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, 2011
Client Code 220

Robert R. Peterson
State Auditor

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Transmittal Letter

December 13, 2011

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, 2011. 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,

Robert R. Peterson
State Auditor

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. Imaging practices and procedures at BSC, MISU, NDSCS, and WSC did not comply with SBHE procedure 1901.4 and Component Unit audit reports for UND Alumni, UND Research Foundation, UND Fellows, and NDSU 4-H Foundation did not comply with SBHE policy 340.2.

For additional commentary see Finding 11-7 on page 16 and Prior Recommendations # 5 on page 10.

3. Was internal control adequate and functioning effectively?

No. We noted the following internal controls issues:

1. Internal Auditors not compliant with IIA requirements. (Finding 11-1)
2. Classification, coding and reconciling at WSC needs improvement. (Finding 11-2)
3. GASB 40 disclosures were not adequate at NDSCS, NDSU, NDUSO, and WSC. (Finding 11-3)
4. Classification and coding of net assets needs improvement at MISU, NDSCS, NDSU, UND, and WSC. (Finding 11-4)
5. Intra NDUS transactions need to be addressed at all institutions. (Finding 11-5)
6. Functional expense note will need additional support. (Finding 11-6)

For additional commentary see the Findings, Recommendations, and University System Responses section of this report, starting on page 11.

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 (5), posted audit adjustments (11), passed audit adjustments (16), and new formal (7) and informal (15) recommendations, in our opinion, there is a lack of efficiency in financial operations and management of the NDUS.

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

No. Five of ten (2 fiscal year 2010 and 3 pre-fiscal year 2010) prior recommendations were not implemented as follows:

1. **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, 2009, and 2010 audits]**

2. **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 these are available. [2008, 2009, and 2010 audits]**

3. **The NDUS has reviewed internal audit staffing levels at UND and NDSU, however, the review determined that UND and NDSU were understaffed and no action appears to have been taken. [2009 and 2010 audit]**

4. **The Board has not adopted an accounting and financial management manual, implemented a review of internal controls, and has had mixed success ensuring that appropriate action is taken to implement audit recommendations. [2010 audit]**

5. **There was great improvement in foundation financial statement preparation but there were many foundations that did not completely comply with SBHE policy 340.2. [2010 audit]**

6. **The institutions using imaging software did not completely comply with the prior audit finding [2009 audit], however, due to new issues and changes to policies we dropped this finding and issued a new finding at 11-7 on page 16.**

7. **GASB risk disclosures are still not completely prepared in accordance with GASB Statement No. 40. [2010 audit] However since all but one of the institution with inadequate disclosures in fiscal year 2011 were not included in the prior recommendation, we are considering this a new finding. See current year finding 11-3 on page 13.**

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 15 informal recommendations to which management responded and agreed to implement except for one (#15). 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. The NDUS's commitments and contingent liabilities are reported on pages 48 and 59 of the fiscal year 2011 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	$3,307,010 (14.7%)
Loans and notes	$7,114,891 (14.9%)

   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 three instances of disagreement with prior years audit recommendation implementation and current year's informal auditor recommendations. The disagreements are included in the University System Response/Planned Corrective Actions on pages 9, 10, and 34.

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, 2011, which collectively comprise the North Dakota University System's basic financial statements and have issued our report thereon dated December 13, 2011. 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. The financial statements of the aggregate discretely presented component units were not audited in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting

Management of the North Dakota University System is responsible for establishing and maintaining effective 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 1, 2, and 4 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 3, 5, and in the schedule of findings, recommendations, and University System responses as findings 11-1 through 11-7 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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards,* and which are described in the accompanying schedule of prior recommendations not implemented and University System responses as item 5, and in the schedule of findings, recommendations, and University System responses as findings 11-7.

We also noted certain other matters that we reported to management of the North Dakota University System in a separate letter dated December 13, 2011, 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 A – NDUS supplemental response. 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, others within the entity, 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 13, 2011

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 2007 and subsequent 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.**

   Current Status:
   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 2011, there were material auditor-identified audit adjustments of $11,771,438, $1,425,730, $40,554,004, $25,285,096, and $25,232,150 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 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. 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. NDUS has improved and continues to strive for improvement. It is important to note the number of audit adjustments decreased to 11 adjustments in FY11 from 41 adjustments in FY10. [See Appendix A for the supplemental response to this recommendation].

2. **During the 2008 and subsequent 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. We also recommended a code of conduct be developed and implemented.**

   Current Status:
   Our current audit indicated that the NDUS:
   - **Contracted with a company to perform a high level, entity-wide control risk assessment at each school and the Board Office, and we received final reports in October 2011, therefore we consider this part of the finding implemented. However, a comprehensive fraud and control risk assessment was not performed by each institution so that part remains not implemented.**
   - **Appropriate internal controls have not been established therefore there has been no formal training on proper internal controls. This was made evident while reviewing the segregation of duties grids completed by the schools. We noted many conflicts regarding personnel and their duties.**
   - **Developed a code of conduct at the institution level with the exception of an incomplete code at NDSCS. (See management letter #2 on page 27)**

University System Response/Planned Corrective Actions:
Risk Assessment: Agree. The LarsonAllen risk assessment was meant to be high level and a starting point for development of the NDUS annual internal audit plan. As such, a fraud and control risk assessment is a part of the NDUS internal audit methodology and will be a part of all future individual audits based on a Risk and Control Matrix. Fraud and process level controls, as well as control gaps, will be identified and documented. This will be done through individual program audits, and will take several years to fully complete due to limited audit staff resources and complexity or organization.

Internal Controls/training: Disagree. Although the NDUS has extensive internal controls in place, we will always continue to strive for improvement. Additional personnel resources are needed to ensure the level of SAO desired controls, and also, for appropriate training and compliance oversight. Appropriate internal controls and formal training is an integral part of the NDUS internal audit methodology and the NDUS Director of Internal Audit will explore various platforms (video, presentations, etc.) to conduct training on internal controls and will implement a plan by June 30th, 2012. Campus accounting staff participates in annual training, which in part, addresses internal control issues.

Auditor's concluding remarks:
Based on our review of the segregation of duties grids, we noted many conflicting duties surrounding internal controls. To say that the NDUS has extensive internal controls in place in all functions is misleading based on our audit work. Management needs to establish written internal control policies and procedures, review and monitor the internal control structure to ensure proper segregation of duties exists in all functions or mitigating controls need to be established.

3. **During the 2009 and subsequent audit we recommended that the NDUS review internal audit staffing levels at UND and NDSU.**

   Current Status:
   A review was done during fiscal year 2011 and a new internal auditor was hired at the Board Office, however, the review also determined that UND and NDSU were understaffed but no additional staff was hired. The new Director of Internal Audit has been assigned to develop a new audit budget to include additional staff. Due to the many potential risks the NDUS and particularly UND and NDSU face, public image being a significant one, additional internal audit staff could help reduce these risks.

   University System Response/Planned Corrective Actions:
   Agree. A staffing report was presented to the SBHE BAFC in November 2011. In follow-up to this report, the BAFC Chair directed the NDUS Director of Internal Audit to prepare a plan to address: level of staff resources needed to adequately meet responsibilities, reporting relationship of system and campus internal audit staff to SBHE, and uniformity of audit plan and program. This plan will be presented to the BAFC on February 15, 2012.

