A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Management Letter

Maricopa 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 29, 2008

Board of Supervisors
Maricopa County
301 West Jefferson, Suite 1020
Phoenix, AZ 85003

Members of the Board:

In planning and conducting our single audit of Maricopa 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. Our review identified certain instances of noncompliance, which are described in the accompanying summary as Recommendation 7.

This letter is intended solely for the information of the Maricopa 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,

Dennis L. Mattheisen, CPA
Financial Audit Director

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County Responses

The County must establish accountability for and monitor its accommodation school's financial condition

The Maricopa County Regional School District is an accommodation school district that was established and administered by the Maricopa County School Superintendent pursuant to Arizona Revised Statutes (A.R.S.) §§15-101 and 15-308. As such, the Maricopa County School Superintendent was the sole governing board member having absolute authority over the Maricopa County Regional School District's operations. Accordingly, the Superintendent had a fiduciary responsibility to operate the accommodation school efficiently and within its means. However, over the past several years, the District expended monies in excess of available financial resources and continued to operate in spite of revenue shortfalls, as evidenced by the District's declining financial position. Consequently, the District's Maintenance and Operation (M&O) Fund has accumulated a deficit since fiscal year 2002 of $45,840 to more than $2.7 million in fiscal year 2006. In addition, at June 30, 2006, the District's M&O Fund owed more than $3.3 million to other district funds and the County Treasurer's investment pool.

During fiscal years 2001 through 2003, the County contributed $365,000 annually to the District and $530,000 annually thereafter, although there was no formal agreement between either the County School Superintendent or District and the Board of Supervisors. It was the County School Superintendent's position that the County should have made up for the District's revenue shortfalls. However, the County School Superintendent did not formally request financial assistance from the Board of Supervisors to cover the deficit for any of these fiscal years. Further, the County School Superintendent did not ensure that the District had sufficient monies available before authorizing the District's expenditures and processing its warrants. When the County School Superintendent became aware that anticipated revenues were insufficient to cover the District's operations, the County School Superintendent did not reduce the District's expenditure budget or otherwise ensure that budgeted expenditures were adequately funded. Moreover, future years' budgeted expenditures were not reduced to control spending beyond the District's spendable resources. Since November 30, 2006, the District has been under the governance of a court-appointed, three-member board.

To help ensure that the accommodation school district is fiscally accountable, the County should implement the following procedures:

- Formalize an agreement between the Board of Supervisors and the District, or the County School Superintendent, for any financial assistance to be provided to the District by the County. The agreement should require periodic fiscal reporting from the District and the submission of an annual budget to the Board of Supervisors at the time when all county departments submit their budgets.

- Monitor the District's cash balances and financial activity on a regular basis and process the District's warrants only when there are sufficient monies available.

The County should ensure all accounts and funds administered by the County School Superintendent are budgeted and correctly reported

The County's budget and financial statements serve several essential purposes to ensure good stewardship over public monies. The budget is used to set public policy, control taxing and spending, and serve as a financial planning tool. Statutes require that the County includes in its adopted budget all accounts and funds administered for each county department or official. In its financial statements, the County demonstrates its fiduciary responsibility by accurately reporting its' activities. However, all accounts and funds administered by the County School Superintendent were not included in the County's adopted budget, as required by A.R.S. §§15–1001, 42–17102, and 42–17106. In addition, for one of these funds, the County incorrectly classified the fund as an agency fund in its financial statements.

To help ensure that its adopted budget is accurate and complete and complies with statutes, and that its financial statements are accurate, the County should implement the following policies and procedures:

- Reconcile all county accounts maintained by the Treasurer to the County's general ledger prior to the budget's preparation to ensure that all county accounts and funds administered by each county department or official are included in the adopted budget.

- Ensure that an administrator, who is independent of the budget's preparation, reviews the budget prior to its adoption to ensure inclusion of all accounts and fund's under the County's control.

