



A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Procedural Review

Apache County

As of February 29, 2012



Debra K. Davenport
Auditor General

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DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

July 17, 2012

Board of Supervisors
Apache County

Ryan N. Patterson, Interim Treasurer
Apache County, Arizona

Delwin Wengert, County Manager
Apache County, Arizona

We have performed a procedural review of the Apache County Treasurer's Office internal controls over the investment of public monies in effect as of February 29, 2012. Our review consisted primarily of inquiries, observations, and selected tests of internal control policies and procedures, accounting records, and related documents. The review was more limited than would be necessary to give an opinion on internal controls. Accordingly, we do not express an opinion on the effectiveness of internal controls or ensure that all deficiencies in internal controls are disclosed.

Specifically, we verified the mathematical calculations of the unrealized and realized investment losses and interest distributions to the pool participants for the period July 1, 2008 through February 29, 2012, and reviewed the County Treasurer's Office investment policies as of February 29, 2012, to determine statutory compliance.

As a result of our review, we noted certain deficiencies in internal controls that the Treasurer's Office should correct to ensure that it fulfills its responsibility to establish and maintain adequate internal controls. Our findings and recommendations concerning these deficiencies are described in the accompanying summary.

Should you have any questions concerning our procedural review, please let us know.

Sincerely,

Debbie Davenport
Auditor General

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INTRODUCTION & BACKGROUND

The Apache County Treasurer's primary responsibility is to manage the public monies the Treasurer's Office holds for the County and its political subdivisions. These political subdivisions consist of school districts, special districts, or other governmental entities residing in Apache County. As of February 29, 2012, the County Treasurer held public monies that totaled approximately \$127.5 million. Much like a bank, the Treasurer must keep accurate records of the County's and the political subdivisions' balances, process the warrants issued by the County and political subdivisions to pay vendors and employees, and prudently invest those monies not immediately needed to pay vendors and employees. In carrying out these responsibilities, the Treasurer must safeguard public monies, promote overall efficiency and effectiveness, and ensure compliance with investment laws specified in state statute.

The scope of our review was limited because the Deputy Treasurer who was primarily responsible for the investment function during the period in review had resigned on April 10, 2012, prior to the commencement of our review on April 27, 2012. In addition, the Apache County Treasurer was suspended of her duties on May 21, 2012. Further, complete investment records were not available for fiscal periods prior to 2009.

The County Treasurer's Office should allocate all investment earnings, gains, losses, and management fees to its investment pool participants

The Apache County Treasurer is responsible for managing and investing public monies of the County and its related political subdivisions. The County Treasurer pools and invests public monies held by the Treasurer's Office. Therefore, the County and the related political subdivisions are participants in the Treasurer's investment pool. The Treasurer's pool functions in a manner similar to a mutual fund, in which public monies are pooled together and invested in instruments or securities like U.S. Treasury bills and bonds. Also, state laws require the Treasurer to maintain accurate balances of each pool participant's accounts and monitor those balances. In addition, the County Treasurer must proportionately allocate pooled investment earnings, gains, losses, and fees to the pool participants. The County Treasurer allocates these distributions based on the participants' average monthly balances.

During the period July 1, 2008 through February 29, 2012, the County Treasurer did not allocate investment gains, losses, and management fees to pool participants. Also, from October 1, 2011 through February 29, 2012, interest earnings were not distributed to pool participants. Additionally, the County Treasurer did not reconcile its account balances monthly to the bank's monthly cash and investment account statements. As a result, the Treasurer's pooled account balances were overstated by approximately \$5.4 million, primarily because the County Treasurer did not allocate investment gains, losses, and management fees to the pooled participants' accounts.

