

To: The Utah County Board Of County Commissioners

Transmitted herewith is our report, Utah County Subdivision Bonding No. 87-1. This audit was initiated by the Utah County Auditor in response to various concerns with the subdivision bonding process in Utah County. **The audit dealt with only those subdivision developments not completed within the two year time period specified in the Utah County Planning Ordinances.** Based upon our preliminary survey, we found a need for a better controlled and administered subdivision bonding process.

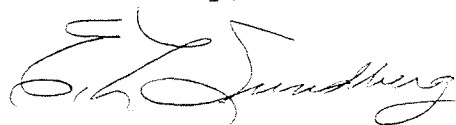
Our review of the subdivision bonding process incorporates the following objectives:

1. Determine whether Utah County may have to use public funds to complete improvements in subdivision developments exceeding the two year time period allowed by County planning ordinances.
2. Determine if the bonds for unfinished and overdue subdivisions are adequate to complete required improvements.
3. Identify ways to improve the efficiency and effectiveness of the bonding process.

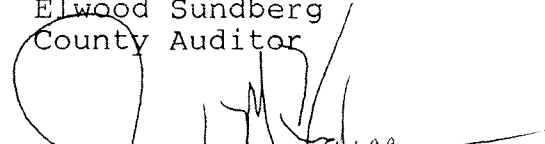
Our examination was conducted in accordance with the United States General Accounting Office, "Standards for Audits of Governmental Organizations, Programs, Activities and Functions," and within the statutory requirements of the Office of the Utah County Auditor. Accordingly, our work includes such tests and other auditing procedures necessary to collect evidence in support of our conclusions and recommendations.

We will gladly meet with Commissioners and other County Officials to discuss or clarify any item contained in the report or to facilitate implementation of the recommendations.

Sincerely,



Elwood Sundberg
County Auditor



Joseph M. Higbee
Audit Supervisor

TABLE OF CONTENTS

LIST OF TABLES	ii
I. INTRODUCTION	1
II. PAST ACCEPTANCE OF PROPERTY BONDS HAS CONTRIBUTED TO CURRENT LIABILITY CONCERNS	4
III. ESCROW AGENTS HAVE RELEASED BOND MONIES WITHOUT COUNTY AUTHORIZATION	8
IV. IMPROVED COMMUNICATIONS AMONG COUNTY DEPARTMENTS CAN STRENGTHEN BONDING CONTROLS	11
AGENCY RESPONSE	14

Utah County Engineer
Civil Division of the Utah County Attorney's Office
Utah County Planning Director

LIST OF TABLES

TABLE 2. 1

Utah County's Liability to Complete Past Due Subdivisions	5
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TABLE 3. 1

Bond Monies Released by Escrow Agents Without County Authorization	9
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REPORT TO
UTAH COUNTY BOARD OF COUNTY COMMISSIONERS
Report No. 87-1

A PERFORMANCE AUDIT
OF UTAH COUNTY
SUBDIVISION BONDING

Audit Performed by:

Audit Supervisor

Joseph M. Higbee

Audit Staff

G. Lynn McCrary

Chapter I

Introduction

In accordance with Utah County Ordinances, when a developer wishes to build a subdivision in the unincorporated area of Utah County, all improvements of the designated land must be completed before homeowners can live in their newly constructed homes. Typically, counties, communities and other regulating authorities secure performance guarantees from developers to ensure the completion of roads, sewers, drainage, and other site improvements required before homes can be occupied.

The performance guarantee is intended to be a fail-safe mechanism, protecting lot purchasers by ensuring the completion of the improvements. The use of performance guarantees, however, transfers some responsibility for ensuring a project is completed from the developer to the future homeowner and to the regulating authority.

In Utah County, the Planning Commission will approve a subdivision project if the developer can provide a bond covering the cost of completing the specified improvements should the developer not perform as required. If the developer cannot or does not make the necessary improvements on an approved project within the specified time constraints, the County becomes liable to ensure the completion of the improvements. In addition, those landowners who in good faith purchased an unimproved subdivision lot and constructed a home, cannot live in their homes until the improvements are completed. Not only are property owners kept from fully utilizing their property, but without improvements, the market value of the property often declines.

The importance of having adequate bonding guarantees for subdivisions has recently received added emphasis. In the 1986 Utah Supreme Court case Michael Cox v. Utah Mortgage and Loan, the Court held that public entities with bonding authority should ensure the timely completion of required improvements. Specifically, the Court found that a public regulatory entity has a "duty to act to bring about the completion of improvements, and does not have the right to indefinitely sit back, refuse to act, and deny to subdivision lot owners benefit and protection of improvement contracts and of escrow funds."

