

Minutes of the February 10, 2011 Meeting
of the Board of Governor's Audit Committee

The Audit Committee met in the Executive Conference Room at the UNC General Administration-Spangler Center in Chapel Hill, North Carolina on Thursday, February 10, 2011 at 4:30 p.m.

Members in attendance were Mr. John Blackburn, Dr. Laura W. Buffalo, Mr. Frank Daniels, Jr., Mr. Walter C. Davenport, Dr. Franklin E. McCain, Ms. Hannah D. Gage, Mr. Ronald C. Leatherwood, and Dr. Irvin A. Roseman. Chancellors Steven Ballard (East Carolina University) and John Bardo (Western Carolina University); Interim Vice Chancellors Greg Lovins (Appalachian State University), Yolanda Banks Deaver (NCCU), and Robert T. Edwards (Western Carolina University); and UNC General Administration staff were in attendance.

Chair Roseman welcomed everyone to the meeting. On a motion from Mr. Daniels, seconded by Mr. Blackburn, the minutes of the January 13, 2011 meeting were approved.

In past meetings, the Committee had expressed interest in touring the Shared Services Center located at UNC General Administration (UNC-GA). Both Chair Roseman and Mr. Daniels took a brief tour of the center located in the Meredith Spangler Building at UNC-GA. They recommended to the members of the Committee to individually take a tour themselves.

Ms. Gwen Canady gave an update (see attachment) on the UNC Finance Improvement and Transformation (UNC FIT) Project.

- January was a milestone for the UNC Shared Services Payroll Project.
 - Three campuses (Fayetteville State University, North Carolina Central University, and Winston-Salem State University) went live on Banner monthly payroll in January.
 - Elizabeth City State University went live on Banner bi-weekly payroll in January.
 - The standard model conversion was completed at UNC School of the Arts and activities included testing, training, report development and self-service setup.
- The implementation for UNC School of the Arts to go live on Banner bi-weekly, the remaining campus, was on schedule. Monthly implementation began at Elizabeth City State University. Both campuses were set to go live in April 2011.
- Advisory teams completed their development work standards for the two new business sub-processes - Capital Assets and Student Accounts. Roll-out of these standards was scheduled to begin in February and be completed by the first week of March 2011.

- Campuses continued to report on Key Performance Indicators (KPIs) in the areas of General Accounting, Financial Aid, and Contracts and Grants. Overall improvement in internal controls had occurred across the campuses.

Next, Vice President for Information Resources and Chief Information Officer John Leydon was asked by the Committee to report on information systems services provided and to be provided to the campuses. Mr. Leydon shared major initiatives and accomplishments in 2010 and 2011(see attachment).

Mr. Jeff Henderson gave a report on the status of the 2011 Internal Audit Plan for UNC-GA. He reported progress had been made and the internal auditor released the first audit on Time and Effort Reporting (see attachment), which had been identified as the area of highest risk at UNC-GA. UNC-GA's Internal Auditor Jan-Rae Castillo reported there were no findings. She also mentioned some procedural recommendations had been made.

Mr. Jeff Henderson reviewed seven external audit reports released since the January meeting.

- The 2009 financial statement audit report for Western Carolina University (WCU) was released with three audit findings. This was the final 2009 financial audit report for the university system.
 - The findings were substantially the same as those from the prior year.
 - The University had addressed the issues.
 - WCU's Chancellor Bardo introduced Mr. Robert Edwards as the Interim Vice Chancellor for Administration and Finance. They both responded to the Committee about the findings and concurred corrective actions had been implemented. They also noted there would be no findings in the 2010 audit report.
- The 2010 financial statements audit reports for Appalachian State University, Fayetteville State University, North Carolina State University, UNC Chapel Hill, and UNC Greensboro were all released with no findings.
- The 2010 financial statement audit report for East Carolina University was released with one finding. Chancellor Ballard addressed the finding to the Committee and stated his campus had begun to make the appropriate corrections.

Lastly, the Committee inquired if UNC-GA would be audited. Mr. Henderson responded that Ken Craig, Associate Vice President for Finance, spoke with the Auditors and there would be an audit performed at UNC-GA soon.

There being no further business, the meeting was adjourned.

Dr. Irvin A. Roseman
Chair of the Audit Committee

Dr. Franklin E. McCain
Secretary of the Audit Committee

UNC Finance Improvement and Transformation (FIT) Update

UNC Shared Services Payroll Project

January was a milestone month for the UNC Shared Services Payroll Project. Three campuses went live on monthly payroll, one campus went live on bi-weekly payroll and standard model conversion was completed at our last campus. Year-end reconciliations, W2 testing and printing occurred at seven of the nine campuses.

Banner Bi-Weekly Payroll for Students and Temporaries

Elizabeth City State University came live on Banner bi-weekly payroll in January, bringing the total number of campuses that are live on Banner Shared Services Payroll to eight. Implementation activities at the remaining campus, UNC School of the Arts, are on schedule for a March implementation. The standard model conversion has occurred and current activities include testing, training, report development and self-service setup.

Banner Monthly Payroll for Permanent Employees

Winston Salem State University, Fayetteville State University and North Carolina Central University went live on Banner monthly payroll in January 2011, bringing the total number of campuses that are completely off of the State's Central Payroll system to seven. Monthly implementation activities have begun at Elizabeth City State University, including job record set-up and validation, interface set-up and testing and staff training. Work will begin at the final campus, UNC School of the Arts, during the month of February. Both of these campuses will go-live in April 2011.

