Client Code 220

NORTH DAKOTA UNIVERSITY SYSTEM

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

For the Year Ended
June 30, 2012

ROBERT R. PETERSON
STATE AUDITOR

Office of the State Auditor
Division of State Audit

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Transmittal Letter

December 13, 2012

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, 2012. 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. UND did not comply with federal law or with the North Dakota Fiscal and Administrative Policy regarding $3.9 million of EERC equipment. These assets were recorded as capitalized equipment in prior years but expensed during the current audit period.

For additional commentary see Finding 12-4 on page 18.

3. Was internal control adequate and functioning effectively?

No. We noted the following internal control matters which need to be addressed and corrected:

1. Internal controls and training to enable the NDUS to prepare financial statements in conformity with GAAP. (Prior Recommendations Not Implemented #1)
2. Comprehensive fraud and control risk assessment. (Prior Recommendations Not Implemented #2)
3. Internal Auditors compliance with IIA requirements. (Prior Recommendations Not Implemented #3)
4. Classification, coding, and reconciling at WSC. (Prior Recommendations Not Implemented #4)
5. GASB 40 risk disclosures at LRSC, MISU, NDSCS, VCSU, and WSC. (Prior Recommendations Not Implemented #5)
6. Functional expense note reporting. (Prior Recommendations Not Implemented #6)
7. Financial statement preparation staffing. (Finding 12-1)
8. Internal auditor independence. (Finding 12-2)
9. BSC NECE lease recording by Foundation. (Finding 12-3)
10. Classification and coding of net assets at LRSC, NDSCS, VCSU, and WSC. (Finding 12-5)

For additional commentary see the Prior Recommendations Not Implemented starting on page 8 and Findings, Recommendations, and University System Responses section starting on page 15 of this report.

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 (6), posted audit adjustments (10), passed audit adjustments (14), and new formal (5) and informal (13) 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. Six of 12 (4-FY11 & 2-pre FY11) 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, 2010, and 2011 audits]

   2. NDUS management 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. [2008, 2009, 2010, and 2011 audits]

   3. The internal audit departments at NDSU, UND, and the NDUSO have not obtained peer reviews in compliance with industry standards nor attended sufficient training to meet IIA CPE requirements. [2011 audit]

   4. Several accounting issues at WSC surrounding the classification, coding, and reconciling of financial records have not been addressed. [2011 audit]

   5. GASB risk disclosures are still not prepared in accordance with GASB Statement No. 40. [2011 audit]

   6. The NDUS has not eliminated the errors in the functional expense note. [2011 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 the following 13 informal recommendations to which management responded and agreed to implement except for one (#12). For additional commentary and management responses, see the Management Letter starting on page 26.

   1. Leases Not Reported in Executive Budget – NDUSO
   2. Untimely Bank Deposits and Lack of Policy - LRSC (GFAFB)
   3. Descriptions Lacking on AP transactions – NDSU, NDUSO, and UND
   4. Inconsistent Recording of International Student Health Insurance Premiums – NDUS
   5. Incomplete IPA Related Party Note to the Financial Statements – DCB

6. No Policies and Procedures to Track Student Fee Expenses – NDUS
7. Scholarship Allowance Calculation Errors – DCB, DSU, LRSC, NDSCS, NDSU, VCSU, and WSC
8. Lack of Policies and Procedures for Cost Transfers – NDUS
9. Inadequate Monitoring of PeopleSoft Access Rights – BSC, DCB, DSU, LRSC, MASU, MISU, NDSCS, VCSU, and WSC
10. Inadequate Capital Expenditure Fund and Account Codes – NDSU
11. Auxiliary Revenue Pledge Disclosure Mistakes – DCB, LRSC, MASU, NDSCS, NDSU, UND, VCSU, and WSC
12. Journal and Interdepartmental Billing Entry Transactions – Improve Descriptions and Add Source Codes – NDSU, NDUSO, and UND
13. Clarify BHE Policies 830.1 (Student Payment Policy) and 440 (Enrollment Reporting) – NDUSO

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 or significant unusual transactions were noted. The NDUS's commitments and contingent liabilities are reported on pages 51 and 64 of the fiscal year 2012 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	$4,395,104 (18.0%)
Loans and notes	$7,341,815 (15.9%)

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 useful lives and 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 one instance of disagreement with prior years audit recommendation implementation and current year's informal auditor recommendations. The disagreement is included in the University System Response/Planned Corrective Actions on page 35.

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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Independent Auditor's 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 North Dakota University System as of and for the year ended June 30, 2012, and have issued our report thereon dated December 13, 2012. 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 opinion 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. 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 and current year findings 12-1 and 12-5 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 6 and in the schedule of findings, recommendations, and University System responses as findings 12-2 through 12-4 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 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 findings, recommendations and University System responses as findings 12-4.

We also noted certain other matters that we reported to management of the North Dakota University System in a separate letter dated December 13, 2012, 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 letter: prior recommendations not implemented and University System responses; findings, recommendations, and University System responses; and management letter. 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, 2012

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

1. INTERNAL CONTROL AND TRAINING

Condition:
During the 2007 and subsequent audits we recommended NDUS management establish appropriate internal controls and provide sufficient training to personnel so the NDUS is able to prepare GAAP financial statements without the necessity of significant audit adjustments.

Current Status:
Our current audit indicated that while progress has been made, the financial reporting system of the NDUS was still not adequate to offer reasonable assurance that management was able to produce GAAP compliant financial statements. In fiscal year 2012, there were material auditor-identified adjustments of $17,258,362, $1,113,673, $21,999,817, $14,296,614, and $4,918,051 to total assets, total liabilities, total net assets, total revenue, and total expenses, respectively. For details, see Posted Audit Adjustments in this report. By comparison, 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 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**.**

Effect:
Financial statements that are not GAAP compliant without significant auditor adjustments.

Cause:
Lack of sufficient priority to provide sufficient resources in the ultimate preparation and compilation of the NDUS financial statements by the NDUS.

Criteria:
Management is responsible designing and implementing internal controls to ensure the reliability of financial statements and thus to comply with all applicable GASB pronouncements.

Recommendation:
We recommend the NDUS provide sufficient resources to enable client personnel to produce materially correct year-end GAAP financial statements.

University System Response/Planned Corrective Actions:
Agree. We have and will continue to improve. The number of adjustments has steadily decreased, at the same time total net assets increased. Given the size and complexity of the NDUS, it is highly unlikely that errors will ever be completely eliminated, especially within current staff resources. The errors noted are not necessarily the exact same errors or are occurring at the same campuses from year to year. Amounts referenced 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). Several are reporting misclassifications, such as reclassifications between within the same category. Audit adjustments to total assets, liabilities, net assets, revenue and expenses represented 0.8%, 0.2%, 1.4%, 1.2% and 0.4% of their respective categories. [We did not include in our report a spreadsheet provided by the NDUS. This information demonstrated improvements over the last four years and is available upon request.]

