

# Donald R Reynolds

Certified Public Accountant

## MANAGEMENT LETTER

Board of Supervisors  
County of Humboldt  
Eureka, CA

In planning and performing my audit of the financial statements of the County of Humboldt for the year ended June 30, 2009, I considered the County of Humboldt's internal control structure in order to determine my audit procedures for the purpose of expressing an opinion on the financial statements but not provide assurance on the internal control structure.

During my audit I noted certain matters involving the internal control structure that I consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to my attention relating to significant deficiencies in the design or operation of the internal control structure that, in my judgment, could affect the County of Humboldt's ability to record, process, summarize, and report the financial data consistent with the assertions of management in the financial statements.

### PRIOR YEAR RECOMMENDATIONS

#### *Fund Balance Reconciliation*

**Recommendation:** I recommended that the County reconcile fund balance amounts to the prior year audited balances on a monthly basis. The County continues to have unreconciled fund balances.

**County Response:** The County of Humboldt has 570 separate funds in its general ledger. Doing a complete monthly reconciliation on all of these funds is not possible with our current level of staffing. We do reconcile cash in the funds per the general ledger to the Treasurer's cash records on a monthly basis but this does not cover all the balance sheet accounts in each fund. At present we reconcile all the balance sheet accounts for the main County funds annually and other funds as time allows. We concur that internal controls would be greatly enhanced by doing more frequent reconciliations of all the accounts in each fund. We will continue to work towards that desirable goal.

#### *Written Accounting, Administrative and Fraud Policies Manual*

**Recommendation:** I recommended that the County develop and maintain an up-to-date accounting, fraud prevention, purchasing and administrative policies and procedures manual.

**County Response:** A good deal of accounting and administrative guidance is present on the County's intranet website but we do not as yet have a single manual tying all this guidance together. This remains a work in progress with no definite completion date in sight. As an

interim measure we will post a link to the State Controller's Accounting Standards and Procedures Manual for Counties on our intranet site for reference by employees ([http://www.sco.ca.gov/Files-ARD/manual\\_cntyman.pdf](http://www.sco.ca.gov/Files-ARD/manual_cntyman.pdf)).

### **Electronic Payments and Transfers**

**Recommendation:** I recommended that the County develop written policies and procedures regarding electronic payments and transfers. I recommended that wire transfers and electronic payments be approved by two check signers prior to transfer.

**County Response:** Auditor and Treasurer staff developed a new form for wire transfers and we are in the process of finalizing procedures and sending them out to departments.

### **Petty Cash**

**Recommendation:** I recommended the County develop and follow written procedures for all petty cash funds.

**County Response:** We concur with the recommendation and are finalizing written procedures for petty cash funds. Once finalized, we will post them on the County's intranet site.

### **Receivable and Payable Reconciliations**

**Recommendation:** I recommended that the receivable reports and vouchers payable detail be reconciled to the general ledger on a monthly basis.

**County Response:** This recommendation is actually the same as the fund balance reconciliation recommendation. We do not have enough staff to reconcile every balance sheet account in each of the 570 funds every month. We reconcile cash monthly and all of the accounts for the main County funds annually.

### **Federal and State Grants**

**Recommendation:** I recommended that the County track federal and state grant revenue and expenditures by grant number.

**County Response:** Currently we do not have a system in place that will allow us to track federal and state revenues and expenditures by grant number. While we believe that current processes in place in individual departments are working well for most grant administration activities, we are committed to implementing a centralized grant-tracking database. We are in the process of evaluating software options for doing this.

### **Financial Management Education for Public Officials**

**Recommendation:** I recommended that the County consider providing public officials with financial management training on an annual basis. This recommendation is very important in the light of the lack of financial oversight observed this year.

**County Response:** We did have some training on accounting principles earlier in the year attended by departmental staff. The County's elected and appointed department heads and management staff assume a number of duties that are passed off to other employees in organizations with greater staffing levels, but will endeavor to improve their financial education as their time and resources permit. The County is committed to making financial education tools available.