The impact of this ruling has reached Utah County. Already the County is being threatened with a lawsuit from a subdivision lot owner whose unimproved property is located in a development that was not completed within the proper time constraints. Unless the County can convince the developer to complete the improvements, the property owner's attorney will proceed with a lawsuit requiring the County to fulfill its obligation. For reasons discussed later, the County no longer has sufficient

bonding to complete the improvements. Under these circumstances, the County must either rely on the "good faith" of the contractor or perhaps spend public funds to complete the improvements.

In addition to developers who are not fulfilling their obligations, past bonding practices have contributed to the County's liability concerns. Primarily, by accepting property bonds the County has allowed the real estate market to place public funds in a position of liability. Property bonds are parcels of land that are deeded to the County by a developer. Should the County have to foreclose on a subdivision project to complete the required improvements, the lots are to be sold and the proceeds used. However, if the market value of the property declines, the value of the bond also decreases. On the other hand, the cost of making improvements may actually increase. These very conditions have largely contributed to the County's current liability problems.

Cash bonding problems have further placed the County in a position of liability. Cash bonds require a developer to secure actual financial resources to ensure the completion of improvements and are the preferred bonding practice. When the cash bond is secured, it is generally placed in the custody of a private escrow agent. The escrow agent in turn signs an agreement to hold the bond until the County provides written approval for its release. Once the developer has completed the specified improvements, the bond should be released to the developer. However, escrow agents are not complying with the terms of these agreements and cash bonds have been released without proper authorization. To collect on prematurely released bonds, the County has to either initiate legal proceedings against the escrow agent or depend on the good faith of a contractor to complete the specified improvements.

As a consequence of past bonding practices, Utah County presently has 4 subdivision developments whose bonding is either inadequate or nonexistent. This does not mean the County has lost any money. However, in a worst case scenario, the County may be liable for as much as \$200,000 in improvements. An additional \$70,000 was prematurely released by escrow agents. Unless bonding practices are tightened and bonding funds are secured, public funds may have to be used to retire the County's liability.

The following paragraphs briefly identify problems encountered with Utah County's past bonding practices and indicate the chapters where we have provided a more comprehensive discussion of the issues.

1. Chapter II examines the problems associated with the County's past acceptance of property bonds. Briefly, property bonds leave the County at the mercy of the

real estate market. In addition, Utah County does not have clear ownership of property lots pledged and accepted for bonding purposes. As a result, \$200,000 in public funds may be needed to complete required improvements.

Although they do not rectify past practices, County Ordinances now prohibit the acceptance of property bonds and should continue to prohibit them. The Planning Commission, however, recently passed an ordinance amendment that once again may allow the acceptance of property bonds.

2. Chapter III identifies how escrow agents have released \$70,000 in cash bonds without the written authorization of the County's representative, as called for in the escrow agreement. This action has further affected the County's liability, by leaving some subdivision developments either inadequately bonded or without a bond at all.

By processing all future bonding agreements through the County Treasurer's Office, or by strengthening the controls over private entities involved in establishing escrow agreements, the County can eliminate the risk of bonds being prematurely released.

3. Chapter IV explains the need for better communications between County departments that are involved in the subdivision bonding process. To ensure the County is not placed in a position of liability, all appropriate parties should agree that required improvements have been installed before bonds are released.

With better communication and project evaluation procedures, the County can eliminate any future interdepartmental conflict that may arise in the bonding process.

Chapter II

Past Acceptance Of Property Bonds Has Contributed To Current Liability Concerns

By accepting property bonds in the past, Utah County may now have to use public funds to complete subdivision improvements. Prior to 1984, Utah County Ordinances allowed the County to accept property as a bond guarantee to ensure the completion of required subdivision improvements. Property lots included in a proposed development were often deeded to the County as bonding collateral in lieu of cash. Unfortunately, the market value of these lots has declined dramatically, leaving a large discrepancy between the value of the bonds and the cost of the improvements. Furthermore, the County has found that it does not have actual title to many of the lots deeded as a bond guarantee. In a worse case scenario, \$200,000 in public funds may be required to retire the County's liability and complete the improvements.

In the following two sections we first explore the full extent of the County's current liability, and second explain very specifically why property bonds should be avoided.

