2006, we considered the Commission's internal controls over financial reporting and tested its compliance with laws and regulations that could have a direct and material effect on the State's financial statements as required by *Government Auditing Standards (GAS)*.

Specifically, we performed tests of cash receipts; receivables; cash disbursements; cash; investments, including securities lending transactions; capital assets; long-term debt; accrued insurance losses; related party transactions; statutory compliance; and financial reporting of the Commission's Special Fund.

There are no audit findings that are required to be reported in the GAS report. However, our audit disclosed internal control weaknesses and instances of noncompliance with laws and regulations that do not meet the reporting criteria. Management should correct these deficiencies to ensure that it fulfills its responsibility to establish and maintain adequate internal controls and comply with laws and regulations. Our recommendations are described in the accompanying summary.

This letter is intended solely for the information of the Commission and is not intended to be and should not be used by anyone other than the specified party. However, this letter is a matter of public record, and its distribution is not limited.

Should you have any questions concerning its contents, please let us know.

Sincerely,

Dennis L. Mattheisen, CPA
Financial Audit Director

TABLE OF CONTENTS



Recommendation 1: The Commission needs to prepare timely financial statements	1
Recommendation 2: The Commission should develop written policies and procedures for computer operations	2
Recommendation 3: The Commission should maintain a back-end changes log for its computer system	2
Recommendation 4: The Commission needs to establish procedures to identify and disclose related party transactions	3
Commission Response	

The Commission needs to prepare timely financial statements

The State of Arizona must issue timely financial statements to satisfy the audit requirements imposed by federal laws, state statutes and regulations, grant contracts, and long-term debt covenants. To help ensure that the State's financial statements are prepared and issued in a timely manner, the Department of Administration's General Accounting Office (GAO) has established timelines for the individual state agencies to submit required financial information to it for inclusion in the state-wide financial statements. The Commission's management is responsible for preparing complete and accurate financial statements for the Commission's Special Fund and submitting them to GAO in a timely manner. However, the Commission did not meet GAO reporting timelines. The Commission submitted preliminary financial statements to the GAO on October 6, 2006, 7 days late, and their final financial statements on January 29, 2007, 76 days late. The delays resulted from the Commission's not preparing and reviewing timely reconciliations of financial records and not posting transactions to the general ledger in a timely manner.

To help ensure that financial statements are prepared and issued in a timely manner, the Commission should implement the following procedures:

- Reconcile the financial records and post all adjustments to the general ledger within 2 weeks of month-end.
- Allocate the appropriate resources and monitor and enforce completion dates for compiling, preparing, and reviewing the financial statements and supporting schedules.
- Provide auditors and the GAO with complete and accurate financial statements, including notes and supporting schedules, by the established deadlines.

A similar recommendation was previously provided in our Management Letter to the Commission dated June 6, 2006.

The Commission should develop written policies and procedures for computer operations

Written policies and procedures provide the basic framework needed for establishing employee accountability. They serve as a reference tool for employees seeking guidance on how to handle complex or infrequent transactions and situations. Additionally, they offer guidance for controlling daily operations. Reliance on appropriate written policies and procedures can enhance both accountability and consistency; safeguard assets and data; and ensure continuity of services in the event of computer system failure. However, the Commission had not established detailed written policies and procedures over its computer operations.

The Commission should develop and implement written policies and procedures that address the following:

- Computer operations—There should be procedures for daily operations and physical security of the PACE computer system to help ensure that operators use the correct data, computer programs, and other resources when processing daily activity. These would help safeguard computer equipment and data against theft or misuse.
- Program changes—There should be procedures that require proper documentation and approval of program change request forms and test results, and separating responsibilities to ensure that one employee does not make, test, and implement program changes.
- Disaster recovery—There should be a written plan to ensure that critical functions continue in the event of a computer system failure.

A similar recommendation was previously provided in our Management Letter to the Commission dated June 6, 2006.

The Commission should maintain a back-end changes log for its computer system

The Commission uses the PACE computer system to record detailed financial transactions and generate monthly and year-end summary reports to support amounts recorded on the general ledger. Therefore, it is essential that changes to the system and data be documented; however, this wasn't always done. When users made changes to system data, the changes were documented in the system; however, if the database administrator made back-end changes to the system database, the changes would not be documented in the system. As a result, unauthorized changes could be made to the system or data without detection.

The Commission should maintain a back-end changes log on the PACE system to help monitor all changes to the system and ensure they have been properly authorized.

The Commission needs to establish procedures to identify and disclose related party transactions

Financial accounting standards require that financial statements include disclosures of related party transactions. In addition, all public officers and employees are required to disclose any potential conflicts of interest in the agency's official records, as required by Arizona Revised Statutes §38-503. However, the Commission did not have written procedures for identifying and disclosing related party transactions. The Commission did require Investment Committee members, employees, and commissioners to annually complete secondary employment and conflict of interest forms. However, these forms only addressed conflicts related to secondary employment and not conflicts involving personal or family relationships with vendors.