4. **In the 2010 audit we recommended the SBHE improve its financial and accounting oversight by ensuring that:**
   - **An accounting and financial management manual is written and adopted;**
   - **Internal controls are adequate and reviewed periodically; and**
   - **Appropriate action is taken to implement audit recommendations.**

   Current Status:
   - **The Controllers Group is working on an accounting manual, but it has not been finalized or adopted as of the issuance of this report.**

- **While reviewing the segregation of duties grids completed by the schools, we noted many conflicts regarding personnel and their duties, concluding that internal control was not adequate and was not being reviewed.**
- **It is not clear based on the number of unimplemented recommendations that appropriate action has been taken to ensure recommendations are implemented.**

University System Response/Planned Corrective Actions:
Accounting Manual: Agree. The original targeted completion date was December 31, 2011. The update was approximately 85 – 90% complete by that date, but full completion has been delayed until March 31, 2012, due to an extended health-related absence of the Director of Financial Reporting during this period.

Segregation of Duties: Agree. Individual campuses agree with and can support some of the proposed changes. However, others will require additional time for review and discussion, in coordination with NDUS Director of Internal Audit. This review will be completed and changes made, as appropriate, by June 30, 2012. In addition, segregation of duties review will continue to be a part of the NDUS internal audit plans.

Internal Control: Disagree. Although the NDUS has extensive internal controls in place, we will always continue to strive for improvement. Additional personnel resources are needed to ensure the level of SAO desired controls, and also, for appropriate training and compliance oversight. Appropriate internal controls and formal training is an integral part of the NDUS internal audit methodology and the NDUS Director of Internal Audit will explore various platforms (video, presentations, etc.) to conduct training on internal controls and will implement a plan by June 30th, 2012. Campus accounting staff participates in annual training, which in part, addresses internal control issues.

Implement Audit Recommendations: Agree. The NDUS Office will continue to monitor the status of audit recommendation implementation and provide updates semi-annually to the BAFC.

5. **During the 2010 audit we recommended that all foundation financial statements be presented in their respective reports in compliance with SBHE policy 340.2, paragraph 3.**

Current Status:
All 2011 component unit reports were filed on a timely basis. However, four foundations (UND Alumni, UND Research Foundation, UND Fellows, and NDSU 4-H Foundation) submitted audit reports where current assets/liabilities were not separated from noncurrent assets/liabilities as required by Board Policy 340.2. NDSU 4-H Foundation and the UND Research Foundation subsequently revised their statements to include current and noncurrent assets.

University System Response/Planned Corrective Actions:
NDSU: Agree. NDSU will continue to work with the ND 4H Foundation to have their balance sheet displayed in the classified format in the future, for correct and timely submission.

UND: Agree. UND Alumni Foundation, UND Fellows, and UND Research Foundation originally issued audited financial statements that did not separately present current and noncurrent assets and liabilities, but were later revised consistent with policy requirements. UND will send timely reminders to the foundations in the future.

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INTERNAL AUDITOR – NDSU, NDUSO, AND UND (FINDING 11-1)

Internal Auditors at NDSU and the NDSUO have not accumulated sufficient hours of continuing professional education (CPE) time. Certified Internal Auditors are responsible for maintaining their knowledge and skills in the internal auditing field, and updating their knowledge and skill related to improvements and current development in internal auditing standards, procedures, and techniques.

All internal audit activities, regardless of size or whether they are outsourced or co-sourced, should undergo external quality assessments. Ongoing and periodic internal QAs lay the foundation for external QAs, and together, internal and external QAs make up the quality assurance and improvement program (QAIP). An external assessment of UND, NDSU, and the NDUSO internal audit quality assurance programs has not been performed or provided for in current policies.

As part of its proficiency and due care and quality assurance and improvement standards, the Institute of Internal Auditors (IIA) requires:

- Internal auditors to obtain 80 hours of CPE every 2 years, and
- An external assessment of the internal audit shop's quality assurance programs, at least once every five years by a qualified, independent reviewer from outside the organization.

Recommendation 11-1:

We recommend:

- All NDUS internal audit staff obtains adequate CPE to enhance their audit skills and professional development and comply with IIA continuing education standards.
- All NDUS internal audit shops undergo an external assessment of their quality assurance programs, at least once every five years by a qualified, independent reviewer.

University System Response/Planned Corrective Actions:

Agree. While we agree that on-going training is extremely important and helpful, workload demands coupled with staff and budget resource constraints may not permit CPE of 80 hours every two years.

Agree. NDUS will plan on having an independent review performed in FY 2016, and at least once every 5 years thereafter. Due to the newness of the System wide internal audit function, it will take time to ensure all the IIA standards are in place and well documented, before an external review would be appropriate or useful.

CLASSIFICATION/CODING/RECONCILING - WSC (FINDING 11-2)

We noted the following issues at WSC:

1. Williston State College issued a revenue bond in 2010 for a new residence hall. We noted several issues with the recording of the bond:
   a. Bond proceeds ($9,262,500) were recorded in fund 00001 (Plant Assets WSC) and all the expenditures for the construction were reported in fund 28001 (Capital Improvements). No cash was transferred into fund 28001 at year end to offset the expenditures, so cash is negative in that fund. The proceeds should have been recorded in fund 28001;
   b. Bond Issue Costs ($66,700-account 144002) were recorded in fund 28001 and should have been recorded in fund 00001;
   c. Bond interest payments (account 701005) for the new bond were recorded in fund 28001 and should have been recorded in a retirement of indebtedness fund (fund 00521-Resident Hall Bond Payment);
   d. An interest subsidy is received by the trustee from the federal government to offset the interest payments. WSC did not record this federal revenue on their general ledger ($219,220), but instead recorded the interest payment that was required per the indenture less the subsidy. They should have recorded the entire interest expense and the federal revenue on their general ledger.

2. WSC had $451,574 misclassified as restricted cash instead of current cash on the Statement of Net Assets.

3. WSC transferred $526,958 from fund 25004 (TrainND) to fund 00523 (Residence Hall Revenue) to act as a deposit for bonds let to build a new dorm-Frontier Hall. No agreement was reached between the programs for repaying TrainND by a certain date or at the end of the Bond Issue, and no inter-fund borrowing was reflected on the GL.

4. While performing our audit work we noted numerous accounting issues including entries being reversed twice, revenue recorded in a fund but the cash not distributed and accounted for in the proper projects, and missing accounting recognition for the payment made on behalf of the College by its Foundation.

5. A journal entry to record salaries payable to account 223001 was not made for fiscal year 2011.

6. Bank reconciliations do not agree and are not reconcilable to the general ledger. Also, it was determined that bond proceeds and debt service cash accounts held by a trust at BND were incorrectly omitted from the reconciliation.

The above noted problems point to the fact that current accounting practices at WSC are not functioning effectively and cannot consistently be relied upon to produce GAAP (generally accepted accounting principles) financial statements. Management needs to review current practices and implement changes to ensure that these problems do not continue.

Recommendation 11-2:

We recommend that WSC:

1. Use the proper funds for bond activity including:
   a. Transferring the bond proceeds to fund 28001;
   b. Reporting bond issue costs in fund 00001;
   c. Recording bond interest payments in fund 00521 for payments in fiscal year 2012 and beyond; and
   d. Record the interest subsidy from the federal government in fund 00521 and account 450020 and record the total amount of interest expense per the bond indenture in fund 00521.