- Periodically evaluate the activity of all funds maintained on the County's general ledger to ensure they are properly classified and reported in the County's financial statements.

The County needs to improve capital assets reporting

Capital assets represent more than 68 percent of the County's total assets. Therefore, it is essential that the County accurately report these assets to its lenders, the public, and other interested parties. However, the County's internal control policies and procedures did not always ensure that its capital assets were properly identified, reconciled, valued, and reported. Specifically, the County did not correctly identify infrastructure assets that it owned. As a result, the County incorrectly reported flood control infrastructure assets valued at $35 million that had been annexed by other governments. The County also omitted transportation infrastructure assets that it owned valued at $48 million. In addition, the County did not have adequate procedures for identifying, reconciling, and reporting completed construction projects. For example, the County reported a completed project as both construction in progress and infrastructure, and deleted other construction projects that it owned. Further, the County did not always follow its capitalization and accounting policies for construction in progress expenditures or correctly record and value capital asset donations. Finally, the County misclassified various capital assets as a result of system coding errors.

The County adjusted the financial statements for all significant errors and restated the July 1, 2004, balances for land, construction in progress, and infrastructure for errors affecting prior fiscal years. To ensure that the County accurately reports its capital assets, the County should implement the following procedures:

- Develop written policies for county departments to communicate accurate infrastructure and other construction costs to the Finance Department, and ensure that the departments follow the procedures.

- Perform a detailed review of intergovernmental agreements and other supporting documentation for all transportation and flood control construction projects to properly ascertain whether the asset should be reported by the County.

- Compare information recorded in the transportation department's infrastructure database, such as donated assets and other additions, to supporting records to ensure that the cost of these assets are properly recorded.

- Review the detailed records of all projects listed as construction in progress at year-end to identify the correct year projects are completed; record completed projects in the appropriate capital asset accounts; and reconcile completed construction projects to assets that are either reclassified as infrastructure, buildings, and improvements or annexed to other governments.

- Review capital asset deletions to the department's records to ensure that all assets removed from the capital asset lists have been properly disposed of.

- Adhere to existing capital policies, including capitalizing only those expenditures that meet the County's capitalization criteria and thresholds, valuing donated capital assets at the estimated fair market value on the date of donation, and coding capital expenditures to the correct capital asset object codes.

- Require a second employee to review all capital asset information for accuracy.

The Treasurer should ensure that responsibilities over investment transactions are properly separated

The Treasurer is responsible for managing and investing more than $2.5 billion in public monies belonging to the County, school districts, and other special districts in the County. Therefore, it is essential that the Treasurer have internal controls to ensure that those monies are adequately safeguarded against loss, misappropriation, and abuse, and are invested as authorized by the Treasurer's policies. However, the Treasurer did not adequately separate its investing activities. For example, the Treasurer's chief investment officer was responsible for initiating, evaluating, and approving investment transactions with no required independent review. As a result, investments might be purchased that are not authorized by the Treasurer's investment policies or that are not the most advantageous to the Treasurer's investment pool.

To safeguard public monies and help ensure that investments are in accordance with policy and are the most advantageous to the investment pool, the Treasurer should separate responsibilities so that the same employee does not initiate, evaluate, and approve investment transactions. Alternatively, the Treasurer could institute independent reviews over these activities.

The Treasurer's Office officials responded in a letter, dated January 29, 2008, that they do not concur with our recommendations. The response addresses current controls to ensure that the transactions are complete and recorded in the County's records. It also points out that even with the optimum controls, there is the risk that an allowable investment is subject to loss and could decline in value. Our recommendations would enhance controls to ensure that only investments authorized by statute and the Treasurer's policies were made, rather than to ensure that the transactions are recorded properly in the accounting records or attempt to mitigate the risk of loss, which is inherent to some degree with all investments.

The County needs to improve access controls for its information systems

The County uses computerized information systems to process and record its financial transactions. Consequently, the County's information systems are vital to its operations and financial reporting. Therefore, the County needs to ensure the integrity of the financial transactions processed on these systems. However, the County did not have adequate procedures to ensure that the appropriate access was granted to its systems.

