A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Management Letter

Coconino County

Year Ended June 30, 2005

Debra K. Davenport
Auditor General

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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

February 16, 2007

Board of Supervisors
Coconino County
219 East Cherry Avenue
Flagstaff, AZ 86001

Members of the Board:

In planning and conducting our single audit of Coconino County for the year ended June 30, 2005, we performed the following as required by *Government Auditing Standards* (GAS) and Office of Management and Budget (OMB) Circular A-133:

- Considered the County's internal controls over financial reporting,
- Tested its internal controls over major federal programs, and
- Tested its compliance with laws and regulations that could have a direct and material effect on its financial statements and major federal programs.

All audit findings that are required to be reported by GAS and OMB Circular A-133 have been included in the County's Single Audit Reporting Package for the year ended June 30, 2005. In addition, our audit disclosed internal control weaknesses and instances of noncompliance with laws and regulations that do not meet the reporting criteria. Management should correct these deficiencies to ensure that it fulfills its responsibility to establish and maintain adequate internal controls and comply with laws and regulations. Our recommendations are described in the accompanying summary.

In addition, as required by Arizona Revised Statutes §41-1279.21(A)(1), we reviewed the County's financial records to evaluate whether the County used Highway User Revenue Fund monies and any other dedicated state transportation monies solely for authorized transportation purposes for the year ended June 30, 2005. We noted no instances of noncompliance during our review.

This letter is intended solely for the information of the Coconino County Board of Supervisors and is not intended to be and should not be used by anyone other than the specified party. However, this letter is a matter of public record, and its distribution is not limited.

Should you have any questions concerning its contents, please let us know.

Sincerely,

Debbie Davenport
Auditor General

2910 NORTH 44th STREET • SUITE 410 • PHOENIX, ARIZONA 85018 • (602) 553-0333 • FAX (602) 553-0051

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The County should strengthen controls over budget preparation and monitoring process

The County's Board of Supervisors is required to adopt a budget to inform taxpayers how it will spend the monies it receives. Arizona Revised Statutes (A.R.S.) and the County's policies require that the County budget tax-levying funds to a zero ending balance to make sure that only the needed amount of taxes are levied, that amendments to the budget are approved by the Board of Supervisors, and that actual expenditures do not exceed amounts budgeted. However, the County did not follow statutes or its written procedures. For example, the County budgeted for an ending balance of over $2.4 million in the General Fund instead of to zero as required by A.R.S. §42-17151 and several departments' actual expenditures exceeded their budgeted expenditures. Further, the County budgeted nondepartmental contingency expenditures of over $10.5 million, and understated beginning fund balance at July 1, 2004, by approximately $9 million. If the County budgeted accurately and in accordance with statute, it may have reduced the amount of fiscal year 2005 taxes it levied for the General Fund.

To help ensure that the County's adopted budget is accurate, complete, and properly monitored, the County should:

- Budget tax-levying funds to zero ending fund balances as required by A.R.S.
- Use reasonable estimates for all revenue sources, unencumbered balances, and expenditures including a reasonable estimate for contingencies for the General Fund, and make sure that the total equals the total amounts proposed to be spent to ensure that only the needed amount of taxes are levied.
- Require an administrator not responsible for budget preparation to review the budget prior to its adoption to help ensure its accuracy.
- Monitor the adopted budget and obtain the Board of Supervisors' approval to transfer portions of the contingency budget to departments in accordance with A.R.S. §42-17106 to prevent department expenditures from exceeding budget.

The County should improve controls over cash receipts

Because cash is highly susceptible to potential theft or misuse, county management should establish, monitor, and enforce effective controls to safeguard cash receipts at the various departments. However, the County did not have effective controls over cash receipts, totaling over $23 million, annually, for the Community Development, Improvement Districts, Recorder, Special Districts, and Public Works departments. Specifically, the County did not follow the Uniform Accounting Manual for Arizona Counties (UAMAC) policies and procedures for collecting, reconciling, depositing, and recording cash receipts. Specifically, checks were not endorsed when received. Also, one employee received and recorded cash receipts from the mail, prepared the deposits, and prepared the daily cash reconciliations. In addition, undeposited receipts were kept in unlocked and unattended cash registers drawers. Further, cash receipts were not deposited in a timely manner as auditors noted a $115,000 check that was not deposited with the County Treasurer for almost 2 months.