Business Process Improvements and Financial Monitoring

Advisory Teams completed their development work in the areas of Capital Assets and Student Accounts during the month of January 2011. Campuses reported their key performance metrics for December and briefing sessions were held with campus controllers, internal auditors and campus project managers on key initiatives.

Standards Development

The UNC FIT team completed the development of standards, checklists, templates and key performance metrics in the areas of Capital Assets and Student Accounts. Materials were sent to the campuses for advanced review and six regional campus visits were scheduled to roll out the prescribed standards and train the campus personnel.

February 7 & 8: UNCA, ASU, and WCU
February 10 & 11: UNCCH, NCCU, and NCSSM
February 14 & 15: UNCG, NCA&T, and NCSU
February 17 & 18: WSSU, UNCSA, and UNCC
February 23 & 24: FSU, UNCP, and UNCW
March 1 & 2: ECU and ECSU

Campuses will begin compliance checklists reporting and preliminary KPI (Key Performance Indicator) reporting in the spring. The standards are expected to be in place by June 30th.

KPI Reporting and Monitoring

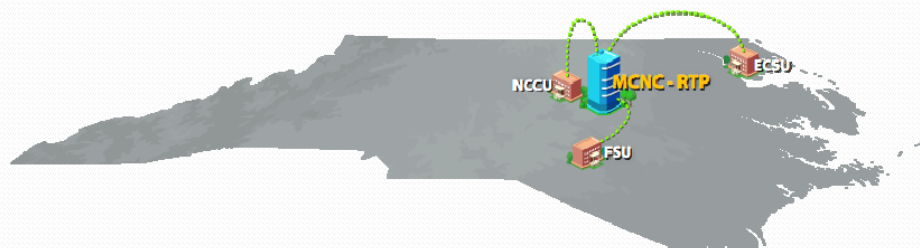
Campuses continued to report on (KPIs) in the areas of General Accounting, Financial Aid and Contracts and Grants. Remediation plans for those areas with unacceptable ratings were prepared. Overall improvement in internal controls has occurred across the campuses, along with a corresponding reduction in audit findings.

UNC-GA Information Resources Division

- Major Initiatives and Accomplishments for Calendar Years 2010 and 2011
 - Critical File Back-up & Shared D/R Site (WDC)
 - Hosting as a Service (HaaS) – Cloud ERP Support
 - ERP and Learning Management System Hosting
 - Combined Pricing Initiative (UNC System-wide licenses)
 - SciQuest e-Procurement
 - Google Apps for Education & MS/Live@EDU
 - PC Marketplace
 - Remote System Administration & Data Base Administration
 - UNC Trust – Federated Id Management

