

# Schedule of Audit Findings and Responses

## **City of Lynnwood Snohomish County January 1, 2011 through December 31, 2011**

- 1. The City's internal controls over accounting and financial reporting are not adequate to ensure the financial statements are accurate, complete and timely.**

### **Background**

It is the responsibility of City management to design and follow internal controls that provide reasonable assurance regarding the reliability of financial reporting.

In each of our five previous audits, we have identified and communicated deficiencies in controls that adversely affect the City's ability to produce reliable financial statements.

### **Description of Condition**

We identified the following deficiencies in internal control over accounting and financial reporting that represent material weaknesses:

- Staff responsible for financial statement preparation and oversight lack the level of technical knowledge needed to ensure the City's financial reporting is accurate and complete according to Generally Accepted Accounting Principles (GAAP).
- The City did not have a detailed plan for the method used to allocate General Fund costs to other funds. It did not annually re-evaluate these estimated allocations. The City could not demonstrate all costs allocated to other funds represent costs incurred by those funds.
- Although the City has procedures to perform a final review of the prepared financial statements prior to audit, the review is not detailed enough to detect significant or material errors. For example, the review did not include steps to ensure that the same amounts presented on multiple statements were the same.
- The City's financial statements should be supported by underlying accounting records, including the general ledger. During our audit, the City had difficulty providing documentation, detailing the funds, and accounts that rolled up into each financial statement balance.

We further identified the following deficiencies in internal controls over accounting and financial reporting that, when taken together, represent significant deficiencies:

- Staff responsible for preparation and oversight of the City's Schedule of Expenditures of Federal Awards (SEFA) lacked the knowledge to ensure the SEFA only included expenditures for the appropriate fiscal period.

- The City did not fully implement Governmental Accounting Standards Board (GASB) Statement No. 54 in its 2011 financial statements. The objective of this Statement is to enhance the usefulness of fund balance information by replacing reserved and unreserved fund balance classifications with five new categories (non-spendable, restricted, committed, assigned, and unassigned). The City is responsible for supporting how it has reclassified its fund balances into the new categories in compliance with GASB Statement No. 54. Although City personnel believed they had a clear understanding of GASB Statement No. 54 requirements, they misunderstood the requirements.
- The City does not have adequate procedures to ensure it adds new utility customers to its utility billing system and bills for services in a timely manner. Utility Billing staff received notification of the new customers from the public works department timely, but failed to add them to the system to begin billing.
- The City does not have a procedure to perform a reconciliation of its inventory of capital assets to the general ledger to ensure only assets the City owns are reported and that capital assets are properly depreciated.

### **Cause of Condition**

City management has not dedicated the necessary time and resources to ensure accounting staff understand and are aware of proper accounting procedures. In addition, it has not dedicated the necessary time and resources to make completing the financial statements accurately and timely a priority. Financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) are more challenging due to the changing nature of the standards and at times, the complexity of the guidance. Therefore, more resources are required to ensure accurate and complete statements.

### **Effect of Condition**

Inaccurate financial reports limit access to financial information used by City officials, the public, state and federal agencies and other interested parties. It also hinders the audit process and increases audit costs.

The following material errors were not detected by the City but were identified during our audit:

- The City's General Fund improperly benefited from other City funds. The City's General Fund charged for services totaling \$1,489,081 including a total of \$1,373,325 and \$115,756, respectively, from the Water and Sewer Utility Fund and the Golf Course Fund without adequate supporting documentation.
- The City did not correctly calculate its balances for Invested in Capital Assets, Net of Related Debt by removing all related debt balances. It overstated the balance in the Water and Sewer Utility Fund by \$7,005,575. This error did not impact ending net assets for the fund.

The City corrected these errors.

The following significant errors were not detected by the City but were identified during our audit:

- The City did not properly report federal expenditures on its SEFA. The original SEFA submitted for audit reported total expenditures of \$1,752,116. It included grant expenditures of \$354,983 that were incurred in 2010 and should not have been reported on the 2011 SEFA. The City corrected this error.
- The City installed new water meters at 21 new properties during 2011; however, the City did not bill any of the new properties for service in 2011. One of the new properties was the City's Recreation Center. This resulted in an understatement of at least \$26,997 to revenues in the Water and Sewer Utility Fund. The City chose not to correct this error.
- The City incorrectly classified the ending fund balance between non-spendable, restricted, committed, assigned, and unassigned. The City corrected this error.
- The City improperly reported its payroll and claims clearing funds in its financial statements resulting in cash and equivalents being overstated by \$1,641,848 and \$306,316 being misclassified in the payroll clearing fund. The City chose not to correct this error.
- The City improperly classified its Recreation Center as Construction-In-Progress even though the asset was put in service in April 2011. This resulted in Construction-In-Progress being overstated by \$23,271,286, buildings and improvements being understated by \$22,022,856 and equipment being understated by \$842,210. The remaining \$406,220 understatement resulted from a reclassification of expenditures as operating instead of capital. The City corrected this error.
- The City reported capital assets of at least \$459,678 that the City no longer owns or could not provide documentation to support ownership of the asset. Further, the City could not provide documentation to show land valued at \$391,900 was properly reported in its statements.

