



Washington State Auditor's Office

Troy Kelley

Integrity • Respect • Independence

Accountability Audit Report

City of McCleary

Grays Harbor County

For the period January 1, 2013 through December 31, 2013

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Washington State Auditor Troy Kelley

October 23, 2014

Mayor and City Council
City of McCleary
McCleary, Washington

Report on Accountability

Thank you for the opportunity to work with you to promote accountability, integrity and openness in government. The State Auditor's Office takes seriously our role of providing state and local governments with assurance and accountability as the independent auditor of public accounts. In this way, we strive to help government work better, cost less, deliver higher value and earn greater public trust.

Independent audits provide essential accountability and transparency for City operations. This information is valuable to management, the governing body and public stakeholders when assessing the government's stewardship of public resources.

The attached comprises our report on the City's compliance and safeguarding of public resources. Our independent audit report describes the overall results and conclusions for areas we examined. We appreciate the opportunity to work with your staff and we value your cooperation during the audit.

Sincerely,

TROY KELLEY
STATE AUDITOR

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AUDIT SUMMARY

Results in brief

In most areas we audited, City operations complied with applicable requirements and provided adequate safeguarding of public resources. The City also complied with state laws and regulations and its own policies and procedures in the areas we examined.

However, we identified areas in which the City could make improvements.

We recommended the City do the following for its transfers from the Light and Power Fund to the General Fund:

- Properly determine the amount of surplus, based on actual operating results, before transferring funds to the General Fund. Documentation of this analysis should be retained as support for the transfers.
- Perform an analysis to determine if there was a surplus for 2011 and 2012 and repay the Light and Power Fund if the transfers were unallowable.
- Review its utility rates to ensure they are set to only cover the costs of operating and maintaining the electric utility.

These recommendations were included in our report as a finding.

About the audit

This report contains the results of our independent accountability audit of the City of McCleary from January 1, 2013 through December 31, 2013.

Management is responsible for ensuring compliance and adequate safeguarding of public resources from fraud, loss or abuse. This includes the design, implementation and maintenance of internal controls relevant to these objectives.

Our audit involved performing procedures to obtain evidence about the City's uses of public resources, compliance with state laws and regulations and its own policies and procedures, and internal controls over such matters.

In keeping with general auditing practices, we do not examine every transaction, activity or area. Instead, the areas examined were those representing the highest risk of fraud, loss, abuse, or noncompliance. The following areas were examined during this audit period:

- Open public meetings
- General revenue and expenditures
- Financial condition
- Interfund activity
- Cost allocation
- Internal controls over significant accounting systems:
 - Cash receipting
 - Utility billing
 - Payroll
 - Disbursements (including credit cards)

SCHEDULE OF AUDIT FINDINGS AND RESPONSES

1. The City did not have documentation to support the methods it used to finance general government activities with restricted revenue.

Background

State law restricts the use of utility revenue to the operation and maintenance of utilities. Cities are not to use utility revenue to finance general government operations. However, the law does allow the City to charge utilities for overhead costs and to transfer unanticipated utility surpluses to the general fund.

Cities with less than 20,000 citizens must transfer any surplus in utility funds to the current expense fund. Surplus is the amount by which operating revenue exceed operating expenses. Cities also must deduct utility capital asset replacement costs, future capital expansions and improvements and any legally restricted resources when determining this surplus amount.

Surplus transfers should be minimal and infrequent as utility rates should be set to only cover the cost of operating and maintaining the electric utility.

Description of Condition

The City transferred Light and Power Fund surplus to the Current Expense Fund. It based the amount of the transfer on budgeted amounts and did not determine the actual surplus or adjust for future utility maintenance or improvements.

Cause of Condition

The City's annual budget includes an annual transfer from the Light and Power Fund to Current Expense Fund. The amount transferred is arbitrary and determined during the annual budget process with no consideration of actual Light and Power Fund operating results.