Treasurer's Investment Losses

On September 15, 2008, Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection. At that time, the County Treasurer's investment pool had \$3.1 million invested in Lehman Brothers corporate bonds. Due to the bankruptcy, the chance of recovering the full amount of the investment was unlikely. Therefore, the County Treasurer should have reduced the balances available to each of its pooled participants. As of February 29, 2012, the market value of the County Treasurer's Lehman Brothers investment was estimated at \$824,000, a loss of approximately

\$2.3 million. However, the County Treasurer's investment pool's accounting records continued to value the investment at its \$3.1 million cost. The investment pool should have been written down to reflect the market value of the investment. Additionally, the participants' proportionate shares of the investment should have been identified and moved into a separate account to help proportionately allocate any recoveries received through the bankruptcy process.

In addition to the loss noted above, the County Treasurer incurred a loss of approximately \$1.4 million prior to fiscal year 2009. The loss resulted when the County Treasurer had monies invested in a State Treasurer's investment pool that incurred losses from an investment in bonds issued by National Century Financial Enterprises (NCFE). The State Treasurer informed the County Treasurer of the loss and recommended that the value of the investment be reduced. Based on available records, it appears that the value of the investment was not reduced and the loss was not allocated to participants invested in the County Treasurer's investment pool.

Further, a net loss of approximately \$1.6 million was incurred during fiscal years 2010 through 2012 and resulted from gains, losses, management fees, and interest earnings on various investment securities purchased by the County Treasurer. The value of the County Treasurer's investment pool was not properly adjusted for gains and losses realized when investment securities were sold and for management fees incurred during this period. In addition, interest earnings were not distributed to pool participants from October 1, 2011 through February 29, 2012. The net losses described above are presented in Table 1 below:

Table 1: Unallocated investment losses by fiscal years prior to 2009 through 2012

Fiscal year	Unallocated Lehman loss	Unallocated NCFE loss	Unallocated gains, losses, fees, and interest	Unreconciled differences	Total
Prior to 2009		\$(1,434,891)			\$(1,434,891)
2009	\$(2,348,040)				(2,348,040)
2010			(1,622,620)		(1,622,620)
2011			(434,768)		(434,768)
2012			439,324	\$(906)	438,418
Total	<u>\$(2,348,040)</u>	<u>\$(1,434,891)</u>	<u>\$(1,618,064)</u>	<u>\$(906)</u>	<u>\$(5,401,901)</u>

Source: Auditor General staff analysis of the State Treasurer's records for the period prior to fiscal year 2009 and the County Treasurer's records for fiscal years 2009 through 2012.

Distribution of Investment Losses

In April 2012, the County provided the pool participants with an estimated reduction to their account balances for the investment losses described above. However, the losses have not yet been deducted from each pool participant's accounts. To comply with state statutes, the County Treasurer's Office must correct all errors within its accounting records and notify its pool participants of the final adjustments to their account balances. It is also important to correct these balances to help ensure the pool participants have accurate balances of their deposits with the County Treasurer's Office so participants can properly budget and manage their accounts. Further, the adjusted account balances will help the Board of Supervisors and other taxing authorities accurately assess future tax rates. Lastly, the County Treasurer's Office still needs to investigate the unreconciled difference and determine necessary corrections to its accounting records and pool participants' account balances.

Written Policies and Procedures

The Treasurer's Office has written policies and procedures for its investing activities to help ensure that it complies with state laws. However, the policies were vague and did not include policies and procedures for several key functions, including reconciling cash and investment balances to the monthly bank cash and investment account statements.

Recommendations

To help ensure the accuracy of the County Treasurer account balances and that investment earnings, gains, losses, and management fees are properly allocated to its investment pool participants' accounts, the County Treasurer should develop and implement the following written policies and procedures that include procedures to:

- Record all deposit and investment activities in the accounting records.
- Reconcile pooled and unpooled investment accounts to the bank cash and investment account statements on a monthly basis. Investigate and correct all differences in a timely manner.
- Allocate quarterly all interest earnings, gains, losses, and management fees to pooled investment accounts based on the pool participants' average monthly balances.
- Organize the accounting records so that pooled investment account balances, deposits, and withdrawals can be distinguished from unpooled accounts.
- Separately account for and allocate investment losses to the applicable pooled participants' accounts.