### **General Journal Entries**

**Recommendation:** I recommended that the Board of Supervisors make every effort to assist the Auditor-Controller's office in maintaining staffing levels which allow for the orderly and timely completion of their assigned tasks.

**County Response:** We agree that additional staffing in the Auditor-Controller's office would strengthen the County's internal control and efficiency but think it unlikely that our Board would approve new positions during this time of economic distress.

### **Auditor Independence**

**Recommendation:** During my 2007-2008 test work on compliance in the Headwaters Mitigation Fund I noted that the County's contract with the Arcata Economic Development Corporation (AEDC) requires that the AEDC have an annual audit performed by an independent certified public accountant. In reviewing loan applications at the AEDC, I noted that AEDC's independent auditor was in the process of applying for an economic development loan from the County and AEDC during the auditor's fieldwork. A check representing the loan proceeds was eventually prepared, but never cashed. The standards related to auditor independence do not allow for material financial transactions between an auditor and auditee.

**County Response:** The County requested that the State Board of Accountancy investigate the alleged violation of auditor independence. The Board of Accountancy responded that they found no impairment of independence. The County is currently seeking clarification on the Board's response as the County feels that the loan does not meet the exemptions under the independence standards of the American Institute of Certified Public Accountants.

In 2009, the State Board of Accountancy conducted an investigation of the allegation and found no impairment of independence.

### **Sub-recipient Monitoring**

**Recommendation:** I noted during my 2007-2008 audit that the County does not exercise adequate sub recipient monitoring of the AEDC. The AEDC does not provide the County an adequate accounting for the collections on economic development loans by the County and AEDC. I found the AEDC to be uncooperative and unresponsive when asked for documentation regarding loan activities. I was unable to determine if the County received loan repayments promptly, if the correct amounts were being remitted and what cash was on hand at AEDC that belonged to the County. This issue was cited in the 2006-2007 management letter and I noted a deteriorated situation again in 2007-2008.

I recommended in 2007-2008, that the County suspend activities with AEDC until AEDC and the County can implement better controls over loan reporting.

The independent auditors of AEDC found significant deficiencies in internal controls at AEDC for the year ended June 30, 2009. Based on prior AEDC audits, the internal controls at AEDC appear to have deteriorated during this most recent fiscal year. In addition, it was represented to us that AEDC did hold cash advances from the County in excess of normal business requirements.

The County did have AEDC address the reporting requirements in the 2008-09 year. AEDC has improved the monthly loan information provided to the County.

The requirements for lending are stipulated in the Headwaters Revolving Loan Fund Manual (Manual). The Manual specifies the duties and responsibilities of the County and AEDC. I was able to test the County's responsibilities under the Manual and any AEDC responsibilities that were documented in County files. I was unable to verify many of AEDC's compliance requirements. This verification is normally a responsibility of the County and is permitted under the Manual. The County may rely on AEDC's independent auditor for auditing AEDC's compliance with the Manual, but AEDC does not maintain any separate account balances pertaining to the County's funds and the independent auditor does not typically audit trust and agency transactions or compliance with trust and agency contracts.

The County is attempting to release another \$1,500,000 in loans through AEDC. This effort is being held up by the County Administrative Office and the Auditor-Controller over concerns about internal controls at AEDC. AEDC has indicated that they are willing to adopt any policies and procedures necessary to continue to participate in the Revolving Loan Program.

I recommend that the County engage an independent CPA firm to perform an agreed-upon procedures engagement on AEDC. The procedures to be examined will relate primarily to AEDC's compliance with the Manual. I also recommend that the County require AEDC to set up a separate bank account and general ledger account to record County cash advances, loan disbursements and loan collections and allow the County to independently review account activity.

**County Response:** The County has engaged a CPA firm to conduct an agreed-upon procedures engagement on AEDC. The recommendation that we develop policies requiring adequate collateral for economic development loans is in the process of being implemented. We are developing new contracts for the economic development agencies that will define specific parameters for these attributes.

### **Management Override**

**Recommendation:** I recommended that the County Administrative Officer and the Board implement a training program with elected officials on internal controls and accountability and this type of activity cease immediately.

**County Response:** Direct access to unbudgeted trust funds by County departments has been halted. A budget unit specifically to control the Treasury-related funds in question has been established.