The Commission should establish procedures requiring all employees, commissioners, and Investment Committee members to disclose any personal or family relationships with vendors and maintain records of any disclosures in the Commission's public records. Further, the Commission should establish procedures to accumulate transactions with related vendors and identify all material transactions that would require disclosure in the State's financial statements.

THE INDUSTRIAL COMMISSION OF ARIZONA



ADMINISTRATION DIVISION

P.O. BOX 19070
PHOENIX, ARIZONA 85005-9070

BRIAN C. DELFS, CHAIRMAN
JOE GOSIGER, VICE CHAIRMAN
LOUIS W. LUJANO, SR., MEMBER
MARCIA WEEKS, MEMBER

LARRY ETCHECHURY, DIRECTOR
TERESA HILTON, SECRETARY

GARY R. NOREM, CFO
ADMINISTRATION - ACCOUNTING
800 W. WASHINGTON ST. - SUITE 301
PHOENIX, AZ 85007-2922
(602) 542-4653
(602) 542-5380
FAX (602) 542-3070

May 24, 2007

Debra K. Davenport
Auditor General
Office of the Auditor General
2910 N. 44th Street, Suite 410
Phoenix, AZ 85018

Dear Ms. Davenport:

In response to the four recommendations listed in the auditor's management letter, the Industrial Commission of Arizona (Commission) has provided the following information.

Recommendation 1: The Commission needs to prepare timely financial statements.

The current Special Fund general ledger system has some limitations for posting monthly entries for the new State Fiscal Year (SFY) while holding the previous SFY open during the period the Auditor General completes the audit. This results in a catch up period every year in which several months of general ledger entries need to be done within a very short period of time. In order to handle this workload issue, the Commission did employ temporary accountants during the last year.

In order to improve the continuity of the staffing for the Special Fund general ledger and financial statement preparation work, the Commission has requested a new higher level accounting position for the SFY beginning July 1, 2007. A permanent position will be a better alternative than using temporary staff members that only stay with the Commission for a limited time.

The CFO will put together a time schedule for completion of the various tasks related to the financial statement preparation process. The CFO will monitor on a regular basis the work progress on the financial statements to be sure that the time lines are met.



Debra K. Davenport
Auditor General
May 24, 2007
Page 2

Recommendation 2: The Commission should develop written policies and procedures for computer operations.

Computer Operations - Written procedures have been prepared to cover the daily and monthly operations associated with the PACE system. Procedures include Daily Warrant Processing, Monthly Accounts Payable Processing, and Monthly Accounts Receivables Processing. Functional and Technical specifications have been written which include specific information regarding modules and data accessed for daily, monthly, and yearly processing. Shutdown and startup procedures for the equipment which house the PACE systems have been written and are available to the appropriate networking staff. Written shutdown and startup procedures for the PACE databases have been written and are available to the appropriate database and programming staff.

Program Changes - A Change Order Process is in the final draft stage and scheduled to be implemented by mid-June 2007. The process will include specific procedures for assigning program versus database change requests, a testing protocol, and to provide separation of responsibilities for the change, testing, and implementation phases.

Disaster Recovery - A written Disaster Recovery plan is in the draft stage.

Recommendation 3: The Commission should maintain a back-end changes log for its computer system.

The Change Order Process will provide tracking of change assignments to the PACE database system which involves the Commission's financial data. Due to the nature of design of the current database system, and the understaffing of the MIS Division, there is not enough trained staff to create a total separation of responsibilities with regard to changes, testing, and implementation of changes to the PACE database. However, the MIS Division is in the process of moving the Commission's financial system off the PACE database system and into a system which will have separate and distinct database, programmer, and user-interface access. At this point, a procedure for changes involving the Commission's financial system database structure, data access, and presentation features will become separate and distinct.



Recommendation 4: The Commission needs to establish procedures to identify and disclose related party transactions.

A.R.S. §38-503 references public agency officers and employees, who are “participating in any manner as an officer or employee in such contract, sales or purchase”. Accordingly, the Commission will require any employee that is involved in selection of a vendor, or potentially the establishment of a vendor, or the payment of billings from vendors to annually file a related party transaction disclosure and a secondary employment disclosure.

The following individuals at the Commission will be required to file both disclosures:

- Commission members
- Investment Committee members
- All management personnel
- Procurement personnel
- Building Engineer
- Accounting personnel
- Special Fund Division personnel

Sincerely,

Gary R. Norem, CPA, CGFM
Chief Financial Officer

GN/sc