Public Funds May Be Needed To Complete Subdivision Improvements

Utah County does not have access to adequate bonding in three subdivisions and may have to use public funds to complete the required improvements. Adequate bonding is lacking for three reasons. First, developers have not fulfilled the terms of their bonding agreements. Second, property deeded to the County as bonding collateral was not owned by the developers involved. Third, property values have declined, leaving the County underbonded. **However, the County has not lost any money and may never have to pay for the required improvements.** Developers may still complete the improvements without having to draw on public resources.

In order to assess the County's liability, however, estimates of the probable cost to complete the improvements were obtained from the Utah County Engineer's Office. From these estimates we subtracted the market value of the bond lots as determined by the Utah County Board of Equalization. The equalization value was established by an independent real estate appraiser with input from the property owner, (Property taxes are also assessed based on the equalization value). Table 2.1 shows the maximum liability the County faces using a worse case scenario.

Table 2. 1

Utah County's Liability To
Complete Past-Due Subdivisions

Development Name	Estimated Amount Needed To Complete Subdivision	Market Value Of Lots Set By B. of Eq.	Number Of Lots In Bond	DIFF.
Subdivision A	\$426,000	-\$12,000 ¹	* 20	= \$186,000
Subdivision B	\$ 11,600	-\$51,000 ¹	* 0	= 11,600
Subdivision C	\$ 7,932	(5,000	* 1)	= <u>2,932</u>
Total Difference				\$200,532

¹ This amount was determined by the Assessor's Office and was not contested by the property owner.

** The developer of Subdivision A pledged lots to the County as a performance guarantee. However, he did not actually own 7 of the lots. Subdivision B's developer pledged one lot to Utah County for bonding purposes, then later pledged the same lot to another institution who now holds the title. The Utah County Attorney's Office believes the County may still have access to this bond through legal action. Subdivision C's property bond has a current market value less than the present cost of the needed improvements.

Once again, the County's projected liability is at best an estimate. Developers may complete the improvements in question without the County's involvement. Also, through legal action the County may be able to regain control over those lots whose titles were not properly deeded. Finally, the real estate market may improve before property bonds have to be liquidated. The amount collectable on the property bonds and the County's actual liability are both dependent on the County's ability to sell the unimproved lots should the need arise.

County personnel are currently negotiating with the developers involved to see if proper bonding can be secured. Even though the County does have the right to foreclose on the existing property bonds, it seems advisable to exercise this right as a last resort only. Although the current liability

situation is certainly uncomfortable, it would appear to be in the best interest of the County to continue to work with the developers and foreclose on the bonds only in an emergency.

Recommendations

1. We recommend that the developers of subdivision A, B, and C be required to increase the amount of their bonds until the bonds are sufficient to complete the needed improvements.
2. We recommend that the County continue to negotiate with the developers rather than foreclose on the inadequate, existing bonds.

Property Lots Are Poor Bonding Instruments

Over the years, real estate property has proven to be too speculative to serve as the kind of guarantee needed to cover the costs of subdivision improvements. Generally, a performance guarantee is designed to place the financial resources necessary to complete improvements at the immediate disposal of the County. The County should be able to access the performance guarantee upon demand.

In direct contrast to this objective, the ability to access the cash value of a piece of property is clearly dependent on the real estate market. Furthermore, the value of property bonds are subject to the market. In fact, many of the lots deeded to Utah County as performance guarantees are valued far below the projected costs of completing required improvements. Furthermore, some of these lots lack improvements, thus reducing their current market value even further. Poor liquidity coupled with the possibility of declining property values, should clearly flag questions about the soundness of accepting property as a performance guarantee.

As a result of the difficulties associated with property bonding, no other County along the Wasatch front allows developers to offer property as a performance guarantee.

Prior to March 7, 1984, Utah County accepted property guarantees. This practice was eliminated under a revision of the Utah County Planning Ordinances. With that revision, only cash or surety bonds were identified as acceptable bonding instruments. Recently, however, the Planning Commission approved

an ordinance change to allow cash, surety, or some other form of bonding deemed sufficient by the Utah County Commission. This change may once again allow the acceptance of property bonds. We feel that such a move would not be in the best interest of the County.