To help strengthen controls over departmental cash receipts, the County should follow the UAMAC policies and procedures for collecting, reconciling, depositing, and recording, cash receipts and periodically monitor that the departments are following them. Specifically, the County should:

- Require employees to restrictively endorse all checks immediately upon receipt.
- Separate responsibilities between employees so that employees with access to cash receipts are not responsible for recording and depositing the receipts. In addition, a supervisor should review the daily reconciliations. If the responsibilities cannot be adequately separated because of small staff size, then a supervisor should review and approve the transactions and related reconciliations.
- Store undeposited receipts in a safe or locked cash register or drawer
- Deposit receipts with the County Treasurer daily, when significant or at least weekly.

The County needs to document and test its disaster recovery plan

The County uses a computerized accounting system to process its financial transactions and maintain its accounting records. Therefore, it is vital for the County to ensure that it can continue to operate in the event of a system or equipment failure by developing, implementing, and testing a disaster recovery plan. A properly designed disaster recovery plan helps ensure that proper procedures are in place to provide for continuity of operations and that electronic data files are not lost in the event of a disaster. However, the County did not have a written disaster recovery plan for processing critical jobs or written backup agreements for systems critical to the County's operations. Without such plans or agreements, financial transactions might not be adequately processed if a disaster occurred. In addition, the County did not monitor access to the computer room and did not store its backup files in a secure off-site location.

To help ensure that the County can provide for the continuity of its operations and to help prevent loss of data in the event of a major system or equipment failure, the County should develop, document, and test a disaster recovery plan. The plan should list the personnel assigned to disaster teams and each team member's emergency phone number; operating procedures; arrangements for a designated physical facility; a risk analysis identifying the critical applications, exposures, and an assessment of the impact on the County; arrangements with vendors to support the needed hardware and software requirements; and any necessary documents and forms. Further, this plan should be stored off-site with the backup files and updated and tested on an annual basis.

To adequately control and safeguard computer hardware, files, and programs, management should monitor access to the computer room and limit access to operators. Access to the computer room can be limited and monitored by using combination entry pads, card-key door locks, surveillance monitors, or intrusion detectors which generate access reports.

The County needs to improve its capital assets reporting

Capital assets, net of accumulated depreciation, represent almost half of the County's total assets. Therefore, it is essential that the County safeguard these assets and accurately report activity related to them to its creditors, the public, and other interested parties. To accomplish this, the County should report capital expenditures in the proper fiscal year, accurately report construction in progress, and identify capital assets as county property. However, the County had not established adequate internal control policies and procedures that would accomplish these objectives. For example, the County recorded over $400,000 of capital expenditures in the wrong fiscal year. In addition, the County overstated construction in progress by approximately $2.4 million since it didn't reclassify projects completed in prior years to appropriate capital asset accounts and capitalized expenditures not meeting the County's capitalization threshold as construction in progress. The County adjusted the financial statements for all significant errors noted by the auditors. Further, donated capital assets were not recorded at estimated fair value at the donation date, and capital assets were not identified as county property.

The following procedures can help the County accurately record its capital assets in its accounting records and report those assets in its financial statements:

- Record expenditures in the fiscal year goods or services are received.

- Have employees perform a detailed review of capital purchases and capital asset donations to ensure that all assets meeting the County's capitalization threshold are accurately recorded and classified on the capital assets list.

- Affix a permanent tag with an identifying number to each equipment item recorded on the capital assets list, or specifically identify the item by some other means, such as a serial number. Tags should be pre-numbered, numerically controlled, and sequentially issued.

- Review all projects listed as construction in progress at year-end and re-classify completed projects to appropriate capital asset accounts.

The County should establish adequate policies and procedures for identifying and disclosing related party transactions

Financial accounting standards require that financial statements include disclosures of material related party transactions. A.R.S. §38-503 deals with conflicts of interest and requires that any public officer or employee who has, or whose relative has, a substantial interest in any contract, sale, purchase, or service to that particular public agency shall disclose that interest and shall refrain from voting upon or participating in that transaction. However, the County did not require all employees having purchasing, spending, or investing authority to file conflict-of-interest statements, and it did not review conflict-of-interest and financial disclosure statements that were filed by county employees and elected officials to identify potential related parties.

To help ensure that related party transactions are properly identified, accounted for, and disclosed, the County should establish policies and procedures to review the conflict-of-interest statements to ascertain and disclose significant related party transactions.