### Cash Overdrafts

**Recommendation:** I recommended that the County develop policies on this type of borrowing which include signed notes and collateral. Many of these governments have little collateral and the loans of this type may never be repaid.

**County Response:** The County no longer permits this practice.

### Decentralization

**Recommendation:** I recommended that the Auditor-Controller and Health and Human Services work together in developing stronger controls County-wide. I recommend that the Auditor-Controller's office provide the leadership and consider adding an internal auditor to the staff.

**County Response:** The Auditor-Controller's office has improved its accounting and auditing ties with the Department of Health and Human Services. DHHS staff is being integrated into the audit process at an earlier stage and with a higher degree of involvement. We agree that an internal auditor in the Auditor-Controller's office would strengthen the County's system of internal control but consider funding for such a position unlikely until the general economic situation improves.

### Audit Committee

**Recommendation:** I recommend that an audit committee be formed.

**County Response:** The County has formed an "audit working group" to perform an advisory function similar to that of an audit committee. The group consists of staff from the Auditor-Controller's office, the Treasurer Tax Collector, CAO, DHHS, Public Works and Information Technology. The group has met twice so far during this audit cycle.

## CURRENT YEAR RECOMMENDATIONS

### Budgeting in Headwaters Fund

The Board of Supervisors is required to approve an annual budget for the Headwaters Fund (HWF) each year according to HWF policy. A partial budget is prepared of administrative expenses only. No budget to actual presentation is made in the County's financial statements as required by generally accepted accounting principles because the required budget is not being prepared. County staff considers the Board's approval of grants during the year to be the equivalent of the use of a full budget. We recommend that either a full budget be prepared and approved by the Board or the HWF policies be changed to reflect the current process.

### County Response

We are working with Headwaters staff to explore the feasibility of budgeting those accounts.

### *Year End Accruals*

In our test work on accounts payable and accounts receivable we noted a lack of consistency in the accruals as well as errors in the balances. In certain cases, the documentation to support the accounts receivable accruals submitted by the departments was insufficient in that no review by the Auditor-Controller could be completed prior to posting. Accounts payable required audit adjustments in excess of \$660,000 for accrual errors.

I recognize the difficulty in trying to train and coordinate all the departments to identify and correctly document accounts receivable and accounts payable at year end. I am recommending that the Auditor-Controller provide the necessary procedures to insure that year end accruals are correct. Since ultimate responsibility for the accuracy of the account balances is with the Auditor-Controller, steps to increase the review of documents to insure complete and accurate accruals needs to take place.

### *County Response*

We agree that the accuracy of year-end accruals and their review by the Auditor-Controller has suffered in recent years. This is due to inadequate staffing of management-level accounting positions caused by retirements and personnel transfers. Given the County's current budget situation, increased staffing at these levels is unlikely for the immediate future. We are considering options for contracting with outside accountants as a short-term measure to improve the accuracy of the year-end accruals and closure of the books.

### *Reporting and Budgets*

Generally accepted accounting principles require the recognition of an expenditure when the goods and or services have been provided regardless of when the goods or services were ordered. However, many departments prefer that an expenditure be recognized as soon as a commitment is made to purchase from a vendor in order to compare budget and actual. The department does this to avoid going over budget. The needs of a department for certain reporting information may be different than the requirements imposed in financial reporting on the Auditor-Controller.

Many counties prepare annual budgets and also keep the actual interim records on a budgetary basis. This enables departments to compare budget and actual using the same basis of accounting. An expenditure would be charged when a commitment is made regardless of delivery. The Auditor-Controller would then make the necessary adjustments to the balances for financial statement purposes.

I am recommending that the County report interim information on a budgetary basis uniformly throughout the County. The Auditor-Controller can these make the necessary year-end adjustments for financial reporting purposes.

### **County Response**

We intend to enforce the June 30th shipping deadline for expenditures to be booked to FY 2009-10. Departments will be held responsible for making sure they are within budget without resorting to the practice of booking expenditures in order to create encumbrances of budgetary resources.

