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Municipal Newsletter

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I hope everyone is enjoying the summer and has found time to relax and enjoy friends, family, and adventure. As summer winds down I want to share some information with you to carry into the next audit and reporting season. The purpose of this newsletter is to update the audit community on the Audits Division's efforts in administering Municipal Audit Law and address other issues of interest. This newsletter includes some of the results of our desk and field reviews of the fiscal year 2017 financial statements as well as addressing questions regarding basis of accounting and audit contracts.

MODIFIED CASH BASIS OF ACCOUNTING

> "In measuring the complete financial health of a state or local governmental entity in the United States, there is no replacement for accounting principles generally accepted in the United States of America (GAAP) as established by the Governmental Accounting Standards Board (GASB).[1]"

As shared in last year's newsletter, some governments are adopting the modified cash basis of accounting for annual financial reporting. The report must still comply in substance with the basic GAAP financial statement presentation and disclosure requirements, as applicable. Cash and modified cash basis statements are not considered appropriate in form unless the financial statements include informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP. Although the financial statement presentation and disclosure requirements of GAAP still apply in context, it's important to make sure statements and schedules are appropriately titled to clarify the basis of accounting being used. A few considerations include the following:

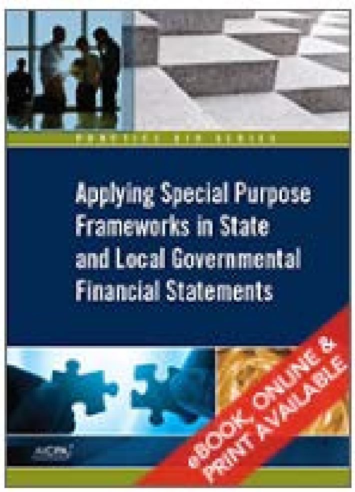
- If a modification to the cash basis of accounting includes reporting capital assets (acquired with cash), the report should include all transactions and disclosures that result from that modification, including depreciation and complete note disclosures as defined by GASB;

[1] AICPA Practice Aid Series, *Applying Special Purpose Frameworks in State and Local Governmental Financial Statements (2016), p. 1*

- The notes to the financial statements must fully describe the modifications to the cash basis of accounting when the modified cash basis of accounting is used; and
- The independent auditor's report should correctly opine on the statements in accordance with the basis of accounting used, and include a properly placed paragraph referencing the note disclosure that further explains the basis of accounting.

I have reviewed several 2017 municipal audit reports stating they present financial statements on the modified cash basis of accounting; I question whether the presentation accurately complies with this basis. Modified cash basis statements take a purely cash basis reporting model and make certain modifications; all transactions and balances recorded in the financial report must stem from a cash transaction.

"The modified cash basis has often been misinterpreted as a mixing of framework principles through the application of cash basis treatment to certain financial statement elements while applying full GAAP-basis treatment to other elements.[2]" Many of the modified cash basis reports I've reviewed may be more appropriately described as GAAP with a departure. Refer to the following excerpt from AICPA's practice aid:[3]



Because modified cash basis frameworks do not involve financial statement elements resulting from accruals and noncash transactions or events, it is unlikely an acceptable modified cash basis framework would ever be materially equivalent to GAAP. However, it is important for financial statement preparers to avoid attempting to make certain modifications to what would otherwise be GAAP financial statements and then referring to them as modified cash basis financial statements. For example, if the modified cash basis framework applied involves reporting accruals of revenues and expenses or applies GAAP, except for the reporting of net pension or OPEB obligations, then the framework should not be considered a modified cash basis framework and should instead be considered a GAAP framework with departures.

I expect the increase in modified cash basis statements coincides with the increased requirements and complexity involved with pension and other post-employment benefits (OPEB) reporting and disclosures. The AICPA uses that very example to emphasize the appropriate, and inappropriate, use of the modified cash basis of reporting.

Going forward I encourage all financial statement preparers and practitioners to consider whether financial statements presented on the modified cash basis of accounting more accurately reflect GAAP statements with one or more departures. The AICPA practice aid pictured above and quoted herein is not authoritative but is a good resource for anyone preparing or auditing financial statements on a basis of accounting other than GAAP.

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[2] Ibid, p. 14
[3] Ibid, p. 21

OREGON MINIMUM STANDARDS

Auditors occasionally overlook the requirement to disclose compliance with programs funded from outside sources (OAR 162-010-0280(1)). Further, a review of auditor engagement files indicates procedures are not always considered or performed when applicable. Some mistakenly believe this requirement only applies to a local government when it is subject to a Single Audit. This rule went into effect long before the Single Audit Act of 1984. Governments frequently receive outside funding such as loans and grants from Oregon state agencies and smaller federal grants below the Single Audit threshold. When these revenues are material to the basic financial statements, the auditor should perform procedures to determine whether the local government complied with the terms, conditions, and restrictions of the grant or loan and report significant violations.

The Oregon Society of CPA's (OSCPA) Governmental Accounting and Auditing Committee has prepared suggested audit procedures for Oregon Minimum Standards. If your firm doesn't already have a Minimum Standards audit program, consider taking a look. If your firm *does* have a program, I recommend you review it against these suggested procedures to ensure it is current and applicable to the engagements you perform. There is a general audit program and separate audit programs for State School Fund (ADM) and local budget law. I expect the recently updated programs to be finalized and published to the OSCPA's website (orcpa.org) very soon.