2. COMPREHENSIVE FRAUD AND CONTROL RISK ASSESSMENT

Condition:

During the 2008 and subsequent audits we recommended the SBHE require a comprehensive fraud and control risk assessment by each institution and they establish 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 ensure the establishment of policies and procedures and to test the effectiveness of such policies and procedures once established**.**

Current Status:

Our current audit indicated the NDUS:

- Used the Larson-Allen, LLC entity-wide risk assessment, for each school and the Board Office, to report on improvements that had been made since the report was issued in October 2011. However, as discussed above, a comprehensive fraud and control risk assessment still had not performed by or at each institution.
- Has not established appropriate internal controls at all levels and there has been limited formal training on proper internal controls. This was made evident while reviewing the updated Larson-Allen report and noting several references to internal control weaknesses that had not been addressed.

Effect:

Undocumented, incomplete, or nonexistent internal controls create an environment conducive to fraud, ineffective and inefficient operations, misstated financial statements, and noncompliance with laws and regulations.

Cause:

In our opinion there are two general reasons for the lack of action in this area. First, our region is generally known for its trustworthy people. This notion carries forward into the work environment, when managers allow trust to take the place of good internal controls. The second reason is that management is not familiar with good internal control practices. Sound internal control procedures are generally a function of accounting or auditing training and/or experience.

Criteria:

SBHE Policy 802.8 as amended 9-26-12.

COSO (Committee on Sponsoring Organizations of the Treadway Commission) outlines five essential component of an effective internal control system. Risk assessment, which involves the identification and analysis by management of relevant risks to achieving predetermined objectives, is one of these five essential components.

Recommendation:

We recommend the University System require:

- a comprehensive fraud and control risk assessment by each institution;
- the establishment of appropriate internal controls policies and procedures to detect, deter, and avoid potential fraudulent activity and risks relevant to the preparation of financial statements;
- 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 test and report on the effectiveness of such policies and procedures, once established.

University System Response/Planned Corrective Actions:

- *Agree. A fraud survey will be administered by June 30, 2013. The results of this will be added to the comprehensive risk assessment to be completed during FY2014. Building from the Larson-Allen risk assessment, internal audit will complete a more in-depth assessment of current risks and controls at all campuses. The risk and fraud assessments will then be updated every other year.*
- *Agree. By June 30, 2013, internal audit will develop process flow charts for the financial close and report preparation process (es) which will outline internal controls as well as segregation of duties to mitigate potential risks. Agree. In addition to the yearly required fraud and code of conduct training, other mandatory training tools to address internal controls, ethics and federal compliance (FERPA) will be deployed prior to June 30th 2013.*
- *Agree. Testing for compliance with SBHE and University policies and procedures is part of the internal audit methodology. The new Chief Compliance Officer will assist with the development and testing of new and existing policies.*

3. INTERNAL AUDITOR (TRAINING AND PEER REVIEWS)

Condition:
During the 2011 audit we recommended all NDUS internal audit staff obtain adequate CPE to enhance their audit skills and professional development and comply with IIA continuing education standards and to undergo an external assessment of their quality assurance programs, at least once every five years by a qualified, independent reviewer.

Current Status:
The Director of Internal Audit at the Board Office did not obtain the required IIA minimum hours of CPE and there were no peer reviews performed on any of the three NDUS internal audit shops (NDSU, UND, and NDUSO).

Effect:
The lack of continuing education for internal auditors may cause errors in auditing techniques, audit approaches, and may ultimately end up causing audit failure and without peer reviews, the NDUS cannot be assured these offices comply with industry standards (IIA) for audits.

Cause:
The Board or the auditor has not scheduled sufficient time to devote to continuing education and the system office and the campuses affected are not willing to pay for or undergo the scrutiny of a peer review for any of their audit shops.

Criteria:
IIA standards require;

- 80 hours of continuing education every two years to maintain certification within their organization.
- A peer review of internal audit shops conducted at least once every five years to ensure that audits conducted by the shop are in compliance with the applicable auditing standards.

Recommendation:
We recommend all internal audit shops obtain peer reviews in compliance with industry standards and attend sufficient training to meet IIA CPE requirements.

University System Response/Planned Corrective Actions:
Agree. On-going training is very important and we will make every effort to comply; however, this will continue to be a challenge due to limited staff time and funding.

Agree. As stated in the FY2011 report, the NDUS, including the System Office and campuses, where appropriate, we will complete a peer review in 2016. Since this is a new review process for the NDUS, the intervening period will be used to put in place the proper procedures, measurements, etc. to ensure a successful peer evaluation process to be completed in 2016.

4. CLASSIFICATION/CODING/RECONCILING – WSC

Condition:
During the fiscal year 2011 audit we noted numerous classification, coding, and reconciliation problems with Williston State College's accounting procedures**.**

Current Status:

- $2,454,541 was recorded in state capital grants and contracts and should have been recorded in state capital appropriations.
- $231,715 of liabilities should have been recorded as expenses and a payable at year-end 2012, but was charged instead to fiscal year 2013.
- $280,105 of state capital appropriations was erroneously recorded as endowment income.
- $571,911 of federal revenue was not recognized as receivable at year-end.
- $566,379 of state appropriation revenue was not recognized as receivable at year-end.
- Entries to record the amounts in the two prior points were made because WSC debited Due from other State Agencies and credited Grant and Contracts Receivable, instead of appropriately recognizing federal revenue and state appropriations.
- $759,390 of federal income (for Pell & FSEOG) was not reclassed to non-operating revenue.
- There are numerous issues in appropriation funds and projects where the cash is not associated with the proper fund or project. Fund 35100 is the worst case as it has 6 projects with a combined deficit cash balance of $8,277,043, but in the fund, and related to no particular project is a positive cash balance of $7,337,693. This cash should be associated with and accounted for in the related projects.
- WSC did not disclose an interfund borrowing of $526,958 from its TrainND fund (25004) to its Residence Hall Debt Service (RHDS) fund (00523). Though it intends to repay TrainND, there is no corresponding agreement or interfund payable or receivable between TrainND and RHDS.
- Based on our examination of bank reconciliations for WSC, there is an irreconcilable difference of $83,235 between the cash balance reported on the general ledger and cash balance reported on the reconciliations.
- Bond Issue Costs ($66,700-account 144002) were recorded in fund 28001 and should have been recorded in fund 00001.
- An interest subsidy is received from the federal government to offset the interest payments. The trustee receives the subsidy and credits the trustee account. WSC did not record this federal revenue on their general ledger ($262,879), 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.

Effect:
Mis-stated financial statements.

Cause:
In our opinion, the problems are largely due to excessive turnover and a general lack of training.

Criteria:
Financial and accounting records should be maintained accurately and timely by personnel with appropriate backgrounds and training to perform said tasks.

COSO identifies a commitment to competence as one of the control environment controls which helps establish the foundation for an internal control system by providing fundamental discipline and structure.

Recommendation:
We recommend WSC with assistance from the NDUSO:

1. Use the proper funds for bond activity including:
   a. Reporting bond issue costs in fund 00001;
   b. Recording 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. 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.
3. Include salaries payable on the general ledger and implement procedures to make sure this entry is made in the future.
4. 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.
5. Reconcile cash per bank and cash per general ledger to a zero difference on a monthly basis. All differences must be isolated and investigated fully in a timely manner so that the appropriate adjustments can be made.