Recommendation

1. We recommend that the County avoid the use of property lots as performance bonds.

Chapter III

Escrow Agents Have Released Bond Monies Without County Authorization

Utah County does not have full benefit of the cash bonds established in its name for the purpose of guaranteeing the performance of subdivision developers. Because some local escrow agents have released cash bonds to developers without authorization from the County, several subdivisions are currently without a bond. A change in the way cash bonds are handled, however, may lend to a more effective method for monitoring cash bonds. By having bond monies deposited directly with the County, or by having local escrow agents frequently report the bond amounts in their custody, Utah County's control over cash bonds will be enhanced.

Cash bonds used for County purposes are held by local escrow agents. The monies for the bond are deposited with the escrow agents in the name of and to the sole credit of Utah County. Withdrawals from the bonds are permitted only upon presentation to the escrow agents of a written invoice or other document, bearing the signature of the County's representative.

As part of the escrow agreement, the developer agrees to complete all designated subdivision improvements. If he does not, the County has the right to foreclose on the bond and use the proceeds to complete the improvements. If any funds exist after the completion of the improvements, these funds are to be returned to the developer. The escrow agents have the responsibility to ensure that monies are released only when authorized by the County.

Some escrows agents, however, have not complied with these requirements. They have released bond funds to developers without the written authorization of the County's representative. As a result, some bonds do not have sufficient funds to cover remaining improvement costs, while other developments are left without any bonding guarantee. Table 3. 1 demonstrates the amounts released by escrow agents without prior authorization.

Table 3. 1

Bond Monies Released By Escrow Agents Without County Authorization

Escrow Agent	Original Bond Amount	Amount Remaining In Bond	Amount Released Without Authorization
Agent A	\$ 39,073	\$ 120	\$ 38,953
Agent B	20,000	-0-	20,000
Agent C	1,115	-0-	1,115 ¹
Agent D	11,500	-0-	<u>11,500</u>
Total Amount Released Without Authorization			\$ <u>71,568</u>

¹ The developers of this project have informed County personnel that they will post a bond for their development in the spring or summer of this year.

Fortunately for Utah County, not all of the funds that were prematurely released are needed. For example, the funds released by Agent A are not fully needed because the project appears to be complete. However, the bond is insufficient to cover Utah County's inspection fees. The funds released by Agent B were later regained through court action. This agent used the bond money to retire debt not associated with the subdivision development. The monies released by Agents C and D, however, need to be replaced or County funds may be necessary to complete the improvements.

Even though the County's liability caused by the unauthorized releasing of bond monies may appear minimal, the fact remains that the County does not have control over all of its cash bonds. The unauthorized releasing of cash bonds would be curtailed and the County's control over cash bonds would be enhanced by having funds deposited directly with the County.

For those developers that provide a cash bond for a

performance guarantee, the County should require that the funds be deposited with the County Treasurer. The depositing of monies with the Treasurer will prevent the unauthorized releasing of funds to developers and will ensure that if the need arises and the County has to complete the subdivision improvements, funds will be available. As the improvements are installed in the subdivision development, monies could be released as authorized by the County's representative.

If the County wishes to continue using local escrow agents as holders of subdivision bonds, better controls are needed. By requiring escrow agents to formally report bond balances and identify transactions affecting those balances on a monthly or quarterly basis, the County's control over cash bonds can be enhanced. These reports should be sent to the County's representative who monitors all bond accounts. If any funds are released without the authorization of the County, immediate action should take place to resecure the bond.

Recommendations

1. We recommend that the County retrieve needed bond monies.
2. We recommend that cash bonds be deposited with the County Treasurer.
3. We recommend that if local escrow agents are used for the holding of cash bonds, these escrow agents be required to formally report bond balances and identify transactions performed on a monthly or quarterly basis.

Chapter IV

Improved Communications Among County Departments Can Strengthen Bonding Controls

Before Utah County can fully minimize its liability concerns associated with subdivision performance bonding, communications must improve among those County departments with oversight responsibilities. Specifically, the County Planning Department which approves subdivision projects, and the County Engineer's Office which monitors required improvements, should better coordinate their efforts to ensure bonding monies are available for required use. In the past, these two departments have disagreed about whether required subdivision improvements were in place before bond monies were released to the developers. By establishing an internal system of checks and balances, perceived and actual problems with premature releases of bonds can be virtually eliminated.

In the latter part of this chapter, we present three options that may enhance bonding controls. Before those options are discussed, however, it may be helpful to better understand engineering and planning's involvement in the bonding process and identify why their communications must improve.