Effect of Condition

As a result of the condition identified above, the City transferred \$200,000 from the Light and Power Fund to the Current Expense Fund in both 2011 and 2012. In addition, the City included transfers in its budget from Light and Power to Current Expense for \$120,000 in 2013 and \$55,000 in 2014.

Recommendation

We recommend the City:

- Properly determine the amount of surplus, based on actual operating results, before transferring funds to the General Fund. Documentation of this analysis should be retained as support for the transfers.
- Perform an analysis to determine if there was a surplus for 2011 and 2012 and repay the Light and Power Fund if the transfers were unallowable.
- Review its utility rates to ensure they are set to only cover the costs of operating and maintaining the electric utility.

City of McCleary's Response

As you know from our prior discussions, the City's management has a fundamental area of disagreement with the contents of the finding contained within the Audit Report in relation to the transfer of funds from the Light and Power Fund to the Current Expense Fund pursuant to the terms of the budget ordinance for 2013. It is the City's position that, based upon the pertinent statutory authority, the fiscal status of the fund, and the precedential pattern of similar steps taken in the past without questioning by your predecessors, the transfer was appropriate and within the discretion of the City.

Based upon prior history I have had with your office on this matter and during the course of our review of your draft report and a discussion of this matter, the Mayor, Clerk-Treasurer, and myself have been made fully aware the position of your Office is the BARS manual and the definitions contained therein, issued pursuant to the authority of RCW 43.09.200, supersede all other authority, and thus make the transfer inappropriate as of the time it was effectuated. We respectfully disagree.

Among the reasons we believe the transfer was appropriate are the following:

A. As is recognized by all, the City of McCleary is an Optional Municipal Code City organized under the provisions of Title 35A RCW. It is made clear by the plain language of RCW 35A.11.050 that the intent of the Legislature in adopting this method of governmental organization was to grant to the City "confer the greatest power of local self-government consistent with the Constitution of this state and shall be construed liberally in favor of such cities." Further, that the provisions of the Optional Municipal Code are to be liberally construed. See further RCW 35A.11.020 and .030. In this case, there is a specific statute which in my opinion supports and, by its language, mandates, the transfer.

RCW 35.37.020, which applies to cities of less than 20,000 population, provides as follows.

*Any deficit for operation and maintenance of utilities and institutions owned and controlled by cities and towns having less than twenty thousand inhabitants, over and above the revenue therefrom, shall be paid out of the current expense fund. Any surplus in the waterworks fund, lighting fund, *cemetery fund, or other like funds at the end of the fiscal year shall be paid into the current expense fund except such part as the council by a finding entered into the record of the proceedings may conclude to be necessary for the purpose of:*

- (1) Extending or repairing the particular utility or institution; or*
- (2) Paying interest or principal of any indebtedness incurred in the construction or purchase of the particular utility or institution; or*
- (3) Creating or adding to a sinking fund for the payment of any indebtedness incurred in the construction or purchase of the particular utility or institution. (Bolding added.)*

The word “shall” indicates that it is a mandatory action, not a discretionary one, unless a finding is made by the Council on one of the three purposes set out. Here, unlike the BARS definition of surplus, is a definition specifically oriented to the fund involved. (In my years of practice, a specific definition of a term applicable to a particular matter will control over a general definition of the same term. The difference between “shall” and “may” in statutory language can be noted by comparing the text of this statute with the use of the word may in RCW 35.23.535, which is cited in your finding. It gives the City the discretion as to which course to take in the event of a surplus from utility operation, reduce rates or transfer the surplus to current expense.)

In relation to the statute, no such finding was made nor does your report indicate that any finding was made that the funds involved in the transfer in question were required for any of the three designated purposes. Thus, the plain language of the statute mandated that any surplus be transferred. Under the language of the statute, the argument can be made that the “sin” committed here was to not transfer all funds not found to be necessary for one of the three indicated purposes rather than to have made the limited transfer.

