

Office of the State Auditor

Division of State Audit

North Dakota University System

Governance Communication
Including the Report on Internal Control,
Compliance and Other Matters

For the year ending June 30, 2010
Client Code 220

Robert R. Peterson
State Auditor



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STATE OF NORTH DAKOTA
OFFICE OF THE STATE AUDITOR
STATE CAPITOL
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BISMARCK, NORTH DAKOTA 58505

Transmittal Letter

December 15, 2010

Honorable Jack Dalrymple, Governor
Members of the North Dakota Legislative Assembly
The State Board of Higher Education

I am pleased to submit our report on internal control and compliance for the North Dakota University System. This report relates to the audit of the North Dakota University System's financial statements for the year ended June 30, 2010. This report on internal control and compliance has been completed in accordance with *Government Auditing Standards*, as issued by the Comptroller General of the United States.

Also enclosed you will find our audit findings, governance communication, posted and passed audit adjustments and management letter. These communications are required by generally accepted auditing standards.

The audit manager for this audit was John Grettum, CPA. Inquiries or comments relating to this audit may be directed to Mr. Grettum by calling (701) 239-7289. I wish to express our appreciation to the North Dakota University System for the courtesy, cooperation, and assistance they provided to us during the audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Bob Peterson".

Robert R. Peterson
State Auditor

Executive Summary

RESPONSES TO THE LAFRC AUDIT QUESTIONS

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state institutions:

1. What type of opinion was issued on the financial statements?

Unqualified.

2. Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?

No. Background checks were not completed timely at DSU, MaSU, NDSCS, NDSU, UND, VCSU and WSC. (Prior recommendation item 5)

For additional commentary see the Prior Recommendations Not Implemented and University System Responses section of this report, starting on page 8.

3. Was internal control adequate and functioning effectively?

No.

1. SBHE oversight could be improved. (Finding 10-1)
2. GASB 40 risk disclosures were not adequate. (Finding 10-2)
3. Foundation audit reports were not properly presented. (Finding 10-3)
4. Grant and contract revenue and receivables were misstated at UND. (Finding 10-4)

For additional commentary see the Findings, Recommendations, and University System Responses section of this report, starting on page 13.

4. Were there any indications of lack of efficiency in financial operations and management of the agency?

Yes. Based on the number of unimplemented prior recommendations (Six), posted audit adjustments (Forty-one), passed audit adjustments (Six), and new formal (Four) and informal (Seventeen) recommendations, in our opinion, there is a lack of efficiency in financial operations and management of the agency.

5. Has action been taken on findings and recommendations included in the prior audit?

No. Six of nine prior recommendations were not implemented as follows:

1. **The NDUS continues to improperly use the account codes, funds, fund groups, and functions that are available on PeopleSoft to comply with General Accepted Accounting Principles (GAAP). [2002, 2005, 2006, 2007, 2008 and 2009 audits]**
2. **NDUS management has not established appropriate internal controls and provided sufficient training to personnel so that the NDUS is able to prepare**

financial statements in conformity with GAAP without a substantial number of audit adjustments. [2007, 2008 and 2009 audits]

3. The NDUS has not:

- conducted a comprehensive fraud and control risk assessment by each institution,
- established appropriate internal controls to detect, deter, and avoid potential fraudulent activity and risks relevant to the preparation of financial statements,
- required formal continuing training on proper internal control techniques and systems to ensure all personnel are aware of institutional and Board policies and procedures and where available,
- directed internal audit staff to aide in the establishment of policies and procedures and to test the effectiveness of such policies and procedures once established. [2008 and 2009 audits]

4. The NDUS has not:

- reviewed internal audit staffing levels at UND and NDSU,
- provided for an internal auditor at each of the schools lacking an internal auditor or provided an internal audit position at the Board level that would perform the function of an internal auditor at these schools,
- required that internal audit staff at all schools report directly to the Budget, Audit and Finance Committee. [2009 audit]

5. Background checks were not completed timely at DSU, MaSU, NDSCS, NDSU, UND, VCSU and WSC. [2009 audit]

6. The institutions using imaging software did not:

- comply with NDUS Board policy (1901.2) and procedures (1901.2, 1901.3, 1901.4 & 1912.1),
- perform and document a review of such compliance with policies and procedures on their campus,
- document that the audit software on their imaging system is turned on and identify who is responsible for monitoring system activity,
- ensure the access provided to the users is limited to the extent necessary to perform their job. [2009 audit]

For additional commentary see the Prior Recommendations Not Implemented and University System Responses section of this report, starting on page 8.

6. Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.

Yes. We made 17 informal recommendations to which management responded. For additional commentary and management responses, see the Management Letter starting on page 25.

LAFRC AUDIT COMMUNICATIONS

1. Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.

There were no significant changes in accounting policies; no management conflicts of interest were noted, except of the adoption of GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, as described in Note 1. The NDUS's commitments and contingent liabilities are reported on pages 54, 61 and 62 of the NDUS Annual Financial Report.

2. Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

- Useful lives of capital assets
- Allowance for uncollectible receivables:

Accounts	\$3,450,758 (16.3%)
Loans and notes	\$6,890,385 (14.4%)

Management's estimate of the useful lives, as described in Note 1, is used to compute depreciation on capital assets. Management's estimate of the allowance for uncollectible receivables is based on aging categories and past history. We evaluated the key factors and assumptions used to develop the allowances in determining that they are reasonable in relation to the financial statements taken as a whole.

3. Identify any significant audit adjustments.

The Posted Audit Adjustments schedule lists material misstatements detected as a result of audit procedures that were corrected by management. The Passed Audit Adjustments schedule summarizes uncorrected misstatements of the financial statements. Management has determined that their effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

4. Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.

We are pleased to report that no significant disagreements arose during the course of our audit. However, we had instances of disagreement with auditor recommendations. The disagreements are included in the University System Response/Planned Corrective Actions and in Appendix B, NDUS Supplemental Responses and Auditor's Concluding Remarks sections of the report.

5. Identify any serious difficulties encountered in performing the audit.

None.

6. Identify any major issues discussed with management prior to retention.

This is not applicable for audits conducted by the Office of the State Auditor.

7. Identify any management consultations with other accountants about auditing and accounting matters.

None.

8. Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.

ConnectND Finance, Human Resource Management System (HRMS) and Student Administration are the most high-risk information technology systems critical to the North Dakota University System. None of the exceptions noted were directly related to the operation of an information technology system.



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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

Honorable Jack Dalrymple, Governor

Members of the Legislative Assembly

The State Board of Higher Education

We have audited the financial statements of the business-type activities of the North Dakota University System and its aggregate discretely presented component units as of and for the year ended June 30, 2010, which collectively comprise the North Dakota University System's basic financial statements and have issued our report thereon dated December 15, 2010. Our report was modified to include a reference to other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the aggregate discretely presented component units, as described in our report on the North Dakota University System's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of the aggregate discretely presented component units were not audited in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the North Dakota University System's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the North Dakota University System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the North Dakota University System's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of prior recommendations not implemented and University System responses and in the schedule of findings, recommendations and University System responses, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the North Dakota University System's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying schedule of prior recommendations not implemented and University System responses as items 2 and 3 and in the schedule of findings, recommendations and University System responses as findings 10-1 and 10-2 to be material weaknesses.

A significant deficiency is a deficiency or combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying schedule of prior recommendations not implemented and University System responses as items 1, 4, and 6 and in the schedule of findings, recommendations and University System responses as findings 10-3 and 10-4 to be significant deficiencies.

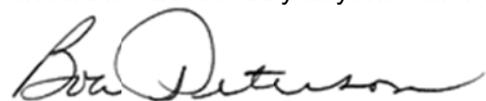
Compliance and Other Matters

As part of obtaining reasonable assurance about whether the North Dakota University System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* and which is described in the accompanying schedule of prior recommendations not implemented and University System responses as item 5.

