

SCHEDULE OF AUDIT FINDINGS AND RESPONSES

**City of Spokane
Spokane County
January 1, 2015 through December 31, 2015**

2015-001 The City did not have adequate internal controls in place to ensure accurate reporting of its financial statements.

Background

It is the responsibility of City management to design and follow internal controls that provide reasonable assurance regarding the reliability of financial reporting. These controls should ensure all Generally Accepted Accounting Principles (GAAP) and Government Accounting Standards Board (GASB) statements are followed.

The City made improvements from the prior year to ensure that financial events are properly identified and accounting methodology is applied correctly. However, our audit identified other internal control weaknesses that adversely affected the City's ability to produce reliable financial statements.

Description of Condition

Our audit identified the following deficiencies in internal controls over financial reporting that, when taken together, represent a significant deficiency:

- The City did not dedicate the necessary time and resources to accurately adjust fund financial statements to government-wide presentation as required by GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*.
- The City did not dedicate the necessary time and resources to properly report net position balances as required by GASB Statement No. 63, *Financial Reporting of Deferred outflows of Resources, Deferred Inflows of Resources and Net Position*.

Although the City has procedures to perform a review of the financial statements for accuracy, the review was not adequate to detect and correct errors prior to audit.

Cause of Condition

The City has experienced employee turnover in key financial statement preparation positions and lacked the resources necessary to accurately prepare the financial statements. Although the City implemented new software that helps prepare its fund financial statements, the City continues to use complex spreadsheets to assist in the preparation of its government-wide financial statements. These spreadsheets contained table and other errors. The City's established controls for financial statement review were not effective at identifying errors.

Effect of Condition

Our audit identified the following errors in the financial statements and schedules provided for audit:

Adjustment of fund financial statements to government-wide Statement of Activities presentation:

- The overall impact of the Statement of Activities errors resulted in a \$1.1 million understatement of Governmental Activity Net Position. Key components include:
 - Inaccurate allocations and calculation errors in Charges for Services revenues by function in the government-wide Statement of Activities of up to \$11.3 million.
 - Inaccurate reporting of interfund activity in the reconciliation of fund statements to government-wide overstating the reporting of General Government expenses by at least \$16.7 million.
 - Inaccurate reporting of changes in long-term debt and other debt amounts in the government-wide Statement of Activities understating the reporting of multiple classifications of governmental activities expenditures by at least \$14 million.

Reporting of net position balances

- Components of Net Position in the Governmental Activities and Internal Service Funds were calculated incorrectly related to unspent bond proceeds and interfund loans, understating Net Investment in Capital Assets by more than \$85 million and \$23 million respectively. This is a classification error with the corresponding offset being undesignated/unrestricted net position.
- Components of Net Position in the Water/Sewer Fund were calculated incorrectly related to unspent bond proceeds, understating Net Investment

in Capital Assets by more than \$197 million in the fund and Government-wide Statements of Net Position. This is a classification error with the corresponding offset being undesignated/unrestricted net position.

Other less significant errors were also identified in the financial statements provided for audit. All material misstatements were corrected.

Recommendation

We recommend City management continue to strengthen internal controls over financial statement reporting by ensuring:

- Accounting staff who prepare financial statements receive necessary training to ensure financial reporting is accurate and complete in accordance with GAAP and GASB pronouncements.
- An effective independent review of the financial statements is performed.

City's Response

Although the City experienced a significant vacancy in one of its key positions related to the preparation of the financial statements during fiscal years 2014 and 2015, the City is committed to providing excellent financial reporting. The vacancy of its Chief Accountant position was filled in June 2016.

For the preparation of its 2015 financial statements, the City purchased and partially implemented additional software, which has significantly reduced the risk of calculation errors. The City will complete the implementation of the new software during 2016, which will further enhance internal controls and reduce the risk of errors.

The City continues to improve its internal control and review processes to improve the reliability of its financial reporting. With the Chief Accountant vacancy filled, the City is diligently working to improve its year end processes to allow for more timely preparation of its financial statements, which will result in significantly improved levels of review.

Auditor's Remarks

We thank the City for its assistance during the audit and acknowledge its commitment to improving the conditions described. We will review the status of this issue during our next audit.

Applicable Laws and Regulations

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

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

The American Institute of Certified Public Accountants defines significant deficiencies and material weaknesses in its Codification of Statements on Auditing Standards, section 115, as follows:

- a. **Significant deficiency:** A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
- b. **Material weakness:** A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

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

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

Budgeting, Accounting and Reporting System (BARS) Manual, Accounting, Accounting Principles and General Procedures, Internal Control, states:

Internal control is a management process for keeping an entity on course in achieving its business objectives, as adopted by the

governing body. This management control system should ensure that resources are guarded against waste, loss and misuse; that reliable data is obtained, maintained, and fairly disclosed in financial statement and other reports; and resource use is consistent with laws, regulations and policies.

Government Auditing Standards Board, Statement No. 63, *Financial Reporting of Deferred outflows of Resources, Deferred Inflows of Resources and Net Position*, paragraph 9 states:

Net Investment in Capital Assets Component of Net Position

9. The *net investment in capital assets* component of net position consists of capital assets, net of accumulated depreciation, reduced by the outstanding balances of bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction, or improvement of those assets or related debt also should be included in this component of net position. If there are significant unspent related debt proceeds or deferred inflows of resources at the end of the reporting period, the portion of the debt or deferred inflows of resources attributable to the unspent amount should not be included in the calculation of net investment in capital assets. Instead, that portion of the debt or deferred inflows of resources should be included in the same net position component (restricted or unrestricted) as the unspent amount.

Governmental Accounting, Auditing and Financial Reporting (GAAFR), Page 64-65 states

Interfund activity between funds included in the same activity column will not appear anywhere in the government-wide financial statements, whereas interfund activity between funds reported in different activity columns will be visible in those columns, but not in the primary governmental-total column. Internal service funds pose a special challenge for consolidation. As discussed previously, internal service funds are intended to function on a cost-reimbursement basis. As a practical matter, a given internal service fund may show a difference between revenues and expenses in any given period. This difference poses no real problem in the fund financial statements, so long

as a material surplus or deficit is not allowed to build up over time. For purposes of consolidation, however, an internal service fund must “break even” each year to ensure a proper allocation of costs. That is, there can be no operating surplus or deficit as the result of purely internal activity.

GAAFR Page 270 states

These assets and liabilities must be restored when preparing the government-wide statement of net position. The same is true of certain accounts associated with deferral and amortization that do not appear in the governmental fund balance sheet:

- Unamortized premium/discount on long-term debt and
- The unamortized difference between the net carrying amount of refunded debt and its reacquisition price.”