Schedule of Audit Findings and Responses

City of Mountlake Terrace
Snohomish County
January 1, 2013 through December 31, 2013

1. The City's internal controls over accounting and financial statement preparation are inadequate to ensure accurate reporting

Background

It is the responsibility of City management to design and follow internal controls that provide reasonable assurance regarding the reliability of financial reporting. Our audit identified a material weakness in internal controls that adversely reporting affect the City's ability to produce reliable financial statements.

Description of Condition

During our audit, we identified the following deficiencies in internal controls over financial reporting that, when taken together, represent a material weakness:

- City staff responsible for compiling the financial statements did not have sufficient technical knowledge and did not always utilize accounting standards and the *Budget Accounting and Reporting System* (BARS) manual when preparing the financial statements.

- The City believed its utility infrastructure spreadsheet contained errors, however, it chose to continue to use the spreadsheet to account for capital assets without performing a full review of the spreadsheet's data and correcting the identified errors.

- Although the City has procedures to perform a final review of the prepared financial statements prior to audit, the review was not effectve in detecting material errors.

Cause of Condition

City management has not dedicated the necessary time and resources to:

- Ensure that accounting staff understand and is trained in proper accounting procedures.

- Review its capital assets to ensure depreciation and amorization is being properly calculated and depreciable values for the assets are appropriate.

The City hired an outside consultant to perform a final review of its statements; however, the consultant's review was not sufficient to identify significant errors.

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. In addition, these conditions delay the audit process and increase audit costs.

As a result of these control deficiencies, our audit identified several material errors in the original financial statements we received for audit. Although errors were identified, the City corrected most significant errors identified and received an unmodified opinion on its financial statements in whole.

Material Errors Identified:

- The City excluded cash and investments held for other governmental entities from the financial statements. Of which, the majority of this amount was attributed to one government and had not been reported in previous years. As a result, the City understated cash and investments by $3,816,227 in its agency funds. The City corrected this error.

- The City overstated road infrasture by $2,472,435 by capitalizing road repair and maintenance projects that it should have expensed. The City corrected this error.

- The City improperly classified a road construction project as construction in-progress even though the asset was put in service in 2010. This resulted in construction in-progress being overstated by $1,599,901. As a result, the City did not start depreciating the asset and over-reported the project's value by $319,980.

- The City used an inaccurate methodology to calculate amortization and depreciation expenses for its Sewer, Water, and Storm Water Utility Funds. Specifically, we found the City overstated accumulated depreciation and amortization by $664,819 for its Sewer Utility Fund. The City corrected this error.

- The City did not classify $2,284,590 in investments from unspent bond proceeds in the Storm Water Utility Fund as a restricted asset. The City corrected this error.

We identified additional, less significant errors in the financial statements and notes to the financial statements.

Recommendation

We recommend the City dedicate the necessary time and resources to ensure:

- Staff is provided the necessary training and resources to prepare accurate and complete financial statements.

- Capital assets and the associated accumulated depreciation and depreciation expense are correctly reported.

- The final review of the financial statements is sufficiently detailed to ensure accurate preparation and reporting.

City's Response

"The City excluded cash and investment held for other governmental entities from the financial statements. Of which, the majority of this amount was attributed to one government and had not been reported in previous years. As a result, the City understated cash and investments by $3,816,227 in its agency funds. The City corrected this error."

The $3,816,227 relates to cash and investments for two agencies that the City provides accounting and budget reporting services. The City has been doing this accounting work for the larger of the two agencies since 2010 and their cash and investments have been a reconciling item and audited as such for the past three years.

During the 2013 audit, auditors suggested the two agencies' cash and investment be added to the City's Agency Funds statements.

The addition of these funds has no effect on the financial condition of the City. Furthermore, the Agency Funds statements have been updated to include these cash and investments. In the future the City will include these two agencies cash and investment balances in its Agency Funds statements per the rule identified by the State Auditor's Office (SAO) in 2014.

"The City overstated road infrastructure by $2,472,435 by capitalizing road repair and maintenance projects that it should have expensed."