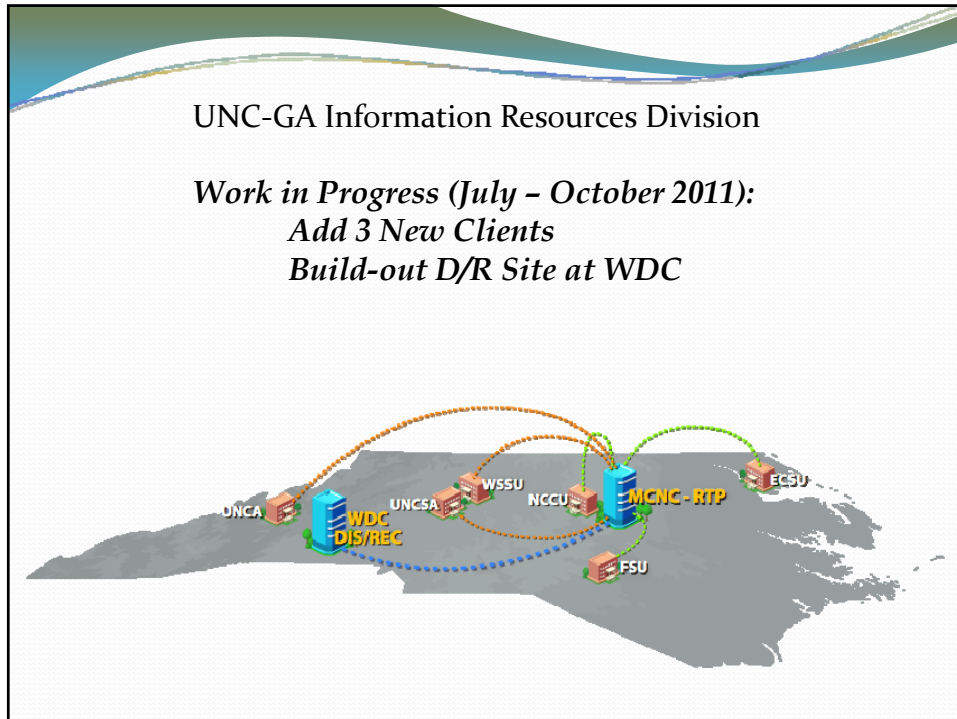
UNC-GA Information Resources Division

Current Hosted Clients



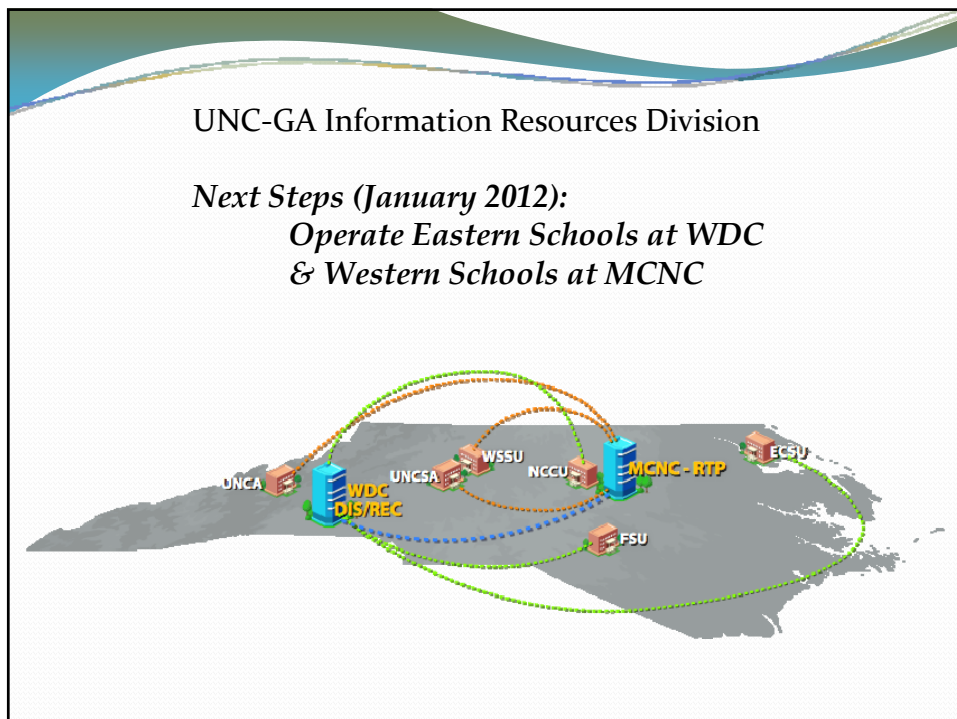
UNC-GA Information Resources Division

*Work in Progress (July - October 2011):
Add 3 New Clients
Build-out D/R Site at WDC*



UNC-GA Information Resources Division

*Next Steps (January 2012):
Operate Eastern Schools at WDC
& Western Schools at MCNC*



UNC-GA Information Resources Division

Goal (July 2012):

Transparent Operations

*No Operational Disruptions (both sites
capable of support of all hosted schools)*



UNC-GA Information Resources Division

- Other Initiatives Under Consideration
 - Remote Network Administration
 - Middleware Support Centers Of Excellence
 - Central Audit and Compliance
 - Document Imaging and Business Process Work Flow
 - Consolidated Pricing for Servers, Storage Arrays, Load Balancers, etc.

UNC General Administration

Audit Plan

Year Ending June 30, 2011

Specific Assignments	Number of Reports/ Letters	Included in Audit Plan	Status	Significant Audit Findings?	Comments
Financial Audits/Reviews: Include audits/reviews having a direct relation to financial information at the institution. None					
Performance/Operational Audits and/or Reviews: Include audits/reviews of departmental operations and activities. Contract and Grant Sub Award Monitoring UNC-TV P-Card and Accounts Payable Processing SEAA Loan / Aid Automated Voucher Feed Processing		Y Y Y	Cancelled		SEAA is not part of GA
Investigations: Include investigations of internal and external hotline reports as well as any similar types of investigations, regardless of the source. Various As Occurs					
Compliance Audits: Include audits/reviews of compliance with federal and state requirements. Also include audit/reviews of compliance with university policies and procedures. None					
Audits/Reviews of Internal Controls: Include audits/reviews of internal control systems and processes, including the EAGLE and UNC FIT assessments and testing. Self Assessment of Internal Control Capital Assets & Inventory Verification Time and Attendance Record System	1	Y Y Y	Complete	N	
Information Systems Audits: Include audits/reviews of information systems, including general controls, application controls, and disaster recovery. Financial Record System Access / Controls		Y	In Process		
Risk Assessments: Include risk assessments performed as part of the internal audit process. None					
Follow-Up: Follow-up activity related to audit findings resulting from external audits and to audits performed internally. None					

UNC General Administration
Audit Plan
Year Ending June 30, 2011

Specific Assignments	Number of Reports/ Letters	Included in Audit Plan	Status	Significant Audit Findings?	Comments
Special Review: Not classified as an audit, but written up as a memo. Carry-forward, Lapsed Salary and Management Budget Flexibility					
Special Projects: Project once examined turns into an audit with results written up as an audit. None					
Technical Assistance: Work performed that does not require a report, such as sitting on a committee, providing technical assistance, and consulting work.					

*** Findings, recommendations, and corrective actions attached**

Status

Complete - Fieldwork complete and report issued
 In Process - Fieldwork in process and/or report not released.
 On-Going - activities of an on-going nature, i.e. committees
 Pending - Fieldwork stopped and /or report held up due to specific delay.
 Deferred - Audit/Review moved to a future year.
 Cancelled - Audit/Review will not be performed in the current or future year.