We noted certain matters that we reported to management of the North Dakota University System in a separate letter dated December 15, 2010, included in this report as "Management Letter".

The North Dakota University System's responses to the findings identified in our audit are described in the accompanying schedules and letters: prior recommendations not implemented and University System responses, findings, recommendations and University System responses, management letter, and Appendix B – NDUS supplemental responses and auditor's concluding remarks. We did not audit the North Dakota University System's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, the State Board of Higher Education, the Governor, and the Legislative Assembly and is not intended to be and should not be used by anyone other than these specified parties.



Robert R. Peterson
State Auditor

December 15, 2010

Prior Recommendations Not Implemented and University System Responses

Prior recommendations not implemented and client responses, item #5 of the Special Comments Requested by the Legislative Audit and Fiscal Review Committee.

- 1). During the 2002, 2005, 2006, 2007, 2008 and 2009 audits we recommended that the NDUS properly use the account codes, funds, fund groups, and functions that are available on PeopleSoft to comply with General Accepted Accounting Principles (GAAP). This includes the proper initial recording of all assets, liabilities, equities, revenues, and expenses. Our testing during the current audit indicated that although there was some improvement, this problem still exists. For details see Appendix A - Classification, beginning on page 33.

- 2). During the 2007, 2008 and 2009 audits we recommended that NDUS management establish appropriate internal controls and provide sufficient training to personnel so that the NDUS is able to prepare financial statements in conformity with GAAP. Our current audit indicated that the financial reporting system of the NDUS was not adequate to offer reasonable assurance that management was able to produce financial statements that comply with GAAP. In fiscal year 2010, there were material auditor-identified audit adjustments of \$22,794,048, \$4,125,906, \$43,489,434, \$4,799,702, and \$10,241,897 to total assets, total liabilities, total equity, total revenue, and total expenses, respectively. For details, see Posted Audit Adjustments on page 20 of this report. By comparison, in fiscal year 2009, there were material auditor-identified audit adjustments of \$14,439,787, \$16,660,471, \$48,802,044, \$33,785,848, and \$10,678,496 to total assets, total liabilities, total equity, total revenue, and total expenses, respectively. In our opinion, all of the accounting issues that required audit adjustments should have been detected by appropriate internal controls or corrected by management responsible for the preparation of financial statements.

University System Response/Planned Corrective Actions:

Agree. Specific recommendations for change will be identified by March 31, 2011 for implementation in the preparation of FY11 statements, to the extent possible.

[See Appendix B, item 1 for the supplemental response to this recommendation.]

- 3). During the 2008 and 2009 audits we recommended that the SBHE require a comprehensive fraud and control risk assessment by each institution and the establishment of appropriate internal controls to detect, deter, and avoid potential fraudulent activity and risks relevant to the preparation of financial statements; require formal continuing training on proper internal control techniques and systems to ensure all personnel are aware of institutional and Board policies and procedures and where available, internal audit staff be directed to aide in the establishment of policies and procedures and to test the effectiveness of such policies and procedures once established.

In our opinion, the only way for an institution to create an atmosphere of awareness of risk is to have substantial buy-in from top management and regularly communicate management's expectation to employees. Management must be cognizant of where potential risks lie, evaluate the significance of the potential risks and where necessary and practical, devise internal controls to mitigate the risk.

Further, in our opinion, a code of conduct should be developed and implemented at the University System level and at the institution level.

Our current audit indicated that:

- An entity wide risk assessment was not performed by the institutions or the system office. However, prior to issuance of this report the NDUS has engaged a private firm to complete an enterprise wide risk assessment.
- The State Board of Higher Education adopted policy 308.1, officer and employee code of conduct, as of June 30, 2010. However, DSU, MaSU, NDSCS and WSC had not adopted a code of conduct policy. NDSU's code of conduct policy was a copy of the Board's code and included paragraph 5 of that policy which discusses Board member's potential conflicts of interest. This should be replaced with NDSU's conflict of interest policy.

University System Response/Planned Corrective Actions:

Agree: Recommendation was not fully implemented by 6/30/10; however, the NDUS initiated an RFP process prior to 6/30/10 to engage an independent third party to conduct an enterprise wide risk assessment at each campus and the NDUS Office. The State Auditor's Office has been kept apprised of this effort. The NDUS Office, BSC, WSC, UND, MaSU, and VCSU have been partially completed to date. It is anticipated that all remaining institutions will be completed before June 30, 2011.

Agree: Recommendation was not fully implemented by 6/30/10; however, the SBHE adopted policy 308.1 on June 17, 2010. To ensure adequate time for institutions to develop or modify their own policy and identify implementation and monitoring procedures, the NDUS System Office asked all institutions to be in compliance by July 1, 2011.

DSU: A committee was formed to draft a Code of Conduct, involving as many campus personnel as possible. The committee completed the draft and it is now being reviewed by the NDUS legal counsel, the faculty and staff senates and the President's office. The final document will be reviewed and signed by all benefitted employees by July 1, 2011.

NDSU implemented the Board's code of conduct to ensure immediate response to the recommendation. NDSU is currently proceeding with its interpretation and guidance through its Policy Coordination Committee for review and acceptance in accordance with established procedures with an expected implementation date by July 1, 2011.

NDSCS is currently in the process of implementing a Code of Conduct policy, with the intention of having it officially in place by June 30, 2011, as directed.

MaSU adopted a draft code of conduct on June 21, 2010 and a final code of conduct on September 27, 2010.

WSC adopted a code of conduct policy on November 29, 2010.

4). During the 2009 audit we recommended that the NDUS:

- Review internal audit staffing levels at UND and NDSU.
- Provide for an internal auditor at each of the schools lacking an internal auditor or provide an internal audit position at the Board level that would perform the function of an internal auditor at these schools, and
- Require that internal audit staff at all schools report to the Budget, Audit and Finance Committee.

Our current audit indicated that this recommendation was not implemented. However, prior to the issuance of this report, we did note that the NDUS office hired an internal auditor at the Board level and implemented a change in board policy to require reporting to the SBHE Budget, Audit and Finance Committee through the chancellor and UND and NDSU Presidents so those parts of this recommendation will be considered implemented.

University System Response/Planned Corrective Actions:

Agree. UND and NDSU administration will be asked to perform an internal review of their staffing levels and submit a report and recommendation to the SBHE Budget, Audit and Finance Committee (BAFC) prior to September 2011.

Agree. The SBHE approved the addition of one System internal audit position. Following a second search, finalists for the position were interviewed in January 2011. An individual has been hired and will start employment in February 2011. The State Auditor's Office has been kept informed of the status of the search throughout the process.

Disagree. The SBHE BAFC considered this option and chose instead to retain staff reporting relationships to the President (for campus IA staff) or Chancellor (for system IA staff); and, furthermore those agency heads have a corresponding responsibility to assure timely conveyance of substantial findings, including suspected fraud and other illegal activities, through established administrative chain of command, and ultimately to the BAFC.

- 5). During the 2009 audit we recommended that DSU and UND perform background checks as required by NDCC and SBHE policy.

This recommendation was not implemented. Our current audit indicated that for 16 of 81 new hires tested, the background checks were done after the employee was hired (DSU, MaSU, NDSU and UND), or were done after we selected the new hire for testing (NDSCS, VCSU and WSC).

University System Response/Planned Corrective Actions:

DSU Agrees. DSU received the original background check recommendation in November of 2009, and responded that we would contract with Castlebranch to complete the background checks and comply with the recommendation. In February 2010, all the required background checks were completed with the exception of one temporary coach. DSU is now fully in compliance with the recommendation.

NDSU Agrees. Appropriate procedures are now in place.

UND Agrees. The corrective action has been fully implemented.

MaSU, NDSCS, VCSU, WSC Agrees. Required background checks will be performed as required by policy.

[See Appendix B, item 2 for the supplemental response to this recommendation.]

