

STATE OF MINNESOTA

Office of the State Auditor



Rebecca Otto
State Auditor

ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA

FOR THE 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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**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

For the Year Ended December 31, 2006



**Audit Practice Division
Office of the State Auditor
State of Minnesota**

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**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

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**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

ORGANIZATION
DECEMBER 31, 2006

			<u>Term Expires</u>
Elected			
Commissioners			
Chair	Peg Sweeney	St. Louis County	January 2008
Vice Chair	Richard Brenner	Carlton County	January 2009
Board Member	Janice Hall	Cook County	January 2007
Board Member	Charles Lepper	Koochiching County	January 2007
Board Member	Wade Pavleck	Koochiching County	January 2007
Board Member	Rick Goutermont	Lake County	January 2007
Board Member	Bill Kron	St. Louis County	January 2008
Board Member	Steve Raukar	St. Louis County	January 2008
Appointed			
Executive Director	Tom Roy		Indefinite

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REBECCA OTTO
STATE AUDITOR

STATE OF MINNESOTA

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INDEPENDENT AUDITOR'S REPORT

Board of Commissioners
Arrowhead Regional Corrections

We have audited the accompanying financial statements of the governmental activities and the General Fund of Arrowhead Regional Corrections as of and for the year ended December 31, 2006, which collectively comprise Arrowhead Regional Corrections' basic financial statements as listed in the table of contents. These financial statements are the responsibility of Arrowhead Regional Corrections' management. Our responsibility is to express opinions on these financial statements based on our audit.

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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the General Fund of Arrowhead Regional Corrections as of December 31, 2006, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis and the required supplementary information are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise Arrowhead Regional Corrections' basic financial statements. The supplementary information listed in the table of contents is presented for purposes of additional analysis and is not a required part of the basic financial statements of Arrowhead Regional Corrections. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 11, 2008, on our consideration of Arrowhead Regional Corrections' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

/s/Rebecca Otto

REBECCA OTTO
STATE AUDITOR

/s/Greg Hierlinger

GREG HIERLINGER, CPA
DEPUTY STATE AUDITOR

February 11, 2008

MANAGEMENT'S DISCUSSION AND ANALYSIS

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**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

**MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2006
(Unaudited)**

Our Management's Discussion and Analysis (MD&A) of Arrowhead Regional Corrections' financial performance provides an overview of the financial activities for the fiscal year ended December 31, 2006. Please read it in conjunction with the accompanying basic financial statements.

FINANCIAL HIGHLIGHTS

Total net assets in 2006 for Arrowhead Regional Corrections increased \$0.2 million to \$6.5 million.

The Arrowhead Regional Corrections' General Fund reported an ending fund balance of \$4.7 million, an increase of \$1.0 million. Part of the fund balance, \$2.7 million, is reserved and not available for appropriation. The remaining \$2.0 million (unreserved fund balance) has been designated for specific uses.

The General Fund reported an excess of revenues over expenditures of \$1.0 million.

OVERVIEW OF THE FINANCIAL STATEMENTS

This MD&A is intended to serve as an introduction to Arrowhead Regional Corrections' basic financial statements. The basic financial statements comprise three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements. This report contains other supporting schedules in addition to the basic financial statements.

Government-wide financial statements: The Statement of Net Assets and the Statement of Activities report information about Arrowhead Regional Corrections as a whole and about its activities. These statements include all assets and liabilities using the accrual basis of accounting, which is similar to the accounting used by most private-sector companies. All current year revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report Arrowhead Regional Corrections' net assets and changes to them. Net assets--the difference between assets and liabilities--is one way to measure Arrowhead Regional Corrections' financial health, or financial position. Over time, increases or decreases in

Arrowhead Regional Corrections' net assets are one indicator of whether its financial health is improving or deteriorating. You will need to consider other nonfinancial factors, such as the condition of buildings and structures, to assess the overall health of Arrowhead Regional Corrections. The government-wide financial statements can be found on pages 11 and 12.

Fund financial statements: These statements provide detailed information about the General Fund, not Arrowhead Regional Corrections as a whole. The Arrowhead Regional Corrections' General Fund is considered a governmental fund.

All of Arrowhead Regional Corrections' services are reported in the General Fund, which focuses on how money flows into and out of the fund and any balance left at year-end is available for spending. This fund is reported using the modified accrual method of accounting, which measures cash and all other financial assets that can be readily converted to cash. The General Fund statements provide a detailed short-term view of Arrowhead Regional Corrections' operations and the basic services it provides. General Fund information helps determine whether there are more or fewer financial resources that can be spent in the near future to finance Arrowhead Regional Corrections' programs. We describe the relationship (or differences) between governmental activities (reported in the Statement of Net Assets and the Statement of Activities) and the General Fund in a reconciliation following each of the fund financial statements. The basic financial statements for the General Fund can be found on pages 13 through 16.

Notes to the financial statements: The notes provide additional information essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes can be found on pages 17 through 30.

Supporting schedules: The budgetary comparison schedule, notes to the required supplementary information, and the schedule of intergovernmental revenue are provided on pages 31 through 34.

Government-Wide Financial Analysis

Net assets may over time be a useful indicator of a government's financial position. In the case of Arrowhead Regional Corrections, assets exceeded liabilities by \$6.5 million.

By far the largest portion of Arrowhead Regional Corrections' net assets is the investment in capital assets. Because Arrowhead Regional Corrections uses these capital assets to provide services to participants, they are not available for future spending.

Table 1
Net Assets
(in Millions)

	Governmental Activities	
	2006	2005
Current and other assets	\$ 5.8	\$ 5.3
Capital assets	6.2	6.4
Total Assets	\$ 12.0	\$ 11.7
Other liabilities	\$ 0.8	\$ 0.8
Long-term liabilities outstanding	4.7	4.6
Total Liabilities	\$ 5.5	\$ 5.4
Net Assets		
Invested in capital assets	\$ 6.2	\$ 6.4
Unrestricted	0.3	(0.1)
Total Net Assets	\$ 6.5	\$ 6.3

The following analysis focuses on Arrowhead Regional Corrections net assets (Table 1).

Governmental Activities

Arrowhead Regional Corrections' net assets increased by \$0.2 million, or 3.0 percent, from \$6.3 million to \$6.5 million. Arrowhead Regional Corrections is able to report a positive balance in net assets unrestricted for 2006 as opposed to 2005, when invested in capital assets exceeded total assets less total liabilities.

Over half of the current and other assets are cash and pooled investments (\$3.1 million).