### **Cash on Hand**

During our test work we noted that fees paid by the public for building permits and other fees collected for construction were remitted by Community Services for deposit on a monthly basis. In certain months the Department had hundreds of thousands of dollars stored in a safe awaiting a monthly deposit. The Treasurer is currently working with the Department to arrange for more timely deposits.

### **County Response**

We agree that Community Services Department's infrequent deposits were a bad practice and now require the Department to make their deposits in a timely manner.

### **Community Services Transactions**

Community Services recently implemented a new software program to track the building permit process. The software maintains information on the permit as well as calculating fees and generating receipts on the collection of fees. During our review of the software we noted that the software generates receipts even when no fees have actually been paid. The software has no efficient way of determining the final disposition of sequentially numbered receipts and voids. Good internal controls require the accounting for all receipts including voids. The County has already started the process to address these deficiencies.

### **County Response**

We are working with the Community Services Department to develop a system that will meet their project tracking needs while also providing an appropriate audit trail for fees and receipts.

### **Annual Closing Process**

The County failed to accrue \$ 1,548,608 in interest receivable on the accounting records at June 30, 2009. This accrual is part of the annual closing process done in the Auditor-Controller's Office. The Auditor-Controller's Office needs to establish quality control measures to prevent an incomplete closing.

### **County Response**

The County's accounting system doesn't allow posting interest for any quarter until all transactions are settled and the general ledger for that period is closed. Then some weeks elapse while the allocation of interest is calculated (based on average daily fund balances) and various final adjustments are made. Approximately two-thirds of the money held in the treasury pool is held for

outside agencies like schools, cities and local districts. The County believes that an estimate of how much interest revenue should be accrued to County accounts for June 30 would be subject to great variance and uncertainty prior to all these steps having been completed. The County has historically booked the April-June interest as of July 1 of each year. The County feels that there are really no reasonable alternatives to the booking the interest on the first day of the following quarter. The County feels that the interest accrual will have to remain an audit only adjustment rather than a GL entry for the foreseeable future.

### **Payroll Accrual**

The County currently accrues payroll at June 30 of each year at one-fourteenth of one payroll in anticipation of having twenty-seven payroll periods every fourteenth year. This accrual prevents the recognition of an extra payroll every fourteen years. This method is used for budgeting purposes but is not a generally accepted accounting method for financial statement purposes. The County did prepare audit only adjustments totaling \$1,818,986 to report accrued wages under generally accepted accounting principles. I recommend that the County record an audit only adjustment each year to report accrued wages under generally accepted accounting principles.

### **County Response**

The County will review this recommendation.

### **Capital Assets**

Because of a defect in the software program in the most recent IFAS update, the accounting system will no longer produce any capital asset reports that agree with the general ledger. I understand that this problem will exist until a correcting software update is issued sometime after June, 2010. I recommend that the County manually reconcile the capital assets detail to the general ledger until this software defect is corrected.

### **County Response**

We concur with the finding and will continue our current practice of manual reconciliation of fixed assets until such time as our software systems can be reprogrammed to perform this task in a reliably automated manner. We hope to have this system fully functional before the next annual reconciliation.

### **Pharmacy Inventory**

During my review and observations on pharmacy inventory I noted that no perpetual inventory system is used in the central pharmacy. It appears that only periodic counts are taken. Most of the drugs in the inventory have a demand on the "street". I recommend that the County establish a perpetual inventory system at the central pharmacy.

County Response

DHHS Public Health Branch procures medical supplies and pharmaceutical items from wholesale suppliers for the services rendered in Sempervirens, County Jail, Regional Center-Juvenile Hall and the Public Health Branch Clinic. The pharmaceutical and medical items in all four locations are locked with access granted to only a limited number of staff and inventories are counted on a regular basis. We will consider the implementation of a perpetual inventory system as funds for additional staff time and IT resources become available. DHHS will continue to monitor staff interaction with the pharmaceutical inventory through internal audits, inventory reconciliation through item cost and shipment monitoring, and staff management.

This letter is solely intended for the information and use of the Board of Supervisors, management, others within the County, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.



Donald R. Reynolds,  
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March 30, 2010