

COUNTY OF HUMBOLDT

**Management Report
with Required Communication**

For the Year Ended June 30, 2011

COUNTY OF HUMBOLDT

Management Report
For the Year Ended June 30, 2011

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To the Honorable Members of the
Board of Supervisors of the County of Humboldt
Eureka, California

We have audited the financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the County of Humboldt (County) for the year ended June 30, 2011. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, *Government Auditing Standards* and OMB Circular A-133, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our engagement letter dated January 23, 2012. Professional standards also require that we communicate to you the following information related to our audit as discussed in the Required Communications section of this report.

In planning and performing our audit of the basic financial statements of the County for the fiscal year ended June 30, 2011, in accordance with auditing standards generally accepted in the United States of America, we considered its internal control over financial reporting as a basis for designing our audit procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the County's internal control. Accordingly, we do not express an opinion on the effectiveness of the County's internal control.

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 entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls.

Honorable Members of the Board of Supervisors
County of Humboldt

We previously reported on the County's internal control in our Single Audit report dated March 29, 2012, which contains our report on significant deficiencies and material weaknesses in the County's internal control. This letter does not affect our report dated March 29, 2012, on the basic financial statements of the County of Humboldt.

During our audit we also became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and suggestions regarding those matters.

This report is intended for the use of management, the Board of Supervisors, and officials of the federal and state grantor agencies.

We thank the County's staff for its cooperation during our audit.

A handwritten signature in cursive script that reads "Gallina LLP".

Roseville, California
March 29, 2012

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Our Responsibilities under U.S. Generally Accepted Auditing Standards and OMB Circular A-133

As stated in our engagement letter dated January 23, 2012, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute assurance that the financial statements are free of material misstatement and are fairly presented in accordance with U.S. generally accepted accounting principles and to express opinions based on the assurance obtained. Because an audit is designed to provide reasonable, but not absolute assurance, and because we did not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us. Our audit of the financial statements does not relieve you or management of your responsibilities.

In planning and performing our audit, we considered the County's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with U.S. Office of Management and Budget (OMB) Circular A-133.

As part of obtaining reasonable assurance about whether the County's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, 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. Also, in accordance with OMB Circular A-133, we examined, on a test basis, evidence about the County's compliance with the types of compliance requirements described in the OMB Circular A-133 Compliance Supplement that could have a direct and material effect on each of the County's major federal programs for the purpose of expressing an opinion on the County's compliance with those requirements. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination on the County's compliance with those requirements.

Planned Scope of Audit

We performed the audit according to the planned scope and timing previously communicated to you in our engagement letter dated January 23, 2012.

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Significant Accounting Policies

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the County are described in Note 1 to the financial statements.

As described in Note 1 to the financial statements, the County adopted Governmental Accounting Standards Board Statement No. 54 (GASB 54), *Fund Balance Reporting and Governmental Fund Type Definitions*. GASB 54 established new accounting and reporting standards for all governments that report governmental funds. The statement provides more clearly defined categories within fund balance to make the nature and extent of the constraints placed on fund balance more transparent.

Other than GASB 54 as described in the preceding paragraph, no new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2011. We noted no transactions entered into by the County during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Significant Accounting 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 estimate(s) affecting the financial statements are discussed below:

- Management believes receivables are fully collectible based on historical experience. Accordingly, no allowance for doubtful accounts is included in the financial statements.
- Management's estimate of risk liabilities and liabilities related to other postemployment benefits (OPEB) is based on either actuarially-determined projections prepared by outside specialists using experiential data gathered over the last several years.

We evaluated the key factors and assumptions used to develop these estimates in determining that they were reasonable in relation to the financial statements taken as a whole.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

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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. Management has corrected all such misstatements. The following material adjustments detected as a result of audit procedures were corrected by management:

- Adjust receivables by \$2.5 million for subsequent receipts not properly accrued by County
- Various reclassifications to properly report interfund loans and transfers involving the Headwaters and CDBG Funds administered by Economic Development.
- Various significant adjustments to proprietary fund capital asset balances and related activity to accounting records.

The County agreed to record all of these adjustments to the June 30, 2011 audit report.

Immaterial Misstatements Not Corrected by Management

Management passed on the following adjustments:

- Adjustment to total pooled cash to account for the fair value of the County's investments at June 30, 2011.
- Adjustment to interest earnings accounts due to the County posting the 4th quarter interest apportionment in the subsequent year.
- Adjustment to accrued salaries to properly account for all working days within the accounting period

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter 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.

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Management Representations

We have requested certain representations from management that are included in the management representation letter dated March 29, 2012.