The long-term liabilities outstanding are 100 percent compensated absences.

A detailed analysis of capital assets is presented in Table 3 under the heading Capital Assets and Debt Administration.

Table 2
Changes in Net Assets
(in Millions)

	Governmental Activities	
	2006	2005
Revenues		
Program revenues		
Charges for services	\$ 1.0	\$ 0.9
Operating grants and contributions	2.3	2.3
General revenues		
Community corrections act subsidy	3.8	3.8
Grant and contributions not restricted to specific programs	11.8	11.1
Miscellaneous	0.5	0.3
Total Revenues	<u>\$ 19.4</u>	<u>\$ 18.4</u>
Expenses		
Program expenses		
Administration	\$ 1.7	\$ 1.8
Court and field services	8.8	8.2
Northeast Regional Corrections Center	5.2	4.7
Arrowhead Juvenile Center	3.5	3.2
Total Expenses	<u>\$ 19.2</u>	<u>\$ 17.9</u>
Increase (Decrease) in Net Assets	\$ 0.2	\$ 0.5
Net Assets, January 1	<u>6.3</u>	<u>5.8</u>
Net Assets, December 31	<u><u>\$ 6.5</u></u>	<u><u>\$ 6.3</u></u>

The following analysis focuses on Arrowhead Regional Corrections' changes in net assets (Table 2).

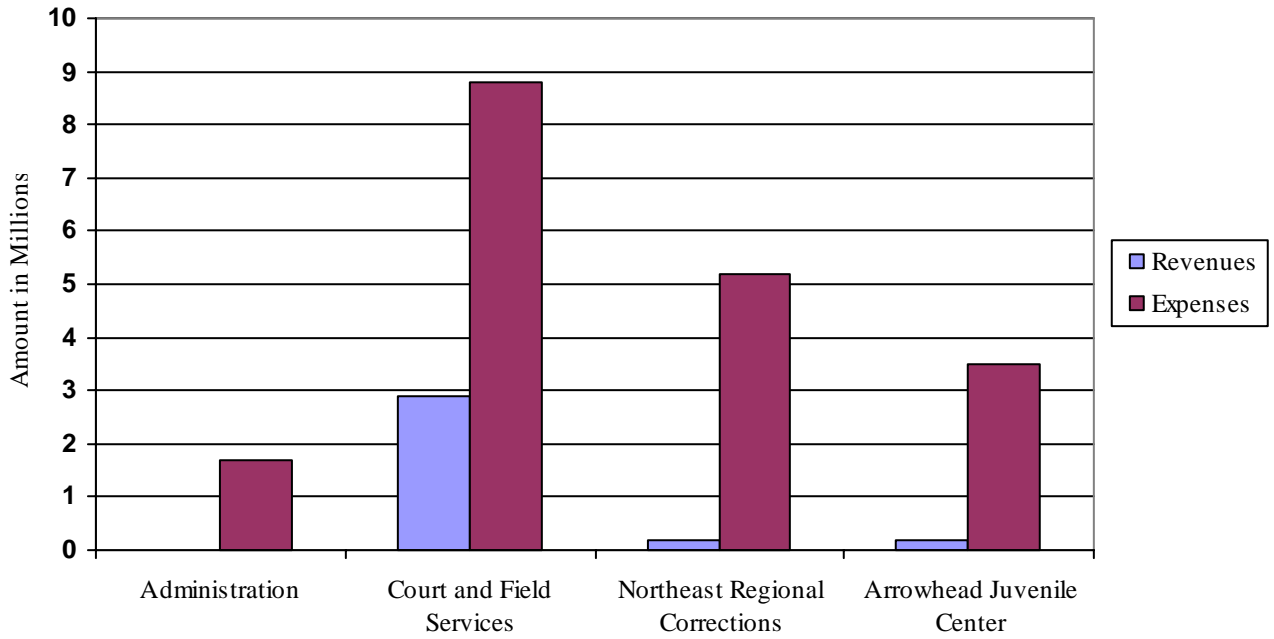
Governmental Activities

Total revenues were \$1.0 million more in 2006 than in 2005, an increase of 5.4 percent. The largest increase was grants and contributions not restricted to specific programs of \$0.7 million. The five member counties contributed \$11.8 million in 2006 compared to \$11.1 million in 2005.

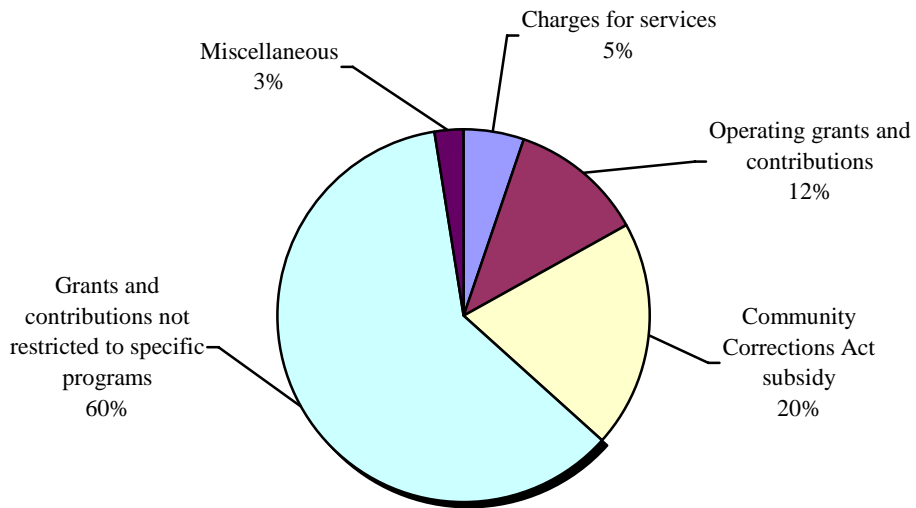
Operating grants and contributions were from state and federal grants. Operating grants and contributions were \$2.3 million in 2006 and 2005.

Total expenses increased in 2006 by \$1.3 million. Court and field services increased the most, going from \$8.2 million in 2005 to \$8.8 million in 2006, or 46.0 percent of total expenses.

Expenses and Program Revenues: Governmental Activities



Revenues by Source: Governmental Activities



Financial Analysis of the General Fund

As noted earlier, Arrowhead Regional Corrections uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

General Fund. The focus of Arrowhead Regional Corrections' General Fund is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing Arrowhead Regional Corrections' financing requirements. In particular, unreserved fund balance may serve as a useful measure of Arrowhead Regional Corrections' net resources available for spending at the end of the fiscal year.