Based upon prior events, I recognize your Office has expressed the opinion in somewhat similar circumstances that RCW 35.27.510 would prohibit the transfer. That statute indicates as follows:

When any special fund of a public utility department of a town has retired all bond and warrant indebtedness and is on a cash basis, if a reserve or depreciation fund has been created in an amount satisfactory to the state auditor and if the fixing of the rates of the utility is governed by contract with

the supplier of water, electrical energy, or other commodity sold by the town to its inhabitants, and the rates are at the lowest possible figure, the town council may set aside such portion of the net earnings of the utility as it may deem advisable and transfer it to the town's current expense fund: PROVIDED, That no amount in excess of fifty percent of the net earnings shall be so set aside and transferred except with the unanimous approval of the council and mayor.

However, it is my opinion the statute would not apply to McCleary's situation. Why? The statute puts forth a series of elements, all of which must be met prior to its being applicable due to the use of the connector "and" which is of significant important in any legal interpretation. The presence of one particular element eliminates any possible applicability to the City. That element is "...and if the fixing of the rates of the utility is governed by contract with the supplier of water, electrical energy, or other commodity sold by the town to its inhabitants,..." While the City obviously has a contract with the Bonneville Power Administration, the agreement with BPA does not govern the rates which are set by the City Council.

B. As to the provisions of the BARS manual issued by your Office, RCW 43.09.200 is core to the matter. The statute reads as follows:

Local government accounting - Uniform system of accounting.

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.

The system shall exhibit true accounts and detailed statements of funds collected, received, and expended for account of the public for any purpose whatever, and by all public officers, employees, or other persons.

The accounts shall show the receipt, use, and disposition of all public property, and the income, if any, derived therefrom; all sources of public income, and the amounts due and received from each source; all receipts, vouchers, and other documents kept, or required to be kept, necessary to isolate and prove the validity of every transaction; all statements and reports made or required to be made, for the internal administration of the office to which they pertain; and all reports published or required to be published, for the information of the people regarding any and all details of the financial administration of public affairs.

There is nothing in the language of the finding that the City did not report all income and expenses. There is language which states that "[t]he amount transferred is arbitrary and determined during the annual budget process with no consideration of actual Light and Power Fund operating results." It is unclear upon what that statement is based since it is my

understanding that during the budgetary process Management considered each of the indicated factors. Additionally, I have been provided a copy of BARS Section 3.9 relating to interfund transfers. The action taken by the City complies with the plain language of the section. When applying the section and the statutory provisions cited in support of the finding, it is difficult to understand upon what the finding is based.

C. Finally, there is precedent. As noted, here is a historical pattern of transfers such as this which were subject to audit review in prior years. Ms. Collins has indicated that in fact, she discussed the matter of the transfer with the Assistant Auditor carrying out the audit for the year 2012 and was given no indication of a problem. In short, at no time was there a question raised as to the appropriateness of such transfers.

Enough said.

As I am certain you all understand, our disagreement on this particular issue in no way reduces the respect we have for you, your office, or your legal advisors.

Auditor's Remarks

We appreciate the City's response, and agree that transfers of surplus utility funds to the General Fund are allowed under RCW 35.23.535. However, we continue to emphasize that the City properly determine the amount of surplus, based on actual operating results, before transferring funds to the General Fund. Further, documentation of this analysis should be retained as support for the transfers. Without the necessary documentation to demonstrate the amount of the surplus, the City is at risk for inappropriately transferring restricted funds.

We thank the City's staff and management for their cooperation and assistance during our audit. We look forward to working with the City on this issue and will follow up on it during the next audit.

Applicable Laws and Regulations

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.

Budget Accounting and Reporting System (BARS) Manual - Part 3, Accounting, Chapter 3.9 Interfund Activities, Section 3. Utility Surplus Transfers, states:

3.9.3.10 **Surplus** – The amount by which operating revenues exceeds operating expenses. When determining the available surplus in a proprietary fund, the following must first be deducted from the proprietary fund balance: capital asset replacement cost, future capital expansions and improvements and any legally restricted resources.