Management Consultations with Other Independent Auditors

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.

Other Supplementary Information Accompanying the Audited Financial Statements

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or the financial statements themselves.

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Management Report – Current Year Comments and Recommendations For the Year Ended June 30, 2011

DISAGGREGATION OF RECEIVABLES

Criteria

Governmental Accounting Standards Board Statement No. 38, *Certain Financial Statement Disclosures*, requires components of significant receivables to be disclosed in the financial statements. Components of receivables include accounts receivable (due from citizens), taxes (property, sales taxes, transient occupancy) receivable, interest receivable, amounts due from other governments and notes receivable.

Condition

Currently, the County records accounts receivable, taxes receivable and due from other governments within the same receivable account within its general ledger. The County's chart of accounts does not currently have separate accounts for the various types of receivables.

Cause

The County's chart of accounts does not currently have separate accounts for the various types of receivables.

Effect of Condition

By not properly classifying receivables in its general ledger, the County is relying on external spreadsheets to ensure receivables are properly disclosed for financial reporting.

Recommendation

We recommend the County modify its chart of accounts to include separate accounts for accounts receivable, loans receivable, interfund advances (and payables) and amounts due from other governments. Year-end closing procedures should be modified to capture receivable balances into each of these accounts according to their nature.

Management Response

We agree that disaggregation of receivables will aid in accounting for these assets and will establish new accounts and accounting procedures to accomplish that.

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GOVERNMENTAL TRUST FUNDS

Criteria

Under Governmental Accounting Standards Board Statement No. 34 (GASB 34), amounts formally held in trust but used to support the County's own programs should be reported as funds within the County's reporting entity so as to ensure all economic resources that can be used by the County are reported in their financial statements. Activity in these accounts is required to be included in the County's reporting entity, either as additional funds or transactions in existing county funds.

Use of the agency fund type is limited to resources the County holds purely in a custodial capacity for individuals or other organizations, such as school districts and special districts not governed by the County Board of Supervisors.

Condition

The County is currently maintaining more than 150 governmental trust funds to track activity benefitting the General Fund and other primary operating funds of the County.

Cause

Before GASB 34 took effect, the County's current treatment was permitted. Although reporting requirements have changed, the County still has a need to account for these resources separately from other general fund resources.

Effect of Condition

By excluding transaction activity in these funds, balances for revenues and expenses in the County's own financial reports (including budgetary reports) are not complete.

There is the potential to double-report revenues when resources are transferred into operating funds. Using multiple funds within the accounting system to control the flow of revenues increases the potential for reporting revenues twice.

As the County does not budget for any activity occurring in these governmental trust funds, any deviations from the adopted budget are not apparent until well after the end of the fiscal year and thus cannot be addressed when they occur.

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Management Report – Current Year Comments and Recommendations For the Year Ended June 30, 2011

GOVERNMENTAL TRUST FUNDS (continued)

Recommendation

We recommend the County analyze each of its governmental trust funds to determine if there is a particular need to account for resources separately from the primary operating funds of the County. We further recommend the County implement controls to minimize the double reporting of revenues and expenditures when utilizing these trust funds for controlling the flow of resources.

Management Response

Generally accepted accounting principles hold that the ideal number of trust funds a government should have is the smallest number that enables that government to achieve its purposes. The number of trust funds established by the County of Humboldt over the past several decades has proliferated with adverse effect on accounting controls, especially in light of the reduced number of accounting staff overseeing the general ledger in recent years.

We agree that many currently active trust funds should be closed and those funds moved into budgeted accounts in the main County operating trusts. The Auditor-Controller and County Administrative Office will work with departments to identify trust funds that should be closed in order to simplify our account structure.

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TAX LOSS RESERVE FUND

Criteria

California Revenue Taxation Code Sections 4703 and 4703.2 requires counties on the teeter plan to establish a tax loss reserve fund maintained at not less than (1) 1 percent of the total of all taxes and assessments levied on the secured roll for the year for participating entities in the county or (2) 25 percent of the total delinquent secured taxes and assessments for participating entities in the county as calculated at the end of the fiscal year. The tax loss reserve fund shall be used exclusively to cover losses that may occur in the amount of tax liens as a result of special sales of tax-defaulted property.

Condition

The County was not in compliance with the minimum requirements of the Tax Loss Reserve Fund at June 30, 2011 by approximately \$231 thousand.

Cause

The County does not currently have a procedure in place to monitor the minimum cash balance of the tax loss reserve fund.

Effect of Condition

The County is not in compliance with the California Revenue Taxation Code Section 4703 and 4703.2.