The University of North Carolina General Administration



Time and Effort Reporting

Audit Report

**Time and Effort Reporting Review
Operational Review**

**Office of Internal Audit
November 5, 2010**

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EXECUTIVE SUMMARY

We conducted an operational audit of the University of North Carolina General Administration (UNC GA) time and effort reporting process. This audit was scheduled as a part of the 2011 fiscal year audit plan. The scope of the audit included a review of time and effort reporting to provide assurance of compliance with federal and UNC General Administration policies and procedures for the audit period July 1, 2009 through June 30, 2010.

In general, the system of internal control with respect to the time and effort reporting process was found to be sufficient. In the course of this review, Internal Audit did not discover any circumstances to have a significant effect on operations to be deemed a finding. No additional audit work is needed at this time.

AUDIT PURPOSE AND SCOPE

PURPOSE AND SCOPE

Operational audits are systematic assessments of activities and operations to determine whether resources are being used economically, effectively, and efficiently. Such audits also serve as a control activity to ensure conformity with management's established policies and regulations.

The audit was conducted to review established federal and departmental policies and procedures and to evaluate operational efficiency, effectiveness, and compliance for the period July 1, 2009 through June 30, 2010. The fieldwork for this audit was completed on November 5, 2010.

The scope of the audit encompassed a review of:

- Policies and procedures
- Time and effort payroll transactions and documentation
- Compliance with federal and UNC GA time and effort policies and regulations

OBJECTIVES

Specific objectives were to provide an independent appraisal of UNC GA Time and Effort accounting regarding:

- Financial accuracy and operational efficiency
- Compliance with applicable institutional policies and external regulations
- Maintenance of records

METHODOLOGY

Our professional pledge is to conduct our audits based upon the best benchmarks available to us. The goal for the Office of Internal Audit is to conduct and manage our audits in accordance with The Institute of Internal Auditors' (IIA) *International Standards for the Professional Practice of Internal Auditors*, which include the definition of internal auditing, Code of Ethics, and the *Standards*. A peer review of our department is required to ascertain compliance with these *Standards*.

The methodology included:

- Reviews of policies and procedures
- Interviews with key personnel
- Testing of internal controls and financial records

OVERVIEW

Time and effort reporting is a process utilized monthly to monitor payroll expense attributed to contract and grant awards. It serves as a tool to ensure actual activity incurred on a grant award is reflected in proportion to the amount of payroll expense charged to the associated grant. This process is required for contract and grant operations under federal mandate via the Office of Management and Budget Circulars A-87 and institutional mandate via Time and Effort Reporting Policy and Procedure 4.8.1.

At the University of North Carolina General Administration (UNC GA), time and effort reporting is administered by the Research and Sponsored Programs Division of the Academic Affairs Department. An employee designated as the time and effort coordinator (TEC) is responsible for overseeing the time and effort reporting process.

For the fiscal year ended June 30, 2010, 33 of the 78 active grants awarded to UNC GA funded compensation expenses totaling \$5,861,827.62. There were an average of 35 time and effort reports processed every month by the TEC.

SYSTEM OF INTERNAL CONTROL

The objectives of a system of internal control are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and are recorded properly.

Because of inherent limitations in any system of internal control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with procedures may deteriorate. Since our examination was based on selective tests of financial records and related data, our study and evaluation would not necessarily disclose all weaknesses in the system of internal control.

In our opinion, the system of internal control over the time and effort reporting process during the fiscal year beginning July 1, 2009 and ending June 30, 2010 was sufficient to meet the objectives stated previously. No additional audit work is needed at this time.

Jeffrey A. Henderson, CPA, CISA
Director, Office of Internal Audit

Jan-Rae Castillo
Internal Auditor

DISTRIBUTION LIST

Dr. Irvin A Roseman, UNC-GA Board of Governors

Mr. Thomas W. Ross, President

Mr. Jeffrey R. Davies, Chief of Staff

Dr. Steven Leath, Vice President for Research

Ms. Sarah Smith, Director of Sponsored Programs

North Carolina Office of Internal Audit, Office of State Budget and Management

2009 and 2010 Financial Audit Reports Released Since Last Meeting by the N.C. Office of the State Auditor:

1. The University of North Carolina at Greensboro: - (Financial) - No Audit Findings
Released Date: 12/20/2010

Report URL

<http://www.ncauditor.net/EpsWeb/Reports/Financial/FIN-2010-6040.pdf>

2. The University of North Carolina at Chapel Hill: - (Financial) - No Audit Findings
Release Date: 12/20/2010

Report URL

<http://www.ncauditor.net/EpsWeb/Reports/Financial/FIN-2010-6020.pdf>

3. North Carolina State University: – (Financial) - No Audit Findings
Release Date: 12/21/2010

Report URL

<http://www.ncauditor.net/EpsWeb/Reports/Financial/FIN-2010-6030.pdf>

4. East Carolina University: - (Financial) – One Audit Finding
Release Date: 12/21/2010

Report URL

<http://www.ncauditor.net/EpsWeb/Reports/Financial/FIN-2010-6065.pdf>

Matters Related to Financial Reporting

The following finding and recommendation was identified during the current audit and discusses a condition that represents a deficiency in internal control.

1. INADEQUATE CONTROL OVER ACCESS TO THE UNIVERSITY’S HEALTHSPAN ELECTRONIC HEALTH RECORD SYSTEM

We identified deficiencies in the University’s oversight and management of access to the HealthSpan Electronic Health Record System. Improper access to computer systems can result in both intentional and unintentional security breaches that place the confidentiality and integrity of information at risk.

