STATE OF MINNESOTA
Office of the State Auditor

Rebecca Otto
State Auditor

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

LINCOLN COUNTY
IVANHOE, MINNESOTA

YEAR ENDED DECEMBER 31, 2011

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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LINCOLN COUNTY
IVANHOE, MINNESOTA

Year Ended December 31, 2011

Management and Compliance Report

Audit Practice Division
Office of the State Auditor
State of Minnesota

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LINCOLN COUNTY
IVANHOE, MINNESOTA

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LINCOLN COUNTY
IVANHOE, MINNESOTA

SCHEDULE OF FINDINGS AND RECOMMENDATIONS
FOR THE YEAR ENDED DECEMBER 31, 2011

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

INTERNAL CONTROL

PREVIOUSLY REPORTED ITEM NOT RESOLVED

98-1 Segregation of Duties

Criteria: A good system of internal control provides for an adequate segregation of duties so that no one individual handles a transaction from its inception to completion.

Condition: Several of the County's departments that collect fees lack proper segregation of duties. These departments generally have one staff person who is responsible for billing, collecting, recording, and depositing receipts as well as reconciling bank accounts.

Context: Due to the limited number of office personnel within the County, segregation of the accounting functions necessary to ensure adequate internal accounting control is not possible. This is not unusual in operations the size of Lincoln County; however, the County's management should constantly be aware of this condition and realize that the concentration of duties and responsibilities in a limited number of individuals is not desirable from an accounting point of view.

Effect: Inadequate segregation of duties could adversely affect the County's ability to detect misstatements in amounts that would be material in relation to the financial statements in a timely period by employees in the normal course of performing their assigned functions.

Cause: The County does not have the economic resources needed to hire additional qualified accounting staff in order to segregate duties in every department.

Recommendation: We recommend that the County's elected officials and management be aware of the lack of segregation of duties of the accounting functions and, where possible, implement oversight procedures to ensure that the internal control policies and procedures are implemented by staff to the extent possible.

Client's Response:

Lincoln County is aware of the lack of segregation of the accounting functions. We continually strive to implement feasible internal controls with our limited staff.

ITEMS ARISING THIS YEAR

11-1 Audit Adjustments

Criteria: 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 of the financial statements on a timely basis. Statement on Auditing Standards 115 defines a material weakness as a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the County's financial statements will not be prevented, or detected and corrected, on a timely basis.

Condition: During our audit, we identified material adjustments that resulted in significant changes to the County's financial statements.

Context: The inability to detect significant misstatements in the financial statements increases the likelihood that the financial statements would not be fairly presented.

Effect: Audit adjustments were necessary to record additional liabilities and corresponding expenditures found during the audit; to adjust the state-aid highway allotment receivable, deferred revenue-unavailable liability, and applicable revenues; and to make reclassification entries as necessary.

Cause: The adjustments resulted from controls over calculating the proper amounts of balances and transactions not detecting a number of errors and the County not considering the need for controls over the recording of certain accounting transactions.

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

Client's Response:

The Auditor's Office and the Office/Manager Accountant in the Road and Bridge Department will work more closely with outside resources in assuring the accuracy of the Financial Statement and the Road and Bridge Annual Report.

11-2 Network/Application Password Controls

Criteria: County management is responsible for the County's internal controls over its information systems. This requires establishing security policies and performing assessments of existing controls to determine if the internal controls established are still effective or if changes are needed to ensure County data is protected as prescribed by management.

Condition: Lincoln County recently updated to a new version of the Integrated Financial System (IFS) application software. This application was written as a web-based application and may be run on a server or a mainframe system. Lincoln County contracts with a vendor for use of space on a mainframe IBM I Series system. For an employee of Lincoln County to access the new IFS application, the user must be signed on to the County network and have a current sign-on for the IFS application. The network sign-on differs from the sign-on for the IBM I Series system, so the mainframe security settings do not apply to the application. Lincoln County has not reviewed the network controls or assessed risks from the change to a web-based application to ensure password controls are working as intended.

Context: The IFS application is the general ledger for Lincoln County. Detailed receipt and disbursement transactions as well as budget information are maintained on the IFS application throughout the year. This information is used by management to monitor the resources available and make decisions based on the available resources. At or near year-end, certain accrual information is also recorded in the application. The information maintained within the IFS application is the key source of information used for the preparation of the County's annual financial statements.

Effect: Normal password controls in place in the IBM I Series system are not effective for the IFS application, so a review of the IFS application controls and County network controls is imperative to ensure passwords are working as intended.

Cause: Lincoln County recently updated to a new web-based version of the IFS application software. County management was not aware of some of the password implications of this change.

Recommendation: We recommend Lincoln County management review password controls in place that limit access to the IFS application to ensure they are appropriate to protect the County data as prescribed by management.

Client's Response:

The County will review password controls.

11-3 Difference Between Budget Approved by Board and Budget in Accounting System

Criteria: The original budget in the accounting system should equal, or reconcile to, the Board-approved budget.

Condition: The Board-approved budget for the General Fund did not match, or reconcile to, the original budget entered into the accounting system. Amounts reported in budgeted revenue codes in the accounting system were $393,229 higher than Board-approved totals.

Context: Detailed information for budgeted and actual revenues and expenditures are maintained on the accounting system throughout the year. This information is used by management to monitor the resources available and make decisions based on the available resources.

Effect: The original budget in the accounting system showed budgeted revenues exceeding expenditures by $76,229; however, the Board-approved budget included expenditures exceeding revenues by $317,000 due to the County's planned use of fund balance to make up for the budgeted deficit.

Cause: No County staff member reviewed or reconciled the original budget after certain information was erroneously entered into the accounting system.