Financial systems user access—The County did not have adequate controls in place to ensure that user profiles within the financial system were compatible with employees' job duties. For example, auditors noted 6 Finance Department users and 15 users from various other departments that had multiple profiles allowing them to approve the receivers, requisitions, journal vouchers, payment vouchers, or fixed asset documents that they created. In addition, the County did not have written policies and procedures for all of its computerized accounting systems to prevent unauthorized access. To help ensure the integrity of financial information and to help mitigate the risk of loss caused by misappropriation, theft, or abuse, the County should implement the following policies and procedures:

- Require systems security and department administrators to review all user profiles to ensure the job duties assigned are compatible and properly separated.
- Develop written policies and procedures to prevent unauthorized access. Such procedures should include a formal process of notifying systems network administrators of users who have been transferred to other departments or terminated. In addition, these controls should include account lock-out features or the ability to track access of unauthorized users.
- Promptly revoke users' access upon departmental transfer or termination.

Data center access—The County did not have adequate procedures to restrict and monitor access to the data center by temporary workers, outside vendors, and visitors. Auditors noted the data center doors propped open, outside vendors allowed access without background checks, and an entrance that was secured only by a key lock with no formal monitoring system, such as a log or security camera. In addition, for one of the data center's security systems, the County did not maintain written policies and procedures for the prompt cancellation of data center access for those employees who were either transferred to other departments or whose employment was terminated.

To restrict access to the data center to only those individuals who are authorized, the County should implement appropriate procedures for:

- Restricting and monitoring temporary access to the data center.
- Ensuring all entrances to the data center are physically secured with safeguards, such as card-key door locks, surveillance monitors, and intrusion detectors.
- Promptly modifying access to the data center for transferred or terminated employees.

The County needs to ensure that environmental claims and liabilities related to its landfills are properly reported

The County is obligated by federal and state laws and regulations to perform certain closure and postclosure care for its municipal solid waste landfills. The County must also accurately report these costs and liabilities in its financial statements. However, for fiscal year 2005, the County did not engage or employ an expert to reevaluate the estimated current cost of closure and postclosure care for its landfills and, therefore, may have misstated this liability and related note disclosures in its financial statements. In addition, the County needs improved procedures to evaluate and report the liability for potential claims against the County for remediation of environmental pollution. County-employed specialists prepare a yearly report on the County's exposure to all environmental claims; however, for fiscal year 2005, the County did not fully use the report to assess the amount of pollution remediation liabilities for specific landfills to report in its financial statements. As a result, the County's environmental claims liability was potentially understated by $2.4 million.

To ensure that environmental claims and liabilities associated with its municipal solid waste landfills are properly reported and disclosed, the County should:

- Annually reevaluate the estimated current cost of closure and postclosure costs for all of its landfills. This evaluation should be performed by a certified specialist or specialists with expertise on municipal solid waste landfills and should be adjusted for the effects of inflation or deflation, as well as changes in operating conditions.
- Report the total costs and liabilities for pollution remediation as assessed by specialists in its financial statements.

- Identify all specialists used to evaluate all environmental liabilities to the auditors, and provide them with adequate documentation to support the assessment of the liabilities and the methods and assumptions used for calculation.

The County should spend highway user and vehicle license tax monies in accordance with state laws

Each year, the State distributes Highway User Revenue Fund (HURF) monies and a portion of the vehicle license tax (VLT) monies to the County pursuant to a mandate that the County use these monies solely for highway and street purposes, as specified in Article IX, §14, of the Arizona Constitution and A.R.S. §§28-5801(B)(1)(c) and (2)(c), and 28-5808(A)(2)(b) and (B)(2)(b). The County received $98 million in HURF and VLT monies in fiscal year 2005. The County's Transportation Department operates primarily from these monies. Based on the Constitution, laws, and Attorney General Opinion No. I05-003, auditors noted the following expenditures that appeared to be unallowable charges:

Description	Amount
General and automobile liability premiums	$1,382,278
Salaries and supplies for improvement districts	115,853
Parade floats	1,054
Leadership conferences	149
Catered food and staff retreat	3,774
Employee recognition plaques	262

Liability premiums represent 92 percent of the questionable expenditures. The Attorney General Opinion specifically states that HURF monies may not be used to pay premiums related to liability for personal injury judgments. County officials have indicated that they do not agree with this opinion. However, our determination in this matter is based on the Attorney General opinion.