- 6). During the 2009 audit we recommended that all institutions using any version of imaging software:
- Comply with NDUS Board policy (1901.2) and procedures (1901.2, 1901.3, 1901.4 & 1912.1).
 - Each institution's CIO performs and documents a review of such compliance with policies and procedures on their campus.
 - Document that the audit software on their imaging system is turned on and identify who is responsible for monitoring system activity.
 - Ensure the access provided to the users is limited to the extent necessary to perform their job.

Our current audit indicated that this recommendation was not implemented.

University System Response/Planned Corrective Actions:

Agree. The NDUS held a meeting on 2/15/11 with the State Auditors' Office to get further clarification on the extent and scope of imaging software for the purposes of this recommendation.



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Findings, Recommendations, and University System Responses

IMPROVED OVERSIGHT BY THE STATE BOARD OF HIGHER EDUCATION (FINDING 10-1)

The North Dakota State Board of Higher Education (NDSBHE) should improve its financial and accounting oversight over the institutions that make up the North Dakota University System (NDUS). This improved oversight should focus on eliminating the need for significant audit adjustments and repeat audit findings. For example, this audit required 41 posted audit adjustments and contained six prior recommendations that had not been implemented including one which has appeared in six previous reports and one which has appeared in three previous reports.

The NDSBHE is charged by the North Dakota constitution and state statutes with governance over the 11 state colleges and universities. As part of that responsibility they are accountable for ensuring that the NDUS establishes internal controls to promote efficiency, reduce risks of asset loss, and helping to ensure the reliability of financial statements and compliance with laws and regulations. Management, the general public, the state Legislature, state and federal agencies and bondholders rely on financial statement information to make decisions. Improved internal controls over the entity's activities and improved reporting responsibility to organizational boards are the cornerstone of proper management.

The NDSBHE should adopt financial management policies and practices in the form of an accounting or financial management manual to provide internal control and consistency in financial reporting for the University System. A uniform accounting or financial management manual is needed to promote proper internal control and consistency in financial reporting between the schools and would assist in meeting the constitutional requirement that the NDSBHE prescribe standard systems of accounts and records (Article VIII, Section 6. subpart 6.c.). Without adequate guidance in the form of an accounting manual, each individual user of the financial system has the increased likelihood of improperly coding financial data. This has contributed to significant, material audit adjustments in the University System's financial statements and inconsistent coding and treatment of similar transactions. The adoption of an accounting/financial management manual would assist the North Dakota State Board of Higher Education by ensuring that the NDUS is establishing internal control policies and procedures that promote consistency, efficiency, reduce the risks of asset loss, and help ensure the reliability of financial statements.

Recommendation:

We recommend the Board improve its financial and accounting oversight by ensuring that:

1. An accounting and financial management manual is written and adopted.
2. Internal controls are adequate and reviewed periodically and,
3. Appropriate action is taken to implement audit recommendations.

University System Response/Planned Corrective Actions:

Agree. The NDUS will update the draft accounting and financial management manual that is currently in place. The update will be completed by December 31, 2011 to allow time for updating consistent with the year-end close processes during the FY2011 close.

Agree. While the NDUS has numerous internal controls currently in place, future areas of focus will be driven by the results of the risk assessment. Also, with the addition of a System internal audit position, some additional internal control oversight will be available.

Agree. The NDUS System Office will continue to monitor the status of audit recommendation implementations and provide updates semi-annually to the BAFC.

[See Appendix B, item 3, for the supplemental response to this recommendation.]

GASB 40 RISK DISCLOSURES (FINDING 10-2)

During our test of deposit and investment risk disclosures, we noted the following errors:

- DSU included
 - \$9,655,000 of BND CD's in the other category of interest rate risk when it should have been included in the BND CD category.
 - \$9,655,000 in the credit risk disclosure when CD's should not be included in that disclosure.
- MiSU incorrectly
 - Disclosed \$8,602,019 as CD's - BND instead of cash deposits – BND and
 - Excluded \$12,055,482 CD's - BND from deposit risk disclosure category A.
- NDSU incorrectly excluded \$3,924,377 from the deposit risk disclosure category B.
- NDSCS incorrectly excluded
 - \$1,056,182 from cash deposits – BND and from the deposit risk disclosure category A, and
 - \$247,069 of cash deposits - other from the deposit risk disclosure category B.

GASB Statement No. 40, Deposit and Investment Risk Disclosures, provides the guidance needed to properly disclose credit risk, interest rate risk and foreign currency risk as they relate to deposits and investments.

Recommendation:

We recommend that DSU, MiSU, NDSCS and NDSU prepare their risk disclosures in accordance with GASB Statement No. 40.

University System Response/Planned Corrective Actions:

Agree. The campuses are now aware of this reporting and will provide the correct disclosures starting in FY 2011.

FOUNDATION AUDIT REPORTS (FINDING 10-3)

Certain NDUS Foundations are not preparing their audited financial statements in the SBHE required format or submitting their financial statements on a timely basis as required by SBHE policy 340.2. The following problems were noted:

- Audit reports for the BSC Foundation, the Lake Region Community College Foundation, the NDSU 4-H Foundation, the Alumni Association of the University of North Dakota and UND Foundation and the Fellows of the University of North Dakota were not presented in compliance with the format required by SBHE policy 340.2.
- Dickinson State University Foundation (54 days late), NDSCS Foundation (30 days late), NDSU Development Foundation (33 days late), Alumni Association of the University of North Dakota and UND Foundation (2 days late), University of North Dakota Research Foundation (2 days late) and Williston State College Foundation (2 days late) were not submitted on a timely basis.
- The auditor for the UND Center for Innovation Foundation (CIF) issued a qualified report based on non-compliance with GAAP. Per the independent auditor, CIF had other investments in partnerships, LLC's and preferred stock of companies that were untraded and therefore carried the investments at cost. No valuation adjustment for possible impairment was provided by management and therefore the statements did not comply with SFAS No. 157.

These shortcomings in financial statement preparation and submittal cause extra work for the NDUS and have led to problems in submitting NDUS financial statements to OMB for inclusion in the state's CAFR report.

SBHE policy 340.2, paragraph 3 includes a requirement to provide the institution with GAAP-compliant financial statements, including separately reported current assets, noncurrent assets, current liabilities and noncurrent liabilities on the face of the financial statements and an annual GAAP audit of the foundation by September 15 each year for all entities considered component units of the NDUS under GASB 39, and all other related organizations that are not component units, whose total assets exceed \$1 million and total program expenses exceed \$100,000, for the previous fiscal year-end.

Recommendation:

We recommend that all foundation financial statements be presented in their respective reports in compliance with SBHE policy 340.2, paragraph 3.

University System Response/Planned Corrective Actions:

NDUSO agrees the foundations' financial statements should be presented in compliance with SBHE policy 340.2, paragraph 3 which requires a September 15th submittal date.

[See Appendix B, item 4, for the supplemental response to this recommendation.]

MISSTATEMENT OF GRANT AND CONTRACT REVENUE AND RECEIVABLES (FINDING 10-4)

We found 3 separate errors when testing UND's grants and contract revenues and receivables which resulted in misstatement of the financial statements. We will break them out as follows:

- **Advance Payable Grant and Contract Receivable**-UND over-stated deferred revenues by \$559,784 and grants and contracts receivable by \$588,789 and private grants revenues by \$29,015. (Posted audit adjustment 1)
- **Cost Reimbursable Grants and Contract Receivable/Revenue**-UND over-stated each of revenue and receivable by \$566,075 due to doubling up on some indirect costs. (Posted audit adjustment 2)
- **Advance Payable Grant and Contract Revenue**-UND booked an error from the fiscal year 2009 audit (JE AUD_ADJ_9) then reversed it in fiscal year 2010, and the reversal was not eliminated so with a slight increase in deferred revenue from the prior year it was over-stated by \$413,952, while private grant and contract revenue was under-stated by \$413,952. (Posted audit adjustment 13)

As a result of the above errors, deferred revenue was over-stated by \$973,736; grant and contract receivable was over-stated by \$1,154,874; private grant and contract revenue was under-stated by \$384,937 and federal grant and contract revenue was over-stated by \$566,075. In our opinion the cause is at least partially the direct result of a lack of communication between UND's Finance and Operations office and Grants & Contracts Administration. This and the fact that an overall review is not performed on these balances prior to closing the general ledger to ensure they are properly stated.