The County should provide complete and accurate information for federal reporting

OMB Circular A-133 §§.300(a) and .310(b) require the County to prepare a Schedule of Expenditures of Federal Awards (SEFA) each year showing the federal programs that the County administered and the corresponding expenditures, related pass-through grantors, and contract numbers. However, the County incorrectly reported expenditures on the SEFA for six programs, reported expenditures for two programs under the wrong CFDA number, and did not accurately identify four program clusters. The County adjusted the SEFA for these errors, which would have caused expenditures to have been overstated by approximately $1.2 million. A similar deficiency was noted in the prior year's Management Letter dated December 30, 2005. The County should establish the necessary procedures to ensure that it administers federal programs and reports federal expenditures in accordance with federal laws and regulations. These procedures should ensure that county departments monitor the federal programs to ensure that program expenditures are properly recorded in the financial accounting system and reported to grantors. Furthermore, county departments should confirm program information reported on the SEFA with supporting documentation, review federal expenditures recorded in its financial accounting system to ensure the amounts reconcile to the amounts reported to grantors, and have a second employee review the information for completeness and accuracy.

COCONINO COUNTY ARIZONA
FINANCE DEPARTMENT

Michael F. Townsend
Director

December 6, 2006

Debbie Davenport
Auditor General
2910 N. 44th Street, Suite 410
Phoenix, AZ. 85018

Dear Ms. Davenport,

Coconino County has chosen to respond to the Management Letter for the fiscal year ended June 30, 2005. Our responses to the Management Letter are below.

Recommendation 1: The County should strengthen controls over its budget preparation and monitoring process.
The County has taken steps to comply with budget preparation requirements and this has been done beginning with the FY2006 budget adoption. Coconino County has considered all available sources when establishing the property tax levy in all years and has levied the appropriate amounts in a responsible and prudent manner that includes many factors and assumptions that are not considered as a part of the annual audit.

- The total revenues received for the fiscal year are correctly reported in the financial statements in accordance with GAAP. However, as these revenues are on an accrual basis there are several million dollars included in the fund balance numbers that represent both the 60 day accrual of tax revenues and grant receivables that do not reflect cash available as of the beginning of the fiscal year.

- As with other Arizona local governments, including counties, there are substantial budgeted amounts in special revenue funds that represent State and Federal grant programs that operate on a reimbursement basis. As a fiscally responsible organization Coconino County has planned for these cash flow needs by planning for sufficient operating and contingency reserves to provide continuous service delivery to the citizens of the County as mandated by state law.

- In the county's effort to follow industry suggested practices in efficient budgeting established by the Government Finance Officers Association, the budgeting process balances the needs of the current year against long-term projections in order to insure sustainable service delivery to avoid deficit shortfalls that could result in severe program reductions and volatile property tax rate variations year-to-year. This allows the County to follow the Going-Concern assumption that is

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one of the primary foundational assumptions of Generally Accepted Accounting Principles.

- One of the purposes of the adopted budget is as a management tool. For the Finance Department to transfer portions of the contingency budget to departments for the sole purpose of preventing them from exceeding their adopted budget is counter to its purpose. During the annual budget process departments will be advised of their responsibility to monitor their budget's and request contingency funds when unanticipated expenditures occur.

Recommendation 2: The County should improve controls over cash receipts.
It is the County's policy to follow the UAMAC policies and procedures regarding cash receipts. The Finance Department reviews this with departments periodically. The County will have these policies formally adopted by the Board of Supervisors to strengthen these controls.

Recommendation 3: The County needs to document and test its disaster recovery plan and provide adequate security for its accounting system.
The County does have a disaster recovery plan, however it has not been documented. The County will document, adopt and test a disaster recovery plan

Recommendation 4: The County needs to improve its capital asset reporting.
The County is working on improving the procedures to ensure that departments process capital expenditures to the correct fiscal year and provide the Finance Department with accurate and timely information on the status of construction in progress. The County currently records donated capital assets at their estimated fair value as of the date of donation.

Recommendation 5: The County should establish adequate policies and procedures for identifying and disclosing related party transactions.
The County will establish policies and procedures for identifying and disclosing related party transactions.

Recommendation 6: The County should provide complete and accurate information for federal reporting.
The County will continue to work with departments to ensure that they follow the County's procedures for monitoring, recording and reporting federal expenditures. The $1.2 million variance was not an error but an agreed upon change in the methodology implemented for determining the expenditures of forest fees

Sincerely,

Michael Townsend
Finance Director