The City has been capitalizing road improvements since 2007 when it implemented GASB Statement 34, which requires capitalization of governmental and business-type activities infrastructure constructed subsequent to 1980. The City has consistently capitalized road improvements per its policy since 2007. The capitalized road projects have been reviewed each of the last five years by the SAO without issue. The $2,472,435 amount cited by the SAO represents a total of 98 projects that had been completed and capitalized since 2000.

The City's reporting of the capitalization of these projects was included in our annual CAFR, which was reviewed by GFOA and for which the GFOA has awarded the Certificate of Achievement for Excellence in Financial Reporting for the past six years.

The City's capital asset policy, which was drafted using BARS and GASB guidelines, required that improvements with costs over $5,000 that improved and extended the useful life of an asset were capitalized. This included chip-seal and overlay road projects.

During the 2013 audit, it is was brought to our attention that chip-seal and overlay projects should not be capitalized, regardless of the cost of the improvement even if the useful life of the road was extended. Obviously, if these projects did not improve an existing road we would not have initiated and completed these projects.

Since this issue was brought to our attention, we purchased the recently GFOA published "Accounting for Capital Assets" written by Stephen J. Gauthier and will follow their various capital asset policy recommendations in the future, including not capitalizing road project unless the capacity of a road is made wider or longer.

The City has updated its governmental capital assets schedule in its 2013 CAFR to exclude the $2,472,435 of projects that are now considered road repairs rather than improvements.

Note there was no previous GAAP guidance on the issue, and our state independent auditors signed off on our policy with an unqualified opinion.

"The City improperly classified a road construction project as construction in-progress even though the asset put in service in 2010. This resulted in construction in-progress being overstated by $1,599,901. As a result, the City did not start depreciation the asset and over-reported the project's value by $319,980."

The City was following its capitalization policy to classify all costs as construction work in progress until all final payments and claims are processed. There was a major claim outstanding of $224,000 that was filed by the contractor on this project in 2011. The unresolved claim delayed the capitalization of the street reconstruction project. This claim was not resolved and settled with the contractor until 2014. The $106,660 annual depreciation was not taken because according to the City, the outstanding claims had not all been resolved.

The City will change in capitalization policy and in the future will capitalize projects when they are substantially complete and put into service even though there may be outstanding claims.

"The City used an inaccurate methodology to calculate amortization and depreciation expenses for its Sewer, Water, and Storm Water Utility Funds. Specifically, we found the City overstated accumulated depreciation and amortization by $664,819 for its Sewer Utility Fund."

This issue comes about due to differing views on the useful life of sewer assets, specifically the City's ownership at the Edmonds Wastewater Treatment Plant. The SAO has identified a useful life for depreciation of this asset as ending in 2018, at the time of the current interlocal agreement between Mountlake Terrace and Edmonds. The City, on the other hand, has used a useful life for depreciation based on the estimated useful life of the treatment plant of 18.5 years assuming the agreement will be extended after 2018. (Neither Edmonds nor Mountlake Terrace anticipate the WWTP will be shut off to Mountlake Terrace at the end of 2017; the City owns a portion of the plant, and that ownership does not dissolve if a successor interlocal is not in place.)

This explanation aside, the City did increase the net value of its ownership of the Edmonds Wastewater Sewer Plant by $684,637 per the SAO's recommendation and will change its depreciation method to the straight line method for infrastructure assets. In the City's opinion, the net adjustment of $684,637 to increase the value of the Sewer Utility capital assets is immaterial as compared to the total Utility Capital assets value of $36.4 million at December 31, 2013.

"The City did not classify $2,284,590 in investments from unspent bond proceeds in the Storm Water Utility fund as a restricted asset. "

The City has consistently reported all of its restricted unspent bond proceeds from the 2010 and 2012 Revenue bond issues in its Notes to the Financial statements, specifically in Note 3-K (Fund Equity) of the City's 2010, 2011 and 2012 CAFR. The unspent portion of the debt has always been included in the calculation of net position restricted for capital projects. These restricted proceeds will now also be included as restricted Cash and Investments on the City's Statement of Net Position in the 2013 CAFR.

Auditor’s Remarks

We appreciate the City’s efforts to resolve the issues identified in this finding. We will review the status of this finding during the next regularly scheduled 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 265, as follows:

> .07 For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:
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> > **Material weakness.** A deficiency, or a 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.
> >
> > **Significant deficiency.** 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.