Recommendation: We recommend an employee outside the budget process review the original budget in the accounting system to ensure the information match, or reconcile to, the Board-approved amounts.

Client's Response:

An employee outside the budget process will review the original budget in the accounting system.

II. OTHER FINDINGS AND RECOMMENDATIONS

A. MINNESOTA LEGAL COMPLIANCE

PREVIOUSLY REPORTED ITEM NOT RESOLVED

10-2 Safekeeping of Investments

Criteria: According to Minn. Stat. § 118A.06, brokers can hold public investments to the extent they have insurance to protect their clients through Securities Investors Protection Corporation (SIPC) coverage or excess SIPC coverage.

Condition: The County does not have sufficient coverage for investments held with Financial Northeastern Companies (FNC).

Context: The County has investments subject to custodial credit risk at December 31, 2011, of $587,541, due to FNC not providing excess SIPC coverage. At December 31, 2011, FNC held security investments totaling $1,087,541 on behalf of Lincoln County.

Effect: The County's investments may not be recovered should the counter-party default.

Cause: Because each negotiable certificate of deposit balance is under $250,000, the County believed it was sufficiently covered by FDIC and did not consider custodial credit risk for those investments.

Recommendation: We recommend that all County securities be held only by brokers that meet the criteria of Minn. Stat. § 118A.06. For brokers such as FNC, the County must verify the brokers have SIPC coverage or excess SIPC coverage sufficient to protect all County securities in their possession in order to be in compliance with Minn. Stat. § 118A.06.

Client's Response:

JP Morgan Clearing Corp. (JPMCC) is first regulated by and subject to the rules of the Security and Exchange Commission (SEC), the New York Stock Exchange, and the Financial Industry Regulatory Authority. In the unlikely event of liquidation, losses of cash or securities, each JPMCC customer (Lincoln County) as defined under the Securities Investment Protection Act of 1970 (SIPA), all customer accounts are to be transferred to another IPC member firm. The Treasurer is downsizing the Financial Northeastern Companies (FNC) portfolio to $500,000.00 as soon as Certificates of Deposit (CDs) are called or come due.

PREVIOUSLY REPORTED ITEM RESOLVED

Publishing Board Minutes and Claims Paid (10-1)

The County Board minutes were not always published within 30 days. Published minutes contained only a summary of payments by fund instead of an individualized, itemized list of County Board-approved payments over $2,000 and a total of claims not exceeding the threshold amount.

Resolution

The County started an individualized, itemized list of County Board-approved payments over $2,000 and a total of claims not exceeding the threshold amount as of August 2, 2011. No instances were noted where the County Board minutes were not published with 30 days.

B. MANAGEMENT PRACTICES

ITEM ARISING THIS YEAR

11-4 Budget Policy

Criteria: Written policies and procedures outline the specific authority and responsibility of County personnel, providing for accountability.

Condition: The Board has not developed and adopted a formal budget policy for management's administration of the County budget.

Context: Written policies serve as a reference and training tool for personnel and ensure that procedures remain in place despite personnel turnover, absences, or other unavailability. To be effective, an accounting policies and procedures manual must be complete, up-to-date, and readily available to all personnel who need it.

Effect: Budgeting procedures may not be clear or fully understood by all those involved in the budgeting process since, as noted in finding 11-3, the Board-approved budget for 2011 did not equal, or reconcile to, the original budget in the accounting system.

Cause: Budgeting procedures exist; however, these procedures have not been formalized into written form to be approved by the Board and included in the County's Accounting Policies and Procedures Manual.

Recommendation: We recommend that the County Board develop and adopt budget policies and procedures to include the following elements:

- which funds require budgets;
- the legal level of budgetary control;
- when budgets can be modified by management and when budget modifications require Board approval;
- procedure for entering the Board-approved budget into the accounting system and for reviewing the budget from the accounting system to see that it equals, or reconciles to, the Board-approved budget;
- the budgetary basis on which the budget is adopted; and
- procedures for monitoring the budget.

Client's Response:

The County will work on a written Budget Policy.

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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
Lincoln County

We have audited the financial statements of the governmental activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of Lincoln County as of and for the year ended December 31, 2011, which collectively comprise the County's basic financial statements, and have issued our report thereon dated September 7, 2012. 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

Management of Lincoln County is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered Lincoln 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 and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying Schedule of

Findings and Recommendations**,** we identified a deficiency in internal control over financial reporting that we consider to be a material weakness and other deficiencies that we consider to be significant deficiencies.

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 material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the County's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the deficiency described in the accompanying Schedule of Findings and Recommendations as item 11-1 to be a material weakness.

A significant deficiency is a deficiency, or 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. We consider the deficiencies described in the accompanying Schedule of Findings and Recommendations as items 98-1, 11-2, and 11-3 to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Lincoln 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 Political Subdivisions*, 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 Political Subdivisions* contains seven categories of compliance to be tested: contracting and bidding, deposits and investments, conflicts of interest, public indebtedness, claims and disbursements, miscellaneous provisions, and tax increment financing. Our study included all of the listed categories, except that we did not test for compliance in tax increment financing because the County does not have any tax increment financing districts of its own.

The results of our tests indicate that for the items tested, Lincoln County complied with the material terms and conditions of applicable legal provisions, except as described in the Schedule of Findings and Recommendations as item 10-2.

Also included in the Schedule of Findings and Recommendations is a management practices comment. We believe this recommendation and information to be of benefit to the County, and it is reported for that purpose.

Lincoln County's written responses to the internal control, legal compliance, and management practices findings identified in our audit have been included in the Schedule of Findings and Recommendations. We did not audit the County's responses 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 Lincoln 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

September 7, 2012