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Government Finance Officers Association of Missouri
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Best Practices–GFOA, IRS and Beyond

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Presentation Outline

- Financial reports per statutes and regulations
- Internal controls
- Records retention and investment policies
- GFOA best practices
- Pitfalls to avoid –
  - Restricted amounts
  - Auditors
  - IRS

Missouri Revised Statutes Chapter 105 Public Officers and Employees--Miscellaneous Provisions

Section 105.145.1

Political subdivisions to make annual report of financial transactions to state auditor.

1. The following definitions shall be applied to the terms used in this section:

(1) "Governing body"…;

(2) "Political subdivision"….

2. The governing body of each political subdivision in the state shall cause to be prepared an annual report of the financial transactions of the political subdivision in such summary form as the state auditor shall prescribe by rule, except that the annual report of political subdivisions whose cash receipts for the reporting period are ten thousand dollars or less shall only be required to contain the cash balance at the beginning of the reporting period, a summary of cash receipts, a summary of cash disbursements and the cash balance at the end of the reporting period.

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15 CSR 40-3.030 Annual Financial Reports of Political Subdivisions (cont.)

- (4) The annual financial report shall be mailed to the State Auditor's Office at PO Box 869, Jefferson City, MO 65102, or emailed to PolySubFS@auditor.mo.gov.
- (5) An unaudited annual financial report shall be submitted within six (6) months after the end of the political subdivision's fiscal year; an audit report prepared by a certified public accountant shall be submitted within six (6) months after the end of the political subdivision's fiscal year.

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RSMo – Semiannual statements

- Fourth Class Cities 79.160 – The board of aldermen shall semiannually each year, at times to be set by the board of aldermen, make out and spread upon their records a full and detailed account and statement of the receipts and expenditures and indebtedness of the city for the half year ending with the last day of the month immediately preceding the date of such report, which account and statement shall be published in some newspaper in the city.
- Third Class Cities 77.110 – The council shall publish a full and detailed statement of the receipts and expenditures and indebtedness of the city at the end of each fiscal year and six months after the end of each fiscal year in a newspaper of general circulation in the city. Each such statement shall be for the six-month period preceding the date of the statement.

Internal Controls

- Standard operating procedures
- Document procedures
- Examples of important systems for internal controls:
  - Payroll
  - Check disbursements
  - Cash receipts
  - Tone at the top
  - Anti-fraud program

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What are Internal Controls?

- Methods and procedures used to provide reasonable assurance that the systems of policies and procedures:
  - Protect the assets of an organization
  - Ensure the validity of financial records and reporting
  - Promote adherence to policies and procedures, as well as compliance with laws and regulations
  - Achieve effective and efficient operations

General Controls

- Is there segregation of duties?
- Are employees cross trained?
- Are approvals (initials, etc.) documented for everything?
- Are the policies and procedures documented?
- Does the Finance Officer perform analytical reviews?
- Finance Officer and City Administrator should ask questions.

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Best Practices

- **Record Retention Manual –**
  - Missouri Secretary of State website:
    http://www.sos.mo.gov/archives/localrecs/schedules/

- **Investment Policy –**
  - Missouri Treasurer website – sample included:
    www.treasurer.mo.gov/link/ModelInvestmentPolicy.pdf

Best Practices

GFOA has many (180+) Best Practices/Advisories

http://www.gfoa.org/best-practices

Mike's Top 10:

1. Appropriate level of fund balance
2. Audit committees
3. Capitalization threshold for capital assets
4. Controls for items not capitalized
5. Credit cards
6. Documenting accounting policies and procedures
7. Enhancing tax abatement transparency
8. Getting management involved in internal control
9. Practical steps to avoid, limit, or eliminate internal control deficiencies identified in an audit
10. Questionable practices/fraud reporting

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BEST PRACTICE

Appropriate Level of Unrestricted Fund Balance in the General Fund

BACKGROUND:

In the context of financial reporting, the term *fund balance* is used to describe the net position of governmental funds calculated in accordance with generally accepted accounting principles (GAAP). Budget professionals commonly use this same term to describe the net position of governmental funds calculated on a government's budgetary basis.[1] While in both cases *fund balance* is intended to serve as a measure of the financial resources available in a governmental fund; it is essential that differences between GAAP *fund balance* and budgetary *fund balance* be fully appreciated.

1. GAAP financial statements report up to five separate categories of fund balance based on the type and source of constraints placed on how resources can be spent (presented in descending order from most constraining to least constraining): *nonspendable fund balance*, *restricted fund balance*, *committed fund balance*, *assigned fund balance*, and *unassigned fund balance*.[2] The total of the amounts in these last three categories (where the only constraint on spending, if any, is imposed by the government itself) is termed *unrestricted fund balance*. In contrast, budgetary fund balance, while it is subject to the same constraints on spending as GAAP fund balance, typically represents simply the total amount accumulated from prior years at a point in time.
2. The calculation of GAAP fund balance and budgetary fund balance sometimes is complicated by the use of sub-funds within the general fund. In such cases, GAAP fund balance includes amounts from all of the subfunds, whereas budgetary fund balance typically does not.
3. Often the timing of the recognition of revenues and expenditures is different for purposes of GAAP financial reporting and budgeting. For example, encumbrances arising from purchase orders often are recognized as expenditures for budgetary purposes, but never for the preparation of GAAP financial statements.

The effect of these and other differences on the amounts reported as *GAAP fund balance* and *budgetary fund balance* in the general fund should be clarified, understood, and documented.

It is essential that governments maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. In most cases, discussions of fund balance will properly focus on a government's general fund. Nonetheless, financial resources available in other funds should also be considered in assessing the adequacy of unrestricted fund balance in the general fund.

RECOMMENDATION:

GFOA recommends that governments establish a formal policy on the level of unrestricted fund balance that should be maintained in the general fund for GAAP and budgetary purposes.[3] Such a guideline should be set by the appropriate policy body and articulate a framework and process for how the government would increase or decrease the level of unrestricted fund balance over a specific time period.[4] In particular, governments should provide broad guidance in the policy for how resources will be directed to replenish fund balance should the balance fall below the level prescribed.

Appropriate Level. The adequacy of unrestricted fund balance in the general fund should take into account each government's own unique circumstances. For example, governments that may be vulnerable to natural disasters, more dependent on a volatile revenue source, or potentially subject to cuts in state aid and/or federal grants may need to maintain a higher level in the unrestricted fund balance. Articulating these risks in a fund balance policy makes it easier to explain to stakeholders the rationale for a seemingly higher than normal level of fund balance that protects taxpayers and employees from unexpected changes in financial condition. Nevertheless, GFOA recommends, at a minimum, that general-purpose governments, regardless of size, maintain unrestricted budgetary fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures.[5] The choice of revenues or expenditures as a basis of comparison may be dictated by what is more predictable in a government's particular circumstances.[6] Furthermore, a government's particular situation often may require a level of unrestricted fund balance in the general fund significantly in excess of this recommended minimum level. In any case, such measures should be applied within the context of long-term forecasting, thereby avoiding the risk of placing too much emphasis upon the level of unrestricted fund balance in the general fund at any one time. In establishing a policy governing the level of unrestricted fund balance in the general fund, a government should consider a variety of factors, including:

2/12=16.67%

1. The predictability of its revenues and the volatility of its expenditures (i.e., higher levels of unrestricted fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile);
2. Its perceived exposure to significant one-time outlays (e.g., disasters, immediate capital needs, state budget cuts);
3. The potential drain upon general fund resources from other funds, as well as, the availability of resources in other funds;
4. The potential impact on the entity's bond ratings and the corresponding increased cost of borrowed funds;
5. Commitments and assignments (i.e., governments may wish to maintain higher levels of unrestricted fund balance to compensate for any portion of unrestricted fund balance already committed or assigned by the government for a specific purpose). Governments may deem it appropriate to exclude from consideration resources that have been committed or assigned to some other purpose and focus on unassigned fund balance, rather than on unrestricted fund balance.