The HealthSpan Electronic Health Record System is used by The Brody School of Medicine at the University as an electronic medical record and patient billing system. The information and data are housed on the University Health System (UHS) server and is maintained by UHS personnel (not University personnel). UHS serves as the application service provider for the University for this specific information system.

During our review of system access, we found that programmers have the ability to access and

update patient information, including billing, payment, and outstanding accounts receivable data. Access to systems and data should be limited to the minimum access necessary for the job function. If the programmers' rights cannot be removed, then procedures should be in place to monitor their activity. In addition, we determined that periodic reviews of user access for this system have not been performed as frequently as required by statewide information technology standards. Maintaining proper access controls over computer systems helps to protect the confidentiality and integrity of information by preventing alteration, unauthorized use, or loss of data. Statewide information technology standards specify that system access be controlled and prescribe procedures requiring documented reviews of users' rights.

Recommendation: The University should improve internal control over granting and managing access to the HealthSpan Electronic Health Record System. Procedures should be in place to limit access to just those employees who need it for their assigned job function. When programmers must have access to production programs or data, their activity should be monitored. In addition, periodic security reviews should be conducted at intervals that meet the minimum schedule as required by statewide information security standards to ensure that access is restricted to authorized users and employee user access rights are systematically evaluated to ensure privileges granted are appropriate for the necessary job requirements.

University Response: East Carolina University agrees with the State Auditor's recommendation:

- We have already begun coordination with our HealthSpan Application Service Provider (ASP), University Health Systems of Eastern Carolina, to remove: (1) programmers' access to change production data, and (2) programmers' ability to move programming changes into production. If this is not possible, then we will work with the ASP to ensure that programmers' activity in the production environment is closely monitored and controlled.
- A process for periodic review of HealthSpan user access is already in place and was reviewed by the State Auditor during the audit fieldwork. We will ensure that user access is reviewed at least twice annually, as required by the statewide information technology standards. We will also ensure that our ASP (University Health Systems of Eastern Carolina) reviews its employees' access to University data at least twice annually.

5. Western Carolina University: - (Financial) – Three Audit Findings
Release Date: 12/22/2010

Report URL

<http://www.ncauditor.net/EpsWeb/Reports/Financial/FIN-2009-6075.pdf>

Matters Related to Financial Reporting

The following audit findings were identified during the current audit and describe conditions that represent significant deficiencies in internal control.

Management's responses are presented after each audit finding. We did not audit the responses, and accordingly, we express no opinion on them. However, *Government Auditing Standards* require that we add explanatory comments to the report whenever we disagree with an audit finding response. In accordance with this requirement and to ensure that the nature and seriousness of the findings are not minimized or misrepresented, we have provided comments to the University's responses when appropriate.

1. INAPPROPRIATE INFORMATION SYSTEM ACCESS TO THE FINANCIAL ACCOUNTING SYSTEM

The University did not maintain adequate internal control over access to its financial accounting system and data. This increases the risk of error or fraud.

The University did not appropriately terminate access rights for all separated employees. We identified 37 former employees whose access to the accounting system and the overall computer network was terminated several days or weeks after separation from the University. Of these, 19 former employees had access rights with update capability within the financial accounting system. Access should be terminated as soon as individuals leave employment.

We further identified users that had access rights that were incompatible with their job functions. The controller is responsible for approving financial transactions of subordinates and also has access rights to initiate and execute accounting transactions. Also, there are two systems accountants who have access rights to initiate and execute accounting transactions. One of these systems accountants shared the user identification and password of the controller. Finally, we identified employees with access rights to modify tuition and fee tables who also maintain student accounts. One user account with this access was shared by three employees. Personnel should only be granted the minimum access needed to perform their job. Sharing a user identification and password reduces accountability for any error or misappropriation that may occur.

Significant aspects of this finding were also reported in the two prior audits. In response to this issue, access rights for the controller were revised in April, 2009.

Recommendation: The University should continue to improve internal control over granting, managing, and monitoring access to the financial accounting system and data.

University's Response: The University agrees with the context of the recommendation and will continue to work to improve internal control over access to financial data. In so doing, it is incumbent upon the University to assess the cost/benefits and practicality associated with these controls in conjunction with associated risks for deviation from the theoretical model of full separation of duties while assuring the operational needs of the University can be met. The University offers the following specific responses to the above items. The University has devoted significant effort within the past two years to address a more automated process for terminating user access rights to the network and Banner data and is currently in the final phase of implementing a University Policy that addresses access rights and timelines for these rights. Unfortunately, the complexities of the academic environment and access needs, accompanied with coordinating and integrating timely departmental notifications for employee separations into the Human Resources and Information Technology business processes have precluded automation at this point. Termination of network access and termination of Banner access are two independent processes. To a great degree, the delay in Banner account terminations can be attributed to a breakdown in communication and understanding of the manual process used to terminate the accounts. Originally, the understanding was that the termination of network access also terminated Banner access; however, this is not the case. This situation was corrected prior to the end of the 2009 fiscal year. It should also be noted that in the WCU Banner Finance centralized environment, update access by campus departments to Banner Finance is restricted only to the purchase requisition create function. We will reemphasize to campus the importance of timely notification of separations to assure access to the requisition create process is disabled immediately upon separation from the University.