The County should strengthen its policies and procedures to ensure that HURF and restricted VLT monies are spent in accordance with the Arizona Constitution and A.R.S., and ensure that its transportation department follows these policies and procedures. Written policies should clearly identify the types of expenditures that are allowable and unallowable. In addition, management should review and approve expenditures to ensure that all expenditures charged to HURF and restricted VLT monies are only for allowable charges. Finally, the County should allocate local revenues to restore the monies it spent inappropriately during fiscal year 2005.

The County needs to implement previously reported recommendations

We have reported to the County certain deficiencies noted during our previous audits that should be corrected to improve county operations. However, the County has not implemented the recommendations to correct these deficiencies. Our Office reported detailed descriptions of these deficiencies and the related recommendations in our prior years' Management Letters.

Related party transactions—Financial accounting standards require that financial statements include disclosures of material related party transactions. The County's procurement policies require anyone with a potential conflict of interest to inform appropriate county management. Although the County's policy is consistent with A.R.S. §38-503 regarding conflicts of interest, it does not provide procedures to identify, account for, and report related party transactions. The County should require all public officers and employees having purchasing, spending, or investing authority to file conflict-of-interest statements, and review all conflict-of-interest and financial disclosure statements that were filed by county employees and elected officials to identify potential related-party transactions and disclose them if appropriate.

Information systems disaster recovery—The County has not established disaster recovery plans and written backup agreements for its payroll and Treasurer's information systems critical to the County's operations. Without such plans or agreements, financial transactions might not be adequately processed or successfully recovered if a disaster occurred.

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 lacked detailed written policies and procedures to provide guidance to the departments for collecting, recording, reconciling, and depositing cash receipts. To help strengthen controls over departmental cash receipts, the County should establish written procedures for collecting, recording, reconciling, and depositing cash receipts and periodically monitor that departments are following them.

Procurement Cards—The County uses three different types of procurement cards (p-cards)—purchasing, fuel, and travel. There are specific restrictions as to the types and expenditure amounts that can be made with each p-card type. However, county policies were not always followed. Auditors noted that approvals for p-card expenditures were not always documented or made before the p-card payment. Furthermore, while certain p-card purchases, such as gift cards to employees, are allowable as incentives under the County's Employee Compensation Plan, the County does not have written policies and procedures providing guidance for departments to properly implement an employee incentive program using p-cards.

As p-card purchases are susceptible to potential misuse, the County should ensure that all departments are following established p-card policies. These policies should also provide guidance for purchases for employee incentive programs.

Maricopa County
Department of Finance

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February 7, 2008

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

Dear Ms. Davenport:

Maricopa County values the input and recommendations from the Office of the Auditor General, as discussed within the June 30, 2005, Management Letter. Prior to the issuance of the Management Letter, the County on its own accord implemented several recommendations that include in part; monitoring the Regional School District's cash balances and financial activity, working with various departments to improve infrastructure and capital asset reporting, and using a specialist to evaluate the current cost of closure and post closure costs for landfills. In fiscal year 2007, the County budgeted the School Superintendent funds. The County believes that the budget preparation and general ledger account maintenance is currently sufficient to properly account for the financial activity of the County.