As of December 31, 2006, Arrowhead Regional Corrections' General Fund reported a fund balance of \$4.7 million, compared with \$3.7 million in 2005. Unreserved fund balance, which is available for spending at Arrowhead Regional Corrections' discretion, was \$2.0 million at the end of the year. All of the \$2.0 million of unreserved fund balance has been designated. Designations reflect Arrowhead Regional Corrections' self-imposed limitations on otherwise available expendable resources. The largest designation is for compensated absences at \$1.9 million, or 90.6 percent. The remaining \$2.7 million of fund balance is reserved. Fund balance is reserved because it is either unavailable for spending or legally restricted. Reserved for correctional fees of \$2.5 million, or 92.4 percent, is the largest reservation of fund balance.

Arrowhead Regional Corrections' fund balance increased \$1.0 million as a result of revenues exceeding expenditures.

General Fund Budgetary Highlights

Drug Court grants continued in St. Louis County, and the State Drug Court work group developed strategies for funding Drug Courts for 2007 and 2008. There were no major increases in 2006.

Also notable in 2006 was an investment of the designated for compensated absences. The accrued interest for 2006 on the investment was \$60,855. This will positively impact the 2007 budget.

Another factor in the 2006 budget was the St. Louis County Auditor implementing departmental allocations of cost based on the Maximus indirect cost allocation report. The impact on Arrowhead Regional Corrections was significant, and the budget had major increases in administrative costs for auditing, legal, personnel management, and safety and training. That increase amounted to \$224,890 over 2005.

Legislative funding for 2006 was very flat, and there was not any major change in the monies received from the state for the Community Corrections Act subsidy.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

At year-end, the County showed total capital assets of \$6.2 million. These amounts represent a broad range of capital assets, including land, buildings, machinery, and vehicles. Detail is presented immediately below in Table 3.

Table 3
Capital Assets at Year-End
(Net of Depreciation, in Millions)

	Governmental Activities	
	2006	2005
Land	\$ 0.5	\$ 0.5
Buildings and improvements	5.6	5.8
Vehicles	0.1	0.1
Totals	<u>\$ 6.2</u>	<u>\$ 6.4</u>

The decrease in capital assets was due to depreciation expense exceeding new purchases by slightly more than \$0.2 million. Purchases were far less than \$0.1 million.

Additional information on Arrowhead Regional Corrections' capital assets can be found in the notes to the financial statements.

Debt Administration

At year-end, Arrowhead Regional Corrections did not have any bonded debt.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES

Local government continues to be challenged in northern Minnesota by a relatively stagnant economy. Increasing costs, especially in energy and health care, continue to be a problem that has to be dealt with. National priorities have also reduced grant opportunities, which often lead to innovation and better services.

CONTACTING ARROWHEAD REGIONAL CORRECTIONS FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, taxpayers, customers, investors, and creditors with a general overview of finances and to show Arrowhead Regional Corrections accountability for the money it receives. If you have a question about this report or need information, contact the Arrowhead Regional Corrections Office at: 100 N. 5th Avenue West, Duluth, Minnesota 55802-1293.

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BASIC FINANCIAL STATEMENTS

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GOVERNMENT-WIDE FINANCIAL STATEMENTS

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**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

EXHIBIT 1

**STATEMENT OF NET ASSETS
DECEMBER 31, 2006**

	Governmental Activities
<u>Assets</u>	
Cash and pooled investments	\$ 3,124,017
Investments	1,400,039
Receivables - net	1,165,386
Inventories	120,447
Prepaid items	9,135
Capital assets	
Non-depreciable capital assets	454,123
Depreciable capital assets - net of accumulated depreciation	5,740,538
Total Assets	\$ 12,013,685
<u>Liabilities</u>	
Accounts payable and other current liabilities	\$ 780,221
Long-term liabilities	
Due within one year	1,153,578
Due in more than one year	3,617,154
Total Liabilities	\$ 5,550,953
<u>Net Assets</u>	
Invested in capital assets	\$ 6,194,661
Unrestricted	268,071
Total Net Assets	\$ 6,462,732

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

EXHIBIT 2

**STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED DECEMBER 31, 2006**

	<u>Expenses</u>	<u>Program Revenues</u>		<u>Net (Expense) Revenue and Change in Net Assets</u>
		<u>Fees, Charges, Fines, and Other</u>	<u>Operating Grants and Contributions</u>	
<u>Functions/Programs</u>				
Governmental activities				
Administration	\$ 1,715,580	\$ -	\$ -	\$ (1,715,580)
Court and field services	8,842,512	790,144	2,072,648	(5,979,720)
Northeast Regional Corrections Center	5,167,528	98,017	95,302	(4,974,209)
Arrowhead Juvenile Center	3,481,596	76,394	93,380	(3,311,822)
Total Governmental Activities	<u>\$ 19,207,216</u>	<u>\$ 964,555</u>	<u>\$ 2,261,330</u>	<u>\$ (15,981,331)</u>
General Revenues				
Community Corrections Act subsidy				\$ 3,776,254
Grants and contributions not restricted to specific programs				11,872,477
Investment income				61,045
Miscellaneous				461,214
Total general revenues				<u>\$ 16,170,990</u>
Change in net assets				<u>\$ 189,659</u>
Net Assets - Beginning				<u>6,273,073</u>
Net Assets - Ending				<u>\$ 6,462,732</u>

FUND FINANCIAL STATEMENTS

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GOVERNMENTAL FUNDS

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**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

EXHIBIT 3

**BALANCE SHEET
GENERAL FUND
DECEMBER 31, 2006**

Assets

Cash and pooled investments	\$	3,102,707
Petty cash and change funds		21,310
Investments		1,400,039
Accounts receivable		85
Accrued interest receivable		61,045
Due from other governments		1,104,256
Inventories		120,447
Prepaid items		9,135
		9,135
Total Assets	\$	<u>5,819,024</u>

Liabilities and Fund Balance

Liabilities

Accounts payable	\$	211,819
Salaries payable		551,117
Due to other governments		17,285
Deferred revenue - unavailable		316,143
		316,143
Total Liabilities	\$	<u>1,096,364</u>

Fund Balance

Reserved for		
Inventories	\$	120,447
Prepaid items		9,135
Health and welfare		74,117
Correctional fees		2,465,378
Unreserved		
Designated for cash flow		171,993
Designated for petty cash funds		21,310
Designated for compensated absences		1,860,280
		1,860,280
Total Fund Balance	\$	<u>4,722,660</u>
Total Liabilities and Fund Balance	\$	<u>5,819,024</u>