University System Response/Planned Corrective Actions:
Agree: WSC faces challenges recruiting and retaining highly qualified staff in all areas. WSC is currently filling the Director for Finance position. Through the hire and training process, WSC will make every effort to ensure proper financial and accounting records. Although WSC will begin implementation in FY13, work will likely need to continue into FY14, with new staff.

The NDUS Office has continued to work with WSC to offer advice and assistance on short-term and long-term improvements.

5. GASB 40 RISK DISCLOSURES – LRSC, MISU, NDSCS, VCSU, and WSC

Condition:
During the 2011 audit we recommended NDSCS, NDSU, NDUSO, and WSC implement procedures to ensure compliance with GASB Statement 40. NDSU and NDUSO did comply, however we noted the following errors at the other institutions:

Current Status:

- LRSC incorrectly excluded $7,721,071 from Cash Deposits – BND and from Deposit Risk Disclosure Category A;
- MISU incorrectly included $369,375 as a Deposit Risk Disclosure Category A. This amount is collateralized with securities held by the pledging financial institution; therefore, it should have been included in the Deposit Risk Disclosure Category B;
- NDSCS incorrectly included $490,899 as a Deposit Risk Disclosure Category A. This amount is collateralized with securities held by the pledging financial institution; therefore, it should have been included in the Deposit Risk Disclosure Category B;
- VCSU incorrectly excluded $121,208 from the Deposit Risk Disclosure Category B, which is the amount of deposits that exceed FDIC insurance, and are pledged with securities held by the pledging financial institution; and
- WSC incorrectly included $137,542 as a Deposit Risk Disclosure Category A. This amount is collateralized with securities held by the pledging financial institution; therefore, it should have been included in the Deposit Risk Disclosure Category B.

Effect:
The financial statement Note #2 Deposit Disclosure is misstated.

Cause:
Internal controls to ensure the reliability of financial statement disclosure were not functioning and/or proper care was not exercised to ensure the Deposit Disclosures were accurate.

Criteria:

- GASB Statement 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.
- Proper internal controls include establishing essential COSO components of control activities (policies, procedures, and practices) and monitoring (management oversight) to reduce the risk of financial statement misstatement and thus help ensure the reliability of financial statements. The notes are an integral part of the financial statements.

Recommendation:
We recommend LRSC, MISU, NDSCS, VCSU, and WSC management implement internal controls and take appropriate action to ensure that Deposit Disclosures are complete and accurate.

University System Response/Planned Corrective Actions:
LRSC, MiSU, NDSCS, VCSU, and WSC: Agree, proper internal controls will be put in place prior to June 30, 2013 to ensure appropriate disclosures.

6. FUNCTIONAL EXPENSE NOTE (REPORTING)

Condition:
During the 2011 audit we made recommendations that would help ensure the functional expense information is accurately reported. There was marked improvement, however we noted the following:

Current Status:
We noted errors in the functional expense note at DCB, LRSC, MASU, and MISU. Errors ranged from $194,799 at DCB to $1,216,971 at MISU.

Effect:
Misstated notes related to functional expenses.

Cause:
The differences probably arise from the schools making additional entries after running the note disclosure query.

Criteria:
Proper internal controls should ensure that amounts in financial statements including the notes to same are fairly stated.

Recommendation:
We recommend the NDUS continue to improve on eliminating the errors in the functional expense note. Entries made after the query is run need to be taken into consideration as they have an effect on categorical amounts.

University System Response/Planned Corrective Actions:
Agree: The NDUSO will continue to review the query used to for functional expense reporting and will make necessary changes for the FY13 year-end close process.

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Findings, Recommendations, and University System Responses

STAFFING SHORTAGE FOR FINANCIAL STATEMENT PREPARATION – NDUS (FINDING 12-1)

Condition:
Over the last five or more years we have noted significant audit adjustments that had to be posted to the client's financial statements. One of the contributing factors appears to be the lack of time available for the Board Office to adequately review financial information submitted by the schools for inclusion into the basic financial statements (BFS) of the NDUS.

Effect:
Without adequate time for review and inspection of financial information submitted by the schools, the risk of material financial misstatement is increased. In 2012, our aggregate errors indicated an absolute value of errors in total assets of $17,258,362, total liabilities of $1,113,673, net assets of $21,999,817, revenues of $14,296,614, and expenditures of $4,918,051.

The 2011 audit indicated 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.

In comparison, 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.

Cause:
Shortage of assigned staff available to adequately review the information supplied by the schools and an apparent lack of due professional care by institutional management for the information supplied for the NDUS BFS.

Criteria:
Management of the NDUS is responsible for establishing proper internal control over the preparation of the NDUS annual financial statements to ensure that financial statements are reliable, accurate, and free of material misstatement.

In 2012, there were two distinct examples where the assurance of materially error free statements failed. One error involved the writing off of capital assets which resulted in a current year and prior year net asset restatement and the other involved the reporting of other assets and payables due to and from the same institution. Neither of these issues should have been allowed to get to the financial statement preparation point.

Recommendation 12-1:
We recommend the Board Office review its financial statement preparation process and consider adding additional qualified personnel and resources, on a permanent or part-time basis, or consider the hiring of a consultant, to ensure the quality and accuracy of the annual BFS.

University System Response/Planned Corrective Actions:

Agree, adequate staff resources are lacking. This staffing need will be prioritized along with other staff needs by the Chancellor, but can only be achieved with added financial resources.

INTERNAL AUDITOR INDEPENDENCE (FINDING 12-2)

Condition:
A change was proposed for Board policy 802.8 to require all NDUS internal auditors to report, through the IA Director, to the SBHE Audit Committee. However, the proposal did not include having the internal auditors at UND or NDSU also report directly to the SBHE Audit Committee. Rather, they are to report to their respective Presidents.

Effect:
The independence of UND and NDSU's internal auditors is compromised. Management can limit the scope and/or content of audits performed by the internal auditor.

Cause:
It would appear that the presidents at NDSU and UND do not fully understand, accept, or support the concept of independence as it relates to the internal audit function.

Criteria:
The International Standards for the Professional Practice of Internal Auditing (Standards) states:

1110 – Organizational Independence

The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity.

Organizational independence is effectively achieved when the chief audit executive reports functionally to the board. Examples of functional reporting to the board involve the board approving the internal audit charter, approving the risk based internal audit plan, approving the internal audit budget and resource plan, receiving communications from the chief audit executive on the internal audit activity's performance relative to its plan and other matters, approving decisions regarding the appointment and removal of the chief audit executive, approving the remuneration of the chief audit executive and making appropriate inquiries of management and the chief audit executive to determine whether there are inappropriate scope or resource limitations.

1110. A11 - The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results.

Recommendation 12-2:
We recommend the internal audit staff at UND and NDSU report directly to the Director of Internal Audit and Risk Assessment and the SBHE Audit Committee.

University System Response/Planned Corrective Actions:
Agree. The SBHE will discuss the realignment of the UND and NDSU internal auditors at an upcoming SBHE Board meeting.

CAPITAL VS. OPERATING LEASE – BSC NECE (FINDING 12-3)

Condition:
In Note 13 of the BSC Foundation 2012 audit report, the foundation is classifying the NECE building transactions between BSC and the Foundation as an operating lease for payments received from BSC on the NECE building. BSC on the other hand is treating the transactions as a capital lease and shows approximately $6.1 million of a capital asset on their books.

