



Washington State Auditor's Office

Independence • Respect • Integrity

Accountability Audit Report

City of McCleary

Grays Harbor County

For the period January 1, 2014 through December 31, 2014

Published November 19, 2015

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Washington State Auditor's Office

November 19, 2015

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,

A handwritten signature in blue ink, reading "Jan M. Jutte".

JAN M. JUTTE, CPA, CGFM
ACTING STATE AUDITOR
OLYMPIA, WA

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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 review its utility rates to ensure they are set to only cover the costs of operating and maintaining the electric utility.
- If future transfers are made, properly determine the amount of surplus, based on actual operating results, before transferring funds to the General Fund. This should include a detailed analysis of rates, operating costs, capital asset replacement costs or future capital expansions and improvements. Documentation of this analysis should be retained as support for the transfers.

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, 2014 through December 31, 2014.

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 Act
- General revenue and expenditures
- Key system controls
- Interfund transactions
- Utility billing
- Financial condition
- Procurement – purchases

SCHEDULE OF AUDIT FINDINGS AND RESPONSES

2014-001 The City did not have adequate documentation to support transfers of restricted utility funds.

Background

State law restricts the use of utility revenues to the operation and maintenance of utilities. Cities are not to use utility revenues 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 revenues 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.

In the prior audit we issued an audit finding which included the following recommendations:

- 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 utility rates to ensure they are set to only cover the costs of operating and maintaining the electric utility.

Description of Condition

During the current audit, we determined the City budgeted for and made another surplus transfer from the Light and Power Fund to the Current Expense Fund in the amount of \$55,000 in 2014. Based on our prior recommendations, the City created documentation to support their claim that the transfers in 2011, 2012 and 2014 were allowable; however the documentation did not include a detailed analysis of rates, operating costs, capital asset replacement costs or future capital expansions and improvements.

We also noted the City's unreserved Light and Power fund balance continued to grow in 2014:

Light and Power Fund balance	2011	2012	2013	2014
Reserved fund balance	\$ 300,122.50	\$ 300,123.00	\$ 300,407.00	\$ 100,160.00
Unreserved fund balance	\$ 510,896.04	\$ 274,620.00	\$ 579,634.00	\$ 627,829.00
Total fund balance	\$ 811,018.54	\$ 574,743.00	\$ 880,041.00	\$ 727,989.00

Cause of Condition

Despite prior audit recommendations, the City believes that the transfers are allowable and that the documentation provided is adequate support for the transfers.

The City does not have a current utility rate study. The last one covered 2009 through 2012.

Effect of Condition

The City's utility rates appear to be too high, resulting in growth in the Light and Power fund's unreserved fund balance.

The City continued to budget surplus utility transfers in 2014. This gives the appearance it is subsidizing the Current Expense Fund with restricted resources.

Recommendation

We continue to recommend the City:

- Review its utility rates to ensure they are set to only cover the costs of operating and maintaining the electric utility.
- If future transfers are made, properly determine the amount of surplus, based on actual operating results, before transferring funds to the General Fund. This should include a detailed analysis of rates, operating costs, capital asset replacement costs or future capital expansions and improvements. Documentation of this analysis should be retained as support for the transfers.

City of McCleary's Response

The issue to which this response is primarily responsive relates to the finding that the transfer of \$55,000.00 from the Reserve Fund of Light & Power, hereafter L&P, to the Current Expense fund in September, 2014, was violative of the Auditor's standards. As was noted at the Exit Conference, no transfer was proposed or implemented in 2015.

As was true in 2014 in relation to the finding in relation to 2013's analysis, the City's Administration respectfully disagrees. As noted on Page 6 of your Accountability Report, the City's position has been and is that such transfers are allowed, if not mandated, under applicable statutes. To an extent, this discussion continues to involve a disagreement as to whether or not certain provisions of the BARS manual override specific statutory authority granted to cities. It continues to be the Administration's position it does not. That being noted, the Administration is reviewing certain of the provisions of statutory authority cited in your Office's Report for possible implementation.