With respect to access rights incompatible with job functions, as noted in the prior year response, the University evaluated the Controller's security and associated risks for choosing an alternative access path and maintains the overall risks to the University and its financial processes were minimized under the approach we took. With control processes in place, it is highly unlikely an unauthorized or unapproved transaction would go unnoticed in Banner Finance. In addition, all transactions entered in Banner Finance store the user id in the transaction table, providing an audit trail of all financial transactions processed. When the

University became satisfied that staff skill sets supported restricting the Controller's access, actions were taken to do so as noted in the finding above. Indicative of the University's consideration of the risks and desire to restrict the Controller's access as soon as operationally feasible, it should be noted the change to the Controller's access in April of 2009 was made prior to the issuance of the fiscal 2008 audit report and related finding.

Further to the Controller's access, the finding suggests the Controller shared both his password and Banner account with one of the Systems Accountants. Consistent with the prior year's response, access to the password was not released, though transactions or reports were processed under the Controller's account within controlled, mentoring events. It should be noted that a unique account for the Systems Accountant was created in March 2009, when he had acquired the appropriate skill sets to support full independence. This change was made in conjunction with restricting the Controller's access and as noted, was done prior to the release of the 2008 audit finding.

With respect to access to the tuition and fee tables and maintenance of student accounts, access was in place to provide back-up functionality. Dual access has now been revoked so that no one individual has access to both processes. In addition, the shared account which essentially was a shared process to drop students for non-payment has been addressed. Individual user accounts to execute this process have been created for each of the three employees referenced.

Auditor Comment: Management is responsible for adopting sound internal control policies and procedures. The timing of the audit or the release of the audit report does not relieve the University management of this responsibility, nor should the audit be management's sole source for evaluating the effectiveness of its internal control. Further, although management has the responsibility for assessing the cost/benefits and practicality associated with controls, the auditor's responsibility to communicate internal control deficiencies exists regardless of management's decisions.

With respect to the University's statement that the update access by campus departments to Banner Finance being limited to the ability to create purchase requisitions, our audit indicated that the ability to create purchase requisitions was equal to the authorization of purchases and was applicable to 16 of the 19. The remaining three had additional rights including two with "finance all" rights. Further, while adequate communication of policy is desirable, communication alone may not be sufficient to ensure separations are timely executed.

With respect to the University's assertion that sufficient controls exists to detect unauthorized or unapproved transactions in Banner Finance, our consideration of these controls, for example bank reconciliations and the reconciliation of Banner to NCAS, during the audit process was that these controls alone were not sufficient to detect unauthorized transactions.

With respect to sharing of passwords, regardless of the environment it would be impossible to determine the responsible party if an error or misappropriation occurred. With respect to access to the tuition and fee tables, a total of four user accounts had update capabilities. Of these four, one account was shared by three individuals. Exception was not taken to the individual that served as a back-up function.

2. DEFICIENCIES IN INTERNAL CONTROL OVER THE RESIDENTIAL MANAGEMENT SYSTEM

The University did not maintain adequate internal control over access to its housing system and data, nor did it maintain adequate internal control to ensure data were transferred from the housing system to the financial system completely and accurately. This increases the risk of error or fraud.

We identified two housing personnel with access rights that were inconsistent with proper segregation of duties. These individuals have full access rights to the housing system, allowing them to enter and change rates, post charges to student accounts, and transmit information to the financial accounting system. One of these individuals also has the responsibility as the security administrator over access to this system. These functions and related computer access should be

segregated so that no one individual has the ability to control all aspects of a transaction. In addition, there was no reconciliation performed of data transmitted between the housing and financial accounting systems to ensure transactions were properly transferred and recorded. This finding was also reported in the prior audit. In response to this issue, the University implemented reconciliation procedures for the daily transfer of data transmitted between the housing and financial accounting systems effective December 2008.

Recommendation: The University should continue to improve internal control and establish policies and procedures over granting and managing access to the housing system and data.

University's Response: The University agrees with the recommendation and will work to satisfy the recommendation to the fullest extent practical. The University offers the following specific responses to the above items.

With respect to the housing personnel access rights, security was changed on July 16, 2009 to remove conflicting access to the rate tables for one of these individuals listed in the 2008 Audit Comments, dated June 10, 2009. Unfortunately, the late issuance date for the 2008 audit prevented the University from making timely adjustments to eliminate this deficiency in the 2009 fiscal year since 11 months of the 2009 year had lapsed when the internal control weaknesses was noted. The University took action within 45 days following the issuance of the 2008 audit finding to address this finding.

Unfortunately, the adjustment was not made until July 16, 2009; however, we are hopeful that our action will eliminate the need to include this finding again in the 2010 audit. In addition, the University is currently exploring options which will allow a separation of the security administration function by adding additional staff or reassigning the responsibility for table maintenance to a department outside of Residential Living.

With respect to the data transfer reconciliation, as noted in the finding the University implemented a formal reconciliation and data review process in December, 2008 to address the prior year finding. These processes continue to be followed.

Auditor Comment: Management is responsible for adopting sound internal control policies and procedures. The timing of the audit or the timing of the release of the audit report does not relieve the University management of this responsibility, nor should the audit be management's sole source for evaluating the effectiveness of its internal control.