ENGAGEMENT LETTERS AND AUDIT CONTRACTS

Every public body, including state agencies and local governments, is subject to the laws of the Public Contracting Code, ORS Chapters 279A, 279B, and 279C. The program and its administrative "Model Rules" are the responsibility of the Oregon Attorney General and are recorded in OAR Chapter 137, Divisions 46-49.

Auditing standards require independent auditors to issue engagement letters meeting certain criteria. Municipal Audit Law (ORS §297.425) and Oregon's Public Contracting Code require municipalities to follow contracting and procurement rules when contracting for professional services such as a municipal audit. Questions have come up recently about whether an engagement letter issued by the independent auditor meets Oregon's public contracting laws — it does not. Local governments should ensure they issue contracts with their auditor that meet Public Contracting Code, and should not rely on the auditor's engagement letter to meet those requirements.

Anyone seeking additional contracting information should read the Model Rules referenced above. The *Model Rules of Procedures* and the *Attorney General's Public Contracts Manual* are available for purchase on the Department of Justice website.

DESK REVIEWS – FY2017 AUDIT REPORTS

Every year we review a sample of financial reports from the nearly 1,800 cities, counties, school districts, fire districts, and other special districts in the state of Oregon. Our goal is to provide timely feedback to the audit community for consideration in planning upcoming engagements. This year, we reviewed 119 audit reports and 32 review reports for fiscal year 2017. The sample reviewed included a selection of cities and counties and also focused on urban renewal agencies, county service districts, schools, community colleges, and charter schools.

We communicated over 400 individual findings to municipalities. The findings fell into the areas of budgeting, basis of accounting, financial statement formatting, accounting issues, and note disclosures. We also issued over 50 letters to auditors addressing errors in the auditor's report. Many of the findings have been noted in prior years and have been communicated in these newsletters. I encourage you to read prior issues of this annual newsletter; they contain information, reminders, and explanations that remain relevant today. The following list of repeat findings includes the more common findings.

Some reasons we see so many repeat findings are that we only select a sampling of reports to review each year, not all recommendations are implemented, and some recommendations are only implemented for the municipality receiving the letter.

Many auditors use the review comments to ensure all of their clients comply with GASB reporting requirements, not just the client associated with the review letter. This is an excellent practice. Another resource to help ensure accurate and complete financial reporting is to consult the GFOA checklist for financial reporting during financial statement preparation and engagement review. The checklists pertain to reporting for a variety of entity types and can be downloaded for free from the GFOA website.

REPEAT FINDINGS

Financial statement presentation

We noted the following issues in the format and content of several financial statements:

- Statements were not presented in a correct and consistent order (fiduciary funds statements before proprietary funds statements);
- The statement of activities did not present revenues by type, especially tax revenues by type of tax. This is most prevalent in reports from school districts, who have other reporting requirements imposed by the Department of Education. Classifications of revenue such as federal, state, local, and intermediate sources don't meet reporting standards and should be replaced with descriptions such as grants, property tax, state school fund (or intergovernmental) revenue, etc.;
- General revenues reported on the statement of activities were not reported separately from other types of revenues, such as transfers or special items;
- Component units did not always identify themselves as a component unit in their statement titles or other areas of the financial report as required;
- Outdated terminology is still being used, such as net assets, reserved fund balance, designated balances, and fund equity;
- State highway funds received were incorrectly reported as tax revenue rather than correctly reported as program revenues to the local government (see the GASB Codification and implementation guide question Q7.34.5 and GASB Statement 34 ¶47); and
- Some reports presented deferred inflows and outflows on the financial statements that should have been reported as liabilities or assets, and vice versa.

Notes to the financial statements

- The notes to the financial statements contained information that did not agree to the financial statements where appropriate;

- Investment notes incorrectly included fair value information related to the LGIP or other external investment pools. External investment pools, including the LGIP, are not subject to fair value disclosures, such as describing the fair value hierarchy used to value the underlying investments;
- Payments subsequent to the measurement date were presented in the table of deferred inflows and outflows as amounts to be recognized in pension expense in subsequent years. However, these amounts should be used to offset pension liability in the following year;
- Capital asset policies incorrectly classified capital assets as assets with an estimated useful life of two or more years, rather than those with an estimated useful life extending beyond a single reporting period (which is how they are defined in GASB §1400);
- Pension notes referenced incorrect actuarial valuation dates (December 31, 2014) and measurement date (June 30, 2016) used by PERS; and
- OPEB disclosures were not always presented for employers participating in PERS.

Independent auditor's report

The most common issues found in the auditor's report include the following:

- Some reports included reference to opinion units in the introductory and opinion paragraphs that did not exist in the financial statements, such as business-type activities or aggregate remaining fund information;
- Some reports omitted reference to opinion units that *were* presented in the financial statements, or omitted reference to budgetary comparison schedules presented as part of the basic financial statements;
- Some reports failed to reference cash flows in the opinion paragraph when applicable; and
- Some reports did not include an emphasis of a matter paragraph bringing attention to the special purpose framework when opining on cash or modified cash basis statements. Additionally, we saw the emphasis paragraph misplaced within the report.

Independent accountant's review report

SSARS 21 revised the form and content of the review report and was effective for fiscal year 2017. Most findings noted a failure to include the newly required headers or not updating the language to comply with the new standards.

CLOSING THOUGHTS

I enjoy working in this role and vow to continue looking for ways to improve our work and assist the municipal audit community as much as possible. As always, call me if you have questions about your responsibilities under Municipal Audit Law or if you have suggestions or comments to improving the program. I can be reached at (503) 986-5160 or amy.dale@oregon.gov.

I look forward to our continued partnership,

Amy Dale, CPA