Changes in State Statutes regarding distribution of revenue (sales taxes).

Use and Replenishment.

The fund balance policy should define conditions warranting its use, and ifa fund balance falls below the government's policy level, a solid plan to replenish it. In that context, the fund balance policy should:

1. Define the time period within which and contingencies for which fund balances will be used;
2. Describe how the government's expenditure and/or revenue levels will be adjusted to match any new economic realities that are behind the use of fund balance as a financing bridge;
3. Describe the time period over which the components of fund balance will be replenished and the means by which they will be replenished.

Generally, governments should seek to replenish their fund balances within one to three years of use. Specifically, factors influencing the replenishment time horizon include:

1. The budgetary reasons behind the fund balance targets;
2. Recovering from an extreme event;
3. Political continuity;
4. Financial planning time horizons;
5. Long-term forecasts and economic conditions;
6. External financing expectations.

Revenue sources that would typically be looked to for replenishment of a fund balance include nonrecurring revenues, budget surpluses, and excess resources in other funds (if legally permissible and there is a defensible rationale). Year-end surpluses are an appropriate source for replenishing fund balance.

Unrestricted Fund Balance Above Formal Policy Requirement. In some cases, governments can find themselves in a position with an amount of unrestricted fund balance in the general fund over their formal policy reserve requirement even after taking into account potential financial risks in the foreseeable future. Amounts over the formal policy may reflect a structural trend, in which case governments should consider a policy as to how this would be addressed. Additionally, an education or communication strategy, or at a minimum, explanation of large changes in fund balance is encouraged. In all cases, use of those funds should be prohibited as a funding source for ongoing recurring expenditures.

Notes:

1. For the sake of clarity, this recommended practice uses the terms GAAP fund balance and budgetary fund balance to distinguish these two different uses of the same term.
2. These categories are set forth in Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*.
3. Sometimes restricted fund balance includes resources available to finance items that typically would require the use of unrestricted fund balance (e.g., a contingency reserve). In that case, such amounts should be included as part of unrestricted fund balance for purposes of analysis.
4. See Recommended Practice 4.1 of the National Advisory Council on State and Local Budgeting governments on the need to "maintain a prudent level of financial resources to protect against reducing service levels or raising taxes and fees because of temporary revenue shortfalls or unpredicted one-time expenditures" (Recommended Practice 4.1).
5. In practice, a level of unrestricted fund balance significantly lower than the recommended minimum may be appropriate for states and America's largest governments (e.g., cities, counties, and school districts) because they often are in a better position to predict contingencies (for the same reason that an insurance company can more readily predict the number of accidents for a pool of 500,000 drivers than for a pool of fifty), and because their revenues and expenditures often are more diversified and thus potentially less subject to volatility.
6. In either case, unusual items that would distort trends (e.g., one-time revenues and expenditures) should be excluded, whereas recurring transfers should be included. Once the decision has been made to compare unrestricted fund balance to either revenues and/or expenditures, that decision should be followed consistently from period to period.

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BEST PRACTICE

Audit Committees

BACKGROUND:

Three main groups are responsible for the quality of financial reporting: the governing body,[1] financial management, and the independent auditors. Of these three, the governing body must be seen as first among equals because of its unique position as the ultimate monitor of the financial reporting process.[2] An audit committee is a practical means for a governing body to provide much needed independent review and oversight of the governments financial reporting processes, internal controls, and independent auditors. An audit committee also provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns. By effectively carrying out its functions and responsibilities, an audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess managements practices, and that the independent auditors, through their own review, objectively assess the governments financial reporting practices.[3]

RECOMMENDATION:

GFOA makes the following recommendations regarding the establishment of audit committees by state and local governments:

- The governing body[4] of every state and local government should establish an audit committee or its equivalent;
- The audit committee should be formally established by charter, enabling resolution, or other appropriate legal means and made directly responsible[5] for the appointment, compensation, retention, and oversight of the work of any independent accountants engaged for the purpose of preparing or issuing an independent audit report or performing other independent audit, review, or attest services.[6] Likewise, the audit committee should be established in such a manner that all accountants thus engaged report directly to the audit committee. The written documentation establishing the audit committee should prescribe the scope of the committees responsibilities, as well as its structure, processes, and membership requirements. The audit committee should itself periodically review such documentation, no less than once every five years, to assess its continued adequacy;[7]
- Ideally, all members of the audit committee should possess or obtain a basic understanding of governmental financial reporting and auditing.[8] The audit committee also should have access to the services of at least one financial expert, either a committee member or an outside party engaged by the committee for this purpose. Such a financial expert should through both education and experience, and in a manner specifically relevant to the government sector, possess 1) an understanding of generally accepted accounting principles and financial statements; 2) experience in preparing or auditing financial statements of comparable entities; 3) experience in applying such principles in connection with the accounting for estimates,

accruals, and reserves; 4) experience with internal accounting controls; and 5) an understanding of audit committee functions;[9]
- All members of the audit committee should be members of the governing body. To ensure the committees independence and effectiveness, no governing body member who exercises managerial responsibilities that fall within the scope of the audit should serve as a member of the audit committee;
- An audit committee should have sufficient members for meaningful discussion and deliberation, but not so many as to impede its efficient operation. As a general rule, the minimum membership of the committee should be no fewer than three;[10]
- Members of the audit committee should be educated regarding both the role of the audit committee and their personal responsibility as members, including their duty to exercise an appropriate degree of professional skepticism;
- It is the responsibility of the audit committee to provide independent review and oversight of a governments financial reporting processes, internal controls and independent auditors;[11]
- The audit committee should have access to the reports of internal auditors, as well as access to annual internal audit work plans;
- The audit committee should present annually to the full governing body a written report of how it has discharged its duties and met its responsibilities. It is further recommended that this report be made public and be accompanied by the audit committees charter or other establishing documentation;
- The audit committee should establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters. Such procedures should specifically provide for the confidential, anonymous submission by employees of the government of concerns regarding questionable accounting or auditing matters.[12] The audit committee also should monitor controls performed directly by senior management, as well as controls designed to prevent or detect senior-management override of other controls[13];
- The audit committee should be adequately funded and should be authorized to engage the services of financial experts, legal counsel, and other appropriate specialists, as necessary to fulfill its responsibilities[14]; and
- In its report to the governing body, the audit committee should specifically state that it has discussed the financial statements with management, with the independent auditors in private,[15] and privately among committee members,[16] and believes that they are fairly presented, to the extent such a determination can be made solely on the basis of such conversations.

Notes:

[1] For the purposes of this recommended practice, the term governing body should be understood to include any elected officials (e.g., county auditor, city controller) with legal responsibility for overseeing financial reporting, internal control, and auditing, provided they do not exercise managerial responsibilities within the scope of the audit. The term governing body also is intended to encompass appointed bodies such as pension boards.

[2] *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees,* Overview and Recommendations.

[3] Securities and Exchange Commission (SEC) Regulation 33-8220, Background and Overview of the New Rule and Amendments.

[4] For the purposes of this recommended practice, the term governing body should be understood to include any other elected officials (e.g., county auditor, city controller) with legal responsibility for overseeing financial reporting, internal control, and auditing, provided they do *not* exercise managerial responsibilities within the scope of the audit. The term governing body also is intended to encompass appointed bodies such as pension boards.

[5] Nothing in this recommended practice should be interpreted so as to limit the full governing body from exercising ultimate authority.

[6] Sarbanes Oxley Act, Section 301.

[7] *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, Recommendation 4.

[8] *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, Recommendation 3. Continuity typically is a positive factor in achieving this goal, a fact that should be kept in mind when considering the appropriate length of service for audit committee members.

[9] Sarbanes-Oxley Act, Section 407.

[10] In certain limited instances, as noted later, the audit committee will need to meet privately to achieve its goals. If the audit committee constitutes a majority of the governing body, such private meetings may be hampered by sunshine laws and similar open meetings legislation.

[11] SEC Regulation 330-8220, Background and Overview.