2. Correctly report restricted cash on the Statement of Net Assets.

3. Record on the general ledger the asset and liability associated with the inter-fund borrowing from TrainND to the Residence Hall Revenue fund, and create an agreement to be signed by the department heads identifying key terms of the borrowing and plans for repayment.

4. Include salaries payable on the general ledger and implement procedures to make sure this entry is made in the future.

5. Reconcile cash per bank and cash per general ledger on a monthly basis and immediately investigate differences.

6. Provide or require outside training to accounting personnel on accounting issues in addition to utilization of the PeopleSoft system, review its capital and grant projects, and ensure they are being accounted for properly, and review current accounting practices and make necessary changes to ensure the general ledger captures all transactions and financial statements are presented in conformity with generally accepted accounting principles

University System Response/Planned Corrective Actions:
Agree: WSC will strive for continuous improvement and intends to engage external assistance with year-end close and statements in FY12. The campus lost 40% of its full-time employees in 2011 due to the economic activity in western ND, many of these financial staff. As a result, WSC is short-staffed and has several new and inexperienced staff. WSC is investing additional funds in salaries and training in an attempt to retain staff and improve performance. In addition, CND and other System campuses are providing advice, tools and resources to assist.

GASB 40 RISK DISCLOSURES – NDSCS, NDSU, NDUSO AND WSC (FINDING 11-3)

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

- NDSCS incorrectly excluded:
  - $1,058,731 from cash deposits - BND and from deposit risk disclosure category A; and
  - $406,647 of cash deposits - other from the deposit risk disclosure category B.
- NDSU incorrectly excluded $5,547,354 from cash deposits - BND and from deposit risk disclosure category A.
- NDUSO did not update disclosure amounts from the prior year for UND, which incorrectly:
  - Excluded $9,553,117 from cash deposits - BND and from deposit risk disclosure category A;
  - Excluded $4,688,862 from CD's - BND and from deposit disclosure category A; and
  - Overstated cash deposits - other by $57,318.
- WSC incorrectly:
  - Excluded $814,010.70 from cash deposits - BND and from deposit risk disclosure category A; and
  - Overstated cash deposits - other and deposit disclosure category A by $234,897.62.

GASB 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 11-3:
We recommend NDSCS, NDSU, NDUSO, and WSC implement proper monitoring procedures to ensure that their deposit and interest risk disclosures are prepared in accordance with GASB 40.

University System Response/Planned Corrective Actions:
NDSCS: Agree. NDSCS will develop procedures for the FY12 year-end close that ensure that the required disclosures are prepared in accordance with GASB 40.

NDSU: Agree. NDSU reported an incorrect amount on NDUSO's Deposit template. We are aware of the error and it won't be repeated on next year's template.

NDUSO: Agree. The NDUSO errors were the result in formula errors in the spreadsheets used to prepare the financial statements. Greater care in the future will be taken to ensure formulas are correct.

WSC: Agree. WSC will properly monitor procedures to ensure that our deposit and interest risk disclosure are prepared in accordance with GASB 40, effective June 30, 2012.

CLASSIFICATION/CODING OF NET ASSETS – MISU, NDSCS, NDSU, UND, AND WSC (FINDING 11-4)

We noted the following misclassification of net assets:

- MISU misclassified $2,290,474 as invested in capital assets instead of unrestricted net assets;
- NDSCS misclassified $894,969 as expendable institutional instead of unrestricted;
- NDSU misclassified $1,000,000 as expendable debt service instead of unrestricted net assets and $233,279 as unrestricted that should have been invested in capital assets;
- UND misclassified $943,096 as invested in capital assets instead of unrestricted net assets; and
- WSC misclassified $9,337,417 as invested in capital assets instead of unrestricted net assets.

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 asset 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."

Recommendation 11-4:
We recommend that MISU, NDSCS, NDSU, UND, and WSC present net assets in compliance with GASB 34 and implement procedures to provide for a review of the classification by a knowledgeable 3rd party who did not perform the classification in the future.

University System Response/Planned Corrective Actions:
MiSU: Agree. We will more closely review the composition of net asset balances prior to making the reclassification entries. These steps will be completed with the FY-12 year-end processes.

NDSCS: Agree: NDSCS will confer with the SAO regarding these misclassifications and implement proper procedures to comply with GASB 34 classification during FY2012.

NDSU: Agree. These errors will not be repeated in FY12 and beyond.

UND: Agree. Better care will be taken to ensure these errors are not repeated in FY2012 and beyond.

WSC: Agree. With the assistance of contracted assistance in FY12, WSC will present net assets in compliance with GASB34.

All campuses: Further discussion and cost/benefit analysis will be necessary regarding the need to engage a knowledgeable 3rd party to review the classification in the future. This review will be completed by June 30, 2012.

Auditors concluding remarks:
Our intent of the recommendation regarding implementing procedures to provide for a review of the classification by a knowledgeable 3rd party was for an internal 3rd party to review the classification, not to have the NDUS hire an external party to review this classification.

ELIMINATION OF INTRA NDUS TRANSACTIONS – ALL SCHOOLS (FINDING 11-5)

Based on our review it appeared that not all revenue and expenses between schools was eliminated for financial statement presentation. Although the NDUS has improved by eliminating subcontract and subrecipient revenue and expense (which is the majority), we believe there is still room for improvement as there was approximately $2.2 million in revenue and expense (not paid on subcontract or subrecipient) that may have needed to be eliminated but was not.

Generally accepted accounting principles require intra-entity transactions to be eliminated for financial statement presentation.

Recommendation 11-5:
We recommend the NDUS review and eliminate all applicable intra-NDUS transactions for financial statement presentation.

University System Response/Planned Corrective Actions:
Agree: The NDUSO will work with CND staff and campus controllers to ensure that all intra-institution revenues and expenses are captured and eliminated appropriately for the FY12 year-end close.

FUNCTIONAL EXPENSE NOTE – ALL SCHOOLS (FINDING 11-6)

We attempted to compare the functional expense note in the financial statements to the general ledger and noted the following:

- Not all general ledger funds had an associated function.
- Not all funds appear to have been reviewed for propriety regarding fund classification.
- The research center function (function 32) amount of $240,000 appears to have been excluded from the note total.
- The functional note does not tie to the general ledger.

Notes are an integral part of the financial statements. As such the information presented must be accurate and complete.

Recommendation 11-6:
We recommend that the NDUS:
- Ensure all funds are coded to a function,
- Review all funds to ensure the assigned function is correct,
- Confirm that the query being used to compile expense by function is pulling the information correctly (functional categories from funds as they existed during the year related to the year under audit) and compare that information by function to the general ledger prior to submission of amounts for note disclosure.
- If possible include parameters in the fund listing so that a given year's funds can be isolated to ensure the query is not pulling information from the wrong year.

University System Response/Planned Corrective Actions:
Agree. The NDUSO will work with CND staff and campus Controllers to ensure that functional information is captured accurately for the fiscal year 2012 year-end close.