Presently, the County Engineer is charged with most oversight responsibilities for subdivision bonding. His responsibilities include: (1) verifying each development engineer's estimates of total improvement costs; (2) recommending bonding amounts; (3) inspecting improvements as they are installed; (4) verifying that all required improvements are in accordance with County standards; and (5) releasing performance bonds to the developers. To meet his responsibilities, the County Engineer has appointed a member of his staff to act as a bonding coordinator.

Though not as involved in monitoring improvements, the Planning Department also has oversight responsibilities. In addition to approving subdivision projects, Planning issues certificates of occupancy to individuals who have built homes on newly completed subdivision lots. Consequently, they need to know the status of subdivision improvements.

The Planning Department issues certificates of occupancy to homeowners who have constructed homes on lots that the Engineer's Office has identified as being complete. In three developments, however, residents have complained that some of the improvements were not installed as required in the approved subdivision plan. Upon inspection, it appeared to Planning that the improvements had indeed not been made. However, the Engineer's Office had

already released the monies specified by the performance guarantees because they deemed the projects to be completed. Should homeowners press the issue, court action may be required to determine whether improvements were actually installed. If such a scenario were to develop, and depending on the Court's decision, Utah County may be held liable to complete the improvements in question. These and other potential liability problems can be avoided, however, through improved communications among those County departments involved in the bonding process.

Management literature indicates that control over a many faceted process is best achieved by splitting oversight duties among individuals associated with the process. There are many ways to achieve this objective. We have briefly presented three possible options. The Board of County Commissioners should evaluate these and other options, then select a process that will minimize any liability concerns

Option one Shared oversight of Utah County's many faceted bonding process may be best facilitated by the development of a bonding committee to coordinate activities. Upon the mutual recommendation of the County Engineer's Office, the County Planning Department, and the Civil Division of the County Attorney's Office, a planning committee should be formulated to regulate the bonding process. This committee should include a representative from each of these three offices plus a representative from the County Auditor's Office. Each representative should help provide necessary checks and balances over the bonding process.

Under the committee format, the County Engineer and his bonding coordinator would continue to recommend bonding amounts, monitor improvements, and monitor bond amounts. Status reports should be provided by the Engineer's Office to help the County Planning Department know when to issue certificates of occupancy. Representatives from both engineering and planning would conduct a joint final inspection of the subdivision improvements before bonds are released. The representative from the Attorney's office would approve all bonding agreements and immediately pursue any legal irregularities. Finally, the County Auditor's representative would provide financial expertise when dealing with bonds. This committee would meet at least monthly to be updated on all development activities in approved subdivisions.

Option two A second possible option is currently used by Weber County. In Weber, the County Engineer sets bonding amounts and inspects improvements. The power to release funds, however, is in the hands of the County Planning Department. This option, however, lacks the added control over the bonding process provided by including a representative from the County Attorney's Office and the County Auditor's Office.

Option three A third option would require both Engineering and Planning to jointly monitor and declare a subdivision project completed. The bond release would then be signed by the County Engineer and by the Director of Planning. Although some may consider this an acceptable option, it also lacks the more comprehensive control offered by a bonding committee and could duplicate services.

Recommendations

1. We recommend that the Board of County Commissioners form a subdivision bonding committee to be responsible for the subdivision bonding process.
2. If the Board of County Commissioners chooses not to form a subdivision bonding committee, we recommend that they implement one of the other cited options to improve the subdivision bonding process.

As a courtesy to the auditee, it is the policy of the Utah County Internal Audit Division to include, without edit, a response from the auditee on the issues raised in the audit report. The auditee's response is reproduced without edit on the following pages.

**RESPONSE TO
A PERFORMANCE AUDIT
OF UTAH COUNTY
SUBDIVISION BONDING**

Submitted by

**UTAH COUNTY PUBLIC WORKS
CLYDE R. NAYLOR
UTAH COUNTY ENGINEER**

**RESPONSE TO AUDITOR'S REPORT TO
UTAH COUNTY BOARD OF COUNTY COMMISSIONERS
Report No. 87-1**

February 17, 1987

INTRODUCTION

Over the years Utah County has fluctuated considerably concerning the type of bonds that have been accepted for subdivision bonding. Even with recommendations on types of bonds written into County policy, other kinds of bonds have been accepted. Many of the problems that the County now faces are a direct result of the County's bond policy.

Even cash bonds have experienced problems in their administration and control, because of a lack of understanding on the part of financial institutions of the nature of a cash bond.

The County Engineers Office agrees with the performance audit of the Utah County subdivision bonding and supports the recommendations given therein.