Additionally, the City did not complete its financial statements and submit the final version for audit until July 9, 2012. As a result, the City missed its federal audit deadline for a second consecutive year in 2011, which could potentially impact future federal funding for the City, and did not have its statements completed within 150 days past year end, as required by state law (RCW 43.09.230).

## **Recommendation**

We continue to recommend the City:

- Provide staff the necessary resources, training, and oversight to prepare accurate and complete financial statements.
- Ensure costs allocated to other funds of the City are for their fair and true value.

- Ensure a person knowledgeable of GAAP and reporting requirements performs a detailed, technical review of the financial statements to ensure accurate preparation and reporting.
- Have procedures to reconcile general ledger balances to adequate supporting documentation.
- Establish processes to enable it to provide a list of funds, accounts and functions that support each financial statement balance timely.
- Establish processes to ensure net assets are reported in accordance with accounting standards.
- Prepares its financial statements by the required state and federal deadlines.

### **City's Response**

*The City of Lynnwood has consistently received opinions from the State Auditor's Office (SAO) that generally indicate that our financial statements fairly present the financial position of the City, in all material respects. We further appreciate recommendations on areas in which the City can improve.*

#### *Overview:*

*Both the Finance Director and Accounting Manager were hired in 2011 and late 2010, respectively, to begin an in-depth and significant review and improvement of the City's past financial operations and reporting, and implement necessary changes, (i.e. upgrading systems and correcting issues). As a result of their efforts, we have replaced the old legacy Excel based financial reporting system, which was the basis of the City's past financial reporting and which was likewise accepted by the SAO in prior audits. While the old systems may have been "efficient" in producing financial reports, it did not reflect the accounting standard we desired to continue regardless of the fact they had been accepted by the SAO for a long time. The SAO is fully aware of the significant effort put forth by the new staffers to transition from the old legacy system to the new interim system. This effort included, among other things, reloading prior City-wide financial data into the new interim system.*

*SAO Comment 1: Staff responsible for financial statement preparation and oversight lack the level of technical knowledge needed to ensure the City's financial reporting is accurate and complete according to Generally Accepted Accounting Principles (GAAP).*

- *While we accept the State Auditor's opinions and comments regarding our technical expertise, we are confident that we do have the proper audit and accounting training, experience, and technical knowledge for the proper preparation, and review of our financial statements and Schedule of Expenditures of Federal Awards.*
- *Moreover, on June 4, 2012, the City filled a long-vacant accountant position to further bolster our efforts in this regard. We covered this point at the July 9, 2012, SAO exit conference with the Lynnwood City Council. We also*

*committed to refilling a vacant financial analyst position and procuring a new enterprise-wide accounting system (ERP) to bolster the City's financial accounting and reporting efforts. The new financial position was granted in the 2013-2014 biennial budget. The new ERP has been selected; the vendor contract has been substantially negotiated, and will soon be ready for funding and implementation.*

- *As we have repeatedly discussed with the SAO, a number of measures have been taken to strengthen internal controls and oversight, increase training, and update procedures to ensure the annual financial statements are completed accurately and timely in the future.*

*SAO Comment 2: The City did not have a detailed plan for the method used to allocate General Fund costs to other funds. It did not annually re-evaluate these estimated allocations. The City could not demonstrate all costs allocated to other funds represent costs incurred by those funds.*

- *The City of Lynnwood has had an overhead cost allocation plan in place for a number of years. Our historical plan was based on an analysis of service levels provided to the Proprietary funds of the City. The plan was developed by impacted department Directors and the Finance Department. The City modified this cost allocation plan biennially to reflect turnover and attrition in staff. The SAO used and approved of our historical allocation plan in the past.*
- *However, in 2012 the SAO decided the level of detail provided with the historical overhead allocation model was not satisfactory. Therefore, the City spent considerable time and resources to revise and update our cost allocation plan to support the amounts charged to the City's Proprietary funds. The new revised plan is currently in place.*
- *We note that the **net change** between our historical overhead cost allocation plan and the revised overhead cost allocation plan was minor (+1% **higher** than the original cost allocation plan), insignificant, and immaterial.*
- *In the July 9, 2012 Exit Conference, the SAO assured the Lynnwood City Council it would work with the city to meet the October federal audit deadline. Shortly **after** that meeting the SAO team decided that they would require a complete review of cost allocation formulas and methodology, but the City was not informed until much later. This action single-handedly made the agreed upon, good-faith joint effort to meet the October federal audit timeline impossible. Given that reality, the City determined that reviewing the cost allocation plan was very important in providing additional clarity regarding our allocation methodology which supports the fairness of our financial statements, notwithstanding the October deadline.*