Recommendation:

We recommend that UND's Finance and Operations office, with assistance from Grants & Contract Administration, establish policies and procedures to ensure that year end totals of grants and contract revenues and receivables be properly stated.

University System Response/Planned Corrective Actions:

Agree. UND Finance and Operations will work directly with the UND Division of Research to require advance pay contracts and deferred revenue to be reconciled every year by June 30th. Closing schedules in Finance and Operations as well as Research are being modified to further define the timeline and checks necessary to implement this recommendation by June 30, 2011.

December 15, 2010

The State Board of Higher Education Budget, Audit and Finance Committee
The Legislative Audit and Fiscal Review Committee

We have audited the financial statements of the business-type activities of the North Dakota University System and its aggregate discretely presented component units for the year ended June 30, 2010, and have issued our report thereon dated December 15, 2010. Professional standards require that we provide you with the following information related to our audit.

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the North Dakota University System are described in Note 1 to the financial statements. As described in Note 1 to the financial statements, the North Dakota University System changed accounting policies related to intangible assets by adopting Statement of Governmental Accounting Standards (GASB Statement) No. 51, *Accounting and Financial Reporting for Intangible Assets* in fiscal year 2010. Accordingly, the cumulative effect of the accounting change as of the beginning of the year is reported in the Statement of Net Assets. We noted no transactions entered into by the governmental unit during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

- Useful lives of capital assets
- Allowance for uncollectible receivables:

Accounts	\$3,450,758 (16.3%)
Loans and notes	\$6,890,385 (14.4%)

Management's estimate of the useful lives, as described in Note 1, is used to compute depreciation on capital assets. Management's estimate of the allowance for uncollectible receivables is based on aging categories and past history. We evaluated the key factors and assumptions used to develop the allowances in determining that they are reasonable in relation to the financial statements taken as a whole.

Difficulties Encountered in Performing the Audit

We encountered no serious difficulties in dealing with management but we did encounter difficulties in completing our audit in the timeframes established by OMB for inclusion of the NDUS in the state's CAFR. These difficulties were a direct result of the problems pointed out in prior years recommendations not implemented items 1 and 2 and current year recommendations, particularly findings 10-1 (Improved Oversight by the State Board of Higher Education) and 10-3 (Foundation Audit Reports).

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. The Posted Audit Adjustments schedule lists material misstatements detected as a result of audit procedures that were corrected by management. The Passed Audit Adjustments schedule summarizes uncorrected misstatements of the financial statements. Management has determined that their effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit. However, we had instances of disagreement with auditor recommendations. The disagreements are included in the University System Response/Planned Corrective Actions and in Appendix B, NDUS Supplemental Responses and Auditor's Concluding Remarks sections of the report.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated December 15, 2010.

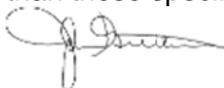
Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the governmental unit's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the governmental unit's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention. It should be noted that the retention of the State Auditor is a matter of state law and is not under the control of the North Dakota University System.

This information is intended solely for the use of the State Board of Higher Education Budget, Audit and Finance Committee, the Legislative Audit and Fiscal Review Committee and management of the North Dakota University System and is not intended to be and should not be used by anyone other than these specified parties.



Very truly yours,

John Grettum, CPA

Audit Adjustments

POSTED AUDIT ADJUSTMENTS

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
1	SNA			
MASU	Net assets restricted expendable for capital projects	1,970,526		Properly classify net assets for Agassiz Hall unspent bond proceeds and to eliminate negative net asset in research and move to restricted.
	Net assets unrestricted	6,115		
	Invested in capital assets, net of related debt		1,970,526	
	Net assets restricted expendable for research		6,115	
2	SNA			
MISU	Restricted cash and cash equivalents	8,602,019		Properly record money market account as cash and not investments.
	Restricted investments		8,602,019	
	SCF-Investing Activities			Include reclassification from investment to cash based on above.
	Purchase of investments	8,602,019		
	Net cash provided by investing activities		8,602,019	
3	SNA			
NDSCS	Net assets unrestricted	351,086		Properly classify net assets per GASB 34/35.
	Invested in capital assets, net of related debt		351,086	
4	SNA			
NDSCS	Notes receivable - noncurrent assets	1,870,340		Properly allocate current from noncurrent note receivable.
	Notes receivable - current assets		1,870,340	
5	SCF-Operating activities			
NDSCS	Grants and contracts	67,241		Reclassify amounts improperly reported as other receipts.
	Sales and service of educational departments	2,294,233		
	Other receipts (payments)		2,361,474	
6	SNA			
NDSU	Long-term liabilities-current portion Due to others	153,415		Remove bond payable from NDSU's general ledger as there is no local match requirement and bond is recorded by the Building Authority.
	Long-term liabilities-Due to others	2,998,755		
	Invested in capital assets, net of related debt		3,152,170	
	SRECNA			
	Increase(Decrease) in net assets	3,152,170		
	Transfers to building authority		3,152,170	
7	SRECNA			
NDSU	Transfers to from building authority	3,299,067		Beginning balance adjustment for the above entry.
	Net assets beginning of year		3,299,067	
8	SRECNA			
NDUSO	Interfund transfer	2,418,790		Reclassify activity that resulted in SNA and SRECNA net assets not agreeing.
	Inter-institutional transfer in		2,418,790	
9	SRECNA-Elimination column entry			
NDUSO	Operating expenses	619,080		Reverse elimination entry to the NDUS financial statements.
	Sales and services of educational departments		619,080	
10	SNA			
NDUSO	Invested in capital assets, net of related debt	215,111		Properly classify net assets per GASB 34/35.
	Net assets unrestricted		215,111	
11	SRECNA-Elimination column entry			
NDUSO	Other nonoperating revenues(expenses)	217,140		Correct double recording of revenue and expense of NDHECSAP funds transferred from UND to NDUSO.
UND	Other expenses		217,140	
12	SRECNA-Elimination column entry			
NDUSO	State appropriations	200,000		Correct double recording of revenue and expenses by NDUSO and VCSU.
VCSU	General and special grant expenses		200,000	

(continued)

Posted Audit Adjustments – continued

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
13	SRECNA-Elimination column entry			
UND	Sales and services of educational departments	335,651		Correct double recording of revenue and expense for UND-ITSS.
NDSU	Operating expenses		335,651	
14	SNA			
UND	Deferred revenue	559,784		Correct advance pay grants and contracts receivable.
	Net assets, restricted, expendable for research Grants and contracts receivable	29,015	588,799	
	SRECNA			
	Nongovernmental grants and contracts Increase (Decrease) in net assets	29,015	29,015	
	SCF-Operating Activities			
	Student tuition and fees Grants and contracts	559,784	559,784	
15	SNA			
UND	Net assets, restricted, expendable for research Grants and contracts receivable	566,075	566,075	Correct grants and contracts receivable duplication during indirect cost calculation.
	SRECNA			
	Federal grants and contracts Increase (Decrease) in net assets	566,075	566,075	
16	SRECNA			
UND	Inter-institutional transfer out Interfund transfer	2,418,790	2,418,790	Reclassify activity that resulted in SNA and SRECNA net assets not agreeing.
17	SNA			
UND	Restricted cash and cash equivalents Unrestricted cash and cash equivalents	347,228	347,228	Properly classify restricted cash based on maximums allowed by bond indentures.
18	SRECNA			
UND	Increase(Decrease) in net assets Nongovernmental grants and contracts	413,952	413,952	Correct reversing entry done in prior year.
	SNA			
	Deferred revenue Net assets restricted expendable for institutional	413,952	413,952	
	SCF-Operating Activities			
	Student tuition and fees Grants and contracts	413,952	413,952	
19	SNA			
UND	Net assets unrestricted Invested in capital assets, net of related debt	186,677	186,677	Properly classify net assets per GASB 34/35.
20	SNA			
UND	Net assets unrestricted Net assets restricted expendable for institutional	6,115,009	6,115,009	Properly classify Chester and Vera Fritz gifts as restricted.
21	SCF-Capital & related financing activities			
UND	Proceeds from issuance of debt Transfers from Building Authority	1,500,000	1,500,000	Correct proceeds from issuance of debt recorded as transfers from Building Authority.
22	SCF			
Various	From Operating Activities: Other receipts from operating activities		302,408	To reclass the line "Other nonoperating revenues (expenses)" under cash flows from noncapital financing activities to "Other receipts (payments)" under cash flows from operating activities and add reconciliation. Authority.
	From Noncapital Financing Activities: Other nonoperating revenues	302,408		
	Reconciliation of Operating Activities: Other nonoperating revenues		302,408	