BONDING

Many of the problems Utah County has experienced with bonds and developments that have not completed their required improvements are a direct result of the County accepting property bonds. We agree with the recommendation that the County should refuse property bonds as a bonding mechanism in the future.

Because of the problems the County has experienced with cash bonds, we concur in the recommendation that cash bonds for subdivisions be posted with the Utah County Treasurer.

At the present time there are several developments that have not completed the required improvements established in the original bond; however, the incomplete nature of the improvements has not created a difficulty with individual property owners because of the nature of the developments. It is the County Engineer's recommendation that Utah County should approach the developers in a spirit of cooperation and encourage them to complete the needed improvements without defaulting the existing bonds. It would appear that assistance instead of pressure on the developer would allow them to complete the projects in a way that the County will not experience any expense related to the projects. We are not suggesting that we spend money in helping the developer to accomplish their goals but that we simply provide encouragement, remove obstacles, and allow bond extensions to comply with the law.

BONDING COMMITTEE

The County Engineers Office concurs with the Auditor's recommendation for establishing a bonding committee to represent the County's interest in the development process. In the past the County Engineer's Office has had construction inspectors that have inspected the construction work as the improvements were completed in each development. These inspectors have kept very good journals showing the work as it was completed. This information could be made available to the bonding committee for review prior to any release of funds under the bond.

The formation of a bonding committee would also provide an important final inspection of the completed improvements in each development. This final inspection would provide an opportunity for input from other county offices and allow everyone to know the final status of each development.

The bonding committee could also create a series of forms which could be sent to developers on a regular basis reminding them of the status of their bonds and the need to complete the improvements in a timely manner. The bonding committee should review all projects and their status on a regular basis.

We, therefore, concur in the recommendation that the Board of County Commissioners form a Subdivision Bonding Committee to be responsible for the subdivision bonding process.

OFFICE OF
Utah County Attorney

170 West 100 North
Provo, Utah 84601

February 19, 1987

Mr. Joseph M. Higbee
Internal Audit Supervisor
Utah County Auditor's Office
Provo, UT 84601

Re: Performance Audit of the Utah County
Subdivision Bonding Procedures

Dear Marv:

This letter shall act as a written response from our office to your performance audit of the Utah County subdivision bonding procedures. I have reviewed the audit report and agree with the conclusions reached in said report, and wish to take this opportunity to offer input from our office concerning the recommendations found within the audit report.

Chapter II of the audit report contains a recommendation that the County should avoid the use of property lots as performance bonds. We would concur with that general recommendation, and would recommend that the County attempt to avoid the use of property lots as performance bonds whenever possible. There is a proposed amendment to the Utah County Zoning Ordinance that would allow the County Commission to take bonds in a form other than surety or cash bonds when deemed advisable by the County Commission, but it would still be the position of our office that property bonds are usually not appropriate surety and should not be accepted by the County in most instances.

Chapter III of the audit report contains two recommendations with which we concur, one being that the County retrieve needed bond monies that have been posted by developers, and the second that cash bonds be deposited with the Utah County Treasurer rather than with local escrow agents. We would prefer that cash bonds be deposited with the County Treasurer as long as such a procedure contained concrete and specific guidelines for the depositing and withdrawing of funds from the County Treasurer.

Joseph M. Higbee
February 19, 1987
Page 2

Chapter IV contains a recommendation that the Board of County Commissioners form a subdivision bonding committee to be responsible for the subdivision bonding process. We would strongly concur with that recommendation, and would urge that that recommendation be adopted by the County Commissioners. It is the opinion of our office that such a subdivision bonding committee as outlined in Chapter IV of the audit report would greatly enhance the bonding processes and procedures in the County.

If you have any further questions regarding this matter please feel free to contact me.

Very truly yours,

STEVEN B. KILLPACK
Utah County Attorney



E. KENT SUNDBERG
Deputy Utah County Attorney

EKS:dm



PLANNING COMMISSION
188 EAST CENTER / PROVO, UTAH 84601 / TELEPHONE (801) 373-5510 EXT. 500

February 18, 1987

J. Marvin Higbee
Internal Audit Supervisor
Utah County
170 West 100 North
Provo, UT 84601

Dear Mr. Higbee:

We appreciated the opportunity to review the Utah County Performance Audit of Subdivision Bonding and to make comments pertaining to past and current practices.

We agree with your recommendation for a bond review committee and would support a move by the Board of Utah County Commissioners to establish this concept.

Sincerely,

Jeff Mendenhall
Director

JM/lh