*SAO Comment 3: Although the City has procedures to perform a final review of the prepared financial statements prior to audit, the review is not detailed enough to detect significant or material errors. For example, the review did not include steps to ensure that the same amounts presented on multiple statements were the same.*

- *See response to SAO Comment 1.*

*SAO Comment 4: The City's financial statements should be supported by underlying accounting records, including the general ledger. During our audit, the City had difficulty providing documentation, detailing the funds, and accounts that rolled up into each financial statement balance.*

- *We provided an adequate level of documentation to generally support our account balances and fund activity. The City acknowledges that a need exists for improving its Capital Asset accounting system and this is currently being addressed. Additionally, we fully completed the review and selection of a new City-wide accounting system which will also provide better documentation and user reporting capability to support all departments and staff.*

*SAO Comment 5: Staff responsible for preparation and oversight of the City's Schedule of Expenditures of Federal Awards (SEFA) lacked the knowledge to ensure the SEFA only included expenditures for the appropriate fiscal period.*

- *See response to SAO Comment 1.*

*SAO Comment 6: The City did not fully implement Governmental Accounting Standards Board Statement (GASB) No. 54 in its 2011 financial statements. The objective of this Statement is to enhance the usefulness of fund balance information by replacing reserved and unreserved fund balance classifications with five new categories (non-spendable, restricted, committed, assigned, and unassigned). The City is responsible for supporting how it has reclassified its fund balances into the new categories in compliance with GASB Statement No. 54. Although City personnel believed they had a clear understanding of GASB No. 54 requirements, they misunderstood the requirements.*

- *We note that we began implementation of the new requirements, created by GASB 54, for the 2011 financial statements. The SAO simply disagreed with our judgment and approach. Given GASB 54's new implementation there is no history or experience to make definitive interpretations in all respects. Implementation of GASB 54 requires a large amount of policy-level analysis and action that will be addressed as soon as possible.*

*SAO Comment 7: The City does not have adequate procedures to ensure it adds new utility customers to its utility billing system and bills for services in a timely manner.*

- *This was an existing issue of which the City was aware and brought to the attention of the SAO auditors. Since 2011 had already passed, unbilled utility accounts were back-billed in 2012 and are reflected in the 2012 financial statements. Procedures are now in place to ensure new accounts are established and billed timely. Additionally there was no loss of revenue to the utility because the city has the ability to back-bill the new accounts for at least three (3) years.*

*SAO Comment 8: The City does not have a procedure to perform a reconciliation of its inventory of capital assets to the general ledger to ensure only assets the City owns are reported and that capital assets are properly depreciated.*

- We appreciate the SAO's review of capital assets. The capital asset issues brought to light by recent audits go back many years. One example of a challenge that current staff encountered in reconciling our land assets to Snohomish County records was that Snohomish County changed their parcel numbering system without providing a system for cross-referencing with the old numbering system. We are actively working to update our policy, database, and resolve accounting issues in this area.

SAO Comment 9: The City installed new water meters at 21 new properties during 2011; however, the City did not bill any of the new properties for service in 2011. One of the new properties was the City's Recreation Center. This resulted in an understatement of at least \$26,997 to revenues in the Water and Sewer Utility Fund. The City chose not to correct this error.

- The City chooses not to correct this error at this time because: 1) unbilled utility accounts were back-billed in 2012 and are reflected in the 2012 financial statements, 2) the cost benefit of correcting this error at this time is not in the City's best interest, and 3) it is within our authority to forgo certain immaterial corrections.
- See response to SAO Comment 7

SAO Comment 10: The City improperly reported its payroll and claims clearing funds in its financial statements resulting in cash and equivalents being overstated by \$1,641,848 and \$306,316 being misclassified in the payroll clearing fund. The City chose not to correct this error

- The Clearing funds are fiduciary funds that are used for internal control and reconciliation purposes for cash disbursements of both payroll and accounts payable. Neither fund's cash balances were reflected in the entity-wide statements of the City and are immaterial to the opinion of the financial statements. The BARS manual (Pt. 3, Ch. 3, Pg. 11) states, "The cash balance in a clearing fund must equal at all times the total warrants outstanding against the fund plus any amounts withheld from payrolls and temporarily unremitted (such as quarterly L&I payments)." This is how the City has been reporting the Clearing funds for at least twenty years on its Fiduciary statements. Both errors listed above will be corrected in the 2012 statements.

SAO Comment 11: The City reported capital assets of at least \$459,678 that the City no longer owns or could not provide documentation to support ownership of the asset. Further, the City could not provide documentation to show land valued at \$391,900 was properly reported in its statements.