(continued)

Posted Audit Adjustments – continued

DESCRIPTION		DR	CR	EXPLANATION/DISPOSITION
COMPONENT UNITS:				
23	SNA			
BSCF	Receivable from primary institution - current	100,039		Reallocate current from noncurrent receivables for amounts owed to the foundation.
	Receivable from primary institution - noncurrent		100,039	
24	SNA			
DCBF	Investments	1,744,814		Properly classify amounts as current investments based on audit report and note 3 and other long term investments per the audit report.
	Other long term investments	37,013		
	Endowment investments		1,744,814	
	Other long-term investments		37,013	
25	SRECNA			
DCBF	Gifts and contributions	10,421		Correct manual computation of gift revenues to agree to the audit report.
	Increase (Decrease) in net assets		10,421	
26	SRECNA			
DSUF	Interest on capital asset-related debt	226,746		Properly record interest expense on bonds and reclassify other expenses.
	Operating expenses		80,914	
	Other nonoperating expense		145,832	
27	SRECNA			
LRCCF	Operating expenses	95,980		Increase salaries and wages per Note 11 of the IPA audit report.
	Payment to or for the institution (CU)		95,980	
28	SRECNA			
MISUF	Depreciation expense	33,554		Properly segregate depreciation expense from other operating expenses.
	Operating expense		33,554	
29	SNA			
NDSUDF	Other noncurrent assets	698,912		Properly segregate current from non-current assets and liabilities.
	Liabilities under trust agreement - noncurrent	675,775		
	Accounts receivable, net		698,912	
	Accounts payable & accrued liabilities		675,775	
30	SNA			
NDSU	Net assets unrestricted	728,476		Non-compliance with SFAS No. 157 Fair Valuation Measurements. Investments booked at \$1,040,037 are composed of \$728,476 of negotiable securities. None of these have been subjected to fair valuation measurements.
4-H	Investments		728,476	
	Endowment & Investment income	728,476		
	Decrease in net assets		728,476	
31	SRECNA			
NDSU	Payments to or for the institution (CU)	2,055,000		Classify scholarship payments to NDSU as non-operating in compliance with Codification 2200.171.
Team-makers	Scholarships and fellowships		2,055,000	
32	SNA			
UNDAF	Other noncurrent assets	345,340		Properly reclass non-current assets from current assets per auditor's report.
	Other current assets		345,340	
33	SRECNA			
UNDAF	Gifts - nonoperating	122,630		Properly reclass operating donations out of nonoperating donations.
	Gifts & Contributions - operating		122,630	
34	SNA			
UND	Other noncurrent liabilities	2,670,256		Show amounts held for others consistent with other IPA and SNA reclass reports.
Alumni	Deposits - Current		2,670,256	

(continued)

Posted Audit Adjustments – continued

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
35	SRECNA			
UNDCIF	Other operating revenue	212,040		Correct SRECNA for doubling interest income and expense and recognizing a transfer as a revenue and expense.
	Other nonoperating revenue	642		
	Operating expenses		212,682	
36	SNA			
UND	Cash and cash equivalents - current	96,719		Properly show classifications of cash and investments based on IPA (Independent Public Accountant) report. And to increase amounts due to UND from the Fellow s.
Fellows	Investments - current	1,840,892		
	Other noncurrent assets Restricted investments - noncurrent	850,618	2,788,229	
37	SNA			
UNDREA	Deferred revenue	2,349,969		Reflect amounts due from ticket sales.
	Accounts payable d accrued liabilities		2,349,969	
38	SNA			
UNDRF	Invested in capital assets, net of related debt	9,837,209		UND did not subtract debt on buildings or leases payable on equipment w hen they calculated Invested in capital assets.
	Net assets unrestricted		9,837,209	
39	SRECNA			
UNDRF	Gifts and contributions	2,875,559		Properly reflect federal grant revenues and compliance w ith the IPA classification.
	Federal grants and contracts		2,875,559	
40	SRECNA			
VCSUF	Gifts and contributions	142,942		Properly classify event income per IPA report.
	Event income		142,942	
41	SNA			
WSCF	Other noncurrent assets	173,368		Correct client's blending of current and non-current loans receivable into accts rec.
	Accounts receivable - current		173,368	

SNA – Statement of net assets

SRECNA – Statement of revenues, expenses and changes in net assets

SCF – Statement of cash flows

PASSED AUDIT ADJUSTMENTS

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
1	SNA			
UND	Receivable from component units	305,783		To post UNDAF receivable and revenue in proper fiscal year.
	Net assets unrestricted		305,783	
	SRECNA			
	Student tuition and fees	305,783		To post UNDAF receivable and revenue in proper fiscal year.
	Increase(Decrease) in net assets		305,783	
2	SRECNA			
BSC	State and local grants and contracts	922,980		To eliminate State grants at BSC already recognized on the NDUSO statements.
	Scholarships and fellow ships		922,980	
3	SRECNA			
WSC	Federal nonoperating grants and contracts	350,315		To correct Pell classification.
	Federal operating grants and contracts		350,315	
4	SCF			
NDUS	Interest paid on capital debt and lease	268,706		To post difference noted between audited amount of interest paid on capital debt and amount recorded.
	Payments to suppliers		268,706	
5	SNA			
NDSU	Net assets unrestricted	273,426		To post known and projected errors from tuition and fee testing.
	Accounts receivable		273,426	
	SRECNA			
	Student tuition and fees	273,426		To post known and projected errors from tuition and fee testing.
	Increase(Decrease) in net assets		273,426	
	COMPONENT UNITS:			
6	SNA			
UND	Net assets unrestricted	256,249		Non-compliance with SFAS No. 157, Fair Valuation Measurements. Other investments in partnerships, LLC's and preferred stock that are untraded have not been subjected to fair valuation measurements.
CIF	Other assets		256,249	
	SRECNA			
	Endowment Investment income (loss)	256,249		Non-compliance with SFAS No. 157, Fair Valuation Measurements. Other investments in partnerships, LLC's and preferred stock that are untraded have not been subjected to fair valuation measurements.
	Increase(Decrease) in net assets		256,249	

SNA – Statement of net assets

SRECNA – Statement of revenues, expenses and changes in net assets

SCF – Statement of cash flows

Management Letter

December 15, 2010

Ms. Robin Putnam
Director of Financial Reporting
North Dakota University System
600 East Boulevard Avenue, 10th Floor
Bismarck, ND 58505-0230

Dear Ms. Putnam:

The Office of the State Auditor has completed its financial audit of the North Dakota University System for the year ended June 30, 2010. As part of our examination, we gained an understanding of the internal control over financial reporting and tested compliance with laws and regulations to the extent we considered necessary. We have issued our report on internal control over financial reporting and compliance and other matters dated December 15, 2010.