IMAGING VALIDATION AND OTHER ISSUES – BSC, MISU, NDSCS, AND WSC (FINDING 11-7)

As imaging becomes more prolific throughout the NDUS, it is increasingly important that established policies and procedures be followed to ensure data integrity. During our review of compliance with those policies and procedures we noted the following issues surrounding imaging:

BSC:

- Is performing verification and has a verification policy but when reviewing the verification form used to document their internal review and verification, we noted that certain useful pieces of information were either not included on the form or appeared to be incomplete. The absent information included the name of the person who originally scanned the document being verified and the name of the department where the record can be found. Further, although BSC did include space on the verification form to describe what document or set of documents were being verified, incomplete descriptions like "whole document (file)" was being used.
- No electronic records management appears to be operational on the ImageNow system. BSC stated that ImageNow does have an electronic records management system available, however it was not considered cost effective. All documents to date that have been scanned to ImageNow are still on the system, per BSC.
- Per discussion with the Chief Information Services Officer, the audit trail software was not activated for fiscal year 2011.
- Based on the ImageNow Users and Departments schedule supplied by BSC, there are five super users in Admissions and Records, three super users in Financial Aid, four super users in Human Resources, two super users in Payroll, and eight super users in Student Records.

WSC:

- SFA verification by someone other than the person who scanned the document did not begin until after fiscal year end 2011 for the Financial Aid Office and no evidence was submitted to support that any verification procedures are in place in the Admissions and Records Office.
- Was unable to provide the acceptable sampling technique used to perform their testing.
- Does not have a written policy or procedure for complying with all of SBHE 1901.4.
- Did not submit requested employee role schedule for review.

NDSCS:

- Has not implemented all of the Procedural Requirements of SBHE Procedure 1901.4.

MISU:

- Does not have a written policy or procedure for validation testing of imaged documents and does not appear to be using an acceptable sampling technique for the testing that is done.

SBHE Procedure 1901.4, Procedural Requirements #9 states "Institutions must develop a validation process that requires someone, other than the person scanning the document, to verify that source document's content matches the scanned document prior to disposition of the source document. Validation must be performed using an acceptable sampling technique at least quarterly."

Furthermore, federal regulations as detailed in Federal Acquisition Regulation (FAR) 4.703(c)(3) seem to require retention of the paper copy for one year after imaging to permit periodic validation of the imaging system.

Recommendation 11-7:
We recommend that:

- BSC:
  - Improve its compliance with SBHE 1901.4 by documenting and using an acceptable sampling technique and including sufficient information on the test document to enable reperformance resulting in same conclusion.
  - Enable the audit trail software and regularly monitor the user listing to assess and eliminate some, if not all of the "super user" access.
- WSC:
  - Improve its compliance with SBHE Procedure 1901.4 by establishing written policies/procedures for imaged documentation validation, using an acceptable sampling technique and including sufficient information on the testing document to enable reperformance resulting in same conclusion.
  - Routinely review its user listing and limit user access to the imaging system to those areas necessary to perform their duties.
- NDSCS:
  - Comply with SBHE Procedure 1901.4, all procedural requirements for both ImageNow and Info-Router.
- MISU:
  - Improve its compliance with SBHE Procedure 1901.4 by preparing a written policy/procedure for validation testing and using an acceptable sampling technique for that testing.

University System Response/Planned Corrective Actions:
BSC: Agree. The BSC Image Now User Group will work with the NDUS Internal Auditor to identify and implement an acceptable audit sampling technique. The User Group will also review the "super user" access roles for potential changes to the definition. These action plans will be completed by April 30, 2012.

Changes were made by BSC to the test document in September 2011 to address the audit issue of sufficient information on the test document. The audit software was enabled on June 13, 2011 when BSC converted to the new version of Image Now, as indicated in the corrective action plan in our response last year to this recommendation.

MiSU: Agree. We will work on developing an acceptable validation testing and sampling technique/procedure, which will be in place by June 30, 2012.

NDSCS: Agree. NDSCS will review our current scanning procedure and modify to comply with SBHE Procedure 1901.4. Procedure will be reviewed and revised by February 29, 2012.

WSC: Agree: WSC will develop policies and procedures for ImageNow in compliance with the above recommendations by December 31, 2012.

December 13, 2011

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, 2011, and have issued our report thereon dated December 13, 2011. 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. 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	$3,307,010 (14.7%)
Loans and notes	$7,114,891 (14.9%)

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 or in performing the audit.

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 shown on pages 9, 10, and 34 of this report.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated December 13, 2011.

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 Manager, Division of State Audit

POSTED AUDIT ADJUSTMENTS

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
1	**SNA**			
NDSCS	Notes rec receivable - noncurrent	2,312,317		Reclass loans receivable and the
	Notes receivable - current		2,312,317	corresponding allow ance as noncurrent (as
				NDSCS did not classify any as such) and to
	Accounts receivable allow ance - current	641,825		correct an error due to client not correcting
	Accounts receivable allow ance - noncurrent		512,076	the Full Accrual ledger from the prior year.
	Increase (decrease) in net assets		129,749	
2	**SNA**			
DSU	Net assets unrestricted	5,856		Reclassify negative net assets for financial
	Expendable scholarships and fellow ships		5,856	reporting purposes.
3	**SNA**			
LRSC	Net assets unrestricted	42,489		Reclassify negative net assets for financial
	Expendable institutional		42,489	reporting purposes.
4	**SNA**			
MISU	Invested in capital assets, net of related debt	2,290,474		Reclassify net asset balance after unspent
	Net assets unrestricted		2,290,474	bond proceeds.
5	**SNA**			
NDSCS	Invested in capital assets, net of related debt	2,133.00		Reclassify net assets for reoccurring
	Expendable institutional	894,969		unknow n errors.
	Nonexpendable scholarships and fellow ships		127	
	Net assets unrestricted		896,975	
6	**SNA**			
NDSU	Expendable debt service	1,000,000		Reclassify restricted net assets to reflect
	Invested in capital assets, net of related debt		233,279	bond indenture and interest payable.
	Net assets unrestricted		766,721	
7	**SNA**			
UND	Invested in capital assets, net of related debt	943,096		Reclassify prepaid expense less interest
	Net assets unrestricted		943,096	payable to unrestricted.
8	**SNA**			
WSC	Invested in capital assets, net of related debt	8,616,919		Restrict the cash portion of unspent
	Expendable capital projects		1,041,532	bond proceeds.
	Net assets unrestricted		7,575,387	
	Invested in capital assets, net of related debt	720,498		Restrict the bond payable portion of
	Expendable capital projects	1,041,532		unspent bond proceeds.
	Net assets unrestricted		1,762,030	
	Net assets unrestricted	42		Restrict net assets for capital assets less
	Expendable institutional	1,858		depreciation.
	Invested in capital assets, net of related debt		1,900	
9	**SNA**			
NDUSO	Cash and cash equivalents	517,830		Record System Information Technology
	Capital assets, net	845,459		Services (SITS) expense and revenue at
	Accumulated depreciation		372,096	NDUSO instead of NDSU.
	Accounts payable and accrued liabilities		363,676	
	Accrued payroll		154,154	
	Due to others, current		58,623	
	Due to others, noncurrent		124,464	
	Invested in capital assets, net of related debt		290,276	

(continued)