Although the County has historically provided a detailed response to each recommendation, the County has decided to provide only a summary response to the June 30, 2005, Management Letter as shown in the above paragraph. The County is currently undergoing the fiscal year 2007 audits; therefore, the County is focusing its attention to the timely completion of those audits. In the future, the County will be providing a detailed response to the Management Letters. As previously stated, the County values the recommendations of the Office of the Auditor General and the County continually reviews and implements many of their recommendations.

The Maricopa County Treasurer's Office has responded to Recommendation 4 which is provided on the following page.

If you have any questions or comments, please contact me at (602) 506-1367.

Shelby L. Scharbach
Deputy Finance Director

Maricopa County
Treasurer

Charles "Hos" Hoskins, Treasurer
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January 29, 2008

Ms. Kathleen Wood
State of Arizona, Office of the Auditor General
2910 N. 44th Street, Suite 410
Phoenix, AZ 85018

RE: Audit Finding Regarding Maricopa County Treasurer

Dear Ms. Wood:

We have reviewed your audit finding for the Maricopa County Treasurer's Office, to be included in the audit for Maricopa County. We still do not concur with your conclusions.

The investment functions are properly segregated to protect the pool participants from loss due to unauthorized use, damage, or modification of investments. The investment office operates directly under the authorization of the County Treasurer, who is solely responsible for the investments of the investment pool per ARS § 35-323(A). The Maricopa County Treasurer established the limits of the investments as outlined by ARS § 35-323 and the investment officer purchases said investments according to those directions. Any investment outside the defined parameters (such as registered warrants) are reviewed and discussed by the Treasurer, Chief Deputy, Investment Officer and the Accounting Manager to insure that the investment is safe and secure.

The investment officer purchases the investments as instructed and records the details of the transactions on the investment system that was designed for his use. He records the nature and details of the investment transactions. The details are then submitted electronically to accounting for verification

The accounting group will print a copy of the investment summary and match the detailed information provided by the bank's daily transaction report (an independent source) daily. The investments purchased, matured, sold, and any related interest received, are verified. The net cash is then matched to the bank statement to insure that the total dollars transacted match the reported investment transactions. Any questions are reported to the accounting manager or supervisor for research and resolution.

Upon verification of the details with the cash deposited or expended, the electronic data is released and posted to the accounting general ledger and to the treasurer's receipt system. The investment officer does not have the ability to modify or reverse the posted transactions on the accounting database.

Monthly, the accounting department will reconcile the bank safekeeping record, the investment officer's portfolio and the accounting investment funds to insure that all items are in agreement. The reconciliation is reviewed by the accounting manager. Any exceptions are reported to the accounting manager.

The process has three sources to verify the transactions to insure proper accounting and protection of the investment dollars.

The audit finding concludes that investments "might" be purchased to the disadvantage of the investment pool. The use of this term points out the speculative nature of this finding. In point of fact, there is no evidence of any of the deleterious events suggested by the audit of ever having occurred.

Additionally, the recommendation of multiple parties reviewing the same transaction does not prevent these unfortunate speculations from occurring. For example, the State Treasurer has a much larger investment staff. They have the redundancies suggested by your finding in place. Additionally, the Treasurer maintained an Advisory Committee in addition to its own staff. Nevertheless, in 2001, the State Treasurer invested $131 million from the Local Government Investment Pool ("LGIP") in National Century Financial Enterprises ("NCFE"). This investment was in commercial paper, which is permitted by statute. In 2002, NCFE became defunct. All of the participants in the LGIP lost money. Although there has been some recapture of these dollars, the magnitude of the loss remains severe. Several cities have moved their money from the LGIP and have chosen to invest on their own. The Maricopa County Treasurer, with its investment manager, and without the redundancies suggested on every transaction, did not invest in NCFE and did not lose one dollar of public money.

This is fact, not conjecture. Implementing the suggestions of the audit does not provide a guarantee that bad investments won't be made. Competent, conservative investment managers are the best defense against a loss. We believe the primary job of the Treasurer is to protect principal, with the secondary goal to maximize profits.

Sincerely,

Steve Partridge
Chief Deputy Treasurer