STATE OF MINNESOTA

Office of the State Auditor

Rebecca Otto
State Auditor

MANAGEMENT AND COMPLIANCE REPORT
PREPARED AS A RESULT OF THE AUDIT OF

MARTIN COUNTY
FAIRMONT, MINNESOTA

YEAR ENDED DECEMBER 31, 2006

Description of the Office of the State Auditor

The mission of the Office of the State Auditor is to oversee local government finances for Minnesota taxpayers by helping to ensure financial integrity and accountability in local governmental financial activities.

Through financial, compliance, and special audits, the State Auditor oversees and ensures that local government funds are used for the purposes intended by law and that local governments hold themselves to the highest standards of financial accountability.

The State Auditor performs approximately 160 financial and compliance audits per year and has oversight responsibilities for over 3,300 local units of government throughout the state. The office currently maintains five divisions:

Audit Practice - conducts financial and legal compliance audits of local governments;

Government Information - collects and analyzes financial information for cities, towns, counties, and special districts;

Legal/Special Investigations - provides legal analysis and counsel to the Office and responds to outside inquiries about Minnesota local government law; as well as investigates allegations of misfeasance, malfeasance, and nonfeasance in local government;

Pension - monitors investment, financial, and actuarial reporting for approximately 730 public pension funds; and

Tax Increment Financing - promotes compliance and accountability in local governments' use of tax increment financing through financial and compliance audits.

The State Auditor serves on the State Executive Council, State Board of Investment, Land Exchange Board, Public Employees Retirement Association Board, Minnesota Housing Finance Agency, and the Rural Finance Authority Board.

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MARTIN COUNTY
FAIRMONT, MINNESOTA

Year Ended December 31, 2006

Management and Compliance Report

Audit Practice Division
Office of the State Auditor
State of Minnesota

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MARTIN COUNTY
FAIRMONT, MINNESOTA

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MARTIN COUNTY
FAIRMONT, MINNESOTA

SCHEDULE OF FINDINGS AND RECOMMENDATIONS
FOR THE YEAR ENDED DECEMBER 31, 2006

I. FINDINGS RELATED TO FINANCIAL STATEMENTS AUDITED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

INTERNAL CONTROL

PREVIOUSLY REPORTED ITEMS NOT RESOLVED

05-1 Agency Funds

The County Auditor/Treasurer's Office does not reconcile agency funds to ascertain their balances are identifiable. Our review of the agency funds disclosed the following:

- The Refunding Fund started the year with a negative cash balance of $15,015, which increased to a negative cash balance of $85,576 as of December 31, 2006. The County made additional refunds to taxpayers during 2006. A negative tax settlement should be prepared to reconcile and eliminate the negative cash balance.

- The Taxes and Penalties Fund has an unidentified balance of $129,579 at December 31, 2006. This may be partially related to the negative balance in the Refunding Fund.

- The State Agency Fund started the year with a positive cash balance of $14,526 and ended with a negative cash balance of $81,817 as of December 31, 2006. The County distributed more County Recorder fees to the General Fund than it collected.

Agency funds are used to account for funds held in an agent capacity for others. All assets reported in an agency fund are offset by a liability to the party on whose behalf they are held.

We recommend that the County identify and reconcile the balances in all the agency funds and make the corrections necessary to eliminate negative cash balances.

Client's Response:

The county has established two new Taxes and Penalties Funds so we can make sure that at the end of each year the funds will equal 0, one fund for the even years and one fund for the odd years. Fund 77 will be open so we can reconcile; new funds 75 and 76 will be used in the future.

The county has established separate funds for the State Agency fund to separate the Recorder fees and the Flex funds. The flex will have two funds, one for the even years and one for the odd years. Fund 82 will be used for the Recorder, and new funds 81 and 86 will be used for the flex.

This will enable the county to identify and reconcile the balances in the Agency Funds and make the corrections necessary to eliminate the negative cash balances.

05-2 Sheriff's Department Checking Accounts

While reviewing the Sheriff's Department checking accounts, we noted the following concerns:

- The checking account for the collections of Writs of Executions, Huber, and other miscellaneous funds had a balance of $76,952 as of December 31, 2006.

- The checking account for the collections of civil process and paper services had a balance of $10,412 as of December 31, 2006.

Collections in these two accounts should be reported and remitted to the County on a timely basis.

We recommend that the County implement procedures in the Sheriff's Department to report and remit all collections in a timely manner.

Client's Response:

The county will implement procedures for this department to report and remit the collections in a timely manner and have another staff trained to help when needed.