Posted Audit Adjustments – continued

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
	SRECNA			
	Salaries & w ages	4,289,689		
	Operating expense	5,615,287		
	Data processing	2,445,212		
	Interest on capital asset-related debt	265,887		
	Accrued payroll	11,948		
	State appropriation revenue		12,487,329	
	Increase (decrease) in net assets		140,694	
	Invested in capital assets, net of related debt at July 1, 2010		430,970	
	SNA			
NDSU	Accumulated depreciation	372,096		
	Accounts payable and accrued liabilities	363,676		
	Accrued payroll	154,154		
	Due to others, current	58,623		
	Due to others, noncurrent	124,464		
	Invested in capital assets, net of related debt	290,276		
	Cash and cash equivalents		517,830	
	Capital assets, net		845,459	
	SRECNA			
	State appropriations	12,487,329		
	Increase (decrease) in net assets	140,694		
	Invested in capital assets, net of related debt at July 1, 2010	430,970		
	Salaries & w ages		4,289,689	
	Operating expense		5,615,287	
	Data processing		2,445,212	
	Interest on capital asset-related debt		265,887	
	Accrued payroll		11,948	
9a	**SNA**			
NDSU	Net assets unrestricted	1,683,796		Record unspent cash for SITS
	Cash and cash equivalents		1,683,796	appropriation at NDUSO instead of NDSU.
	SRECNA			
	Net assets unrestricted at July 1, 2010	1,528,577		
	State appropriations	155,219		
	Increase (decrease) in net assets		155,219	
	SNA			
NDUSO	Cash and cash equivalents	1,683,796		
	Net assets unrestricted		1,683,796	
	SRECNA			
	Increase (decrease) in net assets	155,219		
	Net assets unrestricted at July 1, 2010		1,528,577	
	State appropriations		155,219	

(continued)

Posted Audit Adjustments – continued

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
	COMPONENT UNITS:			
10	**SNA**			
NDSU-DF	Due from primary institution -capital leases - current	2,504,743		Reclassify the component unit statements
NDSU-RTP	Due from primary institution - capital leases - noncurrent	57,180,045		to show what the colleges owe them for
UND-AF	Accounts receivable - net		518,511	bonds, leases and other debt.
UND-Alum	Other assets		106,317	
BSC-Fnd	Other investments		10,345,961	
	Capital assets, net		25,109,774	
	Real estate and equipment held for investment, net of accumulated depreciation		23,604,225	
11	**SNA**			
UND-REA	Accounts payable	2,945,716		Reclassify amounts due to the primary
	Deferred revenue	2,556,442		government from REA for ticket collections
	Payable to university - current		5,502,158	and settlement of contract.

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

PASSED AUDIT ADJUSTMENTS

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
1	**SNA**			
MISU	Accounts receivable, net	17,455		Project difference betw een actual and audited
NDSU	Accounts receivable, net	101,620		indirect costs based on analytics and testing.
UND	Accounts receivable, net	127,993		
	Increase (decrease) in net assets		247,068	
	SRECNA			
	Increase (decrease) in net assets	247,068		
	Indirect costs		247,068	
2	**SNA**			
	Increase (decrease) in net assets	217,962		Post calculated error from grants and
MISU	Grants and contracts receivable, net		12,442	contracts analytics. Used Federal Revenue as
NDSU	Grants and contracts receivable, net		68,607	that is the majority at each school.
UND	Grants and contracts receivable, net		136,913	
MISU	Federal grants and contracts	12,442		
NDSU	Federal grants and contracts	68,607		
UND	Federal grants and contracts	136,913		
	Increase (decrease) in net assets		217,962	
3	**SRECNA**			
WSC	State appropriations	403,477		Reverse entry APPNRECREV made in error.
	Due from state general fund		403,477	Entry w as made at the beginning of the year then
				again tow ard the end of the year.
4	**SNA**			
WSC	Grants and contracts receivable, net	280,105		Correct entry from Oil trust tax revenue and
	Due from state general fund		280,105	receivable. Client w as erroneously recording it as
				endow ment income instead of Capital Grants.
	SRECNA			
	Endow ment income	280,105		
	Capital grants and gifts		280,105	
5	**SNA**			
UND	Building improvements capitalized	1,277,468		Correct entry for building improvement
	Building/Leasehold Improvement additions		1,277,468	additions
6	**SRECNA**			
WSC	Interest on capital asset-related debt	218,988		Record bond interest expense and recognize
	Operating expense	232		the revenue from the federal interest subsidy.
	Nongovernmental grants and contracts		219,220	
7	**SNA**			
UND	Accounts receivable, net	433,434		Accrue UND's Minnesota reciprocity payment
	Net assets unrestricted		433,434	that w as know n in June and should have been
				accrued in July to the prior fiscal year.
	SRECNA			
	Increase (decrease) in net assets	433,434		
	Student tuition and fees		433,434	
8	**SNA**			
NDSU	Increase (decrease) in net assets	604,600		Correct overstatement of compensated
	Compensated absences current		30,230	absences.
	Compensated absences noncurrent		574,370	
	Accrued payroll	604,600		
	Increase (decrease) in net assets		604,600	

(continued)

Passed Audit Adjustments – continued

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
9	**SNA**			
WSC	Cash and cash equivalents	451,574		Reclassify a portion of restricted cash to
	Restricted cash and cash equivalents		451,574	unrestricted.
10	**SRECNA**			
NDSU	Federal grants and contracts	282,136		Reclassify FSEOG grants from operating to
	Federal grants and contracts-nonoperating		282,136	nonoperating.
11	**SNA**			
WSC	Due from other funds noncurrent	526,958		Reflect the interfund borrowing made by
	Due to other funds noncurrent		526,958	TrainND to the residence hall revenue fund.
12	**SRECNA**			
MASU	Salaries and wages	599,774		Project error recognizing tuition waivers related
	Student tuition and fees		599,774	to its independent study courses.
13	**SNA**			
WSC	Net assets unrestricted	168,336		Record payroll accrual at balance sheet date.
	Accrued payroll		168,336	
	SRECNA			
	Salaries and wages	168,336		
	Increase (decrease) in net assets		168,336	
14	**SNA**			
UND	Net Assets unrestricted]	973,430		Project net asset misclassifications based on
	Expendable Institutional	556,821		testing.
	Nonexpendable Scholarships and fellowships		973,430	
	Net Assets unrestricted		556,821	
15	**SNA**			
NDSU	Expendable research	182,175		Project net asset misclassifications based on
	Net assets unrestricted		182,175	testing.
16	**SRECNA**			
NDUS	Operating Revenue	2,218,787		Adjust for possible intra NDUS revenues.
	Operating Expense		2,218,787	

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

December 13, 2011

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, 2011. 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 13, 2011.

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. **Programs Fees – UND and LRSC**

UND's International Studies Program did not follow institutional protocol for approval of fees connected with its International Studies Program.

LRSC has not obtained student and SBHE approval for its Peace Officer Training program fee. However, LRSC contends that this $500 charge is a special course fee, while we believe it to be a program fee. We were unable to determine - based on BHE policy 805 - whether LRSC's fee for its Peace Officer Training program was a special course fee or a program fee. We believe the distinction between the two needs to be made clearer in the policy.

SBHE Policy 805.3(2) (d) states in part...." A program fee may be instituted or increased only with Board approval. All requests for new program fees to support new academic programs must be submitted for Board consideration as part of the new program request. All requests for new or revised program fees for existing academic programs must be submitted for consideration when the Board acts on annual budget guidelines, including tuition rates and other fees. Program fee requests must be submitted on a form approved by the Chancellor for that purpose."