Weaknesses identified during the audit are communicated throughout the process.

3. DEFICIENCIES IN FINANCIAL REPORTING

The financial statements prepared by the University contained misstatements that were corrected as a result of our audit. These misstatements indicate that the University's internal control over financial reporting was not effective, and without the corrections, the financial statements could have been misleading to users. Misstatements noted in our audit included:

- a. The University failed to record the effects of borrowing unrestricted cash to cover deficit balances in restricted funds. As a result, current unrestricted cash was overstated by \$1,936,477, restricted current cash was understated by \$1,910,377, and restricted noncurrent cash was understated by \$26,100.
- b. The restricted expendable capital projects net asset balance was overstated by \$2,578,186, the restricted expendable debt service net asset balance was overstated by \$75,746, unrestricted net assets were understated by \$2,334,647, and invested in capital assets, net of related debt net assets were understated by \$319,286 as a result of classification errors. The restricted nonexpendable scholarships and fellowships net asset balance was

overstated by \$999,139 and the restricted nonexpendable endowed professorships net asset balance was understated by the same amount due to the classification errors.

- c. Nonexpendable net asset balances were overstated as a result of the University's failure to record investment losses that exceeded the related endowment's available accumulated income and net appreciation. Nonexpendable net asset balances were overstated by \$1,063,196 and expendable net asset balances were understated by the same amount. The note disclosure of endowment balances available to be spent and those restricted for specific purposes were also understated.
- d. The beginning balance for construction-in-progress was overstated by \$902,598 and the beginning balance for machinery and equipment was understated by \$902,598. This is a result of the University failing to capitalize completed assets in the appropriate year. Current year additions were also overstated as a result of this error.
- e. Capital asset purchases were reported as expenses rather than capitalized as assets. As a result, depreciable capital assets were understated by \$97,186, supplies and materials expense was overstated by the same amount, and depreciation expense was understated by \$2,390.
- f. Machinery and equipment was understated by \$86,695 and related accumulated depreciation was understated by \$14,449 due to the University incorrectly showing an asset as a disposal in the financial accounting system that was actually still in use. Depreciation expense was also understated by \$5,779.

This finding was also reported in the prior audit.

Recommendation: The University should implement effective internal controls to ensure the accuracy of the financial statements and related notes.

University's Response: The University will continue to work to increase the level of internal control over financial reporting in order to produce annual financial statements with the highest level of accuracy, completeness, and compliance with generally accepted accounting principles possible. Tremendous strides have been made in the last two years to develop systems and procedures to meet the challenges associated with the implementation of the Banner Finance, Student, and Fixed Assets systems without the benefit of additional resources. This has been facilitated by the recent hiring of highly qualified staff to assist with the preparation of the annual financial report in addition to their other duties in the Controller's Office. The University offers the following specific responses to the above items reported as financial reporting deficiencies:

- a. As part of the cash to accrual conversion performed each fiscal year, the University records an accounts receivable amount equal to the amount of cash expended but not reimbursed under cost reimbursable grants and certain student loan programs. We have not, however, recorded a reclassification from unrestricted to restricted cash and cash equivalents to reflect this borrowing of unrestricted cash to cover restricted cash deficits. Failure to make this adjustment has not been an audit issue in the past. The University does, however, agree with this adjustment and a similar reclassification was made for the fiscal year ended June 30, 2010. In addition, this adjustment is now listed on our financial reporting checklist to ensure it will be made in all subsequent years.
- b. The University did not concur with the original adjustment proposed by the Office of State Auditors but does agree that there were net asset classification errors on the University's financial statements as originally prepared. The University recalculated the net asset breakdown on the Statement of Net Assets and this calculation was reviewed by the auditors and accepted as the corrected amounts to be reported on the University's Statement of Net Assets. This same methodology was used for the financial statements for

the fiscal year ended June 30, 2010 and will be used in future years.

- c. This net asset classification error was a result of the University's recording of the market value adjustment on "underwater" permanent endowment funds in the expendable rather than nonexpendable net assets classification. The University concurs with this adjustment and made a similar adjustment on the financial report for the fiscal year ended June 30, 2010. This adjustment has also been added to the University's financial reporting checklist to ensure it will be made in all subsequent years, if applicable.

Findings 3.d. through 3.f. are all related to the recording of fixed assets transactions and balances. Both the implementation of Banner Fixed Assets in fiscal year 2007 and staff turnover in the fixed asset accountant position presented significant challenges to the University. The University has devoted substantial time and effort to overcoming these challenges and feels that we have made tremendous improvements in the accuracy and completeness of the fixed assets records and the internal controls over fixed assets. Given the high volume of equipment purchases and construction activity on a university campus and the necessary dependence of the Fixed Asset Accountant on campus departments for accurate and complete information, it is highly unlikely that 100% accuracy can ever be achieved. The University feels, however, that the fixed asset controls currently in place are highly effective in ensuring that a material misstatement would not go undetected.

Though the University did not restate the June 30, 2008 beginning balance affected by Finding 3.d. nor the June 30, 2009 ending balance affected by Finding 3.e., as explained in more detail below, both of these items were correctly reported in the financial statements in the year following the error and prior to the audit of the June 30, 2009 financial statements or discovery by the auditors. In our opinion, the net effect of these adjustments neither individually nor combined, resulted in a material misstatement of the financial statements. Neither do we believe they are an indication of a control deficiency that could result in a material misstatement that will go undetected.