Recommendation

We recommend the County adopt procedures to replenish the tax loss reserve fund when the balance falls below the minimum State requirements.

Management Response

We agree that the County has not been in compliance with the Revenue and Tax (R&T) Code with regard to minimum balances in the Tax Loss Reserve Fund. It is our intention to introduce a Board resolution in early fiscal year 2012-13 to allow the County the option of setting that minimum balance at 25% of the total delinquent secured taxes pursuant to R&T Code Section 4703.2(c). If that option existed at June 30, 2011, the Tax Loss Reserve Fund would have been underfunded by only about \$35,000. We have sufficient funds in our tax auction fund to bring the tax loss reserve up to the calculated minimum balance at that time.

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Management Report – Current Year Comments and Recommendations For the Year Ended June 30, 2011

USE OF MISCELLANEOUS REVENUE ACCOUNT

Criteria

The miscellaneous revenue account should be used to record revenues that fall outside of the other revenue categories, such as intergovernmental revenues and charges for services, and that are considered to be infrequent in nature.

Condition

We noted that the County's use of the miscellaneous revenue account (i.e., account 808000) includes various types of revenue, including intergovernmental revenues and revenue generated from charges for services. During the audit, we noted that the miscellaneous revenue accounts aggregated for County funds were in excess of \$5 million.

Cause

Departments have initial responsibility for classifying cash receipts for financial reporting and may not have adequate knowledge or guidance to properly classify certain revenues. In the absence of other guidance, departments likely record revenues they are unsure of in the miscellaneous revenue account.

Effect of Condition

When revenues are improperly classified as miscellaneous revenues the true condition of the fund may be misleading. The level of detail for classifying transactions should be sufficiently categorized so as to be meaningful to management in making decisions.

Recommendation

We recommend that the County consider restricting the use of its miscellaneous revenue account for revenue sources that cannot be categorized under the existing revenue types, including charges for services, fines, intergovernmental revenues, and licenses and permits.

Management Response

The generic revenue object, 808000, is primarily used in fiduciary or agency funds where the name of the fund identifies the revenue stream. For the most part these funds are used to channel a single type of revenue; so further identification of the revenue isn't necessary for staff familiar with that particular program. Using more descriptive revenue objects would however help auditors and others who are less familiar with these programs, so we see the value of creating more revenue objects to convey more specific information about these revenue streams. We will work with the departments and administration to assign more descriptive revenue objects to our various programs.

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EXPAND CHART OF ACCOUNTS IN CERTAIN FUNDS

Criteria

The County's chart of accounts should be detailed enough as to provide adequate management information.

Condition

During our review of the County's debt service fund, we noted that the County recorded its annual net change in the cash with fiscal agent account balance to a single expenditure account.

Cause

The County relies on various spreadsheets to track certain accounts at a more detailed level. For example, the County maintains a spreadsheet to track the activity of the debt service fund, including interest earnings and debt service payments.

Effect of Condition

In some cases, the chart of accounts is too general to provide the information needed for management to make decisions or for the County to prepare its annual State Controller's report and annual financial statements without having to rely on spreadsheets and other records external to the general ledger.

Recommendation

We recommend the County expand its chart of accounts in certain funds where applicable to be used for significant accounts, such major sources of revenues and expenditures. In the debt service fund, for example, the County should report the change in the cash with fiscal agent account as adjustments to debt service principal and interest expenditures and interest earnings rather than as a net change to trust fund expenditures.

Management Response

As noted in our previous response, we do have room in our chart of accounts for more descriptive account objects. Especially in dealing with debt service, accounts for principal and interest should be clearly identified and we will make that change.

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FORMAL CAPITAL ASSET POLICY

Criteria

The County has a significant investment in capital assets, such as land, buildings, roads and equipment. Adopting a policy will help ensure that the County's capital assets are acquired, safeguarded, controlled, disposed of and accounted for in accordance with state and federal regulations, audit requirements and generally accepted accounting principles.

Condition

At the time of our audit, we noted that the County did not have a formal capital asset policy.

Cause

The County has not yet written a formal policy for the capitalization of assets.

Effect of Condition

Without a written capitalization policy, inconsistencies and misunderstandings regarding proper policy capitalization thresholds and estimated useful asset lives are likely to occur. In addition, misstatement of net capital assets as well as a lack of comparability between years can result when policies and procedures regarding capital assets are unclear.

Recommendation

We recommend that the County adopt a comprehensive capitalization policy which includes all required capital asset accounting elements.

Management Response

We agree that the County should adopt a comprehensive capitalization policy and will conduct research to find an appropriate model that can be adopted for our use.