[12] Sarbanes Oxley Act, Section 301.

[13] *Internal Control Integrated Framework: Guidance on Monitoring Internal Control Systems* (Discussion Document of the Committee of Sponsoring OrganizationsCOSO, 2007), page 10.

[14] Nothing in this recommended practice should be interpreted so as to limit the full governing body from exercising ultimate authority.

[15] It is important that the audit committee be able to meet privately with the independent auditors, as needed, to ensure a full and candid discussion. Governments are urged to amend sunshine laws and similar open meetings legislation to permit such encounters in these limited circumstances.

[16] It is important that audit committee members be able to meet privately among themselves, as needed, to ensure a full and candid discussion. Governments are urged to amend sunshine laws and similar open meetings legislation to permit such an encounter in these limited circumstances.

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BEST PRACTICE

Establishing Capitalization Thresholds for Capital Assets

BACKGROUND:

The term *capital assets* is used to describe assets that are used in operations and that have initial lives extending beyond a single reporting period. Capital assets may be either intangible (e.g., easements, water (rights) or tangible (e.g., land, buildings, building improvements, vehicles, machinery, equipment and infrastructure). It is incumbent upon public-sector managers to maintain adequate control over all of a governments resources, including capital assets, to minimize the risk of loss or misuse.

As a practical application of the materiality principle, not all tangible capital-type items with useful lives extending beyond a single reporting period are required to be reported in a governments statement of position. Items with extremely short useful lives (e.g., less than 2 years) or of small monetary value are properly reported as an "expense" or "expenditure" in the period in which they are acquired.

When outlays for capital-type items are, in fact, reported on the statement of position, they are said to be *capitalized*. The monetary criterion used to determine whether a given capital asset should be reported on the balance sheet is known as the *capitalization threshold*. A government may establish a single capitalization threshold for all of its capital assets, or it may establish different capitalization thresholds for different classes of capital assets.

Capitalization is, of its nature, primarily a financial reporting issue. That is, a governments principal concern in establishing specific capitalization thresholds ought to be the anticipated information needs of the users of the governments external financial reports. While it is essential to maintain control over all potentially capitalizable items, there exist much more efficient means than capitalization for accomplishing this objective in the case of a governments smaller tangible capital-type items.[1] Furthermore, practice has demonstrated that capital asset management systems that attempt to incorporate data on numerous smaller items are often costly and difficult to maintain and operate.

RECOMMENDATION:

GFOA recommends that state and local governments consider the following guidelines in establishing capitalization thresholds:

- Potentially capitalizable items should only be capitalized only if they have an estimated useful life of at least two years following the date of acquisition;

- Capitalization thresholds are best applied to individual items rather than to groups of similar items (e.g., desks and tables), unless the effect of doing so would be to eliminate a significant portion of total capital assets (e.g., books of a library district);
- In no case should a government establish a capitalization threshold of less than $5,000 for any individual item;
- In establishing capitalization thresholds, governments that are recipients of federal awards should be aware of federal requirements that prevent the use of capitalization thresholds in excess of certain specified maximum amounts (i.e., currently $5,000) for purposes of federal reimbursement; and
- Governments should exercise control over potentially capitalizable items that fall under the operative capitalization threshold.[2]

References:

[1] See GFOAs best practice on Maintaining Control over Items that Are Not Capitalized (2006).

[2] See GFOAs best practice on Maintaining Control over Items that Are Not Capitalized (2006).

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BEST PRACTICE

Maintaining Control over Items that Are Not Capitalized

BACKGROUND:

Accountants use the term *capital assets* to describe tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period.[1] As a practical matter, not all items that technically meet this definition should be capitalized for financial reporting purposes.[2] When potentially capitalizable items are not, in fact, capitalized, care must be taken to ensure that adequate control is maintained over any such items that fall within the following categories:

- *Items that require special attention to ensure legal compliance*. Legal or contractual provisions may require a higher than ordinary level of accountability over certain capital-type items (e.g., items acquired through grant contracts);
- *Items that require special attention to protect public safety and avoid potential liability*. Some capital-type items by their very nature pose a risk to public safety and could be the source of potential liability (e.g., police weapons);
- *Items that require special attention to compensate for a heightened risk of theft (walk away items)*. Some capital-type items are both easily transportable and readily marketable or easily diverted to personal use (e.g., sound equipment).

Noncapitalized items that require special attention because they are sensitive for one or more of these reasons might be described as *controlled capital-type items.*

RECOMMENDATION:

GFOA recommends that every government undertake a systematic effort to identify all of its controlled capital-type items.

Control normally should occur at the departmental level. Departments typically would be expected to concern themselves with controlled capital-type items as an integral part of the process they use to achieve their operational goals. Therefore, individual departments, rather than a centralized finance function (or other designated finance function), normally should be the focus of control efforts.

Control responsibility should be assigned within each department. Control cannot be divorced from accountability. Consequently, departments should assign responsibility for different groups of controlled capital-type items to one or more specific individuals. That assignment should be documented within the department and communicated to the centralized accounting function (or other designated finance function). Likewise, changes in assignments should be documented and communicated.

Individuals responsible for controlled capital-type items should prepare and maintain a complete list of those items each year within the department. At the close of each fiscal year, every individual assigned responsibility for controlled capital-type items should prepare a report (to be maintained within the department) that provides a complete list of those items, along with an explanation of changes from the previous year.

Departments should certify each year to the central accounting function (or other designated finance function) that updated lists of controlled capital-type items are on file and available for inspection. Each department should designate an individual to be responsible for verifying that lists of all controlled capital-type items have been filed each year, as required. The responsible manager in the department should then certify to the central accounting function (or other designated finance function) that those lists are 1) on file and available for inspection and 2) reliable and complete, A sound framework of internal control is necessary to afford a reasonable basis for this certification.[3]

The central accounting function (or other designated finance function) should periodically verify the data on controlled capital-type items on file in each department. No less than once every five years on a rotating basis (more frequently for particularly sensitive items), the central accounting function (or other designated finance function) should ensure that procedures are performed to verify the reliability and completeness of the data on file in each department concerning controlled capital-type items.

Notes:

[1] See GASB Statement No. 34, Basic Financial Statementsand Management's Discussion and Analysisfor State and Local Governments, paragraph 19.

[2] See GFOAs best practice on Establishing Capitalization Thresholds for Capital Assets (2001).

[3] See GFOAs best practice on Getting Management Involved with Internal Control (2004).

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BEST PRACTICE

Accepting Payment Cards and Selection of Payment Card Service Providers

BACKGROUND:

Acceptance of credit and debit cards (herein referred to as payment cards) as a payment method has become virtually universal within the private sector, and more common within the public sector. Many governments now accept cards for taxes, fines, user charges and fees. For a fee, a payment card processing service provider will work with a government to accept and process payment card payments.

While governments may have to absorb extra costs or citizens may have to pay an additional convenience fee for the transaction, establishing a payment card system may be an attractive addition to a governments collection office, as long as it is executed properly.

There are many benefits to accepting payment cards, including:

- Enhanced customer service and convenience
- Increased certainty of collection
- Accelerated payments and the availability of funds
- Improved audit trail
- Reduced cashiering costs
- Improved overall cash flow and forecasting
- Lessened delinquencies
- Reduced return check processing costs
- Reduced collection costs

RECOMMENDATION:

GFOA recommends that governments evaluate whether accepting payment cards as a payment option is reasonable and appropriate for the type of charges or fees being paid, and the level of customer service desired.

In establishing a payment card acceptance program, governments should consider and evaluate the following:

- **Federal, state, provincial and local laws**. Governments should first review applicable laws to determine whether card acceptance is an option.