Effect:
It appears to violate GAAP when one of the parties to the agreement (foundation) treats the related transactions as an operating lease and the other party to the agreement (BSC) treats the related transactions as a capital lease.

Cause:
In our opinion, the Board Office did not adequately examine the audited financial statements of the foundations to ensure GAAP or Policy compliance.

Criteria:
In accordance with the Lease Agreement dated October 19, 2007 between BSC "TENANT" and the Foundation "LANDLORD", Article 10, Option to Purchase states "At the conclusion of this Lease, provided the TENANT has continuously leased the premises for the twenty five (25) years herein provided, and TENANT is not then in default under these lease terms, or upon termination of this lease as set forth in Section 25.01, then, and in such event, the TENANT shall have the right to purchase the lease premises for a total purchase price of One Hundred Dollars ($100).

Lessor Accounting:
The basic criteria for capitalization of a lease by lessor are as follows:

- The lease transfers ownership of the property to the lessee.
- The lease contains a bargain purchase option.
- The lease term is equal to or greater than 75% of the estimated economic life of the leased property.
- The present value of the minimum lease payments (MLP) (excluding executor costs) is equal to or greater than 90% of the fair market value of leased property. To understand and apply this criterion, you need familiarize yourself with what is included in the minimum lease payments and how the present value is calculated. The minimum lease payments include the minimum rental payments minus any executory cost, the guaranteed residual value, the bargain purchase option, and any penalty for failure to renew or extend the lease. The amount calculated is then discounted using the lessee's incremental borrowing rate. However, if the lessee knows the implicit rate used by the lessor and the rate is less than the lessee's rate, the lessee should use the lessor's rate to discount the minimum lease payment.

Board Policy:
In accordance with SBHE Policy 340.2, paragraph 3e, the foundation is required to provide the institution with GAAP compliant financial statements.

Recommendation 12-3:
We recommend the SBHE provide for sufficient review of audited foundation financial statements to ensure compliance with GAAP and Board Policy.

University System Response/Planned Corrective Actions:
Agree. Staffing constraints at the NDUSO limit the amount of detailed review of the foundations' audited financial statements that can be performed without causing significant delays to the year-end close and audit. A high level review of the financial statements is performed and we rely on the fact that the foundations are audited annually by independent public accounting firms and all received unqualified opinions in FY12. This staffing need will be prioritized along with the other staff needs by the Chancellor, but can only be achieved with added financial resources.

CAPITALIZATION POLICY NONCOMPLIANCE – UND (FINDING 12-4)

Condition:
During our testing of capital assets, we noted UND expensed $3.9 million of equipment used in research and fabrication for the Energy and Environmental Research Center (EERC). These assets were recorded as capitalized equipment in prior years, but were expensed during the current audit period.

UND decided that because the Department of Energy reserves the right to transfer title to a third party, that UND does not have title to these assets, and therefore should not capitalize them. However, UND purchased the assets with grant funds, they use the assets in operations, the assets have a useful life of greater than one year, and the cost of the assets exceed the capitalization threshold of $5,000.

Effect:
The original financial statements were misstated due to capital assets being understated and operating expenses being overstated.

Cause:
UND incorrectly decided that because the Department of Energy has the ability to assign assets to third parties, they do not have title to these assets, and therefore need not capitalize them.

Criteria:
10 CFR 600.134 (a) states, "Title to equipment acquired by a recipient with Federal funds shall vest in the recipient."

Also, the ND State Fiscal and Administrative Policy manual states, fixed assets should be capitalized when the following criteria are met:

- The asset is tangible or intangible in nature, complete in itself, and is not a component of another capitalized item;
- The asset is used in the operation of the state's activities;
- The asset has a useful life of one year or more and provides a benefit throughout that period;
- The asset cost is $5,000 or more.

UND purchased the assets with grant funds, they use the assets in operations, the assets have a useful life of greater than one year, and the cost of the assets exceed the capitalization threshold of $5,000.

According to the GFOA Reporting for Capital Assets, when determining which entity's financial statements should report a given asset, "Title, when determinable, generally suffices to establish ownership. An exception would be those rare cases where the government holding title does not, in fact, have ultimate rights to the use and enjoyment of the property."

Recommendation 12-4:
We recommend UND:

- Make adjustments to their financial records to reclassify the expensed EERC assets that meet the capitalization criteria to capitalized equipment;
- Record the depreciation on the reclassified equipment; and
- Follow the capitalization criteria established by the ND State Fiscal and Administrative Policy manual and 10 CFR 600.134 when determining whether a capital asset should be capitalized or noncapitalized.

University System Response/Planned Corrective Actions:
Agree. UND will comply with the capitalization criteria in NDCC 54-27-21. During fiscal year 2012, UND reviewed our process for capitalizing equipment and equipment fabrications for research within the department of EERC. The process review involved professional staff from

EERC, the Controller's Office, Asset Management, the Budget Office, and the Grants and Contracts Office, as well as discussions with federal agency contacts. Subsequently, this review brought about a change to the process. It was decided UND would no longer capitalize and depreciate these items, but rather expense the items. The conclusion reached by the UND group differs from the conclusion reached by the auditors.

To comply with the State Auditors recommendation, UND will revert back to our previous process for capitalizing these specific purchases.

Prior to the State Auditors issuing this recommendation, NDUS did adjust the current UND financial statements so the capitalized assets, depreciation, and operating expenses reflect the adjustments required by the State Auditor's Office.

PROPER CLASSIFICATION OF NET ASSETS – LRSC, NDSCS, VCSU, AND WSC (FINDING 12-5)

Condition:
We noted the following misclassifications of net assets:

- LRSC misclassified $4,579,710 of capital projects instead of invested in capital assets, net of related debt net assets;
- NDSCS misclassified $3,843,866 of unrestricted net assets that should have been recorded as $2,854,327 in invested in capital assets, net of related debt and $989,539 in expendable institutional net assets;
- VCSU misclassified $399,797 of invested in capital assets, net of related debt instead of unrestricted net assets;
- WSC misclassified $720,456 of invested in capital assets, net of related debt instead of unrestricted net assets.

Effect:
Net assets on the Statement of Net Assets are not correct per GASB Statement 34.

Cause:
LRSC had unspent debt proceeds of $4,579,710 that was part of their notes payable balance. Since this amount had not been constructed into an asset yet, the "related debt" did not have a capital asset associated with it. The related unspent cash proceeds net assets were in capital projects, so the debt portion of the net assets should also be in the capital project, which will then net to zero.

NDSCS had unspent bond proceeds of $2,854,327 that were part of the bonds payable balance and invested in capital assets, net of related debt. Since there is no constructed capital asset for this amount, the related debt cannot be shown as restricted, therefore it needs to be shown as unrestricted. Also, fund 40500 ($989,539) should be shown as expendable institutional (instructional departmental uses) instead of unrestricted as it is mapping on the general ledger.

VCSU had excess net assets left in project VSC0007564 and equipment in fund 31800 with a greater net asset balance than what is actually in there for equipment. These issues are due to mapping problems in PeopleSoft.

WSC had a mapping issue in fund 00001 because there is expendable capital projects and net assets restricted in this fund when it should be reported as invested in capital assets, net of related debt.

Criteria:
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."