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

EXHIBIT 4

**RECONCILIATION OF GENERAL FUND BALANCE SHEET TO
THE GOVERNMENT-WIDE STATEMENT OF NET ASSETS--GOVERNMENTAL ACTIVITIES
DECEMBER 31, 2006**

Fund balance - total General Fund (Exhibit 3)	\$ 4,722,660
Amounts reported for governmental activities in the statement of net assets are different because:	
Capital assets, net of accumulated depreciation, used in governmental activities are not financial resources and, therefore, are not reported in the fund.	6,194,661
Other long-term assets are not available to pay for current period expenditures and, therefore, are deferred in the fund.	316,143
Long-term liabilities are not due and payable in the current period and, therefore, are not reported in the fund.	
Compensated absences	<u>(4,770,732)</u>
Net Assets of Governmental Activities (Exhibit 1)	<u>\$ 6,462,732</u>

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

EXHIBIT 5

**STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE
GENERAL FUND
FOR THE YEAR ENDED DECEMBER 31, 2006**

Revenues	
Intergovernmental	\$ 18,375,837
Charges for services	964,555
Interest on investments	61,045
Miscellaneous	375,860
	\$ 19,777,297
Expenditures	
Current	
Administration	\$ 1,678,244
Court and field services	8,741,156
Northeast Regional Corrections Center	5,001,707
Arrowhead Juvenile Center	3,368,550
Capital outlay	15,100
	\$ 18,804,757
Net Change in Fund Balance	\$ 972,540
Fund Balance - January 1	3,729,436
Increase (decrease) in reserved for inventories	20,684
	\$ 4,722,660
Fund Balance - December 31	\$ 4,722,660

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

EXHIBIT 6

**RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES, AND
CHANGES IN FUND BALANCE OF THE GENERAL FUND TO THE
GOVERNMENT-WIDE STATEMENT OF ACTIVITIES--GOVERNMENTAL ACTIVITIES
FOR THE YEAR ENDED DECEMBER 31, 2006**

Net change in fund balance - General Fund (Exhibit 5) \$ 972,540

Amounts reported for governmental activities in the statement of activities are different because:

In the fund, under the modified accrual basis, receivables not available for expenditure are deferred. In the statement of activities, those revenues are recognized when earned. The adjustment to revenues between the fund statement and the statement of activities is the increase (decrease) in revenues deferred as unavailable.

Deferred revenue - December 31	\$ 316,143	
Deferred revenue - January 1	(699,172)	(383,029)

Governmental funds report capital outlay as expenditures. However, in the statement of activities, the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. In the statement of activities, only the gain or loss on the disposal of capital assets is reported; whereas, in the governmental fund, the proceeds from the sale increase financial resources. Therefore, the change in net assets differs from the change in fund balance by the net book value of the assets sold.

Expenditures for general capital assets	\$ 15,100	
Net book value of assets disposed of	(12,002)	
Current year depreciation	(242,454)	(239,356)

Some expenses reported in the statement of activities do not require the use of current financial resources and, therefore, are not reported in governmental funds.

Change in compensated absences	\$ (181,180)	
Change in inventories	20,684	(160,496)

Change in Net Assets of Governmental Activities (Exhibit 2) \$ 189,659

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

**NOTES TO THE FINANCIAL STATEMENTS
AS OF AND FOR THE YEAR ENDED DECEMBER 31, 2006**

1. Summary of Significant Accounting Policies

Arrowhead Regional Corrections' financial statements are prepared in accordance with generally accepted accounting principles (GAAP) for the year ended December 31, 2006. The Governmental Accounting Standards Board (GASB) is responsible for establishing GAAP for state and local governments through its pronouncements (statements and interpretations). Governments are also required to follow the pronouncements of the Financial Accounting Standards Board issued through November 30, 1989, (when applicable) that do not conflict with or contradict GASB pronouncements. The more significant accounting policies established in GAAP and used by Arrowhead Regional Corrections are discussed below.

A. Financial Reporting Entity

Arrowhead Regional Corrections was established pursuant to the Community Corrections Act, Minn. Stat. §§ 401.01-.16, and a joint powers agreement, effective January 1, 1993, between Carlton, Cook, Koochiching, Lake, and St. Louis Counties, pursuant to Minn. Stat. § 471.59. As required by accounting principles generally accepted in the United States of America, these financial statements present Arrowhead Regional Corrections (primary government). Arrowhead Regional Corrections is governed by an eight-member Board. One member is appointed from the Board of Commissioners of each participating county, except for St. Louis County, which has three members from its Board of County Commissioners. In addition, the right to have an additional member is annually rotated among Carlton, Cook, Koochiching, and Lake Counties. Except for the rotating Board member position, all Board members serve two-year terms. The Board is organized with a chair and vice chair elected at the annual meeting in January of each year.

B. Basic Financial Statements

1. Government-Wide Statements

The government-wide financial statements (the statement of net assets and the statement of activities) display information about the primary government. These statements include the financial activities of Arrowhead Regional Corrections. Eliminations have been made to minimize the double counting of internal activities.

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

1. Summary of Significant Accounting Policies

B. Basic Financial Statements

1. Government-Wide Statements (Continued)

The government-wide statement of net assets is reported on a full accrual, economic resource basis, which recognizes long-term assets and receivables as well as long-term debt and obligations. Arrowhead Regional Corrections' net assets are reported in two parts: (1) invested in capital assets and (2) unrestricted net assets. Arrowhead Regional Corrections first utilizes restricted resources to finance qualifying activities.

The statement of activities demonstrates the degree to which the direct expenses of each function of Arrowhead Regional Corrections' governmental activities are offset by program revenues. Direct expenses are those clearly identifiable with a specific function or activity. Program revenues include: (1) fees and charges paid by the recipients of goods, services, or privileges provided by a given function or activity; and (2) grants and contributions restricted to meeting the operational or capital requirements of a particular function or activity. Revenues not classified as program revenues are presented as general revenues.

2. Fund Financial Statements

The fund financial statements provide information about Arrowhead Regional Corrections' General Fund. The General Fund is Arrowhead Regional Corrections' primary operating fund. It accounts for all financial resources of the general government.

