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Certified Public Accountants

July 15, 2011

Klamath County, Oregon  
305 Main Street, Room 121  
P.O. Box 340  
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Dear Commissioners:

In planning and performing our audit of the basic financial statements of Klamath County, Oregon as of and for the year ended June 30, 2010, in accordance with auditing standards generally accepted in the United States of America, we considered Klamath County, Oregon's internal control over financial reporting (internal control) 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 entity's internal control. Accordingly, we do not express an opinion on the effectiveness of Klamath County, Oregon's internal control over financial reporting.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control 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 discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses.

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. We consider the following deficiencies in Klamath County, Oregon's internal control to be material weaknesses:

#### **Fixed Assets**

Our audit procedures revealed that in the process of setting up the new accounting system for 2010, the balances of fixed assets were not entered onto the system. This causes the financial statements to be materially misstated and gives nothing to reconcile to from the detail of fixed assets.

During our audit, we noted Klamath County, Oregon did not maintain a detailed schedule of the balances in property and equipment. While a large portion of the recorded property and equipment is fully depreciated, assets could be potentially misappropriated without the proper records being maintained and controls in place. Also, any obsolete property or property with no value should be properly removed from the books and records. To address this situation, we recommend that Klamath County, Oregon perform an inventory of all property and equipment currently in use. We further suggest that Klamath County, Oregon prepare a detailed depreciation schedule that supports the cost, book value, and depreciation expense for each item and deletes all obsolete or unidentified assets. This schedule should then be maintained on a current basis.

Our audit procedures revealed that capital expenditures as low as \$200 have been capitalized in many cases for several years. This is a violation of Klamath County's capitalization policy, which requires that only asset purchases of greater than \$5,000 be recorded as fixed assets. We recommend that Klamath County adopt and adhere to consistent written policies so there is a consistent application of the capitalization of fixed assets within the organization.

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At the present time, there is no procedure for reconciling detailed fixed asset records to the general ledger on a regular basis. The lack of such procedures has led to inaccurate reporting of fixed asset cost and depreciation expense in the financial statements. To prevent the need for major adjustments to the property accounts at the end of each year, we suggest that the general ledger fixed asset accounts be reconciled to the detailed records on a monthly basis.

### **Long Term Debt**

Our audit procedures revealed that during the process of setting up the new accounting system for 2010, bonds payable and long term debt were not entered onto the system. This causes the financial statements to be materially misstated and gives nothing to reconcile to from the detail of debt. The bonds payable and long term debt were identified and entered on the general ledger during the course of our audit.

### **Component units**

The prior audit report states in note 1 to the financial statements that there are no component units required to be included in the financial statements of Klamath County. There are two blended component units of the County, and one of those component units has discretely presented component units of its own.

One of the component units of Klamath County has inadequate records on the books of the County. The Library Service District books are kept separately and appear to consist entirely of Excel spreadsheets and Word documents. There appears to be little review or oversight of the Library Service District by the County. The Library District has two not-for-profit organizations that are discretely presented component units. We recommend that the County maintain records in the general ledger of the transactions of the Library District.

The Klamath County Drainage Service District had a separate audit prepared by other auditors for the year ended June 30, 2010. That report states that it is a primary government with no component units although the board of directors is identical to the Klamath County Board of Commissioners, and the officials of the District are management personnel of Klamath County. This audit appears to be materially misstated and cannot be relied upon to provide information required to accurately present this component unit in the financial statements of Klamath County. We recommend that the County get new auditors for this entity.

Other recommendations for improvement in the operations and internal controls of Klamath County include:

### **Investments**

During our audit, we noted certain discrepancies between the implementation and the established investment policies adopted by the Board in the past years. The purpose of the adoption of an investment policy is to set forth the overall investment philosophy of Klamath County as defined by its governing board. The policy should be the guiding rule and it should be followed without exception.

Oregon Revised Statute (ORS) 294.125 States that the custodial officer of any county may after having obtained a written order from the governing body of the county and that order is recorded in the minutes of the governing body, invest surplus funds in accordance with ORS 294.035. ORS 294.135(a) states that the custodial officer may make investments having a maturity longer than 18 months when the governing body of the county has adopted a written investment policy that, prior to adoption, was submitted to the Oregon Short Term Fund Board for review and comment to the governing body, that includes guidelines concerning maximum investment maturity dates and that provides by its terms for re-adoption not less than annually. Klamath County Investment Policy also states that the policy will be readopted annually even if there are no changes.

Klamath County has a significant number of investments with maturities greater than 18 months. The investment policy was adopted July 5<sup>th</sup>, 2005. Upon inquiry, we found no evidence that the policy has been readopted since that date, violating both Oregon Revised Statutes and the County Investment policy.

ORS 294.125 states that no custodial officer of any political subdivision of this state may accept for investment or invest the funds of any other political subdivision of this state, except as provided in ORS 294.035. ORS 294.035 states that the custodial officer may invest funds of other political subdivisions, but only after obtaining from the governing body of the county, municipality, political subdivision or school district a written order that has been entered in the minutes of the governing body.