ITEMS ARISING THIS YEAR

06-1 Audit Adjustments

A control deficiency 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 misstatements of the financial statements on a timely basis. One control deficiency that typically is considered significant is identification by the auditor of a material misstatement in the financial statements not initially identified by the County's internal controls. During our audit, we proposed the following adjustments that resulted in significant changes to the County's financial statements.

- Adjustments were made to record interfund accruals for tax credits and aids. During 2004 and 2005, tax credits and aids were not spread correctly; therefore, the amounts were set up as due to other funds/due from other funds at year-end. The money was never transferred to the proper funds. Without transferring the money, the shortage and/or overage was never corrected, and the due to other funds/due from other funds was not removed from the County's records. The problem was compounded with the incorrect spread of market value credits (real and ag) during 2006. If tax credits and aids are not spread correctly, individual funds may be either short or long on the tax levy that was approved by the Board, and the Board may neither have given approval nor be aware of these differences ($488,771).

- Adjustments were made to record cash in individual funds for unapportioned taxes and special assessments in the Taxes and Penalties Fund at year-end ($407,869).

- An adjustment was made to record additional deferred special assessments receivable for septic loans in the General Fund ($117,866).

- Corrections were made for septic loans special assessments in the General Fund ($111,832) and special assessments in the Prairieland Debt Service Fund ($542,431). The total special assessments amount had been recorded as taxes ($654,263).

- Adjustments were made in the Road and Bridge Special Revenue Fund to record the town road allotment as shared intergovernmental revenue and highways/streets construction expenditures ($274,765) and to record Martin County's share of state-aid allotment held by the State of Minnesota as due from other governments and deferred revenue ($235,286).

- An adjustment was made to record an interfund accrual for a receipt recorded in error on April 26, 2004. An entry to correct the error recorded a receivable in the Human Services Special Revenue Fund and a liability in the Building Special Revenue Fund in 2005. In 2006, the entry was reversed, but the money was not transferred to the proper funds; therefore, the original error was never corrected ($56,485).

- Corrections were made in the Building Special Revenue Fund to reclassify building improvements to building operations ($58,668) and to reclassify building improvements from current expenditures to capital outlay expenditures ($342,338).

- A correction was made to reclassify the SCORE grant in the Solid Waste Special Revenue Fund from charges for services to intergovernmental revenue ($49,079).

- A correction was made to eliminate the amount paid to Prairieland in the Prairieland Debt Service Fund. Payments were included as miscellaneous expenditures. Payments should not have been recorded as special assessments or miscellaneous expenditures ($489,977).

- An adjustment was made to loans receivable and deferred revenue in the Area Development Fund. The loans receivable amount was calculated incorrectly ($95,688).

- An adjustment was made for additions to capital assets for Highway equipment ($557,951).

The inability to detect a material misstatement in the financial statements increases the likelihood that the financial statements would not be fairly presented.

We recommend that the County modify internal controls over financial reporting to detect misstatements in the financial statements.

<u>Client's Response</u>:

The adjustments that were made in previous years will be completed by moving the dollars to the correct funds.

We have added new line items to transfer the special assessments from the tax to #5051.

06-2 Budgeting

The County does not have a formal written budget policy. In general, local governments should have an adopted budget policy that includes elements such as:

- procedures for adopting the budget,
- which funds require budgets,
- the legal level of control,
- when budgets can be modified by management and when budget modifications require Board approval,
- the budgetary basis on which the budget is adopted, and
- the procedures for monitoring the budget.

After the County Board has adopted a budget, it should be entered into the Integrated Financial System (IFS) to be used as a monitoring tool. Someone who is independent of the budgeting process should enter the budget. At Martin County, the budget is entered into the IFS by the County Auditor/Treasurer, who is not independent of the budgeting process.

The ability to modify the budget for new circumstances makes the budget more valuable; budgetary differences are not distorted by the new circumstances. Budget modifications should be made throughout the year to maintain the value of the budget as an internal control tool. In Martin County, budget modifications are not always made for significant changes in expected activity.

We recommend the County Board adopt a budget policy to include the elements recommended above, that budget amounts be entered into the IFS by a person independent of the budgeting process, and that the County budget be modified as necessary for significant changes in expected activity.

Client's Response:

The county will establish a formal written budget policy that will take in all the elements listed in the management letter.

06-3 Investment Policy

The County does not have a formal written investment policy. In general, local governments should have an adopted investment policy that guides the Auditor/Treasurer in making investment decisions for the County, and includes such elements as:

- identifying the County's investment objectives and establishing the direction of the investment program;

- establishing a list of appropriate instruments to purchase and set maturity, risk, and diversification requirements;

- identifying internal controls, required documentation, and custodial safekeeping requirements; and

- establishing internal reporting and review procedures.

The policy should also address all of the factors covered in Governmental Accounting Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures*. GASB Statement 40 requires the County to disclose its policies on several investment risks, if applicable to the County. The risks include credit risk, custodial credit risk, concentration of credit risk, interest rate risk, and foreign currency risk.

We recommend that the County Board adopt an investment policy to include all of the elements discussed.

Client's Response:

The county will adopt a formal written investment policy that will include all the elements listed on the management letter.

06-4 Capital Assets

For financial reporting and asset management purposes, the County is required to keep records of its capital assets, including infrastructure. The County's capital asset records are maintained by a consultant retained by the County. Capital asset additions and deletions are summarized and given to the consultant, and depreciation is calculated by the consultant. Capital asset policies utilized by the County in maintaining the capital asset system have not been formally approved. The County Board has not adopted a capital asset policy. A capital asset policy should be adopted which defines the County's accounting policies over capital assets, such as capitalization thresholds, useful lives, and depreciation methods.

The County also does not have policies and procedures in place to identify capital asset additions and deletions for entry in the capital asset system. County staff generally identify capital asset additions by reviewing capital expenditure accounts at year-end and determining which assets to capitalize. There is no system in place to identify asset disposals. Also, a physical inventory of capital assets has never been done.

In addition to the capital asset records maintained by the consultant, the Highway Department maintains a record of its capital assets. These records are not reconciled to the listing maintained by the consultant.

We recommend the County Board establish a capital asset policy to define the County's accounting policies over capital assets. The Board should also establish policies and procedures to identify capital asset additions and deletions. Department heads should report capital asset additions and deletions to the consultant maintaining the capital asset records at least annually. Also, we recommend a physical inventory of capital assets be performed periodically. This physical inventory can be rotated so that a portion of the capital assets is inventoried each year. Each asset should be counted at least once every five years. Some critical capital assets may need more frequent accounting. We also recommend the Highway Department reconcile its capital asset listing to the listing maintained by the consultant.

Client's Response:

The county will adopt a formal written capital asset policy to identify the assets, additions, and deletions. We will purchase a new software package that will help identify and track the capital assets. We also will perform physical inventory on a rotating basis each year.

II. OTHER FINDINGS AND RECOMMENDATIONS

A. MINNESOTA LEGAL COMPLIANCE

PREVIOUSLY REPORTED ITEMS NOT RESOLVED

05-3 Individual Ditch System Deficits

It is a continuing practice for Martin County to have individual ditch systems with cash and fund balance deficits. Of the 180 individual systems, 48 ditch systems had deficit cash balances totaling $226,498 at December 31, 2006. In cases where a ditch account has insufficient funds to pay project costs, Minn. Stat. § 103E.655, subd. 2, allows loans to be made from ditch systems with surplus funds or from the General Fund to a ditch system with insufficient cash to pay expenditures. This statute also specifies such loans must be repaid with interest. Allowing a ditch system to maintain a deficit cash balance, in effect, constitutes an interest-free loan from the other ditch systems in violation of Minnesota law.

In addition, 35 ditch systems had negative fund balances totaling $183,205, on a full accrual basis, as of December 31, 2006. Minn. Stat. § 103E.735, subd. 1, provides that a fund balance to be used for repairs may be established for any drainage system, not to exceed 20 percent of the assessed benefits of the ditch system or $40,000, whichever is larger.

We recommend Martin County eliminate the individual ditch system cash balance deficits by borrowing from an eligible fund with a surplus cash balance and the County levy assessments pursuant to Minn. Stat. § 103E.735, subd. 1, to accumulate a cash balance sufficient to provide for the repair and maintenance costs of ditch systems.

Client's Response:

In the months of September and October each year the commissioners levy dollars to each system that has a negative balance or if repairs are known to be done and the balance of the system does not have enough funds to cover the repairs. We also have cross county systems that we receive bills from the other counties at the beginning of the new year and are not known at the time when the levies are set. We are in the process of redetermining systems in our county that the timing of the completion of the work and when the levy is set that will put a system in the negative. The county is continuing to look at the systems and levy amounts when needed and realize that we will never have all systems in the positive. The commissioners at this time were not all in favor of writing checks out of one fund and to each individual system and then after the first of the year paying back the fund.

05-4 Publication of Vendors

For the years 2005 and 2006, Martin County did not publish a summary of disbursements over $5,000 by vendor. The County also did not list individual vendors paid with credit cards. Minn. Stat. § 375.17, subd. 2, specifies the conditions for publication of payments to vendors. Minn. Stat. § 471.38 specifies the conditions for payment of claims, specifically that claims presented for payment must be in writing and itemized. Bills received from a credit card company lack sufficient detail to comply with these statutory requirements.

We recommend Martin County comply with Minnesota statutes regarding the proper publication of information regarding payments to vendors.

Client's Response:

The county will publish a summary of disbursements by vendor over $5,000.00 when we publish the county financial statement each year.

ITEM ARISING THIS YEAR

06-5 Net Proceeds from Forfeited Land Sale

The County has a Forfeited Tax Fund with a beginning cash balance at January 1, 2006, of $8,799 and an ending cash balance at December 31, 2006, of $10,820. The County had a forfeited land sale on November 29, 2006. The County has not apportioned the net proceeds received from past sales.

Minn. Stat. § 282.05 states, "The net proceeds received from the sale or rental of forfeited lands shall be apportioned to the general funds of the state or municipal subdivision thereof, in the manner provided in Minn. Stat. § 282.08."

We recommend Martin County apportion net proceeds received from the sale of forfeited lands according to Minn. Stat. § 282.08.

Client's Response:

The county will apportion net proceeds received from the sale of forfeited lands each year according to Minn. § Stat. 282.08.

B. OTHER ITEM FOR CONSIDERATION

Other Postemployment Benefits (OPEB)

The Governmental Accounting Standards Board (GASB) recently issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* which establishes financial reporting for OPEB plans, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* which governs employer accounting and financial reporting for OPEB. These standards, similar to what GASB Statements 25 and 27 did for government employee pension benefits and plans, provide the accounting and reporting standards for the various other postemployment benefits many local governments offer to their employees. OPEB can include many different benefits offered to retirees such as health, dental, life, and long-term care insurance coverage.

If retirees are included in an insurance plan and pay a rate similar to that paid for younger active employees, this implicit subsidy is considered OPEB. In fact, local governments may be required to continue medical insurance coverage pursuant to Minn. Stat. § 471.61, subd. 2b. This benefit is common when accumulated sick leave is used to pay for retiree medical insurance. Under the new GASB statements, accounting for OPEB is now similar to the accounting used by governments for pension plans.

Some of the issues that the County Board will need to address in order to comply with the statements are:

- determine if employees are provided OPEB;

- if OPEB are being provided, the County Board will have to determine whether it will advance fund the benefits or pay for them on a pay-as-you-go basis;

- if OPEB are being provided, and the County Board determines that the establishment of a trust is desirable in order to fund the OPEB, the County Board will have to wait until legislation is enacted authorizing the creation of an OPEB trust and establishing an applicable investment standard; and

- in order to determine annual costs and liabilities that need to be recognized, the County Board will have to decide whether to hire an actuary.

If applicable for Martin County, GASB Statements 43 and 45 would be implemented for the years ended December 31, 2007 and 2008, respectively.

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REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Board of County Commissioners
Martin County

We have audited the financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of Martin County as of and for the year ended December 31, 2006, and have issued our report thereon dated January 17, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Martin County's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the County's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the County's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph of this section and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the County's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the County's financial statements that is more than inconsequential will not be prevented or detected by the County's internal control. We considered the deficiencies described in the accompanying Schedule of Findings and Recommendations as items 05-1, 05-2, and 06-1 through 06-4 to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by Martin County's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we consider items 05-1 and 06-1 to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Martin County's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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 and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

Minnesota Legal Compliance

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the provisions of the *Minnesota Legal Compliance Audit Guide for Local Government*, promulgated by the State Auditor pursuant to Minn. Stat. § 6.65. Accordingly, the audit included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The *Minnesota Legal Compliance Audit Guide for Local Government* contains six categories of compliance to be tested: contracting and bidding, deposits and investments, conflicts of interest, public indebtedness, claims and disbursements, and miscellaneous provisions. Our study included all of the listed categories.

The results of our tests indicate that, for the items tested, Martin County complied with the material terms and conditions of applicable legal provisions, except as described in the Schedule of Findings and Recommendations as items 05-3, 05-4, and 06-5.

Also included in the Schedule of Findings and Recommendations is an “other item for consideration.” We believe this information to be of benefit to Martin County, and it is reported for that purpose.

Martin County’s written responses to the significant deficiencies, material weaknesses, and legal compliance findings identified in our audit have not been subjected to any auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Board of County Commissioners, management, and others within Martin County and is not intended to be, and should not be, used by anyone other than those specified parties.

/s/Rebecca Otto	*/s/Greg Hierlinger*
REBECCA OTTO STATE AUDITOR	GREG HIERLINGER, CPA DEPUTY STATE AUDITOR

January 17, 2008