C. Measurement Focus and Basis of Accounting

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned, and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

1. Summary of Significant Accounting Policies

C. Measurement Focus and Basis of Accounting (Continued)

Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Arrowhead Regional Corrections considers all revenues as available if collected within 60 days after the end of the current period. Expenditures are recorded when the related fund liability is incurred, except for principal and interest on long-term debt, compensated absences, and claims and judgments, which are recognized as expenditures to the extent that they have matured. Proceeds of long-term debt and acquisitions under capital leases are reported as other financing sources.

When both restricted and unrestricted resources are available for use, it is Arrowhead Regional Corrections' policy to use restricted resources first and then unrestricted resources as needed.

D. Assets, Liabilities, and Net Assets or Equity

1. Cash and Pooled Investments

Arrowhead Regional Corrections' available cash balances are pooled and invested by St. Louis County in accordance with Minnesota statutes. The County's cash balances and investments are at fair value based on quoted market prices. Additional disclosures defining cash and pooled investments can be found in the St. Louis County Comprehensive Annual Financial Report.

2. Inventories

All inventories are valued at cost using the first in/first out (FIFO) method. Inventories in governmental funds are recorded as expenditures when purchased rather than when consumed. Inventories at the government-wide level are reported as expenses when consumed.

3. Capital Assets

Capital assets, which include property, plant, and equipment, are reported in the governmental activities column in the government-wide financial statements. Capital assets are defined by Arrowhead Regional Corrections as assets with an

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

1. Summary of Significant Accounting Policies

D. Assets, Liabilities, and Net Assets or Equity

3. Capital Assets (Continued)

initial, individual cost of more than \$5,000 and an estimated useful life in excess of two years. Such assets are recorded at historical cost or estimated historical cost if purchased or constructed. Donated capital assets are recorded at estimated fair market value at the date of donation.

The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets' lives are not capitalized.

Property, plant, and equipment of the Arrowhead Regional Corrections are depreciated using the straight-line method over the following estimated useful lives:

<u>Assets</u>	<u>Years</u>
Buildings	30 - 70
Building improvements	10 - 20
Furniture, equipment, and vehicles	3 - 15

4. Compensated Absences

The liability for compensated absences reported in the financial statements consists of unpaid, accumulated annual vacation and sick leave balances. The liability has been calculated using the vesting method, in which leave amounts for both employees who are currently eligible to receive termination payments and other employees who are expected to become eligible in the future to receive such payments upon termination are included. Compensated absences are accrued when incurred in the government-wide financial statements. A liability for these amounts is reported in the governmental funds only if they have matured, for example, as a result of employee resignations and retirements.

5. Deferred Revenue

The General Fund and the government-wide financial statements defer revenue for resources that have been received, but not yet earned. Governmental funds also report deferred revenue in connection with receivables for revenues not considered to be available to liquidate liabilities of the current period.

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

1. Summary of Significant Accounting Policies

D. Assets, Liabilities, and Net Assets or Equity (Continued)

6. Long-Term Obligations

In the government-wide financial statements, long-term debt and other long-term obligations are reported as liabilities in the governmental activities statement of net assets.

7. Fund Equity

In the fund financial statements, governmental funds report reservations of fund balance for amounts not available for appropriation or legally restricted by outside parties for use for a specific purpose. Designations of fund balance represent tentative management plans subject to change.

8. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Detailed Notes on All Funds

A. Assets

1. Deposits and Investments

Minn. Stat. §§ 118A.02 and 118A.04 authorize Arrowhead Regional Corrections to deposit its cash and to invest in certificates of deposit in financial institutions designated by the St. Louis County Board of Commissioners and the Arrowhead Regional Corrections Board. The County invests the funds of Arrowhead Regional Corrections. By agreement, Arrowhead Regional Corrections retains the interest earned on investments purchased with funds designated for compensated absences. The County retains the interest from the remainder of the funds. Minnesota statutes require that all County deposits be covered by insurance, surety bond, or collateral.

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

2. Detailed Notes on All Funds

A. Assets

1. Deposits and Investments (Continued)

Minn. Stat. §§ 118A.04 and 118A.05 authorize the types of securities available to Arrowhead Regional Corrections for investment.

Additional disclosures, as required by GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*; GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*; and GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, are disclosed on an entity-wide basis in the St. Louis County Comprehensive Annual Financial Report.

The following is a summary of Arrowhead Regional Corrections' cash:

	<u>December 31, 2006</u>
Cash and pooled investments	\$ 3,102,707
Petty cash and change funds	21,310
Investments	<u>1,400,039</u>
Total	<u>\$ 4,524,056</u>

2. Receivables

Receivables as of December 31, 2006, for Arrowhead Regional Corrections' governmental activities are as follows:

Due from other governments	\$ 1,104,256
Accrued interest receivable	61,045
Accounts	<u>85</u>
Total Receivables	<u>\$ 1,165,386</u>

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

2. Detailed Notes on All Funds

A. Assets (Continued)

3. Capital Assets

Capital asset activity for the year ended December 31, 2006, was as follows:

	Beginning Balance	Increase	Decrease	Ending Balance
Capital assets not depreciated				
Land	\$ 454,123	\$ -	\$ -	\$ 454,123
Capital assets depreciated				
Buildings	\$ 7,765,071	\$ -	\$ 33,495	\$ 7,731,576
Machinery, furniture, and equipment	982,023	15,100	32,690	964,433
Total capital assets depreciated	\$ 8,747,094	\$ 15,100	\$ 66,185	\$ 8,696,009
Less: accumulated depreciation for				
Buildings	\$ 1,974,638	\$ 179,807	\$ 21,493	\$ 2,132,952
Machinery, furniture, and equipment	792,562	62,647	32,690	822,519
Total accumulated depreciation	\$ 2,767,200	\$ 242,454	\$ 54,183	\$ 2,955,471
Total capital assets depreciated, net	\$ 5,979,894	\$ (227,354)	\$ 12,002	\$ 5,740,538
Capital Assets, Net	\$ 6,434,017	\$ (227,354)	\$ 12,002	\$ 6,194,661

Depreciation expense was charged to functions/programs of Arrowhead Regional Corrections as follows:

Administration	\$ 19,568
Court and Field Services	2,057
Northeast Regional Corrections Center	128,338
Arrowhead Juvenile Center	92,491
Total Depreciation Expense	\$ 242,454

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

2. Detailed Notes on All Funds (Continued)

B. Liabilities

1. Payables

Payables at December 31, 2006, were as follows:

Accounts	\$	211,819
Salaries		551,117
Due to other governments		17,285
Total Payables	\$	780,221

2. Leases

Operating Leases

Arrowhead Regional Corrections leases office space and office equipment under noncancelable operating leases. Total costs for such leases were \$162,255 for the year ended December 31, 2006. The future minimum lease payments for these leases are as follows:

Year Ending December 31	Amount
2006	\$ 167,392
2007	167,392
2008	167,392
2009	167,392
2010	167,392
Total	\$ 836,960

3. Changes in Long-Term Liabilities

Long-term liability activity for the year ended December 31, 2006, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Compensated absences	\$ 4,589,552	\$ 548,177	\$ 366,997	\$ 4,770,732	\$ 1,153,578

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

2. Detailed Notes on All Funds

B. Liabilities (Continued)

4. Deferred Compensation

Arrowhead Regional Corrections' employees participate in St. Louis County's deferred compensation plan.