Recommendation:

We recommend UND:

- Change the description of fees that are not program fees.
- Follow institutional procedures for approving new fees by:
  - Submitting the fee request to the VPFO (Vice President for Finance and Operations);
  - Documenting VPFO review and approval of the fees and maintain on file;
  - Bring the request to full committee for further review and specific recommendations; and
  - Upon approval send a memo to the Director of International Programs and Student Account Services and maintain the approval on file.

We recommend LRSC in consultation with the SBHE:

- Determine whether the Police Officer Training fee should be a program fee or special course fee as LRSC suggests.

We recommend that the SBHE:

- Revise NDUS fee policy 805.3 and make clear the difference between what is considered a program fee and a special course fee.

University System Response/Planned Corrective Actions:

UND agrees and has implemented the recommendations. The descriptions were changed in November, 2010. This particular study abroad fee has been in place for more than ten years and we were unable to find proof of approval. We believe this is an isolated incident.

LRSC: Neutral: While we do maintain that the POT fee is not a program fee, we agree to consult with the SBHE and assist in the clarification of NDUS fee policy 805.3. We believe the course fee covers the unique and extraordinary costs of the Police Skills course. A student must be in the POT Program to enroll in this course; however, if the student has received equivalent training elsewhere, the course is not required for completion of the POT Program.

NDUSO: Agree: The NDUS has a special task force currently reviewing student fees. This will be forwarded to them for review and consideration.

2. **Code of Conduct – NDSCS (Prior Management Letter Comment)**
When reviewing the Code of Conduct for NDSCS we noted that two elements of the code were absent. The issue of conflicts of interest and the consequences of non-compliance with the policy by the individual responsible for the conflict were not addressed.

Board Policy 308.1 requires specific elements be contained in the institutional Code of Conduct and NDSCS failed to meet all of these requirements.

Recommendation:
We recommend NDSCS revise its code of conduct to incorporate conflict of interest and the consequences of non-compliance with the policy as required by SBHE policy 308.1.

University System Response/Planned Corrective Actions:
Agree: NDSCS Human Resources Manager will add Conflict of Interest Policy to the Code of Conduct Policy. The Conflict of Interest policy states the consequences of non-compliance as does the Code of Conduct Policy. Update will be done by February 1, 2012.

3. **Imaging Software – NDSCS (Prior Formal Not Implemented)**
Based on our inquiries we learned that new imaging software (InfoRouter) had been implemented in the Human Resources department at NDSCS. When we inquired further, we found that the prior Director of HR had implemented this new system without instructing staff or informing the IT department on the details of the software. Without sufficient information on the nature and extent of this software, it is not possible to determine if this system is adequately secured, operated appropriately and contains proper internal controls over vital human resource information.

SBHE procedure 1901.4 states that NDUS institutions must adhere to NDSU Procedure 1901.2, Computer and Network Usage and NDUS Procedure 1912.1 Information Security Procedures when document imaging systems are implemented.

Recommendation:
We recommend NDSCS take appropriate steps to ensure compliance with all applicable State Board of Higher Education policies and procedures surrounding imaging software usage, software implementation, software security, internal controls over the use of that software and all federal regulations surrounding HR information stored on the InfoRouter imaging system.

University System Response/Planned Corrective Actions:
Agree: NDSCS will review our current scanning procedure and modify to comply with SBHE Procedure 1901.4. Procedure will be reviewed and revised by February 29, 2012.

4. **Misstated Payroll Accruals – NDSU**
NDSU accrued over $600,000 of sick time liability for employees who did not meet the 10 year service requirement.

SBHE Human Resource Policy Manual, section 7.5, states “An employee with at least ten continuous years of state employment who leaves the employ of the state, is entitled to a lump-sum payment equal to one-tenth of the pay attributed to the employee's unused sick leave accrued under this Section 7 and in accordance with N.D.C.C. Section 54-06-14. The pay attributed to the accumulated, unused sick leave must be computed on the basis of the employee's salary or wage at the time the employee leaves the employ of the state.”

NDCC 54-06-14, states in part…"An employee with at least ten continuous years of state employment is entitled to a lump sum payment equal to one-tenth of the pay attributed to the employee's unused sick leave accrued under this section."

Recommendation:
We recommend that NDSU ensure proper accrual of the sick leave liability according to NDCC 54-06-14 and the SBHE Human Resource Manual.

University System Response/Planned Corrective Actions:
NDSU agrees. An error was made in running the PeopleSoft query for financial statement preparation this year. Now that we know of the error, through the audit finding, it will not be repeated in the future. It is important to note that the employee data in the HR system was correct.

5. Component Unit Related Party Disclosures – DCB, NDSCS, and UND

Upon review of component unit audit reports we noted DCB Foundation, NDSCS Foundation, and the REA that did not mention the primary institution as a related party of the Foundation and/or did not specifically include related party disclosures in the financial statements. Significant transactions between the schools and their foundations occur each year which are not specified (disclosed) in the Foundation's financial statements.

Per FASB 57, "Related Party Disclosures," financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. The disclosure shall include the nature of the relationships involved, a description and dollar amount of the transactions, and amounts due from or to related parties.

Recommendation:
We recommend foundations prepare financial statements including adequate related party disclosures in compliance with Generally Accepted Accounting Principles as required by SBHE policy 340.2.

University System Response/Planned Corrective Actions:
UND agrees. REA's FY11 statement was prepared in compliance with GAAP, as required by SBHE policy, and is evidenced by the unqualified audit opinion issued by the external CPA firm. REA"s financial statement clearly states "for the benefit of the University of North Dakota". In fact, either UND or the University of North Dakota is mentioned by name 10 times in their 9 page financial report. REA sees the changes recommended by the SAO as optional and will consider these in the future.

NDSCS and DCB agree and will work with their Foundations' auditors to properly disclose the Related Party relationship and transactions in the notes to the financial statements.

6. Overtime Hours Computation – NDUSO

The wording of NDUS Human Resource Policy Manual, Section 12.3 allows non-exempt employees to earn overtime in a work week where annual leave, sick leave, official closings, and holidays are taken/given. The NDUS opens itself up to paying overtime when not required to and possible abuse by employees leading to inefficient use of funds.

NDCC 34-06-04.1 states, in part…"The state or a political subdivision of the state may provide for compensatory time and for a work period for compensatory time and overtime calculation for its employees if the state or political subdivision complies with the requirements of the Fair Labor Standards Act of 1938, as amended, [Pub. L. 75-718; 52 Stat. 1060; 29 U.S.C. 201 et seq.] and any rules and interpretations adopted by the United States department of labor."

The Fair Labor Standards Act of 1938 states overtime must be paid at 1.5 times the regular hourly rate for all hours worked in excess of 40 hours during a seven-day work week. The key words are "hours worked" and annual leave, sick leave, official closings, and holidays do not necessarily qualify as hours worked.

Recommendation:
We recommend the NDUS review and revise its policy for overtime so an employee can earn overtime and compensatory time only when "hours worked" exceeds 40 in one week.