3.9.3.20 The surplus can be transferred to the general (current expense) fund under the following circumstances:

- Second class cities may transfer the excess income to the general (current expense) fund (RCW 35.23.535).
- Cities under 20,000 (except first class) must transfer any surplus in utility funds to the general (current expense) fund unless the legislative body finds the money necessary for certain utility fund purpose (RCW 35.37.020).

RCW 35.23.535 Utilities – Maintenance and operation – Rates, states in part:

Rates shall be fixed by ordinance for supplying water, light, power, or heat for commercial, domestic, or irrigation purposes sufficient to pay for all operating and maintenance charges. If the rates in force produce a greater amount than is necessary to meet operating and maintenance charges, the rates may be reduced or the excess income may be transferred to the city's current expense fund.

Complete separate accounts for municipal utilities must be kept under the system and on forms prescribed by the state auditor.

The term "maintenance and operating charges," as used in this section includes all necessary repairs, replacement, interest on any debts incurred in acquiring, constructing, repairing and operating plants and departments and all depreciation charges. This term shall also include an annual charge equal to four percent on the cost of the plant or system, as determined by the state auditor to be paid into the current expense fund, except that where utility bonds have been or may hereafter be issued and are unpaid no payment shall be required into the current expense fund until such bonds are paid.

RCW 35.37.010 Accounting – Funds, states in part:

Every city and town having less than twenty thousand inhabitants shall maintain a current expense fund out of which it must pay current expenses. It shall also maintain an "indebtedness fund," and if it has outstanding general

indebtedness bonds, it must maintain a sinking fund therefor. If it maintains waterworks, lighting plant, cemetery, or other public works or institutions from which rent or other revenue is derived it must maintain a separate fund for each utility or institution. All moneys collected by such cities and towns from licenses shall be credited to the current expense fund.

RCW 35.37.020 Accounting – Surplus and deficit in utility accounts, states in part:

Any deficit for operation and maintenance of utilities and institutions owned and controlled by cities and towns having less than twenty thousand inhabitants, over and above the revenue therefrom, shall be paid out of the current expense fund. Any surplus in the waterworks fund, lighting fund, *cemetery fund, or other like funds at the end of the fiscal year shall be paid into the current expense fund except such part as the council by a finding entered into the record of the proceedings may conclude to be necessary for the purpose of:

- (1) Extending or repairing the particular utility or institution or
- (2) Paying interest or principal of any indebtedness incurred in the construction or purchase of the particular utility or institution; or
- (3) Creating or adding to a sinking fund for the payment of any indebtedness incurred in the construction or purchase of the particular utility or institution.

RELATED REPORTS

Financial

Our opinion on the City's financial statements is provided in a separate report, which includes the City's financial statements.

INFORMATION ABOUT THE CITY

The City of McCleary, incorporated in 1943, serves 1,565 citizens in Grays Harbor County. It is administered by a mayor-council form of government with five elected Council Members and an independently elected Mayor. The City operates on a \$4.5 million annual budget. Its 23 employees provide an array of services including public safety, street improvement, parks and recreation and general administrative services. Additionally, the City provides water, sewer, and electricity services.

Contact information related to this report	
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Information current as of report publish date.

Audit history

You can find current and past audit reports for the City of McCleary at <http://portal.sao.wa.gov/ReportSearch>.

ABOUT THE STATE AUDITOR'S OFFICE

The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

We work with our audit clients and citizens to achieve our vision of government that works for citizens, by helping governments work better, cost less, deliver higher value, and earn greater public trust.

In fulfilling our mission to hold state and local governments accountable for the use of public resources, we also hold ourselves accountable by continually improving our audit quality and operational efficiency and developing highly engaged and committed employees.

As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

Our audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. In addition, we conduct performance audits of state agencies and local governments as well as [fraud](#), state [whistleblower](#) and [citizen hotline](#) investigations.

The results of our work are widely distributed through a variety of reports, which are available on our [website](#) and through our free, electronic [subscription](#) service.

We take our role as partners in accountability seriously, and provide training and technical assistance to governments, and have an extensive quality assurance program.

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