

SCHEDULE OF AUDIT FINDINGS AND RESPONSES

- 2019-001 The City's internal controls over accounting and financial statement preparation were not adequate to ensure accurate and complete financial reporting.**

Background

The City Council, the Mayor, state and federal agencies, and the public rely on the information included in the financial statements and reports to make decisions. City management is responsible for designing, implementing, and maintaining internal controls to ensure financial statements are prepared and fairly presented in accordance with generally accepted accounting principles (GAAP).

The audit identified deficiencies in internal control that could affect the City's ability to produce reliable financial statements. When taken together, the deficiencies represent a significant deficiency. *Governmental Auditing Standards* requires the auditor to communicate significant deficiencies, defined in the Applicable Laws and Regulations section below, as a finding.

Description of Condition

Historically, the City has had strong internal controls over the financial statement preparation process. However, during the preparation of the 2019 financial statements, the control processes did not ensure the financial statements were accurate. We noted the following:

- The City's review process relied on past practice to assess whether a sale of land was appropriately reported when preparing the government-wide financial statements which was not effective.
- The City chose to early implement GASB Statement No. 84, *Fiduciary Activity*. Although the City performed an evaluation, it did not ensure the activity reported met the definition of fiduciary activity. The City reported various intergovernmental activities such as school district impact fees as fiduciary, which are not fiduciary in nature because they are imposed by the City. Therefore, they are considered the City's own source of revenue. The City's controls over evaluating revenue recognition did not ensure that revenue earned in 2020 was reported in the correct fiscal year.

Cause of Condition

The City did not dedicate the time and resources to the year-end financial statement preparation and review process to ensure the financial statements, notes, and supplementary schedules were accurate and complete.

Effect of Condition

The City's control deficiencies led to the following:

- General Government expense was overstated by \$10,013,812 in the Governmental Activities and Contributions/Disposals from Capital Assets was overstated by the same amount. The amount represents the value of land that was sold in 2019, which does not affect expenses. Instead, the City should have reported a Loss on the Sale of Capital Asset of \$1,732,716. The City subsequently corrected the errors.
- The City incorrectly reported \$616,979 of various intergovernmental activities as fiduciary activity. As a result, fiduciary activities were overstated by \$616,979 on both the Statement of Fiduciary Net Position and Statement of Changes in Fiduciary Net Position, which accounted for 45 percent of the entire fiduciary activities. The City subsequently corrected the error.
- License and permit revenues was overstated by \$1,236,918 in the Aggregate Remaining Fund. The amount represents first quarter 2020 revenue that was reported in fiscal year 2019.

Recommendation

We recommend the City strengthen its controls over the financial statement review process, implementation of new accounting standards as well as its evaluation of revenue recognition by dedicating sufficient resources, such as staff time and training, to ensure the financial statements are accurately prepared in accordance with GAAP.

City's Response

The City disagrees with the findings of this audit. The City has a long history of accurate financial reporting and a many pronged approach to make sure the financial statements are a true and correct representation of its financial standing and takes the accuracy of its financial reporting very seriously. We have a proved track record that our internal controls and management oversight is adequate. Our approach includes the following:

- *Accounting staff prepares the financial statements*
- *The Financial Planning Division reviews the statements for accuracy*
- *The Accounting Manager reviews the statements against best practices.*

- *The Deputy Finance Director and then the Director also review the statements*

Recording of Capital Assets

Consistent with past practice and historical audited transactions, the City recorded the sale of the land correctly in the Fund Statements and the General Ledger. The overstatement in the Governmental Activities and Contributions/Disposals from Capital Assets affected both revenues and expenditures, therefore the City's net position was accurate and would not mislead a user of the financial statements. The \$1.7 million loss on the sale of the property was also recorded accurately and it also did not affect the net position. A reasonable person relying on the City's financial statements would not be misled and/or influenced by the inclusion or correction of this item. The amount of the overstatement is also immaterial given the size of the City's portfolio.

GASB 84 Interpretation

After careful consideration and research, the City's interpretation of GASB 84 related to fiduciary activities is correct and should not be a part of these audit recommendations. A fiduciary activity, according to GASB 84, should have one or more of the following characteristics, "the assets are for the benefit of organizations or other governments that are not part of the financial reporting entity. In addition, the assets are not derived from the government's provision of goods or services to those organization or other governments."

Lake Washington School District is not a part of the City's financial reporting entity nor do the impact fees represent the provision of goods and services to or from the City. School impact fees are not a resource of the City and therefore should be considered fiduciary in nature as the City has no control over the rates or the policy and procedures that govern school impact fees. Reporting school impact fees as a revenue and expense in the City's financial statements overstates both and is misleading to the users of financial statements.

Licenses and Permit Revenue

The City agrees with the auditor's statement that license and permit revenues were overstated by \$1,236,918. At the developer's request the City billed the company early for the next development agreement payment due on the developer's \$17 million contract and the City inadvertently billed the developer on 12/31/2019 for revenue due in 2020. The error was a timing issue and is not significant given the magnitude of the development agreement. The amount (\$1.2 million) reflects only 6% of the total governmental funds license and permit revenue and less than 1% of the City's total governmental fund revenue. The City's process for entering and billing customers includes management review prior to posting. The incorrect posting of the revenue was merely an oversight, not an internal control issue and does not rise to the level of a finding.

None of the transactions recorded above meet the materiality threshold according to GAAP standards, therefore the City concludes the findings should be removed from the audit documentation.

Auditor's Remarks

Government Audit Standards require auditors to communicate control deficiencies identified and the effects noted that, when taken together, represent a significant deficiency. City management is responsible for the proper presentation of financial statements in accordance with the City's chosen basis of accounting. We reaffirm the finding.

We appreciate the communication with the City and encourage the City to dedicate sufficient resources to strengthen its control structure over financial accounting and reporting.

Applicable Laws and Regulations

Government Auditing Standards, December 2011 Revision, paragraph 4.23 establishes reporting requirements related to significant deficiencies or material weaknesses in internal control, instances of fraud or abuse, and noncompliance with provisions of law, regulations, contracts, or grant agreements.

The American Institute of Certified Public Accountants defines significant deficiencies and material weaknesses in its Codification of Statements on Auditing Standards, section 265, Communicating Internal Control Related Matters Identified in an Audit, paragraph 7.

RCW 43.09.200 Local government accounting – Uniform system of accounting, requires the state auditor to prescribe the system of accounting and reporting for all local governments.

The *Budgeting, Accounting, and Reporting System* (BARS) manual, 3.1.3, Internal Control, Internal Control, requires each local government to establish and maintain an effective system of internal controls that provides reasonable assurance that the government will achieve its objectives.