5. Other Employee Benefits

Under Arrowhead Regional Corrections' personnel policies and union contracts, its employees are granted vacation and sick leave in varying amounts based upon length of service. Vacation leave accrual varies from two to nine hours per biweekly pay period. Sick leave accrual is from 2.0 to 5.5 hours per biweekly pay period.

Unused accumulated vacation is paid to employees at termination. All vacation pay is accrued when earned in the government-wide financial statements.

Vested sick leave is paid to employees at retirement or is used for the payment of employee's health insurance coverage during their retirement. The vested sick leave and unvested sick leave likely to become vested (vesting sick leave) are estimated using the vesting method prescribed by GASB Statement 16. Both vested and vesting amounts are recognized in the government-wide statements as liabilities, but not in the governmental fund.

Unvested sick leave of \$1,451,093 (total accumulated sick leave less estimated amounts of vested and vesting sick leave) at December 31, 2006, is available to employees in the event of illness-related absences and is not reported in the financial statements.

6. Risk Management

Arrowhead Regional Corrections is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors or omissions; injuries to employees; or natural disasters. Risk management is handled through a combination of purchased commercial insurance and participation in the St. Louis County self-insurance program. Arrowhead Regional Corrections did not have a loss exceeding the limits of insurance coverage for any of the past three years. There were no significant reductions in insurance from the prior year.

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

2. Detailed Notes on All Funds

B. Liabilities

6. Risk Management (Continued)

St. Louis County handles its self-insurance through three internal service funds. Additional disclosures as required by GASB Statement No. 10, *Accounting and Reporting for Risk Financing and Related Insurance Issues*, are disclosed on an entity-wide basis in the St. Louis County Comprehensive Annual Financial Report.

3. Employee Retirement Systems and Pension Plans

A. Plan Description

All full-time and certain part-time employees of Arrowhead Regional Corrections are covered by defined benefit pension plans administered by the Public Employees Retirement Association of Minnesota (PERA). The PERA administers the Public Employees Retirement Fund and the Public Employees Correctional Fund, which are cost-sharing, multiple-employer retirement plans. These plans are established and administered in accordance with Minn. Stat. chs. 353 and 356.

Public Employees Retirement Fund members belong to either the Coordinated Plan or the Basic Plan. Coordinated Plan members are covered by Social Security, and Basic Plan members are not. All new members must participate in the Coordinated Plan. Members who are employed in a county correctional institution and have direct contact with inmates are covered by the Public Employees Correctional Fund.

The PERA provides retirement benefits as well as disability benefits to members and benefits to survivors upon death of eligible members. Benefits are established by state statute and vest after three years of credited service. The retirement benefits are based on a member's highest average salary for any five successive years of allowable service, age, and years of credit at termination of service.

Two methods are used to compute benefits for Coordinated and Basic Plan members. The retiring member receives the higher of a step-rate benefit accrual formula (Method 1) or a level accrual formula (Method 2). Under Method 1, the annuity accrual rate for a Basic Plan member is 2.2 percent of average salary for each of the first ten years of service and 2.7 percent for each year thereafter. For a Coordinated Plan member, the annuity accrual rate is 1.2 percent of average salary for each of the

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

3. Employee Retirement Systems and Pension Plans

A. Plan Description (Continued)

first ten years and 1.7 percent for each successive year. Under Method 2, the annuity accrual rate is 2.7 percent of average salary for Basic Plan members and 1.7 percent for Coordinated Plan members for each year of service. For Public Employees Police and Fire Fund members, the annuity accrual rate is 3.0 percent of average salary for each year of service. For Public Employees Correctional Fund members, the annuity accrual rate is 1.9 percent of average salary for each year of service.

For all Public Employees Retirement Fund members whose annuity is calculated using Method 1 and Public Employees Correctional Fund members, a full annuity is available when age plus years of service equal 90. A reduced retirement annuity is also available to eligible members seeking early retirement.

The benefit provisions stated in the previous paragraphs of this section are current provisions and apply to active plan participants. Vested, terminated employees who are entitled to benefits but are not yet receiving them are bound by the provisions in effect at the time they last terminated public service.

The PERA issues a publicly available financial report that includes financial statements and required supplementary information for the Public Employees Retirement Fund and the Public Employees Correctional Fund. That report may be obtained on the internet at www.mnpera.org; by writing to PERA at 60 Empire Drive, Suite 200, Saint Paul, Minnesota 55103-2088; or by calling 651-296-7460 or 1-800-652-9026.

B. Funding Policy

Pension benefits are funded from member and employer contributions and income from the investment of fund assets. Minn. Stat. ch. 353 sets the rates for employer and employee contributions. These statutes are established and amended by the State Legislature. Arrowhead Regional Corrections makes annual contributions to the pension plans equal to the amount required by state statutes. Public Employees Retirement Fund Basic Plan members and Coordinated Plan members were required to contribute 9.10 and 5.50 percent, respectively, of their annual covered salary in 2006. Contribution rates in the Coordinated Plan increased in 2007 to 5.75 percent. Public Employees Correctional Fund members are required to contribute 5.83 percent of their annual covered salary.

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

3. Employee Retirement Systems and Pension Plans

B. Funding Policy (Continued)

Arrowhead Regional Corrections is required to contribute the following percentages of annual covered payroll in 2006 and 2007:

	2006	2007
Public Employees Retirement Fund		
Basic Plan members	11.78%	11.78%
Coordinated Plan members	6.00	6.25
Public Employees Correctional Fund	8.75	8.75

Arrowhead Regional Corrections' contributions for the years ending December 31, 2006, 2005, and 2004, for the Public Employees Retirement Fund and the Public Employees Correctional Fund were:

	Public Employees Retirement Fund	Public Employees Correctional Fund
2006	\$ 485,595	\$ 239,127
2005	394,793	228,257
2004	399,375	232,207

These contribution amounts are equal to the contractually required contributions for each year as set by state statute.