University System Response/Planned Corrective Actions:
Agree. The NDUS will review its current policy, which currently meets minimum FLSA requirements. Policy revisions, if any, will be determined based on employee recruitment and retention and operational needs. A review of this management decision and practice will be completed by June 30, 2012.

7. Tuition Waivers – MASU

MASU allows the instructors of its Independent Study programs to grant tuition waivers but does not recognize them with an accounting entry.

NACUBO's Financial Accounting and Reporting Manual for Higher Education (FARM) 703.101 states that the Scholarship expense subclass includes grants-in-aid, trainee stipends, **tuition and fee waivers**, and prizes to undergraduate students.

Recommendation:
We recommend Mayville State University record all tuition revenue and the corresponding tuition waiver expense in all instances where waivers are granted; in this case, specifically related to Independent Study courses.

University System Response/Planned Corrective Actions:
Agree. Items previously not recognized with an accounting entry will now be recorded as tuition revenues and with a corresponding tuition waiver expenses.

8. Classification and Coding Errors – NDSCS (Prior Management Letter Comments)

NDSCS:

- Did not properly accrue $9,600 of payroll liabilities for fiscal year 2011;
- Did not reverse a $640,000 full accrual ledger entry from the prior year; and
- Overstated salaries payable by $37,233 in fund 22450, at June 30, 2011. 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.
- Did not reclassify a portion ($2.3 million) of its loans receivable as noncurrent

GAAP requires the recognition of an expense when incurred and subsequently the liquidation of the payable when paid. Additionally, current and long-term balances are to be separately reported.

Recommendation:

We recommend that NDSCS:

- Accrue payroll liabilities in the proper fiscal year and agree the general ledger to the payroll summary reports and reconciliations be provided for all differences.
- Classify a portion of loans receivable and the related allowance account as noncurrent for financial statement presentation
- Review year-end entries to ensure compliance with audit recommendations and GAAP before financial statements are submitted.
- Eliminate the overstated salaries payable from the general ledger.

University System Response/Planned Corrective Actions:

NDSCS agrees and will review and update FY12 year-end processes and procedures to ensure classification and coding errors are minimized and will correct the overstatement of payables.

9. Employee Tuition Waivers - BSC

BSC classified employee tuition waivers as scholarship and fellowship waivers (661015) rather than employee benefit tuition waivers (516020).

Per NACUBO tuition waivers granted to employee should be recognized as an employee benefit expense and when applicable, the other schools within the NDUS are properly using account 516020 to account for employee tuition waivers.

Recommendation:

We recommend BSC properly use the account codes, funds, fund groups, and functions that are available on PeopleSoft to properly record and report employee tuition waivers to ensure compliance with Industry accepted standards (NACUBO) and ensure consistent reporting with the other NDUS institutions.

University System Response/Planned Corrective Actions:

Agree. An error in set-up of the account code in student finance occurred in fall 2010. The error was discovered by student finance in September 2011 after the FY11 general ledger had been closed. The error has already been corrected for FY12 whereby employee tuition waivers are once again properly coded to account 516020 - employee benefit tuition waivers.

10. Grant System Recognition of Receivable – MISU, NDUS, and UND

The three schools that use the Grants system use different methods to accrue receivables for scheduled payment type grants and contracts. UND and MISU use one method and NDSU uses another.

One of the primary principles of financial reporting is consistency. Consistency is required to ensure comparability as well as proper recognition of assets and revenue.

Article VIII, section 6, subpart 6.c. of the constitution of North Dakota states: "Said board shall prescribe for all of said institutions standard systems of accounts and records and shall biennially,

and within six (6) months immediately preceding the regular session of the legislature, make a report to the governor, covering in detail the operations of the educational institutions under its control."

Recommendation:
We recommend UND, MiSU, and NDSU decide upon a single, uniform method of accruing year-end receivables related to scheduled payment type grants and contracts, and incorporate the chosen method into the NDUS Accounting Manual.

University System Response/Planned Corrective Actions:
Agree: New procedures have been drafted and will be used by all three schools beginning with the FY12 year-end close.

11. Direct On-Line Transactions – MASU, NDSU, UND, and VCSU

We have noted over the years that descriptions for journal entries (JE) are getting shorter and a user of the ledger has no way to know what the JE is for unless the JE is opened and reviewed or examined offline. There is a 30 character description field that could be filled out.

Additionally, JE's and interdepartmental billings (IDB) are both classified together and we are unable to determine which entries are IDB's or JE's, as there is no IDB specific coding. Adding a source code of IDB and using it only for IDB's would provide increased transparency and facilitate a better audit trail.

As an example of best practices in the industry, the University of Michigan's policy on JEs states that the journal description (or long description) should completely describe the transaction being processed and should indicate why the journal entry is necessary. The text of the description should contain:

- What is being transferred/corrected;
- Where it is being transferred;
- Why the original transaction(s) was incorrect; and
- A reference to applicable supporting documentation.

The AICPA Center for Audit Quality has stated that JE's are a relatively common means of perpetrating fraudulent financial statement reporting. False JE's figured prominently in the frauds at WorldCom, Cendant, and Xerox.

Additionally, SAS 99, "Consideration of Fraud in a Financial Statement Audit" states in part ..."Characteristics of fraudulent entries include adjusting entries recorded at the end of the period or as post-closing entries that have little or no explanation or description."

Recommendation:
We recommend:

- The schools include better descriptions for JEs and that the text of the description include:
  - What is being transferred/corrected;
  - Where it is being transferred;
  - Why the original transaction(s) was incorrect;
  - A reference to applicable supporting documentation; and
- NDUSO implement a new source code to be used specifically for IDB transactions.

University System Response/Planned Corrective Actions:
UND agrees, we will document and analyze our current business process. When documentation and analysis is complete, we will review for enhancements that campus can make to the journal entry descriptions by June 30, 2012.

MaSU: Agree. Mayville State University will include more detail in the long descriptions of our journal entries. This detail will include why the transaction is necessary and why the transaction should be processed. We will also comply with the NDUS wishes on how to record IDB transactions.

NDSU: Agree. Although space is limited on the PeopleSoft JE form, we agree to take more care in using the available space. NDSU will forward this finding to individuals entering on-line journals.

VCSU agrees and will add more description to their JEs and include IDB if it is one as outlined by the University of Michigan per the recommendation.

NDUS will meet with the campus controllers and SITS personnel by June 30, 2012 to determine the feasibility of implementing a new source code for IDB transactions.

12. Classification/Coding of Operating Revenue – BSC, MASU, NDSCS, NDSU, and UND

Bonded auxiliary facilities funded in part by state appropriation revenue reflect this revenue as operating rather than nonoperating on the bonded facility statement in the NDUS financial report. There were multiple templates used some of which reported it properly and some which did not.

GASB Statement 35, paragraph 50 indicates that state appropriations are nonoperating revenue.

Recommendation:
We recommend state appropriation funding be recognized as nonoperating revenue in all cases and the template be updated to reflect the proper presentation.

University System Response/Planned Corrective Actions:
Agree. Some templates were not formatted correctly and the NDUSO will ensure that templates in the future are formatted correctly for all campuses.

13. Financial Statement Disclosures - NDUSO

We could not recalculate the amounts reported in the template for Auxiliary Revenues Pledged as Security for Revenue Bonds. Additionally, there were three different versions of the template for Supplementary Information Bonded Building submitted.