- See response to SAO Comment 8

SAO Comment 12: Additionally, the City did not complete its financial statements and submit the final version for audit until July 9, 2012. As a result, the City missed its federal audit deadline for a second consecutive year in 2011 which could potentially impact future federal funding for the City and did not have its statements completed within 150 days past year end as required by state law (RCW 43.09.230).

- See response to SAO Comment 2

*SAO Recommendations:*

*Provide staff the necessary resources, training, and oversight to prepare accurate and complete financial statements.*

- See response to SAO Comment 1

*Ensure costs allocated to other funds of the City are for their fair and true value.*

- See response to SAO Comment 2

*Ensure a person knowledgeable of GAAP and reporting requirements performs a detailed, technical review of the financial statements to ensure accurate preparation and reporting.*

- See response to SAO Comment 1

*Have procedures to reconcile general ledger balances to adequate supporting documentation.*

- See response to SAO Comment 4

*Establish processes to enable it to provide a list of funds, accounts and functions that support each financial statement balance timely.*

- See response to SAO Comment 4

*Establish processes to ensure net assets are reported in accordance with accounting standards.*

- See response to SAO Comments 1 and 8

*Prepares its financial statements by the required state and federal deadlines.*

- See response to SAO Comments 1 and 2

*Conclusion:*

*The City corrected all material errors and many of the immaterial errors as they were detected. The time needed to address the remaining immaterial errors would have caused further delays that would have impacted the timely completion of the 2012 statements, thus creating another finding by the SAO. Given that it was within our authority to forgo correcting these errors, we chose to reflect these corrections as part of the 2012 statements.*

*The City of Lynnwood in the last seven (7) months has taken real action and proven that it is committed to dedicating resources and strengthening internal controls over accounting and financial reporting to ensure the financial statements are accurate, complete, timely, and at the appropriate standard.*

## **Auditor's Remarks**

It is the responsibility of City management to design and follow internal controls that provide reasonable assurance regarding the reliability of financial reporting. The current audit included a review of the City's cost allocation plan as it relates to the City's financial statements. We have discussed cost allocation with the City in previous accountability audits and issued recommendations related to improving its plan.

We began our audit in July 2012 and communicated with the City as issues arose to ensure the City was well informed of the progress of the audit. The City chose to miss its federal audit deadline in order to redo its cost allocation plan and avoid a qualified opinion on its financial statements. We reaffirm our finding.

## **Applicable Laws and Regulations**

Statement on Auditing Standards No. 115, issued by the Auditing Standards Board of the American Institute of Certified Public Accountants, defines material weakness and significant deficiency as follows:

a. 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.

b. 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.

*Government Auditing Standards*, July 2007 Revision – Section 5.11, provides that auditors should report significant deficiencies and material weaknesses in internal control.

RCW 43.09.200, Local government accounting -- Uniform system of accounting, states:

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 there from; 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. 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 1. Accounting Principles and General Procedures, Section B. 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.

Each entity is responsible for establishing and maintaining an effective system of internal control throughout their government.

RCW 43.09.230, Local Government Accounting – Annual Reports, states in part:

The state auditor shall require from every local government financial reports covering the full period of each fiscal year, in accordance with the forms and methods prescribed by the state auditor, which shall be uniform for all accounts of the same class.

Such reports shall be prepared, certified, and filed with the state auditor within one hundred fifty days after the close of each fiscal year.

OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, states in part:

#### Section 200

##### (a) Audit required.

Non-Federal entities that expend \$300,000 (\$500,000 for fiscal years ending after December 31, 2003) or more in a year in Federal awards shall have a single or program-specific audit conducted for that year in accordance with the provisions of this part. Guidance on determining Federal awards expended is provided in §\_\_\_\_.205.

##### (b) Single audit.

Non-Federal entities that expend \$300,000 (\$500,000 for fiscal years ending after December 31, 2003) or more in a year in Federal awards shall have a single audit conducted in accordance with §\_\_\_\_.500 except

when they elect to have a program-specific audit conducted in accordance with paragraph (c) of this section.

#### Section 300

The auditee shall:

(b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.

(c) Comply with laws, regulations, and the provisions of contracts or grant agreements related to each of its Federal programs.

(d) Prepare appropriate financial statements, including the schedule of expenditures of Federal awards in accordance with §\_\_\_\_.310.

(e) Ensure that the audits required by this part are properly performed and submitted when due. When extensions to the report submission due date required by §\_\_\_\_.320(a) are granted by the cognizant or oversight agency for audit, promptly notify the Federal clearinghouse designated by OMB and each pass-through entity providing Federal awards of the extension.

#### Section 320

a) General. The audit shall be completed and the data collection form described in paragraph (b) of this section and reporting package described in paragraph (c) of this section shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit.