SCHEDULE OF AUDIT FINDINGS AND RESPONSES

Chelan County
January 1, 2016 through December 31, 2016

2016-001 The County's internal controls over financial statement preparation were inadequate to ensure accurate reporting.

Background

Management is responsible for designing, implementing and maintaining internal controls to fairly present financial statements and provide reasonable assurance regarding reliability of financial reporting. The County prepares its financial statements in accordance with generally accepted accounting principles (GAAP) as prescribed by the *Budgeting, Accounting and Reporting System* (BARS) Manual.

Our audit identified deficiencies in controls over financial statement reporting that hindered the County's ability to produce reliable financial statements. These deficiencies represent a material weakness.

Government Auditing Standards requires the auditor to communicate material weaknesses, defined in the Applicable Laws and Regulations section below, as a finding.

Description of Condition

We identified the following deficiencies in internal controls over financial reporting that, when taken together, represent a material weakness over financial reporting:

- Although Management has a process for reviewing the year-end financial statements, this review did not identify the omission of a bond refunding on the Fund Financial Statements and the netting of cash receipts and payments on the Statement of Cash Flows.

- The Public Works Department did not communicate the correct completion date of projects in construction in progress to the Accounting Department; also, it included misclassified costs such as land and costs to be expensed immediately.

- Decentralized departments do not consistently post expenses to the correct period. The Accounting Department's review is limited and did not identify certain expenses paid after year-end but incurred in the prior year that required reclassification.

- The Natural Resources Department's review of year-end receivables was insufficient to identify overstatements and misclassifications.
- County management was unable to acquire capital asset information to calculate the equity interest in a joint venture and did not include long-term liabilities in the estimate.
- County personnel were unable to accurately calculate and report a court judgment receivable for the District Court Probation Department.

Cause of Condition

We identified the following causes:

- County management's final review of the financial statements was not effectively applied throughout the financial statement preparation and review process, which resulted in unidentified misstatements.
- The Accounting Department relies heavily on financial information posted and received from decentralized departments. Those departments do not always have adequate knowledge of financial reporting requirements, and they have not dedicated the necessary time and resources to ensure financial information communicated to the Accounting Department is accurate and complies with the applicable financial reporting framework.
- Rivercom reports on the cash basis of accounting and does not provide the necessary capital asset information for the County to calculate its equity interest in accordance with generally accepted accounting principles (GAAP). However, the County did receive long-term debt information and did not include this in the calculation.
- The District Court Probation Department recently converted to using new software and is unable to retrieve financial information sufficient to calculate a court judgement receivable.

Effect of Condition

We identified the following errors in the financial statements. The County:

- Did not report a bond refunding on the Statement of Revenues, Expenditures and Change in Fund Balance, resulting in an understatement of:

- Other financing uses - payments to refunded bond escrow agent of $9,889,831
- Expenditures for debt issuance costs of $109,260
- Other financing sources - refunding bonds issued of $8,955,000
- Other financing sources - premium on refunding bonds of $1,044,091

- Understated cash received from customers and users and cash payments to suppliers both by $5,442,196 on the Statement of Cash Flows
- Overstated construction in progress by $1,143,069 and understated infrastructure, transportation expenses and land by $677,588, $313,636 and $151,845, respectively
- Overstated due from other governments for the Natural Resources Fund by $195,484, including $175,000 that should have been reported as a deposit
- Did not report $131,870 in expenses on the Proprietary Statement of Revenues, Expenses and Changes in Net Position and $33,957 in expenditures on the Statement of Revenues, Expenditures and Changes in Fund Balance
- Understated its Equity Interest in Joint Venture by an estimated $880,000
- Did not report an estimated $300,000 court judgements receivable

The County corrected most of the above errors and all material errors.

Recommendations

We recommend the County:

- Apply designed internal controls to the financial statement preparation and review processes effectively and consistently
- Provide training on financial reporting requirements to decentralized departments responsible for communicating financial information and recording financial transactions
- Research methods to calculate or estimate a court judgment receivable for the District Court Probation Department and investigate possible methods to acquire the information needed to calculate the County’s equity interest in Rivercom

County's Response

Management of Chelan County would like to thank the State Auditor's Office for its review of the County's financial statements, the professionalism they displayed during the conduct of their audit, and for the opportunity to provide the response below.

The single item that raised the reporting threshold of this audit report to that of a finding rather than a lower level of reporting relates to a bond refinancing that occurred in mid-2016. The refinancing was never recorded in the fund financial statements at the time the transaction occurred. The omission was discovered by County management, but not until after the financial statements were given to the auditors to begin the conduct of their audit. The impact of the refinancing was originally included in the financial statements in the government wide financial statements, notes, and management discussion and analysis. The single transaction, had it not been omitted originally, would have been completely eliminated during the conversion from fund financial statements to government wide financial statements. As such, the government wide financial statements, notes and management discussion and analysis were accurate as originally presented to the auditors. Despite the fact that management felt the financial statements as originally presented were not materially misstated, the transaction was later recorded in the fund financial statements before the annual report was filed with the Auditors Office at the end of May, and the transaction was recorded and reflected in the fund financial statement portion of the final comprehensive annual financial report.

County management is working with the software provider used by the District Court Probation office in an attempt to get reports or data from that system to accurately calculate the amount of receivables at year-end rather than using an estimate similar to the one used by the auditors. Our desire is to have actual data from which to report the correct amount of Probation receivable at year-end. County management will reinforce with the departments the proper cutoff procedures at year-end, including when capital projects are completed for capitalization purposes.

The rest of the items contained in this finding report relate to items that the auditors requested changes in classification in the financial statements, which the County has done, or one-time corrections to spreadsheets used to compile the financial statements. These items have been corrected. The financial statements were prepared after turnover in the position responsible for preparing these statements. Management is confident that with the typical time allotted for preparing and reviewing the financial statements, there will be improvement in the accuracy of the preparation and review of the statements.

Auditor’s Remarks

The County was very helpful during the audit process, and we appreciate the steps the County is taking to resolve this issue. We will review the condition during our next audit.

Applicable Laws and Regulations

Government Auditing Standards, December 2011 Revision, paragraph 4.23 states:

> 4.23 When performing GAGAS financial audits, auditors should communicate in the report on internal control over financial reporting and compliance, based upon the work performed, (1) significant deficiencies and material weaknesses in internal control; (2) instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the audit and any other instances that warrant the attention of those charged with governance; (3) noncompliance with provisions of contracts or grant agreements that has a material effect on the audit; and (4) abuse that has a material effect on the audit.

The American Institute of Certified Public Accountants defines significant deficiencies and material weaknesses in its *Codification of Statements on Auditing Standards*, section 265, as follows:

> Deficiency in internal control. A deficiency in internal control over financial reporting 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 deficiency in design exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

> Material weakness. A deficiency, or a combination of deficiencies, in internal control over financial reporting, 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. A reasonably possibility exists when the likelihood of an event occurring is either reasonably possible or probably as defined as follows:

> Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.
>
> Probable. The future event or events are likely to occur.

Significant deficiency. A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

A11 Indicators of material weaknesses in internal control include:

- identification of fraud, whether or not material, on the part of senior management. For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers as well as any other members of senior management who play a significant role in the entity's financial reporting process;
- restatement of previously issued financial statements to reflect the correction of a material misstatement due to fraud or error;
- identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected and corrected by the entity's internal control; and
- ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

RCW 43.09.200 Local government accounting – Uniform system of accounting, states in part:

> The state auditor shall formulate, prescribe, and install a system of accounting and reporting for all local governments, which shall be uniform for every public institution, and every public office, and every public account of the same class.

Budgeting, Accounting, and Reporting System (BARS) Manual - Accounting, Accounting Principles and Internal Control, Internal Control states in part:

> 3.1.3.20 Internal control is a process – affected by those charged with governance, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
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> - Effectiveness and efficiency of operations
> - Compliance with applicable laws and regulations
> - Reliability of financial reporting
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> 3.1.3.30 Management and the governing body are responsible for the government's performance, compliance and financial reporting. Therefore, the adequacy of internal control to provide reasonable assurance of achieving these objectives is also the responsibility of management and the governing body. The governing body has ultimate responsibility for ensuring adequate controls to achieve objectives, even though primary responsibility has been delegated to management. Since management and the governing body are assumed to work in harmony, both parties are collectively referred to as "management" throughout the rest of this section.
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> 3.1.3.140 This objective refers to fair presentation of financial statements and required schedules in all material respects in accordance with the stated basis of accounting.
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> 3.1.3.150 In meeting this objective, the government should have controls that accomplish the following key functions:
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> - Identification of financial events – Controls should ensure financial events and transactions are properly identified and recorded.
> - Properly applying accounting standards – Controls should ensure correct criteria and methodology is applied when accounting for financial events. When the correct method of accounting for or reporting a transaction is unclear, the government should seek clarification by performing research, contracting for accounting assistance, or communicating with the State Auditor's Office or standard setting bodies.

- Correctly accounting for all financial events – Controls should ensure that:
    - Only valid transactions are recorded and reported.
    - All transactions occurred during the period are recorded and reported.
    - Transactions are recorded and reported at properly valued and calculated amounts.
    - Recorded and reported transactions accurately reflect legal rights and obligations.
    - Transactions are recorded and reported in the account and fund to which they apply.
  - Preparation of the annual report – Controls should ensure that financial statements and required schedules are properly compiled and prepared from source accounting records. Controls should also ensure correct presentation of statements and schedules.