Our audit procedures are designed primarily to enable us to report on the internal control over financial reporting and compliance with laws and regulations as they relate to the financial statements and may not bring to light all deficiencies in internal control or noncompliance with laws and regulations that may exist. We aim, however, to use our knowledge gained during our work to make comments and suggestions, which we hope will be useful to you.

In connection with the audit, we noted certain conditions that we did not consider reportable within the context of your audit report. These matters, which do not have a material effect on the financial statements, involve control deficiencies and/or instances of noncompliance with laws and regulations. The recommendations presented below are intended to improve or correct control deficiencies and noncompliance with laws and regulations. During future audit engagements, we will review the status of these recommendations to ensure that procedures have been initiated to address these recommendations. If no action has been taken, we will consider the appropriate course of action. Action could consist of inclusion in future audit reports.

I would encourage you to contact our Fargo office if you have any questions about the implementation of recommendations included in your audit report or this letter.

Sincerely,



John Grettum, CPA
Audit Manager, Division of State Audit

1. Inventory Ratios – LRSC (*Prior Management Letter Comment*)

Based on our evaluation of days in inventory and inventory turnover ratios, the LRSC bookstore exceeded the days in inventory by 38 days and the inventory turnover was slower than expected. Further, the LRSC food service inventory showed 5 days in inventory longer than expected and showed inventory turnover 3 times slower than expected. Our expectation of the bookstore's inventory to be in inventory between 85 to 185 days and the turnover to be between 1.5 and 4 times per year does not seem unattainable. Similarly, the expected food service days in inventory are between 6 to 20 days and turnover should be approximately 15 to 30 times per year. The total inventory at June 30, 2010 was \$251,178.

Recommendation:

We recommend that LRSC's management review current bookstore and food service inventories to determine if the size and content of the inventory is necessary and reasonable.

University System Response/Planned Corrective Actions:

Agree. The Vice President for Administrative Services will review the size and content of inventories with the Bookstore and Food Service Directors to determine rationality and develop a plan to reduce items that may be contributing toward the deviation from the auditor's benchmarks and meet with the Directors by March 1, 2011.

2. Overspent Project – MiSU

MISU overspent the authorized amount for the dome floor project by \$25,321. NDCC 54-27-12 provides the requirements related to the expenditure of amounts in excess of appropriations.

Recommendation:

We recommend MiSU implement a system of monitoring capital projects to ensure amounts spent do not exceed amounts authorized.

University System Response/Planned Corrective Actions:

Agree. MiSU has procedures in place to monitor capital projects but will monitor the information more often. Monthly meetings between Plant Services, ITC, and the Business Office have been scheduled to discuss the status of ongoing capital projects.

3. Bank Reconciliation – NDSCS

NDSCS did not include all of their BND bank accounts in their year-end bank reconciliation. The total bank balance of the accounts not included was \$1,056,181.95. The client believed they did not have to include these accounts as there were no reconciling items. However, all accounts should be shown in order to document that total cash per bank has been reconciled to total cash per books even if some individual accounts have no reconciling items.

Recommendation:

We recommend that NDSCS include all bank accounts in the year end reconciliation.

University System Response/Planned Corrective Actions:

Agree. NDSCS will revise their procedures in regards to these money market accounts so they will be properly recorded in the notes to the financial statements

4. Overstatement of Salaries Payable – NDSCS (*Prior Management Letter Comment*)

Salaries payable was overstated \$37,233 in fund 22450, at June 30, 2010. In an attempt to implement a prior recommendation to correct the overstated salaries payable balance in fund 22505, NDSCS transferred the overstatement to fund 22450; however, this did not eliminate the overstatement. GAAP requires the recognition of an expense when incurred and subsequently the liquidation of the payable when paid.

Recommendation:

We recommend that NDSCS eliminate the overstated salaries payable from the general ledger.

University System Response/Planned Corrective Actions:

Agree. The general ledger will be corrected in FY11 to eliminate the overstatement.

5. Graduate Application Fee – NDSU

NDSU charged \$10-\$15 more than the approved rate of \$35 for graduate application fees. We estimate the additional charge generated about \$15,000 additional revenue. NDSU believed it could alter fees based on the catch-all phrase in BHE policy 805.3.2.e - Institutions may charge these additional fees: Parking fees and such additional incidental fees as may be necessary to facilitate the operation of the institution. Per NDSU, the additional charge was to pay for the computer system used to process graduate fee applications. No other school with a graduate level program was charging a fee in excess of \$35.

BHE Policy 805.3 Application, Course, Program and Other Miscellaneous fees states:

1. Institutions *shall* charge these fees:

- a) An application fee charged all students applying to an institution at either the undergraduate or graduate level or to a professional program. The undergraduate fee shall be the same at each institution. The graduate application fee shall be the same at each graduate institution. The Chancellor *shall* approve application fees...

Additionally, BHE Procedure 805.3 Fees states:

1. Effective January 1, 2002, the application fee for admission at the undergraduate or graduate level at all institutions is \$35.

Recommendation:

We recommend that NDSU charge only those fees and at amounts provided by BHE policy, and if it wishes to charge more for application fees it obtain approval from the Chancellor or the BHE.

University System Response/Planned Corrective Actions:

Agree. NDSU will cease collecting the amount over the approved rate of \$35 and will seek the required approval of the additional amount above \$35 from the Chancellor.

6. Inventory Internal Control – NDSU

During fiscal year 2009 we informed Dining Services (DS) we felt there were segregation of duty issues related to employees having incompatible duties. NDSU's Internal Auditor contacted them and said they would work with them to alleviate our concerns so we did not address it then. A year later nothing has been done to address this issue. DS has personnel that can write receipts and also reconcile those receipts to the deposit; write receipts and prepare billings; prepare customer billings and write receipts and approve bad debt write-offs and/or make adjustments to those receivables. In addition, we noted that the internal controls that effectively segregate duties of staff for the NDSU bakery department (\$8,096.73 ending inventory balance and \$211,913.90

purchases for resale during the year) and salad department (\$3,060.41 ending inventory balance and \$94,898.68 purchases for resale during the year) do not exist. Segregation of duties is an internal control intended to prevent or decrease the occurrence of innocent errors or intentional fraud. This is done by ensuring that no single individual has control over all phases of a transaction.

Recommendation:

We recommend that NDSU better segregate the duties surrounding the dining services, bakery and salad departments.

University System Response/Planned Corrective Actions:

Agree. NDSU Internal Audit reviewed segregation of duties in the areas as described. Due to low staffing levels and/or customer service needs, there are shared responsibilities where some individuals serve as backup when others are not available. NDSU Internal Audit will work with the departments on clearly documenting who has primary responsibility and identifying mitigating controls when pure segregation of duties is not feasible by March 31, 2011.

7. Expenditure Approval – NDSU

Four out of 25 expenditures tested at NDSU were not properly approved. Good internal controls require proper approvals for all expenditures.

Recommendation:

We recommend that NDSU ensure that each expenditure is properly approved.

University System Response/Planned Corrective Actions:

Agree. Although a good faith effort and approvals were in place in all cases, NDSU agrees that approvals did not fully comply. Approval of one of the four exceptions was on a separate cover sheet, but there were three clear audit exceptions. The NDSU Accounting Office will work with the departments to ensure proper approvals are documented.

8. Functional Expense Elimination – NDUSO

The functional expense reduction of \$3,510,776 to "instruction" for elimination entry E5 was incorrect. None of the \$2,622,278 we tested was charged to instruction - \$2,611,278 was charged to research and \$11,551 was charged to public service. GASB Statement No. 34, paragraphs 57-61, provide guidance for eliminations and reclassifications.

Recommendation:

We recommend that the proper functional expense category be adjusted for elimination entries.

University System Response/Planned Corrective Actions:

Agree. The year-end templates will be changed to ensure the information is reported correctly beginning in FY 2011.