Recommendation 12-5:
We recommend LRSC, NDSCS, VCSU, and WSC present net assets in compliance with GASB Statement 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:
Agree. LRSC, NDSCS, VCSU and WSC will work with the NDUSO and CND to ensure proper classification for the FY13 financial statements.

December 13, 2012

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, 2012, and have issued our report thereon dated December 13, 2012. 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 which is not addressed either as a recommendation or posted or passed audit adjustment. 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 useful lives and 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 one instance of disagreement with auditor recommendations. This disagreement is shown on page 35.

Management Representations
We have requested certain representations from management that are included in the management representation letter dated December 13, 2012.

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.

Recent auditing standards make a fundamental change to the relationship between auditors and when auditors can rely upon work of other auditors. Without appropriate cooperation from the auditors of the component units, the State Auditor may not be able to rely upon the work of other auditors, which could have a negative effect on future audit opinions. Management should ensure component units make sure their auditors are willing to work with the State Auditor relating to group audit requirements.

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	**SRECNA**			
WSC	State capital grants & contracts	2,454,541		To record state capital appropriation revenue erroneously recorded as Oil Trust Tax revenue.
	State capital appropriations		2,454,541	
2	**SNA**			
LRSC	Cash - in BND (noncurrent restricted)	4,579,710		To restrict to unspent note payable proceeds that are in the construction fund.
	Cash-savings/money market BND		4,579,710	
3	**SNA**			
NDSCS	Cash - in BND (noncurrent restricted)	1,033,609		To restrict unspent bond proceeds for project SCS0007422.
	Cash - in BND		1,033,609	
4	**SNA**			
UND	Deferred revenue	1,113,673		To reverse entry moving SOMHS fall 2013 tuition and fees posted in FY12 to deferred revenue
	Accounts receivable		1,113,673	
5	**SNA**			
UND	Machinery and equipment	3,905,779		To reverse entry that moved EERC capital assets from capitalized to noncapitalized.
	Machinery and equipment acc dep		1,012,272	
	Invested in capital assets, net of related debt		2,893,507	
	SRECNA			
	Depreciation expense	1,012,272		
	Increase (decrease) in net assets	2,893,507		
	Non owned equip/fabrication		3,905,779	
6	**SNA**			
LRSC	Expendable capital projects	4,579,710		To restrict net assets for unspent notes payable proceeds as there is no capital asset and reclass negative net asset.
	Net assets unrestricted	9,326		
	Exp instruction dept uses		9,326	
	Invested in capital assets, net of related debt		4,579,710	
7	**SNA**			
NDSCS	Net assets unrestricted	3,843,866		To restrict net assets for unspent bond proceeds and instructional dept uses
	Exp instruction dept uses		2,854,327	
	Invested in capital assets, net of related debt		989,539	
8	**SNA**			
VCSU	Invested in capital assets, net of related debt	399,797		To restrict net assets based on GASB 34/35 requirements.
	Net assets unrestricted		399,797	
9	**SNA**			
WSC	Net assets unrestricted	720,456		To restrict net assets based on GASB 34/35 requirements and correct mapping.
	Invested in capital assets, net of related debt		720,456	
10	**SRECNA**			
NDUS	Auxiliary revenue	4,693,766		To reduce parenthetically disclosed amount for auxiliary revenues pledged as security for revenue bonds to $91,746,465
	Other adds/deductions		4,693,766	

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

PASSED AUDIT ADJUSTMENTS

1	**SNA**			
VCSU	Infrastructure/Land Improve	754,316		To book the gift, purchase and asset from the
	Invested in capital assets, net of related debt		754,316	foundation for the Lokken Turf project.
	SRECNA			
	Increase (decrease) in net assets	754,316		
	Gift from related foundation		754,316	
2	**SNA**			
NDUS	Accounts receivable - current	309,475		To post projected error from tuituion and fee testing
	Net assets unrestricted		309,475	of the entire NDUS.
	SRECNA			
	Increase (decrease) in net assets	309,475		
	Tuition and fees		309,475	
3	**SRECNA**			
WSC	Tuition and fees	344,222		To post WSC's known scholarship allowance error.
	Auxiliary revenues	26,908		
	Scholarships		371,130	
4	**SNA**			
WSC	Net assets	231,715		To post FY12 payable recorded as expense in FY13
	Accounts payable		231,715	
	SRECNA			
	General contractor capitalized	231,715		
	Increase (decrease) in net assets		231,715	
5	**SNA**			
NDSU	Building improvements	304,741		To post projected error of payments that should
UND	Building improvements	564,336		been capitalized but classified as noncapitalized
	Invested in capital assets, net of related debt		869,077	
	SRECNA			
	Repair services capitalized	869,077		
	Repair services noncapitalized		869,077	
6	**SNA**			
NDUS	Net assets unrestricted	232,487		To record the timing differences between Institution
	LT liability due to CU-non current		232,487	and Component unit year ends.
	SRECNA			
	Building capital lease	232,487		
	Increase (decrease) in net assets		232,487	
7	**SRECNA**			
WSC	State capital appropriations	280,105		To reclass reversal of Oil trust fund drawdowns.
	Endowment income - non operating		280,105	
8	**SRECNA**			
WSC	Bond interest payment	262,986		To record bond interest expense and recognize
	Other professional fees	416		the revenue from federal interest subsidiary.
	Interest income - non operating		523	
	Federal G&C non operating		262,879	

(continued)

Passed Audit Adjustments – continued

	DESCRIPTION	DR	CR	EXPLANATION/DISPOSITION
9	**SNA**			
UND	Cash - in BND (noncurrent restricted)	335,399		To restrict cash based on maximums required by
	Cash - in BND		335,399	bond indentures.
10	**SNA**			
NDSU	Net assets unrestricted	390,599		To correct FY12 purchase card expenses that were
	Accounts payable		390,599	recorded in FY13.
	SRECNA			
	Purchase card expenses	390,599		
	Increase (decrease) in net assets		390,599	
11	**SNA**			
WSC	Grant and contract receivable	571,911		To recognize federal revenue and set revenues
	Increase (decrease) in net assets		571,911	to equal expense. Also eliminate deficit fund
				balance.
	SRECNA			
	Increase (decrease) in net assets	571,911		
	Federal grant and contract revenue		571,911	
12	**SNA**			
WSC	State appropriation receivable	566,379		To recognize state appropriations to avoid having
	Increase (decrease) in net assets		566,379	deficit in appropriated funds.
	Increase (decrease) in net assets	566,379		
	State appropriation revenue		566,379	
13	**SRECNA**			
WSC	Federal grants and contract revenue	759,390		To reclass Pell and SEOG from operating to non-
	Federal non-operating revenue		759,390	operating income.
14	**SNA**			
MISU	Due to other funds	3,922,348		To eliminate intra-campus borrowing
	Due from other funds		3,922,348	

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

December 13, 2012

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, 2012. 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, 2012.

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. Lease Not Reported in Executive Budget – NDUSO

Condition:
The North Dakota University System Office entered into one new capital lease for video equipment for SITS/ConnectND for $303,214. The lease payments were paid with appropriated funds. This lease was not included in the Governor's Executive Budget for the 2011-2013 biennium.