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Klamath County currently has significant amounts of other political subdivision's funds in custody. Upon inquiry with Klamath County, and to our knowledge from other political subdivisions without current inquiry, there has never been a written order from another political subdivision allowing the County Treasurer to invest such funds.

Klamath County Investment Policy states that the County Treasurer shall maintain a system of written internal controls which shall be reviewed and tested by the independent auditor annually.

Upon inquiry, we were informed that written internal controls over investments are not followed as written. The internal controls in place exist primarily in the knowledge of the County Treasurer with no cross training or other backup.

We suggest Klamath County take steps to inform its investment managers and the treasurer of these discrepancies and that the investment policy is to be followed as it is stated. A copy of the investment policy should be provided to the investment manager with written correspondence of these matters. An investment policy is a very effective means of protecting the assets of Klamath County, and we suggest that a procedure be implemented to be certain that it is carried out.

To strengthen internal controls over the County's investment accounts, we recommend that consideration be given to establishing dual authorization on any transfers, withdrawals, or changes in the investment portfolio that are not in accordance with an established investment policy. To strengthen controls further, the County could establish a requirement that at least one of the authorizations be from a Board member. If possible, having this dual authorization requirement established through the investment broker or bank before investment transactions can occur would be most effective.

ORS 294.155 states that (1) the custodial officer for a local government that holds and invests funds on behalf of another government unit shall at least once a year submit an audited report to that government unit for which funds are invested. An audit report shall be submitted to the local governmental unit or units within 30 days after receipt of the audit report by the custodial officer's governing body.

(2) The custodial officer shall prepare a report not less than monthly to each county, municipality, school district and other political subdivision the segregated funds of which the custodial officer is then investing, as to changes made in the investments of the funds of that body during the preceding month. If requested by that body, the custodial officer shall furnish to it details on the investment transactions for its fund. The custodial officer shall also provide copies of any investment policy which has been adopted to the custodial officer's governing body upon request. [1981 c.880 §9; 1995 c.245 §9]

During our audit procedures, it came to our attention that Klamath County, Oregon does not follow ORS 294.155 regarding the audit of the investments that it holds for other municipalities, and we were informed that reports of the segregated funds were not timely during the later part of the year. We recommend that they establish procedures and policies to ensure that Klamath County, Oregon is in compliance with ORS 294.155.

## **Cash**

During our audit procedures, it was noted that checks produced in July 2010 were backdated using a June 2010 date. These checks were then included in the list of June 30, 2010, outstanding checks as if they had been actually cut in June. Proper cutoff is extremely critical in all aspects of accounting. Any process or procedure that holds the books open or closes them in advance will yield inaccurate financial results. We strongly recommend that all check disbursements be dated in sequence using the date the check is actually produced.

During our test of Klamath County's bank reconciliations, we noted a number of reconciling items, often noted as "period adjustments," which were from one to three years old. We also noted an abnormal amount of reconciling items less than one year old. As a result of this practice, some reconciling items are written off without investigation regarding their nature. Reconciling items should be researched promptly so that corrective action may be taken, where necessary, to dispose of them. This process will substantially increase control over cash. We suggest that bank accounts be reconciled and all differences between book and bank balances be investigated on a timely basis by appropriate accounting personnel so that errors and adjustment can be quickly identified and corrected.

While performing the audit on cash accounts, we noted that Klamath County, Oregon maintains separate cash accounts for different departments as well as several accounts for general operations. This requires that a significant amount of time be spent on the monthly accounting responsibilities and it weakens the overall cash controls due to the number of accounts maintained. To save time and money and increase the efficiency of operations, we suggest that some of these accounts be combined and otherwise eliminated. If it is necessary to track the cash balance of a particular program or

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fund, the features of the accounting software should be used to accomplish this task. We also noted that some of the bank accounts are not reconciled by the finance department. We recommend that the finance department reconcile all bank accounts.

During our audit, it came to our attention that Klamath County, Oregon had bank accounts that had incorrect names and only certain employees had access to these accounts. We recommend that all accounts be in Klamath County, Oregon's name and under its employer identification number.

As a result of our audit procedures in the cash disbursements area, we found that invoices were not effectively canceled after payment was made. In some instances, invoices were paid twice due to this lack of a notation system for paid invoices. To maintain stronger controls over cash disbursements, we suggest that invoices be canceled by stamping "PAID" on the face of the invoice upon receipt of final payment.

While reviewing the bank statements for year ending June 30, 2010, we noted that checks are frequently issued out of sequence. This is a major weakness in the system of controls over cash disbursements because it can be virtually impossible to be certain all checks are accounted for at any given point in time. As such, this practice makes the reconciliation of checks issued and unissued quite difficult and therefore the bank reconciliation may be completely unreliable. We strongly recommend that as soon as possible, a process be implemented whereby the organization prepares a complete listing of all checks outstanding. In the future, all checks should be issued strictly in sequence.