- Notify pool participants of all changes in their account balances, including losses, so they can record the changes in their accounting records.
- Provide the pool participants with both the cost and market value of their account balances at fiscal year-end.
- Separate employees' responsibilities so that no one employee maintains too much control.

The County Treasurer's Office should have procedures in place to properly account for negative account balances

When the Treasurer's Office allocates the unrecorded investment losses totaling \$5.3 million to the individual participants' investment accounts, it may cause some pool participants' accounts to be negative. Many of those accounts will belong to related political subdivisions, such as school districts, special districts, or other governmental entities residing in Apache County. Although the County Treasurer cannot directly loan monies to those political subdivisions, the Treasurer can consider the following options outlined in state laws to help participants pay for lawful claims and obligations if they have insufficient monies:

- Establish a revolving line of credit with the County Treasurer's servicing bank for each political subdivision.
- Establish the ability to register warrants, which are similar to checks, issued by political subdivisions with the County Treasurer's servicing bank.
- Invest in bonds, notes, or other types of indebtedness issued by political subdivisions.

The County Treasurer should maintain accounting records of and agreements for all revolving lines of credit, registered warrants, or investments in debt. Additionally, the County should meet with the pool participants to discuss the options and current account balances.

COUNTY RESPONSE



APACHE COUNTY

P.O. BOX 428
ST. JOHNS, ARIZONA 85936-0428

DIRECT LINE: (928) 337-4364
FACSIMILE: (928) 337-7600

July 17, 2012

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

Dear Ms. Davenport,

The Apache County Treasurer's Office has chosen to respond to the Auditor General's procedural review report dated as of February 29, 2012. This review was performed under the direction and as a request of the Board of Supervisors and our office has begun to implement the following recommendations.

Finding 1: The County Treasurer's Office should allocate all investment earnings, gains, losses, and management fees to its investments pool participants.

Response:

Treasurer's Investment Losses

The Apache County Treasurer's Office, as of January, 2012, has begun the process of reconciling the account balances to the bank's monthly cash and investment account statements for 2012. By means of this reconciliation, the amounts not allocated for investment gains, losses, and management fees to the pooled participants have been identified.

Distribution of Investment Losses

In order to comply with state statute, Apache County Treasurer's Office will correct all errors within the accounting records and notify its pool participants of the final adjustments. The table included in this report will be distributed to the participants along with all recommendations herein provided by the Office of the Auditor General. Moving forward this will allow the pooled participants to be able to properly budget and manage their accounts.

Written Policies and Procedures

As identified by the Office of the Auditor General the current policies are vague and did not include policies and procedures for several key functions, including reconciling cash and investments. The Apache County Treasurer's Office is currently working on these Policies and Procedures in order to meet the recommendation aforementioned.

Recommendations

The Treasurer's Office has reviewed the OAG's recommendations to ensure the accuracy of the account balances and investment pool participants' accounts and is in the process of addressing each item as follows:

1. We have secured a financial management software system and will have it in place by Second Quarter of the fiscal year. At which time deposits and investment activities will be tracked within the accounting records.
2. Reconciling of investment accounts is now being completed.
3. Allocation of interest earning, gains, losses, and management fees to the pooled participants is now being done quarterly.
4. Currently there are no unpooled investment accounts.
5. Along with the release of this report all investment losses are accounted for and allocated to the pooled participants accounts.
6. As noted above, all pool participants are being notified on a quarterly basis of the changes in their account balances so they can change their accounting records.
7. All participants will be given their cost and market value of their account balances at fiscal year-end.
8. At this time employees' responsibilities are being adjusted so that no one employee maintains too much control.

Finding 2: The County Treasurer's Office should have procedures in place to properly account for negative account balances.

Response:

The Treasurer's Office has worked with a couple of the political subdivisions in establishing a revolving line of credit with our servicing bank. We are also researching the establishment of revolving lines of credit for each of the political subdivisions to address any issues they might have with insufficient monies.