9. Restricted Cash – UND

We noted that UND should have classified an additional \$347,228 as restricted cash instead of current cash on the Statement of Net Assets. GASB 34 paragraph 99 states that "restricted assets should be reported when restrictions on asset use change the nature or normal

understanding of the availability of the assets.” These assets cannot be used to pay other current liabilities.

Recommendation:

We recommend that UND correctly report restricted cash on the Statement of Net Assets.

University System Response/Planned Corrective Actions:

Agree. UND incurred debt for the construction of hanger, the financing was secured from an external entity. The loan funds not yet spent were held in the construction fund which was classified as unrestricted but were managed internally and restricted to construction of the hanger only. If funds remain at the end of fiscal year 2011, we have added to our closing schedule to re-classify these funds to restricted funds.

10. Payroll Withholding Payables – WSC (*Prior Management Letter Comment*)

WSC was unable to prepare timely accrued payroll liability reconciliations for accounts 223026, 223051 and 223076. The unreconciled difference was \$169.

Recommendation:

We recommend that payroll withholding payables per the general ledger agree to the payroll summary reports, or reconciliations be prepared accounting for the differences.

University System Response/Planned Corrective Actions:

Agree. WSC will prepare timely accrued payroll liability reconciliations by March 31, 2011

11. FAMIS Incompatible Duties – NDSU and UND

Our review of the Facilities Management System (FAMIS) disclosed segregation of duties weaknesses with one person having administrator, security, data entry, and approval roles. Of the 36 FAMIS roles, one user at NDSU had 16 of them and one user at UND had 35 of them. At UND, the employee is an administrator and security officer for FAMIS, but with all of these roles is able to enter data and approve transactions.

Recommendation:

We recommend that the administrator/security officer's access be limited to only those roles which are necessary for the performance of essential job duties, and that data entry and non-essential approval roles be removed.

University System Response/Planned Corrective Actions:

NDSU agrees and is in the process of reviewing FAMIS access for all users. The review is expected to be completed by March 31, 2011.

Agree. The UND Controller and FAMIS project manager are working on acceptable access for this position that meets internal control standards along with the ability to perform the job well by June 30, 2011.

12. Revenue Net of Allowance for Receivables – All Schools

Increases and decreases in the estimate of uncollectible accounts were reported as an expense, rather than as a change to revenue. For fiscal year 2010, for the University System, the decrease

to expense, rather than revenue, was \$150,188. GASB Statement No. 34, footnote 41, states that revenues should be reported net of discounts and allowances with the discount or allowance amount parenthetically disclosed on the face of the statement or in a note to the financial statements. Alternatively, revenues may be reported gross with the related discounts and allowances reported directly beneath the revenue amount.

Recommendation:

We recommend that revenues be reported net of the increase or decrease in the estimate of uncollectible accounts.

University System Response/Planned Corrective Actions:

Agree. Changes will be made to the year-end templates to ensure that the information is reported correctly beginning in FY 2011.

13. Direct Lending, Stafford, and Plus Loans – All Schools

Direct Lending, Stafford, and PLUS loans are not reported on the statement of cash flows. Question 83 of NACUBO's GASB 35 Implementation Guide states in part..."Receipt and disbursement of these loans are reported in the statement of cash flows as cash flows from noncapital financing activities:..."

Recommendation:

We recommend that the NDUS report Direct Lending, Stafford, & PLUS loans on the statement of cash flows.

University System Response/Planned Corrective Actions:

Agree. Changes will be made to the year-end templates to ensure that the information is reported correctly beginning in FY 2011.

14. Revenue Producing Buildings Schedule – All Schools

The unaudited financial Information for revenue producing buildings schedule, included in the NDUS financial statements, reports state appropriations as operating revenues. Based on supporting documents received from the schools, of the \$98 million reported as operating revenue, almost \$9 million was state appropriations. GASB Statement No. 9 defines state appropriations as non-operating revenue.

Recommendation:

We recommend state appropriations be reported as non-operating revenue on the Financial Information for Revenue Producing Buildings schedule.

University System Response/Planned Corrective Actions:

Agree. Changes will be made to the year-end templates to ensure that the information is reported correctly beginning in FY 2011.

15. Non-operating Revenue and State Grants – All Schools and BSC

Schools are required to reclassify Pell grants from operating to non-operating revenue, but some schools have taken that further and reclassified ACG, SMART and TEACH grants as well. We are not sure where the guidance was obtained for reclassifying anything other than Pell; but if it was to

be applied further, we question why FSEOG wasn't included as well as it is probably the second highest dollar total amongst those grants and probably the most closely related to Pell. NACUBO FARM Section 364.451-Pell Grants and GASB *Comprehensive Implementation Guide* state in question 7.72.10 that Pell grants are not agency transactions and that Pell grant receipts are non-operating revenues because they are non-exchange transactions.

BSC provided inaccurate information to the Board Office regarding its state grant program. BSC reported the state grants were accounted for in an agency fund but instead they were accounted for in a non-agency fund. As a result, revenue and expenses totaling \$922,980 were recorded twice for the system; once at BSC and once at the Board Office. GAAP requires that revenue and expense only be counted once for the NDUS. Also, the need for concise accurate information from the colleges is important if the NDUS is to have properly stated financials.

Recommendation:

We recommend that:

1. The NDUS research the topic of operating versus non-operating revenues in relation to Pell, ACG, SMART, TEACH and FSEOG grants and create policies and procedures to insure consistent reporting across the NDUS.
2. BSC take more care in responding to the Board Office so that accurate information is provided.

University System Response/Planned Corrective Actions:

Agree. The NDUS will research the reporting of Pell, ACG, SMART, TEACH and FSEOG grants and create accounting procedures to insure consistent reporting across NDUS by June 30, 2011.

Agree. BSC will take greater care in reviewing and responding to requests from the system office.

16. Notes Receivable – Student Loan Service Center and NDSCS

The schools used last year's percentages to calculate the current and non-current portions of notes/loans receivable, rather than updated percentages. Management is responsible for making the accounting estimates included in the financial statements and for reporting in compliance with generally accepted accounting principles (GAAP). Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take. Those assumptions are to be based on relevant and reliable data. To be relevant and reliable the information must be up to date.

In addition, NDSCS did not allocate any of the notes receivable to non-current. GAAP requires current and long-term balances to be separately reported.

Recommendation:

We recommend that:

1. The schools of the NDUS use updated percentages for current vs.: non-current loans receivable. This should include contacting the director at the Student Loan Service Center and ensuring that it provides an estimate based on information applicable to the current year.
2. NDSCS break out its loans receivable into current and non-current.

University System Response/Planned Corrective Actions:

Agree. Due to staff turnover, the Student Loan Service Center inadvertently sent out last year's calculation. The SLSC will provide an updated calculation to the campus in the future.

Agree. NDSCS will revise their year-end close procedures so this reclassification is not omitted in the future.

17. Interim Financial Statements

The University System only closes their general ledgers at the end of the fiscal year, for the preparation of the annual financial statements. No interim statements are produced. This infrequent activity causes considerable problems for the campuses in the collection of financial information to include in closing their financial records. The problems include: the status of construction projects, the status of receivables and payables with vendors, students and component units and most problematic, remembering what closing entries are necessary. If this process was required to be performed more frequently than annually, the financial records would be more up-to-date and financial reporting would be improved throughout the year. We also believe this would lead to increased efficiencies and would not require additional staffing.

Recommendation:

We recommend the University System close its general ledgers and post all receivables, payables and other closing entries monthly.

University System Response/Planned Corrective Actions:

Disagree. The NDUS is committed to improving the efficiency of the year end closes and reducing errors. However, at this time, the NDUS does not believe we have adequate information to determine whether performing monthly closes will result in time savings and reduced errors without requiring additional resources. We are considering various options and will forward a recommendation to the SBHE BAFC by June 30, 2011.

Appendix A - Classification

Presented below are details of the classification differences noted:

1. MaSU used account 681015, construction in progress additions, instead of accounts in the 682000's, to record construction in progress additions. The total amount inappropriately charged was \$2,287,681.