- **Scope**. Typically, in implementing a system to accept payment cards, governments should determine the required scope for the system and the services required from a payment card service provider. Governments should:

- Review existing (or estimate potential) usage of each card brand (e.g., Visa, MasterCard, American Express, and Discover) and types (credit or debit cards), in order to determine which brands and types to accept. Be sure to review seasonal use, such as park fees in the summer.
- Consider payment type. Governments should consider whether they want to accept cards for mandatory charges (such as taxes and utility bills) or discretionary charges (such as recreation fees and performing arts admissions), or both.
- Inventory any hardware the government uses to accept payment cards. In some cases, the equipment may be easily and inexpensively reprogrammed for a new vendor, while in other cases, new hardware may be necessary.
- Consider the governments potential need to accept payment cards at special events (at different locations and for limited periods of time, and the staffing implications).
- Review and document existing processing procedures, focusing on the process used to receive cards.
- Consider mode of presentation: office, Internet, lockbox processing facility, temporary or mobile location, telephone.
- Evaluate internal system security capabilities to determine whether to contract directly with a payment processor or through a third party portal. It is the governments responsibility to be payment card industry (PCI) compliant.
- Consider governments liability in the event of a security breach, loss of data, or default by the payment card service provider or third-party portal.
- Consider intergovernmental cooperation arrangements and whether piggy-backing is an option.
- Determine if changes are needed to the governments internal control system to the acceptance of payment cards.

- **Fees**. Governments should be aware that different card processing service providers may have significantly different rates and fees depending on the methods they use to process payment card transactions. Fees may include:
  - *Discount rate* The fee that payment card service providers charge merchants for processing transactions. These are fees based upon the mode of presentation (card present, telephone, Internet).
  - *Interchange fees* - This is the largest component of the discount rate. It is paid by the merchants bank to the customers bank, but is passed along to the merchant in the discount rate. These are the standard fees applied based upon merchant code by the merchant card companies (e.g. VISA, Mastercard).
  - *Bank fees* These are variable fees based upon the value of the transaction or fixed fee per transaction. Due to the complexity of the fee structure, governments should be prepared to monitor the billings on a regular basis in order to ensure that the government is not overcharged.
  - *Administrative fees* Various fees that may be charged by the payment card provider or processor.

Governments should negotiate the lowest possible fee to minimize the financial impact to the government
or to the consumer, whichever party will ultimately pay the fee.

- Internal costs and benefits. Governments should bear in mind their own costs in processing cards, such as:
  - *Administrative costs*. Governments have their own costs for equipment and associated personnel necessary to process card transactions, including costs associated in ensuring PCI compliance, which is the governments responsibility.
  - *Cost savings*. Governments should measure their administrative cost savings and compare this against receiving and processing checks and cash transactions.

  - *Convenience fees*. Governments should consider charging a convenience fee for transactions. The advantage of convenience fees is that they can recoup the cost of merchant fees. A disadvantage of convenience fees is that they may deter some users from paying with a card. In addition, card companies have strict regulations that limit the use of convenience fees (for example, payments made by telephone or via a third-party processor. In most instances, major card companies do not allow governments or businesses to pass on merchant fees directly to customers.

- **Request for Proposal**. GFOA recommends competitive procurement of card processing service providers. Governments should use the RFP process when selecting a vendor. This process allows a government to gather data necessary to make an appropriate selection.

Governments may consider issuing a joint RFP with other jurisdictions because larger card volumes generally result in lower fees. As well, governments may include a section on merchant services in their banking services procurement RFP. Third-party processors, such as commercial automated services capable of processing card transactions seven days per week, 24 hours per day, should be considered as part of the evaluation because they may prove to be essential in recovering discount fees. GFOA further recommends that a card acceptance agreement be made as a bank services agreement administered by the public official in charge of the treasury function.

In the RFP process, governments should evaluate:

- How funds are made available to the government. The funds availability may range from same day, next day credit to next week credit. Depending on volume, this could be important in determining the profit/cost/benefit position of the program.
- The equipment that may be required. Differences in equipment requirements may affect the initial cost of the program as well as its the long term operating efficiency. For example, the cost of new equipment may be offset by a lower discount rate or per -item fee. A break-even analysis should be performed to evaluate the options. Consider leasing versus buying for equipment as leasing provides the flexibility to stay current with changing technology and security requirements.
- Whether the payment vendor fees and the actual payment to the government are considered two different and separate transactions, so that the tax/fee is automatically sent to the government and the processing fees are automatically sent to the payment vendor service for processing.
- The vendors reporting capabilities. Each vendors reporting capabilities should be evaluated. While most vendors provide the basic information, governments should evaluate the vendors ability to provide customized reports and interfacing capability.
- The vendors procedures and experience in maintaining security. This review should include the vendors response to security breaches or loss of information. Service providers should provide a comprehensive review of their internal and external security procedures. Pay particular attention to the Internet sign-on and multi factor identification procedures. Standard protocols include passwords, tokens, fingerprint or bio-metrics.
- The governments liability in the event of a security breach, loss of data, or default by the payment card service provider or third-party portal.
- Experience with governments as the needs of governments differ from private sector entities. Governments should consider this and any special pricing arrangements the vendor has for governments.
- The training provided by vendor.
- The vendors problem resolution, including the timely processing of chargebacks.

References:

- *An Introduction to Treasury Management Practices*, GFOA, 1998.

- *An Introduction to Electronic Commerce: Government Cash Management Programs*, GFOA, 1998
- *Banking Services: A Guide for Governments*; GFOA, 2004.
- *Treasury Management Newsletter* articles
    - Five Myths About the Payment Card Industry Data Security Standard May 2008
    - The Payment Card Industry Data Security Standard: Where to Begin January 2008
- PCI Security Standards Council, https://www.pcisecuritystandards.org/
- Payment Card Industry Standards: https://www.pcisecuritystandards.org/

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Government Finance Officers Association

BEST PRACTICE

Documenting Accounting Policies and Procedures

BACKGROUND:

Communication is an essential component of a comprehensive framework of internal controls. One method of communication that is particularly effective for controls over accounting and financial reporting is the formal documentation of accounting policies and procedures. A well-designed and properly maintained system of documenting accounting policies and procedures enhances both accountability and consistency. The resulting documentation can also serve as a useful training tool for staff.

RECOMMENDATION:

Every government should document its accounting policies and procedures. Traditionally, such documentation has taken the form of an accounting policies and procedures manual. Thanks to advances in technology, even more effective methods are now also available for this purpose.

An appropriate level of management to emphasize their importance and authority should promulgate accounting policies and procedures. The documentation of accounting policies and procedures should be evaluated annually and updated periodically, no less than once every three years, according to a predetermined schedule. Changes in policies and procedures that occur between these periodic reviews should be updated in the documentation promptly as they occur. A specific employee should be assigned the duty of overseeing this process. Management is responsible for ensuring that this duty is performed consistently.

The documentation of accounting policies and procedures should be readily available to all employees who need it. It should delineate the authority and responsibility of all employees, especially the authority to authorize transactions and the responsibility for the safekeeping of assets and records. Likewise, the documentation of accounting policies and procedures should indicate which employees are to perform which procedures. Procedures should be described as they are actually intended to be performed rather than in some idealized form. Also, the documentation of accounting policies and procedures should explain the design and purpose of controlrelated procedures to increase employee understanding of and support for controls.

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Government Finance Officers Association

BEST PRACTICE

Enhancing Tax Abatement Transparency

GASB No. 77 effective beginning with 12/31/16 FYE.

BACKGROUND:

For accounting and financial reporting purposes, a *tax abatement* is an agreement whereby a government agrees to forgo tax revenues to which it is otherwise entitled in exchange for a promise by the counterparty to the agreement to take specific future actions that will contribute to the government's economic development, or which otherwise benefits the government or its citizens (GASB Statement No. 77, *Tax Abatement Disclosures*). GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, indicates that the notes to the financial statements should *not* include "either (a) subjective assessments of the effects of reported information on the reporting unit's future financial position or (b) predictions about the effects of future events on future financial position." (paragraph 37). Moreover, information presented in the notes to the financial statements must be "essential to a user's understanding of those financial statements" (paragraph 36). Thus, governments may find themselves effectively prevented from providing certain highly useful information concerning the justification and expected long-term benefits of tax abatements in the notes to the financial statements. Consequently, if the comprehensive annual financial report (CAFR) of a government is to provide a complete picture of tax abatement transactions to the citizenry, the governing body, rating agencies, and other key stakeholders, additional information concerning the justification and expected long-term benefits of tax abatements may need to be provided elsewhere in the CAFR.