Effect:
Noncompliance with NDCC 54-44.1-06 part 8. Internal controls are compromised as a part of any effective internal control system is assurances that there is compliance with laws and regulations.

Cause:
NDUS may have missed reporting this lease since it was reported on NDSU's general ledger originally as NDSU is the SITS fiscal agent.

Criteria:
NDCC 54-44.1-06 states that the director of the budget, through the office of the budget, shall prepare budget data which must contain and include the following:

- A list of every individual asset or service, excluding real estate, with a value of at least fifty thousand dollars and every group of assets and services comprising a single system with a combined value of at least fifty thousand dollars acquired through a capital or operating lease arrangement or debt financing arrangement by a state agency or institution. The list must include assets or services acquired in the current biennium and anticipated assets or services to be acquired in the next biennium.

Recommendation:
We recommend NDUS/SITS properly budget and plan to report all leases greater than $50,000 and paid with appropriated funds in the Governor's Executive Budget that are anticipated for the biennium.

University System Response/Planned Corrective Actions:
Agree. It was an oversight and has been corrected in the 13-15 budget process.

2. Untimely Bank Deposits and Lack of Policy - LRSC (GFAFB)

Condition:
During our testing of receipts, we noted that payments collected at the Grand Forks Air Force Base (GFAFB) are not being brought to the bank in a timely manner. In addition, LRSC does not have a written policy in place dictating when deposits are to be brought to the bank.

Effect:
Increased risk of loss due to theft or missappropriation of cash.

Cause:
According to LRSC Management, they don't have a policy in place but it has been a standard albeit unwritten procedure to bring on-campus deposits to the bank daily.

They have had numerous documented conversations with GFAFB regarding making deposits on at least a weekly basis, but are not sure why this does not happen.

Criteria:
Cash is a highly liquid asset. Good internal controls serve to reduce the risk of asset loss. This would in turn dictate that management adopt a policy that clearly states receipts are to be deposited daily or if immaterial, when they reach a predetermined dollar threshold (i.e. $5,000) but at least weekly.

Recommendation:
We recommend:

- LRSC develop and implement a policy that requires receipts to be deposited daily if over a set dollar amount. If not, deposits should be brought to the bank when they reach a predetermined threshold and at least weekly.

- Personnel at the GFAFB follow the deposit policy established by LRSC. If deposits cannot be brought to the bank in a timely manner, the GFAFB should no longer accept payments.

University System Response/Planned Corrective Actions:
Agree. LRSC is pursuing the discontinuation of acceptance of cash and check payments at the GFAFB. If we discover it is no longer necessary, we will discontinue that option as soon as practicable during FY13. The GFAFB office would however, continue to accept credit and debit card payments. If for some reason, we discover that we need to continue accepting cash and checks, a policy will be developed dictating when deposits are to be brought to the bank.

3. Descriptions Lacking on AP transactions – NDSU, NDUS, and UND

Condition:
From our testing of Expenditures we noted NDSU, NDUSO and UND were not always completing the APDescr field when completing an AP transaction. We noted 9 of 23 (40%) at NDSU, 3/3 (100%) at the NDUSO, and 8/17 (47%) at UND. Further review shows that the NDUSO sample correlates to the population as they are not including the APDescr field at all.

Effect:
Without adequate descriptions an audit trail is missing and accountability and transparency is diminished for those transactions. While it is evident who they were made to the business purpose is not evident without knowing what they were made for and why.

Cause:
We are unsure, but based on our review it appears the NDUSO does not feel it necessary, NDSU is likely due to decentralization and training while the reason at UND is unclear as all transactions run thru accounting services and reviewers should ensure there is a description.

Criteria:
Internal controls need to include an adequate audit trail as a necessary part of ensuring the accuracy, completeness and timeliness of accounting transactions, as well as providing documentary support for all data generated and recorded in the accounting systems and used in financial reports.

Recommendation:
We recommend that the APDescr field be completed by all NDUS entities.

University System Response/Planned Corrective Actions:
Agree. The NDUS, through the Controller's Group, will review the use of the descriptors, and will make changes, if deemed appropriate, by June 30, 2013.

4. Inconsistent recording of International Student Health Insurance Premiums – NDUS

Condition:
Over the course of planning the 2012 NDUS audit, we observed that international student health insurance premiums are not being handled consistently among the institutions of the University System. Some schools are using a local fund, while others are using an agency fund.

Effect:
International student health insurance premiums are inconsistently classified and reported by the various institutions.

Cause:
The SAO made the Controllers of the institutions aware of the issue prior to year end. The Controllers could not come to an agreement on how to handle these transactions. Some institutions feel strongly that they should not be agency funds; some already have them as agency funds, while others don't have a preference.

Criteria:
Some of the primary principles of financial reporting are consistency and comparability. To enhance the consistency and comparability of the data presented the North Dakota University System needs to record like transactions consistently.

Also, the NDUS Accounting Manual states, "agency funds are funds that are owned and controlled by a third party, that are held by the campus as custodian or fiscal agent." Therefore, due to the fact that these funds are not the institutions, and they have a custodial responsibility to collect the funds from the student and then pay them to the insurance provider, we feel that the proper way to handle these transactions is to use an agency fund.

Recommendation:
We recommend all institutions classify payments received and paid for international student health insurance premiums as agency funds.

University System Response/Planned Corrective Actions:
Agree. Prior to June 30, 2013, the NDUS will review and define a consistent recording methodology for these premiums.

5. Incomplete IPA Related Party Note to the Financial Statements – DCB

Condition:
The Independent Public Accountant/Auditor (IPA) for Dakota College Bottineau Foundation did not include the fact that the foundation was and is a related party or component unit of DCB or disclose any transactions between the Foundation and DCB in the notes to the Foundation's financial statements. [This issue was also addressed last year in an informal recommendation.]

Effect:
Because transactions between related parties are not considered to be arms-length transactions, greater care in investigating such transactions and disclosing them is required by the auditing profession.

Cause:
In our opinion, either the IPA felt that adequate disclosures had been made, thereby fulfilling compliance with FASB 57 or there was an unintentional compliance oversight.

Criteria:
Disclosures of activity between related parties cannot be considered as arms-length transactions due to the relationship.

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:
Agree. DCB will forward the request to the Foundation's IPA for consideration for the FY13 financial statements.

6. No Policies and Procedures to Track Student Fee Expenses – NDUSO

Condition:
None of the schools of the NDUS have policies and procedures in place to properly track fees to ensure they are expended in accordance with the purpose of the fee. This includes program fees,

special course fees, etc. but not mandatory fees. Per a cursory review of fees we estimate there are better than $25,000,000 in non-mandatory fees during the year.

Effect:
Schools, students, and concerned stakeholders have no way to track and ensure that program, special course, and other fees are being spent for the purpose for which they were assessed and therefore directly benefit those approving and paying the fee.

Cause:
In our opinion, the NDUS has not to this point felt it necessary to develop clear and consistent policies to regulate the fee expenses to ensure the fee is expended for intended purposes.

Criteria:
One of COSO's five essential components of an effective internal control system is control activities. COSO defines control activities as policies, procedures, and practices that ensure management objectives are achieved and risk mitigation strategies are carried out. Policies and procedures should be formulated to ensure fees charged benefit the intended individuals who paid the fee.