GASB Codification Section 1800.101 states the use of proper terminology and appropriate classification is essential throughout the budgeting, accounting and reporting processes.

2. MiSU should have classified a money market account (\$8,602,019) as cash, instead of investments, on the Statement of Net Assets.

GASB Codification Section 1800.101 states the use of proper terminology and appropriate classification is essential throughout the budgeting, accounting and reporting processes.

3. We noted the following misclassification of net assets:

- MASU misclassified \$1,970,526 as capital projects instead of invested in capital assets, net of related debt and misclassified \$6,115 as expendable research instead of unrestricted net assets.
- NDSCS misclassified \$351,086 as unrestricted net assets that should be invested in capital assets, net of related debt.
- NDUSO misclassified \$215,111 as unrestricted net assets that should be invested in capital assets, net of related debt.
- UND misclassified \$186,677 as unrestricted net assets that should be invested in capital assets, net of related debt.

GASB 34 paragraph 33 states, "If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds should *not* be included in the calculation of *invested in capital assets, net of related debt*. Rather, that portion of the debt should be included in the same net assets component as the unspent proceeds-for example, *restricted for capital projects*."

GASB 34 also states that "restricted net assets is the portion of net assets subject to constraints placed on their use either (a) externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws and regulations of other governments, or (b) imposed by law through constitutional provisions or enabling legislation."

4. NDSU miscoded the following three items:

- \$83,335 as tuition & fees (T&F) in fund 18719-Military Logistics. The receipts are used for graduate school reimbursement for military students in the Logistic program with some revenue going back to the programs. Customer Account Services (CAS) records the entire receipt into fund 18719 as T&F (460001) and when the student(s) whose tuition and fees these apply to are paid there is a reduction in T&F for monies sent back to CAS. Any remainder between what was receipted in as 460001 and what was paid back to CAS from AP is miscoded as T&F revenue. That difference was the amount noted above in this instance. The part of that revenue not for student T&F should be recorded as federal grants and contracts. The part for the student should be coded in as deposits (account 224002) until such

time it is remitted back to CAS for payment of T&F. Additionally, these payments of tuition by the Army are not being reflected as 3rd party payments on NDSU's FA-801 report.

- \$8,300 as tuition and fees for their Summer Intensive English Language & Culture program, which is a non-credit program. The amount should have been coded as non credit course fees (account 462100).
- \$33,306 as tuition and fees in fund 18300 instead of correctly coding it as registration fees (account 462130). The fees are for short course programs that are provided through NDSU to scientists during the summer.

Generally Accepted Accounting Principles dictate use of proper account coding to facilitate accurate financial reporting.

Appendix B – NDUS Supplemental Responses and Auditor’s Concluding Remarks

Presented below are the NDUS Supplemental Responses/Planned Corrective Actions’ and auditor’s concluding remarks to selected audit recommendations:

1. (Prior Recommendation Not Implemented #2) *Agree. Although the NDUS continues to strive for improvement, we believe improvements have been made. Given the size and complexity of the NDUS, it is highly unlikely that errors will ever be completely eliminated. Human error will always be a factor in any organization and it is impossible to check every transaction. It is also important to point out that errors noted in the recommendation are not necessarily the same errors or are occurring at the same campuses from year to year. Additionally, the amounts referenced in the recommendation are gross amounts. For example, a \$1.0 million entry to increase a current asset and decrease a non-current asset is counted as a \$2.0 million adjustment, rather than a \$1.0 million adjustment. Also, several of the adjustments are reporting misclassifications, such as reclassifications between current and non-current assets or between operating or non-operating revenues. To put into the context of materiality, although the number of adjustments has not decreased significantly, 50% of the campus adjustments and 53% of the component unit adjustments are individually less than \$1.0 million and account for 0.47% and 0.31% of total net assets, respectively as the chart below illustrates.*

	FY10	FY09
Number of Campus adjustments	22	30
1. Individually < \$1.0 million	11	17
% of adjustments < \$1.0 million	50%	57%
a. Total dollar amount	\$3,917,691	\$7,574,715
b. Adjustments as a percent of total net assets	0.47%	1.01%
2. Individually < \$500,000	7	9
% of adjustments < \$500,000	32%	30%
a. Total dollar amount	\$1,852,893	\$1,673,072
b. Adjustments as a percent of total net assets	0.22%	0.42%
Number of Component Unit adjustments	17 1/	7
1. Individually < \$1.0 million	9	4
% < \$1.0 million	53%	57%
a. Total dollar amount	\$1,453,281	\$3,110,537
b. Adjustments as a percent of total net assets	0.31%	0.73%
2. Individually < \$500,000	9	1
% < \$1.0 million	53%	14%
a. Total dollar amount	\$1,453,281	\$354,000
b. Adjustments as a percent of total net assets	0.31%	0.09%
Total NDUS Net Assets	\$ 824,924,773	\$ 750,617,068
Total CU Net Assets	\$ 476,443,492	\$ 430,284,158

1/ 5 entries related to new component units in FY10. Risk of error during the first year is greater as we gain familiarity with the new component units' financial transactions

2. (Prior Recommendation Not Implemented #5) *NDSU Agrees. The three exceptions at NDSU were during a transition period when the recommendation was being implemented.*

UND Agrees. The employees in this case were two student employees at the University Children's Center (UCC). Background checks for UCC employees were being processed through the ND Department of Human Services (DHS) for licensure purposes but were allowed, by DHS, to work "with supervision" prior to completion of the check. Because of this recommendation, the UCC now runs two checks on each prospective employee, one through DHS for licensure requirements and one through the UND HR Office.

3. (Finding 10-1) *Disagree. The State Board of Higher Education takes its responsibility in fulfilling its constitutional and statutory duties very seriously. The State Board of Higher Education has, and will continue to fill those duties fully, including the duty to require accurate financial reporting of the 11 institutions of higher education, and their component units. The State Board of Higher Education takes great exception to, and disagrees completely with, any statement or implication by the State Auditor's Office that the State Board of Higher Education had not met its duties. Notwithstanding, the forgoing, the State Board of Higher Education recognizes that there are, and will continue to be, opportunities for improvement in the financial reporting done by the institutions. Keeping in mind the constraints implicit in meeting the educational needs of the students and the resources available to it, the State Board of Higher Education will continue to work to achieve improvements in the financial reporting of the institutions under its control.*

It is important to note that audit recommendations are received over six months after the close of the fiscal year. Thus, we have less than six months to make the necessary changes. Some of the recommendations require input and participation from multiple groups within the NDUS and it is not always practical to fully implement before year end and the start of the next audit cycle.

Auditor's concluding remarks:

While it is true that audit reports are formally issued approximately six months after the close of the fiscal year, all recommendations are known prior to the final report issuance. We generally indicate in our comments if corrective action is taken at any time prior to the issuance of our next report. Three of the prior recommendations not implemented were from reports issued from two to eight years ago. In each of those instances the NDUS indicated corrective action would be taken but the problems still remain.

4. (Finding 10-4) *It is important to note that MaSU Foundation submitted a draft report on September 14th. The report was not considered final solely because it required Foundation Board approval prior to final issuance. The Alumni Association of the University of North Dakota and UND Foundation and the UND Research Foundation submitted draft reports on September 17th. The reports were also in draft form, pending Board approval. In all three of the reports, there were no changes to the audited financial statement amounts between the draft and final issued report. The NDUS finds this acceptable.*

Agree. BSC management met with BSC Foundation management and their auditors in December to review SBHE Policy 340.2. Beginning with FY11, the Foundation will include financial statements in compliance with the policy.

Agree. Although the institutions do not directly control their affiliated, but otherwise independent, foundations' accounting practices, DSU, LRSC, NDSCS, NDSU, UND and WSC agree and will work with the foundations to comply with the SBHE policy. It is important to note that the NDSU 4-

H Foundation's audited financial statements were issued in November, 2009 before the policy went into effect in June, 2010.