The letter of transmittal, located in the Introductory Section of CAFR, provides a government the opportunity to include information regarding its current economic condition, which includes the subjective analysis of its projected future financial direction. Therefore, the letter of transmittal is well suited to provide the justification and expected long-term benefits of tax abatements.

RECOMMENDATION:

GFOA recommends that governments that are party to significant tax abatements do all of the following:

1. The government should disclose the following information in its letter of transmittal:
    1. A reference to other documents (budget, economic development plan, board minutes) where a complete cost/benefit analysis can be found, along with information on how to access those documents;
    2. An explanation of how tax abatements are accounted for and incorporated into the budget process and the final approved budget;

   3. A description of the policies governing tax abatements, including what the government is hoping to achieve with them, and the methodologies used to determine the entity's return on investment;
   4. An identification of those responsible for monitoring compliance with abatement agreements;
   5. An explanation of the relationship between tax abatements and the government's goals set forth in its strategic plan;
   6. A five-year chart of benefits anticipated and received due to the abatement, which should include both financial and nonfinancial benefits (e.g., increased employment).
2. In preparing and presenting tax abatement information in the letter of transmittal, a government should adhere to the following guidelines:
3.
   1. Avoid duplicating information already provided in the notes to the financial statements and management's discussion and analysis;
   2. Avoid unnecessary detail by aggregating information both by government and by type of tax being abated (consistent with GASB Statement No. 77);
   3. Keep the discussion simple and straightforward;
   4. Use charts and graphs to supplement (but not replace) recommended contents; and
   5. Be mindful of materiality (both quantitative and qualitative).
4. GFOA recommends that finance staff initiate communication and develop/maintain relationships with its entity's economic development partners and/or budgetary officials charged with initiating, developing, and affirming tax abatements to ensure the proper flow of information.
5. The government should establish the same relationships with other governmental entities that have the power to abate their taxes, as well as a timeline to ensure that they provide all necessary information soon enough to prevent any delay in the timely issuance of a government's comprehensive annual financial report.

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Government Finance Officers Association

BEST PRACTICE

Getting Management Involved with Internal Control

BACKGROUND:

GFOAs *Code of Professional Ethics* requires finance officers, as part of their responsibility as public officials, to exercise prudence and integrity in the management of funds in their custody and in all financial transactions. GFOAs *Code of Professional Ethics* also requires of finance officers in connection with the issuance and management of information that they not knowingly sign, subscribe to, or permit the issuance of any statement or report which contains any misstatement or which omits any material fact. Both provisions presume the existence of a sound framework of internal control:

- Prudence in the management of public funds requires that there be adequate control procedures in place to protect those funds.
- A sound framework of internal control is necessary to afford a reasonable basis for finance officers to assert that the information they provide can be relied upon.

While a governments independent auditors and similar outside parties often can provide valuable assistance to management in meeting its internal-control-related responsibilities, their contribution can never be a substitute for managements direct and informed involvement with internal control.

Ultimately, it is the responsibility of appropriate elected officials to ensure that the managers who report to them fulfill their responsibilities in implementing and maintaining a sound and comprehensive framework of internal control.

RECOMMENDATION:

GFOA recommends that financial managers obtain the information and training needed to meaningfully take responsibility for internal control. In particular, they should obtain a sound understanding of the essential components of a comprehensive framework of internal control as set forth by the Council of Sponsoring Organizations (COSO) of the Treadway Commission on Fraudulent Financial Reporting in the publication I*nternal ControlsIntegrated Framework*.[1] They also should ensure that all employees responsible in any way for internal control receive the information and training they need to fulfill their particular responsibilities.

GFOA also recommends that internal control procedures over financial management be documented.[2]

Documented internal control procedures should include some practical means for lower level employees to report instances of management override of controls that could be indicative of fraud.[3]

GFOA further recommends that financial managers, with the assistance of internal auditors[4] or equivalent personnel as needed, periodically evaluate relevant internal control procedures to satisfy themselves that those procedures 1) are adequately designed to achieve their intended purpose, 2) have actually been implemented, and 3) continue to function as designed.

Evaluations should also encompass the effectiveness and timeliness of the governments response to indications of potential control weaknesses generated by internal control procedures(e.g., resolution of items in exception reports).[5]

The determination of whether controls have been implemented necessarily involves establishing their initial effectiveness as a *baseline* for future monitoring. Effectiveness then needs to be reassessed periodically. Moreover, there should be a process in place to 1) identify changes, either in what is being controlled or in the controls themselves and 2) make appropriate modifications. Following each periodic reassessment or modification a new baseline of effectiveness needs to be established as a basis for subsequent monitoring.

In addition, GFOA recommends that upon completion of any evaluation of internal control procedures financial managers determine what specific actions are necessary to remedy the root case of any disclosed weaknesses. A corrective action plan with an appropriate timetable should be adopted. There should be follow-up on the corrective action plan to ensure that it has been fully implemented on a timely basis.

Notes:

[1]This information is specifically adapted to the needs of state and local governments in GFOAs publication *Evaluating Internal Controls: A Local Government Managers Guide*.

[2]See GFOAs recommended practice on *Documenting Accounting Policies and Procedures* (2002).

[3]See GFOAs recommended practice on *Encouraging and Facilitating the Reporting of Fraud and Questionable Accounting and Auditing Practices* (2007).

[4]See GFOAs recommended practice on *Establishing an Internal Audit Function* (1997) governments response to indications of potential control weaknesses generated by internal control procedures.

[5]It normally would not be practical for financial managers to attempt to undertake a thorough evaluation of all of their internal control procedures in a single year. Therefore, it is appropriate that financial managers evaluate their various control cycles on a cyclical basis.

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Government Finance Officers Association

BEST PRACTICE

Practical Steps to Avoid, Limit, or Eliminate Internal Control Deficiencies Identified in an Audit

BACKGROUND:

The Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) has issued guidance on communicating matters related to a governments internal control over financial reporting identified in an audit of financial statements. This guidance is applicable whenever an auditor expresses or disclaims an opinion on financial statements. These standards require auditors to report any *material weaknesses*[1] or *significant deficiencies*[2] identified in conjunction with the financial statement audit.

This guidance indicates that it is *not* sufficient that the independent auditor determine that the financial statements under audit are, in fact, *fairly presented* in accordance with generally accepted accounting principles (GAAP). Generally accepted auditing standards (GAAS) also require that the financial statements be the product of a financial reporting system that offers reasonable assurance that management is able to produce financial statements that comply with GAAP.

Independent auditors often assist clients with the preparation of their financial statements. Such assistance poses no problem if it is provided merely as a matter of convenience (i.e., management could produce the financial statements, but chooses not to). However, such assistance will constitute either a significant deficiency or a material weakness if it is provided as a matter of necessity rather than of convenience (i.e., management does not have the skills needed to prepare GAAP financial statements).

If management does not possess the skills to prepare GAAP financial statements on its own, the government could always choose to engage the services of someone other than the independent auditor to provide the needed assistance. Because such contractors would work for management (unlike the *independent* auditors) they would qualify as part of the governments financial reporting system, thus avoiding an automatic finding of a significant deficiency or material weakness. The guidance also makes it clear that material auditor-identified audit adjustments typically will require that a significant deficiency or material weakness be reported.

RECOMMENDATION:

GFOA recommends that governments take into account the following considerations in crafting a strategy[3] for minimizing any potential negative effect resulting from the communication of internal control related matters identified in an audit.