4. Summary of Significant Contingencies and Other Items

A. Contingent Liabilities

Amounts received or receivable from grant agencies are subject to audit and adjustment by grantor agencies, principally the federal government. Any disallowed claims, including amounts already collected, may constitute a liability of the applicable funds. The amount, if any, of the expenditures that may be disallowed by the grantor cannot be determined at this time, although Arrowhead Regional Corrections expects such amounts, if any, to be immaterial.

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

4. Summary of Significant Contingencies and Other Items (Continued)

B. Claims and Litigation

Arrowhead Regional Corrections, in connection with the normal conduct of its affairs, is involved in various claims, judgments, and litigation.

The County Attorney estimates that the potential claims against Arrowhead Regional Corrections that would not be covered by insurance will not have a material adverse effect on the financial condition of Arrowhead Regional Corrections.

C. Participation

The budget of Arrowhead Regional Corrections is financed through state grants and contributions from the participating counties. County contributions are shared in the following proportion:

	<u>Percent (%)</u>
Carlton County	9.38
Cook County	1.44
Koochiching County	1.96
Lake County	2.19
St. Louis County	<u>85.03</u>
Totals	<u>100.00</u>

Member contributions for the current year totaled \$11,729,527, or 64 percent, of the total intergovernmental revenue received.

Of the various state grants available to Arrowhead Regional Corrections, the most significant is the grant authorized under the Community Corrections Act. Grant proceeds for the year 2006 totaled \$3,776,254, or 21 percent, of total intergovernmental revenue received.

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

4. Summary of Significant Contingencies and Other Items (Continued)

D. Jointly-Governed Organizations

Arrowhead Regional Corrections, in conjunction with other governmental entities and various private organizations, formed the jointly-governed organizations listed below:

Duluth Family Service Collaborative
Koochiching County Family Services Collaborative
North St. Louis County Family Services Collaborative
North Shore Collaborative

The collaboratives were established to create opportunities to enhance family strengths and support through service coordination and access to informal communication. Arrowhead Regional Corrections has no operational or financial control over the collaboratives. During the year, Arrowhead Regional Corrections had expenditures of \$500 related to the North Shore Collaborative.

REQUIRED SUPPLEMENTARY INFORMATION

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**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

Schedule 1

**BUDGETARY COMPARISON SCHEDULE
GENERAL FUND
FOR THE YEAR ENDED DECEMBER 31, 2006**

	Budgeted Amounts		Actual Amounts	Variance with Final Budget
	Original	Final		
Revenues				
Intergovernmental	\$ 18,240,823	\$ 18,264,632	\$ 18,375,837	\$ 111,205
Charges for services	773,500	778,314	964,555	186,241
Investment earnings	-	-	61,045	61,045
Miscellaneous	352,185	363,381	375,860	12,479
Total Revenues	\$ 19,366,508	\$ 19,406,327	\$ 19,777,297	\$ 370,970
Expenditures				
Current				
Administration				
Administrative support services	\$ 1,776,384	\$ 1,776,384	\$ 1,143,553	\$ 632,831
Research and evaluation	202,230	202,230	204,319	(2,089)
Staff development	139,111	139,111	101,002	38,109
Arrowhead Council of Churches	24,924	24,924	24,924	-
Women offenders program	174,015	174,015	114,461	59,554
Use of institutions	100,000	100,000	89,985	10,015
Total administration	\$ 2,416,664	\$ 2,416,664	\$ 1,678,244	\$ 738,420
Court and field services				
Probation	\$ 8,189,895	\$ 8,189,895	\$ 7,931,900	\$ 257,995
St. Louis County data processing charges	134,322	134,322	134,322	-
Intensive supervision program	230,292	230,292	230,292	-
Short-term consequences	132,853	132,853	189,273	(56,420)
Sentence to service	171,054	171,054	171,054	-
Juvenile restitution	-	-	733	(733)
Correctional fees	62,500	62,500	81,878	(19,378)
Total court and field services	\$ 8,920,916	\$ 8,920,916	\$ 8,741,156	\$ 179,760
Northeast Regional Corrections Center				
Administration	\$ 4,330,466	\$ 4,330,466	\$ 4,564,879	\$ (234,413)
Special education	174,244	174,244	162,621	11,623
Basic education	117,611	117,611	130,654	(13,043)
Vocational education	135,766	135,766	143,553	(7,787)
Total Northeast Regional Corrections Center	\$ 4,758,087	\$ 4,758,087	\$ 5,001,707	\$ (243,620)
Arrowhead Juvenile Center				
Administration	\$ 3,226,018	\$ 3,226,018	\$ 3,368,550	\$ (142,532)
Capital outlay				
Northeast Regional Corrections Center	\$ 15,100	\$ 15,100	\$ 15,100	\$ -
Total Expenditures	\$ 19,336,785	\$ 19,336,785	\$ 18,804,757	\$ 532,028

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

Schedule 1
(Continued)

**BUDGETARY COMPARISON SCHEDULE
GENERAL FUND
FOR THE YEAR ENDED DECEMBER 31, 2006**

	<u>Budgeted Amounts</u>		<u>Actual Amounts</u>	<u>Variance with Final Budget</u>
	<u>Original</u>	<u>Final</u>		
Net Change in Fund Balance	\$ 29,723	\$ 69,542	\$ 972,540	\$ 902,998
Fund Balance - January 1	3,729,436	3,729,436	3,729,436	-
Increase (decrease) in reserved for inventories	-	-	20,684	20,684
Fund Balance - December 31	<u>\$ 3,759,159</u>	<u>\$ 3,798,978</u>	<u>\$ 4,722,660</u>	<u>\$ 923,682</u>

**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

**NOTES TO THE REQUIRED SUPPLEMENTARY INFORMATION
FOR THE YEAR ENDED DECEMBER 31, 2006**

Budgetary Data

The Arrowhead Regional Corrections Board adopts annual revenue and expenditure budgets for the General Fund on a basis consistent with generally accepted accounting principles. The budget is subject to approval by member counties and the State of Minnesota.

On or before mid-June of each year, all divisions submit requests for appropriations to the Executive Director so that a budget can be prepared. Before September 15, the proposed budget is presented to the Board for review and approval.