Recommendation:
We recommend the NDUS develop clear and consistent policies and procedures related to tracking program, special course and other fees, to ensure they are expended for the intended purpose (i.e. the program, special course, etc.) to ensure transparency with accountability for all fees charged.

University System Response/Planned Corrective Actions:
Partially agree. Policies are in place, and have been improved over time. The Office has not had the level of staff resources in place to regulate and monitor expenditures at this level.

A new tuition model will be implemented in the Fall 2014, blending most non-mandatory fees with tuition. Combined revenues will be deposited in institutional collections, and managed by each campus to support general instruction and other related functions. Policies for remaining stand-alone fees will be updated to ensure proper approval, accounting, monitoring, and disposition by Fall 2014.

As of December 31, 2012, we have completed a review of accumulated fee balances, and provided direction regarding disposition of balances to campuses in support of students and programs for which the original fee was paid.

7. Scholarship Allowance Calculation Errors – DCB, DSU, LRSC, NDSCS, NDSU, VCSU, and WSC

Condition:
We noted the following when reviewing the scholarship allowance (SA) calculations at the schools:
- Seven schools had errors in the information input into the data field tab of the SA calculation (DCB, DSU, LRSC, NDSCS, NDSU, VCSU, and WSC). Of these errors, only WSC's was material.
- There was confusion regarding what to use for the state grant totals in the worksheet at a number of schools.
- LRSC did not use the sources indicated in the SA instructions data tab, and also changed some of the formulas in the SA.

Effect:
Scholarship Allowance (which includes tuition and fees as well as auxiliary expense) could be materially misstated.

Cause:
Some schools are not taking enough care when inputting the SA data and completing the calculation and the NDUSO did not properly identify what makes up the total for state grants.

Criteria:
Internal controls should provide reasonable assurance that financial reporting is reliable. Meaningful, reliable, comparable financial statements require accuracy and consistency in application to avoid material errors.

Recommendation:
We recommend:
- Schools take more care in completing the Scholarship Allowance calculations, and perform double checks of the numbers, as well as comparing the prior year's data and calculation to identify errors prior to remitting.
- The NDUSO provide and fully identify what components make up State Grant totals. The school should insure State Grant revenues and expense are not included in their general ledgers (i.e. use an agency fund or make year-end adjustments).
- All schools but LRSC in particular complete the Scholarship Allowance using provided template instructions and do not change any of the formulas without the NDUSO's consent.

University System Response/Planned Corrective Actions:
DCB, DSU, LRSC, NDSS, NDSU, VCSU, WSC and NDUSO: Agree, and will implement prior to June 30, 2013.

8. Lack of Policies and Procedures for Cost Transfers – NDUS

Condition:
During our test of journal entries, we noted instances where cost transfers did not have supporting documentation attached to the journal entry forms. After further audit work, it was determined that supporting documentation is kept at the department level, but there are no policies and procedures in place surrounding these transactions.

Effect:
Without having written policies and procedures in place, there is an increased risk of employee misunderstanding their authorization and documentation responsibilities surrounding cost transfers, resulting in improper journal entries.

Cause:
The institutions feel that in certain instances the journal entry form is sufficient support to validate the cost transfers. What is expected to be submitted as support varies on a case by case basis, and the accounting staff have to use judgment as to what is adequate based on knowledge of departments, amount of journal entry, etc. The institutions apparently do not feel that developing written policies and procedures surrounding this process is important to ensure compliance, transparency, and accountability.

Criteria:
One of COSO's five essential components of an effective internal control system is control activities. COSO defines control activities as policies, procedures, and practices that ensure management objectives are achieved and risk mitigation strategies are carried out. Good internal controls require establishing adequate written policies and procedures to provide for accurate financial reporting, mitigate the risk of loss, and provide clarity of the responsibilities of personnel.

Recommendation:
We recommend the NDUS develop policies and procedures to be included in the Accounting Manual that dictate the responsibility of each initiating department regarding cost transfers, and what is expected from accounting staff when entering and reviewing these transactions.

University System Response/Planned Corrective Actions:
Agree. The NDUSO will work with the campus Controllers to update the NDUS Accounting manual, where feasible, by June 30, 2013.

9. Inadequate Monitoring of PeopleSoft Access Rights – BSC, DCB, DSU, LRSC, MASU, MISU, NDSCS, VCSU, and WSC

Condition:
We obtained and reviewed the access roles and monitoring activities for both the Financial and HRMS Environments of PeopleSoft for all NDUS institutions. We noted several instances where individuals had access to roles that were unnecessary and conflicted with other access roles and/or duties performed.

Effect:
Lack of monitoring an individual's access roles to PeopleSoft increases the risk of misstatement and fraud and increases the risk that too much control rests in one individual's hands knowingly or unknowingly leading to internal control issues surrounding segregation of duties.

If adequate monitoring of access rights does not exist, the following could occur:
- Misappropriation of assets;
- Misstated financial statements;
- Incomplete and inaccurate financial documentation (i.e. errors or irregularities);
- Improper use of funds or modification of data could go undetected.

Cause:
Not understanding the different levels of access in PeopleSoft, and the complexity of segregation of duties and conflicting access roles. Further, not continuously monitoring the levels of access employees have with what access levels are available in the different PeopleSoft environments.

Criteria:
Proper internal controls should provide reasonable assurance that operations are effective and efficient and financial reporting is reliable. An integral part operational effectiveness and efficiency as well as ensuring the reliability of financial information is requiring that proper restrictions on the different levels of access are continuously monitored to ensure the integrity of the data.

Proper internal controls also provide reasonable assurance of compliance with applicable laws and regulations. NDUS Procedure 1912.1 identifies risks and requires coordinators to review procedures, keep current on potential threats, and conduct regular risk assessment and an annual evaluation to ensure ongoing compliance. System access and security is an identify risk in NDUS Procedure 1912.1.

Recommendation:
We recommend:
1. BSC, DCB, DSU, LRSC, MASU, MISU, NDSCS, VCSU, and WSC implement continuous monitoring of roles in both the Financial and HRMS environments of PeopleSoft, to ensure that the proper level of access is granted and/or removed, and to ensure that adequate segregation of duties is achieved.
2. At minimum, a yearly evaluation of all access roles are reviewed and documented.

University System Response/Planned Corrective Actions:
BCS, DCB, DSU, LRSC, MiSU, NDSCS, and VCSU: Agree. These campuses currently perform the review at least annually but will document the review starting in FY13.

MaSU: Agree. We will review the following roles and limit access to individuals to view only access as needed based upon their job duties by June 30, 2013.

WSC: Agree. A review of access rights was completed in November of 2012, which resulted in significant access changes and restrictions. Removal of access rights will be added to the college's list of processes executed when an individual changes roles or leaves the organization. WSC wants to note, similar to many small schools, that we encounter structural difficulty in achieving ideal segregation of duties due to size of staff. Completion date: December 31, 2013.

10. Inadequate Capital Expenditure Fund and Account Codes - NDSU

Condition:
While reviewing NDSU's capital tracking report we ran a trial balance of 682000 (capitalized) accounts and determined that there were $1,399,042 of capital expenditures not included on the report. Additionally, none of the expenditures were recorded in unexpended plant or capital improvement funds.