- ***Be prepared to provide evidence that the government has a sound financial reporting system in place***. GFOA recommends that a government establish and *document*[4] a system of financial reporting that is sufficient to provide reasonable assurance that management is able to prepare financial statements in conformity with GAAP. Appropriate criteria for evaluating the adequacy of a governments financial reporting system can be found in *Internal Control: Integrated Framework*, published by the Council of Sponsoring Organizations of the Treadway Commission (COSO).[5] In particular, the financial reporting system should incorporate an anti-fraud program and controls, as well as ongoing internal audit/risk assessment activity commensurate with the size and complexity of the entity. Further, the financial reporting system should include a program to test controls, assess the results of testing, and take prompt corrective action as necessary.

- ***Minimize the likelihood of material audit adjustments.*** Every practical step should be taken to minimize the possibility of material auditor-initiated audit adjustments. A periodic process during the year to ensure the ongoing completeness and accuracy of data[6] can aid in identifying and preparing adjustments to limit the number and dollar amounts of adjustments that result from the auditor. Further, procedures at the end of the period can also help limit auditor-initiated adjustments. For example, a government should carefully review its cutoff procedures and the method it uses to uncover unrecorded liabilities at the end of the fiscal period (items found by the auditor rather than by management could result in a significant deficiency or material weakness being reported).

Special care also should be taken to ensure the timely and effective implementation of new accounting standards.[7] Accordingly, ongoing training should be provided to ensure that appropriate staff remains current on the authoritative guidance as it evolves.[8] Every attempt should be made to ensure that such training is provided consistently even when the government experiences fiscal stress or tough economic times.

- Review any financial statement preparation assistance provided by the independent auditors. If management chooses to make use of the services of the independent auditors in helping to prepare the financial statements as a matter of convenience, it should carefully document that a staff member with the requisite skills has reviewed all of the work performed by the auditor (e.g., by completing the GFOA financial reporting checklist or by using some similar review tool). If management does not have the skills necessary to prepare GAAP financial statements and desires the assistance of its independent auditors to help it do so, but without exposing itself to the risk of an automatic significant deficiency or material weakness, it may wish to consider obtaining the services of a consultant or some other outside party (e.g., retiree volunteer) to review the auditors work on the governments behalf. Further, the use of a consultant can provide other benefits. For example, consultants may perform work during the year or at year end that can help the government minimize adjustments as discussed above.

GFOA does not recommend that governments engage the services of a second accounting firm to assist in preparing its financial statements solely to avoid having a significant deficiency or material weakness reported. It is by no means assured that the benefits of engaging a second firm would outweigh the costs. Moreover, a significant deficiency or material weakness might still be reported as the result of some other weakness in the financial reporting system (e.g., auditor-discovered audit adjustment), which could defeat the purpose of hiring the second firm.

If management decides that the costs of remedying a significant deficiency or material weakness in its financial reporting system cannot be justified by the benefits to be obtained, it should take care to alert the governing body as early as possible to explain its conclusion. In that case, governments subject to a Single Audit should explore the possibility of obtaining a waiver pursuant to paragraph 530c of U.S. Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, so as not to jeopardize the auditees low risk status.

Notes:

[1] A deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility (the likelihood of the event is either reasonably possible or probable as those terms are defined in the Financial Accounting Standards Board *Accounting Standards Codification* glossary) that a material misstatement of the governments financial statements will not be prevented, or detected and corrected on a timely basis.

[2] 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.

[3] While this strategy will help the government to avoid, limit, or eliminate findings related to its internal control over financial reporting, ultimately, it is the independent auditors responsibility to make the judgment about what findings to report.

[4] See GFOAs Best Practice, *Documenting Accounting Policies and Procedures,* 2007.

[5] The guidance offered in this report is discussed and applied specifically to local governments in the GFOA publication *Evaluating Internal Controls: A Local Managers Guide*.

[6] See GFOAs Best Practice, *Improving the Timeliness of Financial Reports*, 2008.

[7] See GFOAs Best Practice, *Improving the Timeliness of Financial Reports*, 2008.

[8] While governments are encouraged to document their considerations in determining whether the person responsible for the accounting and reporting function has the knowledge and skills to appropriately apply generally accepted accounting principles in that capacity, ultimately, it is the responsibility of the independent auditor to make that judgment about the governments management.

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Government Finance Officers Association

BEST PRACTICE

Encouraging and Facilitating the Reporting of Fraud and Questionable Accounting and Auditing Practices

BACKGROUND:

Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, emphasizes the need for governments to have a financial reporting system in place that is sufficient to provide reasonable assurance that management can prepare financial statements in conformity with generally accepted accounting principles (GAAP). To meet that objective, a financial reporting system must be designed to detect not only material fraud or abuse, but also any questionable accounting or auditing practices that could jeopardize the integrity of financial reporting. SAS No. 112 instructs independent auditors that inadequate anti-fraud programs and controls constitute, at a minimum, a *significant deficiency* that would need to be reported.

In most cases, potential instances of fraud or abuse and questionable accounting or auditing practices come to the attention of responsible parties thanks to employees or citizens who become aware of such practices. Governments can and should take practical steps to encourage and facilitate such reporting.

RECOMMENDATION:

GFOA recommends that every government establish policies and procedures to encourage and facilitate the reporting of fraud or abuse and questionable accounting or auditing practices. At a minimum, a government should do all of the following:

- Formally approve, and widely distribute and publicize an ethics policy that can serve as a practical basis for identifying potential instances of fraud or abuse and questionable accounting or auditing practices.
- Establish practical mechanisms (e.g., hot line) to permit the *confidential, anonymous reporting* of concerns about fraud or abuse and questionable accounting or auditing practices to the appropriate responsible parties.[1]
- A government should regularly publicize the availability of these mechanisms and encourage individuals who may have relevant information to provide it to the government.
- Since ensuring or enhancing confidentiality can significantly increase costs, consider minimizing those costs by providing a separate reporting mechanism for employees, who typically desire greater assurance of confidentiality than do outside parties. In this regard, a government may wish to explore the possibility of engaging the services of an outside vendor

to receive complaints from employees. The use of an outside vendor offers a number of potential advantages, including the following:
    - Employees may be more readily persuaded of the confidentiality of their calls if they are made directly to a party outside the government.
    - Vendors may be able to provide extended hours of service, thus avoiding the need to place a call during regular working hours (i.e., while the employee is still at work).

- Train those answering calls from the general public to recognize calls that are reporting fraud or abuse and direct them appropriately to ensure that reports of instances of fraud or abuse by outside parties receive the appropriate disposition even when they are not made through the mechanism established for that purpose.
- Make internal auditors (or their equivalent) responsible for the mechanisms used to report instances of potential fraud or abuse and questionable accounting or auditing practices. Emphasize that they should take whatever steps are necessary to satisfy themselves that a given complaint is without merit before disposing of it. Further, they also should document the disposition of each complaint received so it can be reviewed by the audit committee.
- Have the audit committee, as part of its evaluation of the governments internal control framework, examine the documentation of how complaints were handled to satisfy itself that the mechanisms for reporting instances of potential fraud or abuse, and questionable accounting or auditing practices are in place and working satisfactorily.

Notes:

[1]While providing mechanisms to promote the reporting of fraud is an important element of an overall fraud prevention program there are other elements necessary for a complete program that are outside the scope of this recommended practice.

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Fraud Reporting/Whistleblower/Compliance Policy Considerations

- Will items reported to supervisors, or department heads?
- Will items also be reported to the Government Administrator or Board? If not, will the Administrator or Board ever know of alleged or actual fraud? What would be the policy when to report to the Administrator or Board? Generally, false allegations should be kept private until confirmed.
- A single person, such as a designated compliance officer, would be able to be aware of trends and set policies for following-up on allegations.
- Determine if these policies should be included in the personnel manual vs. annual distribution?
- Do you want to develop a standard form so standard information is presented to report? For instance a Uniform Complaint Report identifying who is making the report, against whom and do you want them to attach details such as copies of documents, or other exhibits to support the report. This will determine a policy if the government wants all reports to be in writing (to avoid potential misinterpretation of the issue).
- Determine if you allow anonymous allegations.
- Will the Government follow-up with the accuser in order to communicate resolution of the issue?