Schools in the system should strive for consistency, comparability, and leave an adequate audit trail to facilitate review.

Recommendation:
We recommend the templates for Auxiliary Revenues Pledged as Security for Revenue Bonds and Supplementary Information Bonded Building be reviewed and revised so that each school is submitting the correct amounts for the financial statements.

University System Response/Planned Corrective Actions:
Agree: The templates will be reviewed and revised by June 30, 2012 to ensure that the information is reported accurately.

14. Classification/Coding - UND

We noted the following issues at UND:

- $1,277,468 of leasehold improvements were recorded in account 681005 (building/leasehold improvement additions) instead of account 682020 (building improvement capitalized). According to the North Dakota University System Accounting Manual, account 681005 should only be used for capitalizing items to the plant fund at the end of the year, while 682020 should be used to record expenses throughout the year.
- $981,000 was recorded as prepaid expenses (account 142002) for prepayment on equipment that had not been received as of June 30, 2011. This balance should have been recorded as deposits (account 143002). The use of prepaid expenses should be limited to expense due and payable in one accounting period but which the underlying asset will not be entirely consumed until a future period such as insurance and rent

Consistent classification and coding is a necessary part of ensuring that financial statements fairly present the financial balance and activity of the NDUS. Decision makers rely on the information presented in financial reports therefore it is imperative that the information presented by accurate, complete, and current.

Recommendation:
We recommend UND properly and consistently code all transactions using available general ledger accounts.

University System Response/Planned Corrective Actions:
UND agrees and greater care will be taken in the future to ensure consistent classification/coding.

15. Reconciliation of Component Unit – BSC, DSU, NDSU, UND, and WSC

When examining the amounts due to and due from the schools and their component units, we were not able to determine on the face of the component unit statements or in the note disclosures which receivables/payables were due to/from the primary government. Without this disclosure, it is difficult to determine which receivables/payables are associated with the related parties and whether the related financial statements are fairly stated relative to the related party transactions.

The following schools and their component units are the ones we were unable to reconcile the due to/from on the statements:

- BSC and Bismarck State College Foundation.
- DSU and Dickinson State University Foundation.
- NDSU and NDSU Development Foundation, NDSU Research Foundation, and NDSU Team Makers Club.
- UND and UND Alumni Foundation, UND Research Foundation, UND Center for Innovation Foundation, The Fellows, REA Arena, and UND EERC Foundation.
- WSC and Williston State College Foundation.

Recommendation:

We recommend the NDUS fully disclose receivables and payables between the institutions under its control and their related component units. This can be accomplished in one of three ways:

- Show specific payables to and receivables from on the face of the component unit statements; or
- Provide detailed disclosure in each individual note of the institutional financial statements; or
- Show a detailed reconciliation in the component unit note of the institutional financial statements.

University System Response/Planned Corrective Actions:

Disagree: Based on research of other state university system's audited financial statements, we do not believe this is a required GASB disclosure. In addition, review of other audited financial statements (i.e. the Oregon University System, the State University of New York System, the California State University System and the University System of Georgia) suggest they do not disclose this information on the face of their financial statements or in their footnotes. We believe limited staff resources are better utilized to prepare and review required disclosures instead of optional disclosures. We will consult with GASB and NACUBO to seek further clarification of the requirements prior to preparing the FY12 financial statements. We will continue to provide this information separately to OMB by using Excel templates, as the information is necessary for the State's CAFR.

Auditor's concluding remarks:

We applaud the System's plan to contact GASB and NACUBO on this issue and would appreciate being included in drafting the question(s) and obtaining their response(s). Contrary to the System Office, OMB collects this information because, in their opinion, it is a required disclosure by GASB for the State's CAFR. Finally, in comparing other's financial statements…we simply do not know the circumstances of those reports.

Given the size and complexity of the NDUS, it is highly unlikely that errors will ever be completely eliminated, especially within the current staff resources. Additionally, human error will always be a factor. It is also important to point out that errors noted in the recommendation are not necessarily the exact same errors or are occurring at the same campuses from year to year. Additionally, the amounts referenced in the finding are gross amounts (e.g. $1.0 million entry to increase a current asset and decrease a non-current asset is a $2.0 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 it into the context of materiality, 44% of the campus and system office adjustments noted above were less than $1.0 million and account for 0.21% of total net assets, as the chart below illustrates.

A list of 6 action items for improvement were presented to and approved by the SBHE BAFC in June 2011. Some of additional actions taken during fiscal year 2011 to improve the year end close process were:

- *The NDUS began a project to automate as many financial statement schedules as possible, rather than relying heavily on Excel spreadsheets. As a result, some schedules were automated in fiscal year 2011 and this project will continue into fiscal year 2012.*

- *The NDUS eliminated the conversion of the component unit financial statements from a FASB basis to a GASB basis. We have performed the conversion in the past even though GAAP does not require it for the NDUS financial statements. This significantly reduced the amount of time needed to review and report the component unit financial statements as well as removing a certain degree of subjectivity necessary to analyze financial statements issued by a third party.*

	FY11	FY10	FY09
Number of campus & system office adjustments	9	22	30
a. total dollar amount	$81,662,078	$60,172,055	$68,025,563
b. adjustments as a percent of total assets	9.1%	7.3%	9.1%
Number of Component Unit adjustments	2 **2/**	17 **1/**	17
a. total dollar amount	$65,186,946	$27,196,438	$42,066,196
b. adjustments as a percent of total assets	8.7%	5.7%	9.8%
Total NDUS Net Assets	$ 902,149,270	$ 824,924,773	$ 750,617,068
Total CU Net Assets	$ 564,794,059	$ 476,443,492	$ 430,284,158

	FY11	FY10	FY09
Number of Campus adjustments	9	22	30
1. Individually < $1.0 million	4	11	17
% of adjustments < $1.0 million	44%	50%	57%
a. Total dollar amount	$1,888,544	$3,917,691	$7,574,715
b. Adjustments as a percent of total net assets	0.21%	0.47%	1.01%
2. Individually < $500,000	2	7	9
% of adjustments < $500,000	22%	32%	30%
a. Total dollar amount	$48,346	$1,852,893	$1,673,072
b. Adjustments as a percent of total net assets	0.01%	0.22%	0.42%
Number of Component Unit adjustments	0	17 **1/**	7
1. Individually < $1.0 million	0	9	4
% < $1.0 million	0%	53%	57%
a. Total dollar amount	$0	$1,453,281	$3,110,537
b. Adjustments as a percent of total net assets	0.00%	0.31%	0.73%
2. Individually < $500,000	0	9	1
% < $1.0 million	0%	53%	14%
a. Total dollar amount	$0	$1,453,281	$354,000
b. Adjustments as a percent of total net assets	0.00%	0.31%	0.09%
Total NDUS Net Assets	$ 902,149,270	$ 824,924,773	$ 750,617,068
Total CU Net Assets	$ 564,794,059	$ 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.

1/ FY10 was the first year the campus controller's prepared the GASB51 conversion of the CU

2/ Adjustments were reclassifications to disclose balances due to and due from campuses on a separate line item of the financial statements. Amounts were recorded in the component units' audited financial statements but were not presented in a separate line item. GASB **does not** requie a separate disclosure of these amounts for the NDUS financial statements.

See our response to informal recommendation # 15.

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