### **Other areas with issues and suggestions for improvement**

Our testing in the area of payroll revealed to us that there was a difference between what was paid to PERS and what was expensed. We recommend that the difference is investigated and payroll withholdings are set to the correct amount.

During our audit procedures on the budget it came to our attention that Klamath County, Oregon is out of compliance with local budget law. We recommend that the Board of Commissioners set a policy to review the budget periodically during the year to ensure Klamath County, Oregon is in compliance with the local budget law and that the preparation of the budget be done by personnel familiar with the requirements. This process will allow departmental personnel to accurately track their expenditures so that budgetary adjustments and supplemental budgets can be prepared, as necessary.

We noted that the accounts receivable subsidiary is not routinely reconciled to the general ledger. This practice serves as a check on the accuracy of the record-keeping process and maintains the accounts receivable on a more timely and accurate basis. The detail listing of accounts receivable should be reconciled to the general ledger control accounts at the end of each month. Any differences should be investigated and resolved as soon as possible.

During the testing of accounts receivable it came to our attention that interfund receivables were included in trade account receivables. This has caused the trade accounts receivable to be overstated. We recommend that Klamath County, Oregon implement policies and procedures for interfund receivables to avoid the overstating of trade account receivables.

During our audit, we noted that Klamath County, Oregon does not have a consistent system of taking periodic inventory counts for portions of the inventory. This is a serious weakness in the system of controls and has the potential for allowing abuse, including fraud and other defalcation, to exist and not be detected. Physical counts of inventory should be performed at least annually. The results should be reviewed and reconciled to the general ledger and any large discrepancies should be investigated and explained.

In an effort to improve communications between management, the Board of commissioners, and the auditor, we suggest the establishment of an audit committee to assist the Commissioners in accomplishing their fiduciary duty and responsibility to Klamath County in the financial realm. The audit committee would be responsible for engaging the independent auditors, reviewing the overall audit plan, reviewing the audited financial statements and the related management letter; creating a summary and conclusion; and reporting the resulting summary and conclusion to the Board of Commissioners. Statements on Auditing Standards require, in certain circumstances, that the independent auditor have a direct contact with such a committee of the governing board. An audit committee is advantageous because it ensures direct communication between the independent auditor and the Commissioner. Our experience has been that Commissioners generally approve of audit committees because these committees prove to be the most effective and time-efficient method of communication within the Board.

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We noted that Klamath County is experiencing significant delays in its accounting and reporting processes due to an understaffed accounting department. Continued problems in receiving timely and current financial information can significantly impact senior management's abilities, such as providing relevant oversight and budgetary control, and timely addressing the cash flow issues that currently affect Klamath County. We suggest Klamath County hire additional qualified employees as soon as possible, because time must be allowed for training new hires. Klamath County should give the accounting department staffing issue the highest priority in the upcoming months in order to provide continuity.

During our audit, we noted that Klamath County, Oregon does not have a current, comprehensive manual of accounting policies and procedures. This manual could help to standardize the County's accounting processes and be used to inform all employees of desired operating procedures and policies. Such a manual could also greatly minimize the time required to train new staff members with accounting responsibilities. Features of the system of internal controls would also be documented in the manual for future reference.


At the time of the audit, Klamath County, Oregon's accounting records, supporting schedules, documents, and other files were not in order and were in a general state of disarray. This extreme level of disorganization has the potential to cause serious errors in the financial records and financial statements. There is also a substantial risk that irregularities such as fraud and defalcation could occur and, because there is no reliable system of detection, continue undetected. We have made Klamath County, Oregon aware of this, and we suggest that efforts be made during the current year to improve accounting processes and the condition of the records and files. Orderly accounting records and supporting document files should be maintained on a consistent basis so that this information is readily available to Klamath County, Oregon. Financial statements should be well supported by the corresponding backup information included in these records.

During our audit, we noted that the existing chart of accounts is not well organized or maintained. We strongly recommend that the chart of accounts be updated and streamlined, that all accounts be assigned account numbers, and that all programs and/or projects be assigned a functional area. Management decisions are based on this type of financial data and inaccurate information will lead to poor stewardship of the enterprise. Additionally, a streamlined chart of accounts could greatly enhance the review and reconciliation process. We understand that management is in the process of doing this for the current year.

While conducting our audit, we detected numerous instances of inadequate interdepartmental communication within the County. Oftentimes, this included frequent misunderstandings that led to significant interdepartmental mistrust. These conditions can have an extremely negative impact on internal efficiencies of systems, contribute to low employee morale and frustration, and ultimately jeopardize the County's future. We highly recommend that this issue of lack of communication be investigated and that a solution be implemented as soon as possible. Perhaps a regularly scheduled meeting of all department directors to discuss and review the recent and upcoming events in their respective areas will be a positive beginning to allow for a better flow of information between each department.

Many of the areas outlined above have already been addressed by management as of the date of this letter. Others will be addressed as time and availability of staff allow.

This communication is intended solely for the information and use of management, the County Commissioners, others within the organization, and the State of Oregon and is not intended to be and should not be used by anyone other than these specified parties.



Andrew E. Peterson, Partner