The appropriated budget is prepared by each division of Arrowhead Regional Corrections. Department heads may make transfers of appropriations within a department. Transfers of appropriations between departments require Board approval. The legal level of budgetary control (the level at which expenditures may not legally exceed the budget) is at the divisional level. During the year, the Board made supplemental budgetary appropriations of \$39,819 to the revenues in the General Fund.

Encumbrance accounting, under which commitments for the expenditure of monies are recorded in order to reserve that portion of the applicable appropriation, is employed as an extension of formal budgetary integration in the General Fund. Encumbrances (purchase orders and contracts) outstanding at year-end are reported as reservations of fund balances and provide authority for the carryover of appropriations to the subsequent year in order to complete these transactions. There were no encumbrances reported at December 31, 2006.

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SUPPLEMENTARY INFORMATION

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**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

Schedule 2

**SCHEDULE OF INTERGOVERNMENTAL REVENUE
FOR THE YEAR ENDED DECEMBER 31, 2006**

Shared Revenue

State

PERA rate reimbursement	\$ <u>51,530</u>
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Member Contributions

Shared operations

Carlton County	\$ 1,005,553
Cook County	116,806
Koochiching County	246,720
Lake County	219,834
St. Louis County	10,140,614
Local contributions	<u>110,001</u>

Total shared operations	\$ <u>11,839,528</u>
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Grants

State

Minnesota Department of Education	\$ <u>81,906</u>
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Minnesota Department of Corrections

Court and field services	
Caseload/workload reductions grant	\$ 1,641,803
Intensive supervision grant	178,871
Sex offender grant	448,713
Felony caseload reductions grant	127,440
Remote electronic monitoring	12,895
Truancy Action Project	<u>42,434</u>

Total court and field services	\$ 2,452,156
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Arrowhead Juvenile Center

Sex offender grant	37,810
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Community Corrections Act subsidy	<u>3,776,254</u>
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Total Minnesota Department of Corrections	\$ <u>6,266,220</u>
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Total State Grants	\$ <u>6,348,126</u>
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Federal

Department of	
Agriculture	\$ 52,963
Justice	70,294
Education	<u>13,396</u>

Total Federal Grants	\$ <u>136,653</u>
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Total State and Federal Grants	\$ <u>6,484,779</u>
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Total Intergovernmental Revenue	\$ <u>18,375,837</u>
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**ARROWHEAD REGIONAL CORRECTIONS
DULUTH, MINNESOTA**

Schedule 3

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

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

INTERNAL CONTROL

PREVIOUSLY REPORTED ITEM NOT RESOLVED

96-2 Internal Control/Segregation of Duties

Management is responsible for establishing and maintaining internal control. This responsibility includes the internal control over the various accounting cycles, the fair presentation of the financial statements and related notes, and the accuracy and completeness of all financial records and related information. Adequate segregation of duties is a key internal control in an organization's accounting system. The size of Arrowhead Regional Corrections (ARC) and its staffing limits the internal control that management can design and implement into the organization. Management should be aware that segregation of duties is not adequate from an internal control point of view.

Management is responsible for the accuracy and completeness of all financial records and related information. Also, management is responsible for controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

Management has requested that we prepare the annual financial statements and related notes. This arrangement is not unusual for an organization the size of ARC. This decision was based on the availability of ARC staff and the cost benefit of using our expertise.

During our audit, we proposed material adjustments to convert ARC's financial records to the financial statements as reported. These adjustments recognized prior year audit adjustments not booked in the general ledger; decreased revenue; reclassified liabilities; reclassified revenues; increased reserved fund balances; and increased unreserved, designated fund balances.

We recommend the Board of Directors be mindful that limited staffing causes inherent risks in safeguarding ARC's assets and the proper reporting of its financial activity. We recommend the Board of Directors continue to implement oversight procedures and monitor those procedures to determine if they are still effective internal controls.

Client's Response:

Arrowhead Regional Corrections' management is aware of the lack of segregation of accounting functions as a result of our limited number of office personnel. Internal control policies and procedures will continue to be followed by corrections staff.

ITEM ARISING THIS YEAR

06-1 Capital Assets

For financial reporting and asset management purposes, ARC is required to keep records of its capital assets. ARC's capital asset records are recorded on a separate software system maintained by its fiscal agent. Capital asset additions and deletions are entered into this system, and depreciation is calculated by the system. Capital asset policies utilized by ARC in maintaining the capital asset system have not been formally approved, but current practices parallel the policy utilized by its fiscal agent. A capital asset policy should be adopted, which defines ARC's accounting policies over capital assets, including capitalization threshold, useful lives, and depreciation methods.

ARC also does not have policies and procedures in place to identify capital asset additions and deletions for entry to the capital asset system. ARC's fiscal agent enters capital asset additions into the system based on capital expenditure accounts, but ARC has no procedure in place to review these accounts at year-end. ARC staff identify capital asset deletions by reviewing the capital asset listing at year-end and determining which assets have been sold or removed from service.

We recommend the ARC Board establish a capital asset policy to define ARC's accounting policies over capital assets. ARC should also establish policies and procedures to identify capital asset additions and deletions. Department heads should report capital asset additions and deletions to the person 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.

Client's Response:

The Arrowhead Regional Corrections management team will develop a capital assets policy and procedure that will identify asset deletions and additions and incorporates a periodic schedule of physical inventory.

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STATE AUDITOR

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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 Commissioners
Arrowhead Regional Corrections

We have audited the financial statements of the governmental activities and the General Fund of Arrowhead Regional Corrections (ARC) as of and for the year ended December 31, 2006, and have issued our report thereon dated February 11, 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 ARC'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 ARC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of ARC'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 ARC'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 ARC's financial statements that is more than inconsequential will not be prevented or detected by ARC's internal control. We considered the deficiencies described in the accompanying Schedule of Findings and Recommendations as items 96-2 and 06-1 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 ARC'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 item 96-2 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether ARC'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 five categories of compliance to be tested: contracting and bidding, deposits and investments, conflicts of interest, public indebtedness, and claims and disbursements. Our study included all of the listed categories.

The results of our tests indicate that, for the items tested, ARC complied with the material terms and conditions of applicable legal provisions.

ARC's written responses to the significant deficiency and material weakness 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 ARC Board, management, and others within ARC and is not intended to be, and should not be, used by anyone other than those specified parties.

/s/Rebecca Otto

REBECCA OTTO
STATE AUDITOR

/s/Greg Hierlinger

GREG HIERLINGER, CPA
DEPUTY STATE AUDITOR

February 11, 2008