Pitfalls To Avoid

<u>Restricted revenues should be used per restriction and a system should be in place to monitor expenditures and balances:</u>

- Grant money – Grant revenue should be in same fund that spent the money.
- Have a system to track restricted revenues and related expenditures for:
  - Capital Improvements tax, Parks/Stormwater tax, Fire tax, Economic Development tax, Road and Bridge tax, Gasoline tax, Motor Vehicle Sales/Fee Increase taxes, etc.

Pitfalls To Avoid – Audit Issues

- Auditor's Independence issues:
  - Auditors should not determine the amounts and disclosures for the financial report.
  - Auditors should not be the internal bookkeeper for the entity being audited.
  - Auditors can provide training and consulting.
  - Auditors can process certain calculations as long as client assumes responsibility.
- Capital assets hints:
  - Schedule of capital assets and depreciation.
  - Schedule of capital asset additions and deletions.
  - Schedule of depreciation by department.
  - Schedule of repairs and maintenance.
  - Reconciliation of capitalized and noncapitalized expenditures.

Pitfalls To Avoid – Audit Issues

- Review support for numbers before auditors show up:
  - All balance sheet items should be verified–cash, investments, receivables, payables, payroll liabilities, etc.
  - Significant changes in balances should be known. Review before the auditors show up.
  - Don't be over budget.
- Discuss any big changes before auditors start the audit.
- Communicate and document timing.
- Follow-up with comments/findings from last year.
- Discuss potential findings early and often.

Pitfalls To Avoid – Audit Issues

- Things that may hold up the final audited financial report:
  - Actuarial reports:
    - Pension
    - OPEB
  - Landfill closure liability engineering reports
  - Continuing disclosure for debt
  - Statistical information from other departments or other entities
- MD&A – Management's Discussion and Analysis:
  - Determine who will draft and finalize
- Determining items outside the Finance Department such as litigation for disclosure
- Client representation letter (all parties need to sign)
- Attorney audit representation letter

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Pitfalls To Avoid

<u>IRS Quick Reference Guide For Public Employers</u>

www.irs.gov/pub/irs-pdf/p5138.pdf

Hochschild, Bloom & Company LLP
Certified Public Accountants

most recent update

February 2014

Quick Reference Guide for Public Employers

Office of Federal, State and Local Governments

Publication 5138 (2-2014) Catalog Number 66217H Department of the Treasury **Internal Revenue Service** www.irs.gov

Other Workers

Most other types of workers in a local government entity, including moderators, civil emergency directors, bus drivers, harbormasters, correction officers, fire chiefs, fire and ambulance workers, airport managers, summer aides, and librarians are generally considered employees, but in each case the common-law standards should be considered.

FRINGE BENEFITS

Fringe benefits include any compensation other than cash wages. The general rule is that the compensation is taxable; however, the Internal Revenue Code provides exclusions for numerous forms of noncash compensation provided to employees. Some of the common fringe benefit issues encountered by public employers are discussed below. For a more detailed discussion of fringe benefits, see Publication 15-B and Publication 5137, Fringe Benefit Guide.

Reimbursement for Expenses

In general, reimbursements or expenses paid by the employer on behalf of the employee, such as travel expenses, are taxable unless they are provided for allowable excluded benefits or expenses, and made under an *accountable plan*. For payments to be considered made under an accountable plan, the employees must:

- Incur the expenses in the performance of work;
- Adequately account for the expenses within a reasonable period of time; and
- Return any amounts in excess of expenses within a reasonable period of time.

If the accountable plan rules are met, no tax reporting is necessary. If they are not met, the reimbursements or advances are included in wages, and the employee may deduct allowable business expenses on his or her Form 1040.

De Minimis Fringe Benefits

De minimis fringe benefits are excludable from wages. A de minimis benefit is any property or service you provide to an employee that has so little value (taking into account how frequently you provide similar benefits to your employees) that accounting for it would be unreasonable or administratively impracticable. Cash or gift cards cannot be de minimis, except for occasional meal money or transportation fare. Common examples include small holiday gifts, occasional use of photocopiers, tickets, or personal use of an employer-provided cell phone.

For more information, see the Fringe Benefit Guide.

Government-Owned Vehicles

The personal use of a government-owned vehicle is generally a taxable fringe benefit. It may, however, be excludable as a de minimis benefit, discussed above. Personal use includes the value of commuting in a government-owned vehicle, even if the vehicle is taken home for the convenience of the employer (but see Commuting Valuation Rule, below). The value of the benefit must be included in wages, but withholding of income tax on the value of vehicle use is at the employer's option. Social security and Medicare withholding is required.

All of your employee's use of a *qualified nonpersonal use vehicle* qualifies as a working condition fringe. You can exclude the value of that use from employee income. A qualified nonpersonal use vehicle is any vehicle the employee is not likely to use more than minimally for personal purposes because of its design. Qualified nonpersonal use vehicles include:

- Clearly marked police, fire, and public safety officer vehicles. The employee must be on-call, required to commute in the vehicle, and be prohibited from personal travel outside the jurisdiction.
- Unmarked vehicles used by law enforcement officers. The officer must be authorized to carry a firearm, execute search warrants and make arrests.
- Qualified specialized utility repair truck
- An ambulance or hearse used for its specific purpose.
- Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds.
- Delivery trucks with seating for the driver only, or for the driver plus a folding jump seat.
- A passenger bus with a capacity of at least 20 passengers, used for its specific purpose.
- School buses.
- Tractors and other special purpose farm vehicles.

All Other Employer-Provided Vehicles

If you provide an employee with a vehicle that does meet the qualified nonpersonal use criteria, the personal use of the vehicle is a taxable fringe benefit. It is the employer's responsibility to determine the actual value of this fringe benefit and to include the taxable portion in the employee's income.

Example: A town-owned pickup truck is marked with the town name. It is not a police, fire, or public safety vehicle, or other qualified nonpersonal use vehicle. The employee is usually allowed to take the vehicle home because he is "on call." The vehicle is not a qualified nonpersonal use vehicle, thus the commuting is a non-cash taxable fringe benefit.

Special Valuation Rules

There are three methods to determine the value of the vehicle provided to the employee:

1) Lease value rule
2) Cents-per-mile rule
3) Commuting valuation rule

1) **Lease Value Rule**

The lease value method may be used for any vehicle, and must be used if the conditions for using rule (2) or (3) are not met. It calculates the value of the benefit by determining the annual lease value of the vehicle, as follows:

- Determine the fair market value of the vehicle when first made available.
- Determine the annual lease value (ALV) from the table in Publication 15-B, which is
- based on a four-year lease term. This value will generally stay the same for each year. If the vehicle remains in service after four years, it must be revalued and the ALV recomputed.
- Multiply the annual lease value by the percentage of personal miles out of the total miles driven by the employee. This is the value of the taxable benefit.

2) **Cents-Per-Mile Rule**

To use the vehicle cents-per-mile rule, one of the following tests must be met:

- The employer reasonably expects the vehicle to be regularly used in the trade or business throughout the calendar year; or
- The mileage test is met.

A vehicle is considered “regularly used in the business” if:

- At least 50% or more of the total annual mileage each year is in the employer's business; or
- It is generally used each workday to transport at least three employees to and from work, in an employer sponsored commuting vehicle pool.

The mileage test is met if the vehicle is driven by employees at least 10,000 miles (personal and business) per year and use of the vehicle is primarily by employees.

The value of the personal use of a vehicle may be figured at 56 cents per mile for 2014 if the following conditions are met:

If you do not provide fuel, you can reduce the value of the personal use by up to 5.5 cents per mile.

To use the cents-per-mile rule, the vehicles cannot have a greater fair market value in the year placed in service than a maximum amount determined by the IRS for each year (for 2014, $16,000 for cars and $17,300 for trucks).