The University offers the following specific comments to items 3. d. - f.:

- d. As part of the annual financial reporting process, the Capital Improvements Accountant sends a listing of all amounts accumulated as "construction in progress" on capital projects to the Facilities Management department to verify if any projects listed were completed as of the end of the fiscal year. Based on this response, the accumulated cost of completed projects is then reclassified out of construction in progress and into the appropriate fixed asset category. This procedure was followed in fiscal year ended June 30, 2008 and reclassifications were made based on this confirmation. The Facilities Management employee completing the verification form indicated that a capital project was still in progress at year end because funds were remaining in the project and it appeared additional costs would be incurred. In reality, the project had been completed by year end and, therefore, should have been reclassified to Machinery and Equipment, rather than included in Construction in Progress. This resulted in the beginning balances in these two categories in the capital asset footnote being misstated in offsetting amounts (\$902,598) and since it was reclassified by the University correctly in the fiscal year ended June 30, 2009, had no effect on the June 30 2009, Statement of Net Assets or on depreciation expense for that year. For fiscal year ended June 30, 2010, the University Controller and Associate Vice Chancellor for Financial Services met with the Associate Vice Chancellor for Facilities Management and the Director of Facilities Planning, Design and Construction to review the status of all capital projects at year end to ensure proper reclassification of all completed projects. This practice will continue in future years. In addition, the Fixed Asset Accountant will be provided access to CAPSTAT, UNC's capital project status system, so he can review completion dates and other pertinent information about the status of capital projects.

- e. The University has in place a chart of accounts and reports to provide a means to identify equipment, furnishings, and other purchases that require capitalization in accordance with the University and state policies. The Fixed Asset Accountant, however, relies on the accuracy of account coding by campus departments in order to ensure that additions can be identified for entry into the fixed asset system. The assets that were identified in this finding were not capitalized as a result of campus departments using incorrect account codes on purchase requisitions that resulted in these purchases being omitted from the reports used by the Fixed Asset Accountant. As a result of this, the reports have been expanded to include accounts that would not typically include assets that should be capitalized to ensure that items entered with incorrect account codes can be captured for capitalization. In addition, the Fixed Asset Accountant is now reviewing all daily checks issued for the purchase of goods and services, along with supporting documentation, to ensure that the University's fixed assets records are as complete and accurate as possible. While the University does not feel that a 100% review of all transactions is a reasonable use of State resources, we do feel it is necessary to ensure that a similar error and resulting audit finding do not occur in future years.
- f. This understatement in Machinery and Equipment was a result of an incorrect tag number on a list of items that were sold at a surplus yard sale. The list was submitted to the Fixed Asset accountant and all items were recorded as disposals in fiscal year ended June 30, 2009, including this particular piece of equipment that was removed in error. Subsequent to year end, the Fixed Asset Accountant was reviewing the fixed assets records and noticed that this item flagged as "disposed" had remaining useful life and a fairly significant cost so he asked the department the reason for its disposal. The department responded that they still had the equipment and it was at that time the Fixed Asset Accountant determined what had happened and took immediate steps to enter the item back in the system and to prepare the journal entry to record the correction in the finance system in the 2009-2010 fiscal year. Based on the immateriality of this error, the University did not consider it necessary to restate the June 30, 2009 balances. The fact that the University detected this error as a result of careful review and follow up by the Fixed Asset Accountant is an indication that controls are in place to detect errors and to prevent misstatements, not a deficiency in financial reporting as presented in the audit report. Unfortunately, in this particular situation, the error was discovered shortly after the 2009 year end was closed, resulting in an understatement of \$72,246 (.03%) of Net Capital Assets and \$5,779 (.07%) of total Depreciation Expense on the June 30 2009 financial report.

Auditor Comment: While some of the misstatements noted in items (d) through (f) may not be considered material misstatements individually, the cumulative effect of the misstatements, when combined with the other items included in the finding, indicates that the University did not have adequate controls in place to prevent or detect errors to the financial statements prior to their issuance. The University is responsible for fair presentation of their financial statements and previous audit results should not be considered a primary control for accurate financial reporting.

With respect to the University's specific response to finding 3b, upon reviewing the auditor's initial corrections to the net assets classification, the University identified additional errors in the net assets classifications in the statements as originally presented. This resulted from incomplete evidence provided to the auditors. The net effect of the additional evidence and subsequent adjustment did not result in a material variation from the original proposed correction.

With respect to the University's response to findings 3d - 3f, an adequate internal control structure includes, in addition to preventing or detecting errors, processes to correct errors identified and to timely evaluate the impact of errors identified on the financial statements. Also, while some of the assets identified in 3e were not capitalized due to incorrect account coding, this was not the sole reason for all errors described in the finding.

6. Appalachian State University: (Financial) - No Audit Findings
Release Date: 12/22/2010

Report URL

<http://www.ncauditor.net/EpsWeb/Reports/Financial/FIN-2010-6080.pdf>

7. Fayetteville State University: (Financial) – No Audit Findings
Release Date: 1/4/2011

Report URL

<http://www.ncauditor.net/EPSWeb/Reports/Financial/FIN-2010-6088.pdf>