On an associated matter, a comment is made in the Report that the "rates appear to be too high" as a result of the fact the L&P's Unreserved Fund Balance increased. That increase is largely as a result of the City's following the recommendations contained in the rate study completed in 2012 as to what rates should be established. As to the rates currently applied, to the extent it may be relevant in relation to the comment, the City's rates are in fact less than the rates charged by the Grays Harbor Public Utility District to the customers in the surrounding area not served by the City's utility.

All of that being said, in recognition of the benefits of formalizing the information upon which actions are taken, including reducing the likelihood of disagreements with your office, the Administration has implemented a practice which will be utilized in certain situations relating to budget preparation. That practice is, if future transfers are proposed from an enterprise fund to the current expense fund, a written report in the general nature of that set out in the December 14, 2014, letter to your office will be developed by Staff and provided to the Mayor and Council. Also, based partially upon your office's expressed concern, it is my understanding the City Administration will be proposing to fund a rate study in its budget for 2016. If approved, upon completion that information will also be made available to the then serving Mayor and Council for consideration in not only setting rates, but also as an element of any review of an interfund transfer.

In closing, we do appreciate the generally positive nature of the relationship which continues to exist between your Office and the City and the positive comments your Report contains about the efforts of the City's Administration and Staff to correct prior problems of accountability. That agencies and their representatives can disagree on matters without being disrespectful or uncooperative with one another is only too rare in today's environment.

Auditor's Remarks

We appreciate the City's response, and continue to agree that transfers of surplus utility funds to the General Fund are allowed under RCW 35.23.535. However we want to emphasize that the City needs to properly determine the amount of surplus before transferring funds to the General Fund.

We also appreciate that the City is proposing a rate study for its 2016 budget. This will help determine if there is a surplus and will help ensure rates are set to only cover the costs of operating and maintaining the electric utility.

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 - Accounting, Interfund Activities, 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.

STATUS OF PRIOR AUDIT FINDINGS

This schedule presents the status of findings reported in prior audit periods. The status listed below is the representation of the City of McCleary. The State Auditor's Office has reviewed the status as presented by the City.

Audit Period: January 1, 2013 – December 31, 2013	Report Ref. No.: 1012813	Finding Ref. No.: 1
Finding Caption: 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. 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.		
Status of Corrective Action: (check one) <div style="display: flex; justify-content: space-between;"> <div> <input type="checkbox"/> Fully Corrected </div> <div> <input checked="" type="checkbox"/> Partially Corrected </div> <div> <input type="checkbox"/> No Corrective Action Taken </div> <div> <input type="checkbox"/> Finding is considered no longer valid </div> </div>		
Corrective Action Taken: <i>As an initial point, the City's Administration did not and does not agree that the finding was appropriate. It is recognized that the SAO places great weight upon the statutory authority granted to it in relation to the establishment of what is known as the BARS accounting protocols. The City's Administration utilizes that system for maintaining its accounting records. However, as your office is aware it is the Administration's position that the transfers questioned by the Report were made pursuant to and in compliance with specific statutory authority cited in the City's response. That the conditions of adequate funding were met were confirmed in the information provided in the December 17, 2014, letter setting out the fiscal information which was requested in your Office's report. It is my understanding that this information was informally considered in making the decision but apparently had not been set out in an explicit format/summary.</i>		

That being said, in recognition of the benefits of formalizing the information upon which actions are taken, including avoiding disagreements with your office, the Administration has implemented a policy. That policy is that if future transfers are proposed from a fund, a written report in the general nature of that set out in the December 14 letter to your office will be developed by Staff and provided to the Mayor and Council.

RELATED REPORTS

Financial

Our opinion on the City's financial statements is provided in a separate report, which includes the City's financial statements. That report is available on our website, <http://portal.sao.wa.gov/ReportSearch>.

INFORMATION ABOUT THE CITY

The City of McCleary was incorporated in 1943 and serves 1,653 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 operated on a \$6.9 million annual budget for 2014.

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, storm water and electricity services.

Contact information related to this report	
Address:	City of McCleary 100 S. Third McCleary, WA 98557
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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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