Per review of NDSU's building improvement detail records, $341,298 of the $1,399,042 should have been reclassified as equipment expense.

Effect:
By not having the proper classification and coding on the general ledger, NDSU's capital tracking is not proper as all capital expenditures are not being reported.

Cause:
It does not appear that NDSU compares or reconciles capitalized expense accounts to the capital tracking report. Per the NDUS accounting manual, NDSU's fund number ranges and ledgers may differ from those in the manual.

Criteria:
One of the integral components of internal control is providing reasonable assurance that financial reporting is reliable. 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 NDSU use proper fund and account codes related to all capital expenditures they are included on the capital tracking report.

University System Response/Planned Corrective Actions:
Agree. NDSU compares the costs only in capital improvement funds to the capital tracking report. This comparison by fund has been a consistent agreed upon standard procedure.

For complete implementation of this recommendation there is a need to resolve a difference of opinion between NDSU & the SAO regarding the accounting for small remodeling projects (between $10,000 and $100,000) and other small capital costs that are charged to operating funds, rather than capital improvement funds. In the past, these costs were charged to an account code called "capitalized repairs". The discontinuation of the "capitalized repairs" code has created confusion about the need to include the applicable costs in the tracking report and perhaps the propriety of using operating funds at all. (These are costs requiring only institutional approval.) NDSU will work with the other institutions, System Office, and SAO to gain agreement on a consistent accounting practice for small remodeling projects and the related capital tracking report by June 30, 2013.

11. Auxiliary Revenue Pledge Disclosure Mistakes – DCB, LRSC, MASU, NDSCS, NDSU, UND, VCSU, and WSC

Condition:
We noted what appear to be errors for the amounts of Auxiliary Revenues Pledged as Security for Revenue Bonds. The most material errors were at the two largest schools, where NDSU and UND had errors of $2,225,455 & $6,866,402, respectively. Lesser errors at the smaller schools ranged from $3,640 at VCSU to $102,605 at WSC. In all, 8 of the 11 schools had errors.

Effect:
Misstated parenthetical disclosures for Auxiliary Revenues Pledged as Security for Revenue Bonds.

Cause:
In our opinion, not much consistency or effort went into these parenthetical disclosures prior to this year. Last year was the first time we addressed this issue and the schools have made progress, but there is more work to do to get the numbers materially correct.

Criteria:
Internal controls should provide reasonable assurance that financial Statement notes and disclosures are properly stated.

Recommendation:
We recommend the NDUS continue working toward materially accurate disclosures for Auxiliary Revenues Pledged as Security for Revenue Bonds.

University System Response/Planned Corrective Actions:
Agree. The NDUSO will work with the various campuses to ensure that the information is accurately presented in the FY13 financial statements.

12. Journal and Interdepartmental Billing Entry Transactions – Improve Descriptions and Add Source Codes – NDSU, NDUSO, and UND

Condition:
We have noted over the years that descriptions for journal entries (JE) are getting shorter and a user of the ledger or a potential reviewer 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, IDB's do not have a specific coding or source code making it difficult if not impossible to identify IDB's and ensuring they are being used solely for interdepartmental transactions.

Effect:
Journal entries contain the best description possible to facilitate understanding by both internal users/approvers and external users.

Journal Entries and IDB's are made with the same source codes and cannot be easily identified as to what type of transaction it is thus clouding the audit trail and increasing the risk of improper transactions.

Cause:
Of the four schools included in the prior informal recommendation (MASU, NDSU, UND and VCSU) and based on a review of JE's posted after 1/1/12, it appears progress has been made regarding the JE descriptors at the two smaller schools (MASU and VCSU). The two larger ones still have a ways to go (which is understandable as it is more difficult to implement on a large campus) so that we might say the descriptors are adequate.

Criteria:
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."

As an example of best practices in the industry, the University of Michigan's policy on JEs states 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 or corrected;
- Where it is being transferred;

- Why the original transaction(s) was incorrect; and
- A reference to applicable supporting documentation.

Recommendation:
We recommend:

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

University System Response/Planned Corrective Actions:
NDSU: Agreed. NDSU is working on some new procedures to assist with improvements in this area. Those procedures are expected to be put in place by June 30, 2013.

UND: Disagree. UND disagrees that the entry can be explained in a 30 character description field. A UND department prepares and approves a journal entry; UND audits the journal entries centrally to verify the what, where and why is either included on the face of the journal entry and/or the attached backup. The time involved in trying to summarize this information in 30 characters or less outweighs the benefit. UND can process approximately 8,000 journal entries annually. In addition, journal entries and all backup are now available online (Image Now).

NDUSO will review this issue through the campus controllers, and adopt a common approach prior to June 30, 2013.

Auditor Concluding Remarks:
We initially made this recommendation in FY11 at which time UND agreed to implement by June 30, 2012.

13. Clarify BHE Policies 830.1 (Student Payment Policy) and 440 (Enrollment Reporting) – NDUSO

Condition:
During our audit we noted the schools were considering a student as being enrolled (proven as enrolled) if they had made any payment toward tuition and fees (at UND it was a minimum of $100), which does not appear to meet the requirements of BHE Policy 830.1. That policy states tuition and fees shall be collected in the first 12 scheduled class days of the term, unless the student meets one of the 7 (a.-g.) exceptions listed in the policy (which doesn't appear to include partial payment).

Conversely, BHE Policy 440 (1.) states in part (and this is what the schools are using to prove enrollment) "Enrolled means the student has registered and paid tuition and fees, made arrangements to pay or a plan for payment is in place; an extension has been granted as provided by Policy 830.1; or the institution has other documentation the student is registered and in attendance, including, documentation of class attendance or student access or use of a learning or management system or other online services on or after the first scheduled class day of the semester."

Therefore, if the student has made any payment toward tuition and fees (at UND-$100) then per the school's enrollment has been proven and collection within the first 12 class days is not considered necessary. We see the principles of "shall be paid in the first 12 scheduled class days" in conflict with schools saying they have proven enrollment because partial payment was received. The BHE needs to determine if that meets its intent and if it does the policies should be altered to clearly state that fact. The opposite is true if it doesn't meet its intent.

Effect:
Schools may or may not be in compliance with BHE policy 830.1. However, due to the ambiguity of the two polices we are unsure if schools are in compliance.

Cause:
In our opinion, it would probably be difficult to try and collect all tuition and fees within the first 12 class days, so the schools took a liberal interpretation of the policies and made it work for them.

Criteria:
BHE Policies 830.1 (Student Payment Policy) & 440 (Enrollment Reporting).

Recommendation:
We recommend the BHE determine if paying a portion of tuition and fees meets the requirements of being enrolled so that these receivables don't have to be collected in the first 12 class days. The Policies (830.1 & 440) need to be edited and clarified to identify if collecting partial payment equates to the student being enrolled, and thereby allowing more than 12 class days for collection by the schools.

University System Response/Planned Corrective Actions:
Agree. The NDUS will review the policies and make changes, as necessary, by August 1, 2013.

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Division of State Audit
at the following address:

Office of the State Auditor
600 East Boulevard Avenue – Department 117
Bismarck, ND 58505-0060
(701) 328-2241

Reports are also available on the internet at:
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