3) Commuting Valuation Rule

Under this rule, you determine the value of a vehicle you provide to an employee (other than a qualified nonpersonal use vehicle, discussed earlier) for commuting by valuing each one-way commute (home to work or work to home) at $1.50. If more than one employee commutes in the vehicle, this value applies to each employee. Unless the employee reimburses this amount to the employer, the amount is included in the employee's wages. This rule may be used if all of the following apply:

- You own or lease the vehicle and provide it to an employee to use in your business.
- For bona fide noncompensatory business reasons, you require the employee to commute in the vehicle.
- You establish a written policy allowing no personal use other than commuting or de minimis personal use (such as a stop for personal errand).
- Your employee does not use the vehicle for personal purposes other than commuting and de minimis personal use.
- The employee is not a government control employee. A government control employee is either (i) an elected official, or (ii) an employee whose pay is at least Federal Government Executive Level V ($147,200 in 2014).

Example: An employee takes a city vehicle home in order to avoid exposing it to harm. The vehicle has a city seal on the door and policy prohibits noncommuting personal use. If this is an infrequent occurrence (less than once a month) this may be excludable as a de minimis fringe benefit. If this is a frequent or regular occurrence, the commuting may be valued using the commuting rule. If the vehicle is not a qualified nonpersonal use vehicle as discussed earlier, and the employee drives it home, there is a taxable commuting benefit.

To conform to the accountable plan rules, employees using a vehicle for business purposes (regardless of which special valuation rule is used) should keep daily records of business miles by keeping a log showing the date, mileage, destination, business purpose, and personal use (including commuting) mileage.

Clothing Provided by the Employer

The value of work clothing provided by the employer is not taxable to the employee if:

- The employee must wear the clothing as a condition of employment; and
- The clothes are not suitable for everyday wear.

It is not enough that the employee wear distinctive clothing; the employer must specifically require the clothing as a working condition. Nor is the test met because the employee does not, in fact, wear the work clothes away from work. The clothing must not be suitable for taking the place of regular clothing However, a detective's suit jacket and related clothing, since they are suitable for everyday wear, do not qualify as a uniform and are taxable to the employee.

The value and upkeep of work clothes provided to firefighters, health care workers, law enforcement officers or letter carriers is nontaxable to the employee. Similarly, the value of safety shoes or boots, safety glasses, hard hats and work gloves provided and maintained by the employer are not taxable. Reimbursements to employees for their purchase of any of these are excludable if the expenditures are substantiated under the accountable plan rules.

Clothing Allowances

If clothing provided does not qualify as a deductible expense (i.e. as a uniform), then the clothing, or reimbursement for the clothing, must be treated as a taxable fringe benefit and is subject to income, social security and Medicare taxes. Thus, a clothing allowance, such as for a police officer or firefighter uniform, qualifies for exclusion from income if it meets all the requirements of an accountable plan (qualified expense, substantiation, and return of excess).

Group-Term Life Insurance

An employer may exclude from income the cost of up to $50,000 of group-term life insurance from an employee's wages. If the employee receives more than $50,000 insurance, as determined by a table provided by IRS regulations, then the excess is includable as wages. The tables for determining the cost of the additional insurance to be used are included in Publication 15-B, Employer's Tax Guide to Fringe Benefits, and in Regulation 1.79-3(d)(2).

If the employee makes any payment toward the cost of the insurance, then the amount of coverage attributable to that payment is not considered in determining the amount of insurance provided by the employer.

Taxable employer-provided group-term life insurance is treated as wages, but is not subject to income tax withholding. It is subject to social security and Medicare tax withholding and must be included on Form W-2, in box 1, 3, 5 and 12 (code C). The taxable portion is included on Form 941, Employer's Quarterly Federal Tax Return, as part of wages, tips and other compensation, and on the lines for social security and Medicare wages.

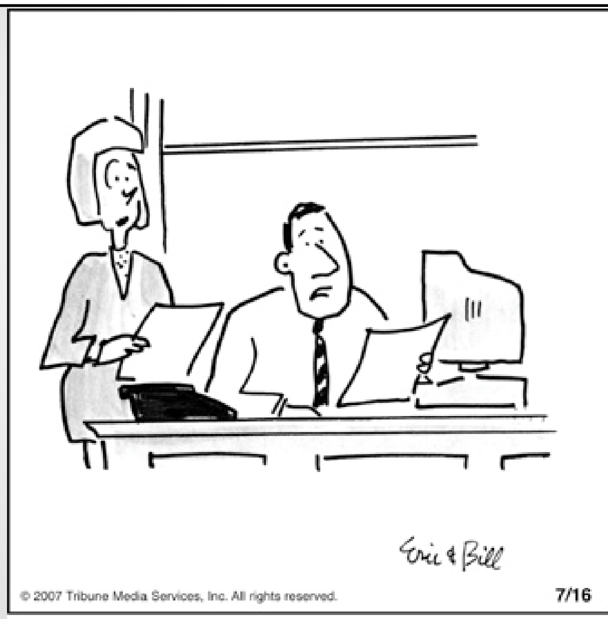
Meals

Reimbursement for meal expenses may be excludable if they are qualifying travel expenses paid under an accountable plan, discussed earlier. You can exclude the value of meals you furnish to an employee from the employee's wages if they meet the following tests:

- They are furnished on your business premises.
- They are furnished for your convenience.

This exclusion does not apply to additional compensation provided in lieu of meals, or to an allowance provided based on number of hours worked.

In addition to any exclusion allowable under the provisions above, you can also exclude, as de minimis fringe benefits, infrequent meals provided to employees if they have so little value that accounting for them would be unreasonable or administratively impracticable. Occasional meal



"Hey, we're government accountants.
These numbers aren't supposed to add up."

Company LLP
Certified Public Accountants

Questions and Discussion

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SIMPLIFIED INTERNAL CONTROL POLICIES AND PROCEDURES CHECKLIST

Cash Receipts:

- ❒ Is incoming mail opened, listed, and deposited by persons separate from the recording of receipts and receivable accounting records?
- ❒ Are receipts always issued for collections, other than through the mail?
- ❒ Are prenumbered cash receipts prepared and attached to customer remittance data?
- ❒ Are the mail receipts compared to the cash receipts and bank deposit slip?
- ❒ Are numerical sequences of prenumbered receipts accounted for?
- ❒ Are currency receipts reconciled to the cash register?
- ❒ Are deposits made daily?
- ❒ Are accounts receivable billings reconciled monthly and delinquent accounts investigated?
- ❒ Are accounts receivable write-offs and adjustments reviewed and authorized?

Cash Disbursements:

- ❒ Are all payments made by check or credit card (vs. cash)?
- ❒ Does support accompany the check when presented for signature?
- ❒ Are all checks or check requests approved for payment by the check signer?
- ❒ Are voided checks properly mutilated and retained?

(Over)

- ❒ Are all supporting documents properly canceled at the time of signature to prevent duplicate payment?

- ❒ Are physical and accounting controls over checks and credit cards used?

- ❒ Are details of credit card charges maintained and reviewed?

Bank Reconciliation:

- ❒ Are bank accounts reconciled soon after the end of each month and reviewed by management?

- ❒ Are old, outstanding checks investigated and is stop payment made?

General:

- ❒ Is petty cash periodically examined?

- ❒ Are there procedures to prevent unauthorized access to inventories?

- ❒ Is payroll verified and properly reviewed?

- ❒ Are general journal entries properly authorized?

- ❒ Are monthly accounting reports prepared timely?

- ❒ Are there documented internal control procedures?

- ❒ Is there proper segregation of duties?

- ❒ Are people required to take vacations and/or rotate functions?

- ❒ Are security controls over IT addressed, are procedures in place to remove former employee's access, and are proper back-ups made and stored offsite?

- ❒ Is employee fidelity bond/dishonesty insurance adequate?

- ❒ Does management demonstrate the importance of integrity?

This is a simplified internal control checklist. All organizations are complex and unique regarding operations and internal controls. Therefore, please consult with us regarding the organization's specific circumstances and more detailed internal control policies and procedures.