

Today's Objective To review the different reports that are part of the Town's annual audit. Basic Financial Statements Management Letter Schedule of Federal Awards To focus on what is important to know To discuss what cannot be found in the financial statements



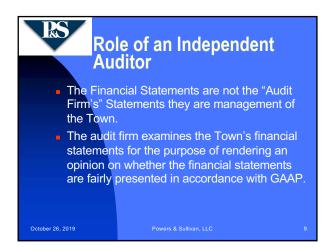
Private-Sector versus Governmental Financials > Because there is no profit motive, the need exists for defining performance measurement in the public-sector. > Governmental financial statements have not played the same role in assessing performance as they do in the private-sector.

Who Makes the Rules? For Private-Sector financial statements the Financial Accounting Standards Board (FASB) is the nation-wide body that establishes the form and content of the statements. For Governmental financial statements the Governmental Accounting Standards Board (GASB) is the nation-wide body that establishes the form and content of the statements.

Who Makes the Rules? The GASB provides the standards on how to prepare financial statements in accordance with Generally Accepted Accounting Principals (GAAP). Users such as investors and rating agencies rely on the consistent application of GAAP. This is the only way users can assess the financial position of one government compared to another.

Who Makes the Rules? It is important to remember that the GASB and FASB are independent bodies not associated with either the Federal or State governments. The standards are not a Federal or State Mandate. Massachusetts General Laws along with the Department of Revenue (DOR) establishes the accounting standards are unique only to Massachusetts governments.

Who Makes the Rules? The financial statements include budget to actual statements prepared in accordance with accounting standards established by the DOR. The DOR accounting standards are known as the Uniform Municipal Accounting System (Umas). Umas is different than GAAP and therefore General Fund Unassigned Fund Balance is normally different than Free Cash.





Role of the Audit Committee

- More communities are establishing Audit Committees that are responsible for managing the audit process.
- They have open meetings where the financial statements and management letters are reviewed and discussed.
- They also approve the final products.
- Since these are open meetings you may want to attend them.



Independent Auditor's Report

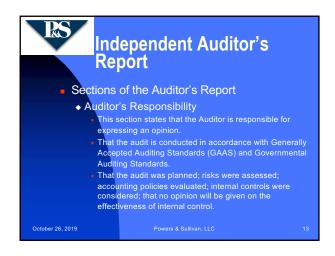
- When you review an audited financial statement this is the first thing I look at.
- This will tell you if there is anything seriously wrong with the financial statements.
- It will also tell you if the statements are OK.
- Look at the DATE of the report as this can be an indication of potential management issues.
- The Independent Auditor's Report is comprised of several sections.



Independent Auditor's Report

- Sections of the Auditor's Report
 - ◆ Report on the Financial Statements This defines the statements being audited
 - Management's Responsibility for the Financial Statements
 - This tells the reader that management is responsible for the fair presentation in accordance with GAAP; that management is responsible for Internal Controls for preparation of Financial Statements; and free from material misstatement due to error or fraud.

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Independent Auditor's Report

Sections of the Auditor's Report

Opinions

If the in the auditor's opinion they believe that the financial statements are fairly presented in accordance with GAAP this section will tell you this.

If the auditor does not believe the financial statements are fairly presented the opinion will be Modified.

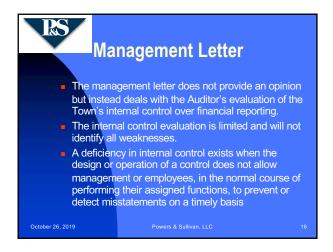
Modified Opinions are usually a bad sign and you should understand the reason.

Management Letter

• At the conclusion of each audit a management letter may issued by the Independent Auditor.

• It is not required if there are no findings that are considered significant.

• It is a good idea to get a copy of recent management letters before you start reviewing the actual financial statements.

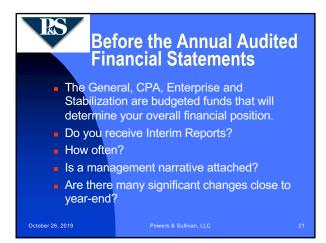


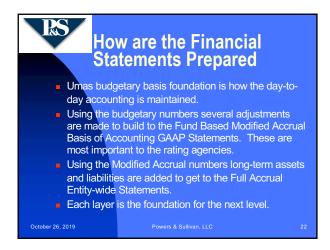
Management Letter A Material Weakness is the most serious finding. A material weakness is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. One common example is that the Town did not reconcile Cash for the entire year. Cash is a material item and an undetected error could lead to a material financial statement misstatement. Since it was not performed at all the IC is not timely.

A Significant Deficiency is a level down from a material weakness but is still serious. Significant deficiencies must also be communicated in writing to management. A significant deficiency is similar to a material weakness only that the possible financial statement error is a low dollar value. One example is that the Town did not have an internal control policy and related procedures on the timeliness of the Departmental receipts.

RS Ma	nagement Letter	
 An Other Matter is normally a finding that does not have any significant financial impact but it is a best practice recommendation. 		
 For example, Cash may be reconciled each month but the process is entirely manual and time consuming. The suggestion may be to automate the process to be more efficient. 		
 All of these findings will provide insight into how well your community is managed. 		
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Before the Annual Audited Financial Statements - Audited Financial Statements come out once per year and usually between 1 to 7 months after year-end. - Information received as a Finance Committee member during the year will do more to set expectations of what you will see in the audit. - The Budgetary Process sets the most important stage for the audited results.





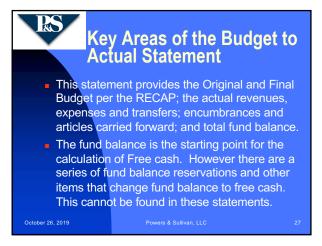
Financial Statement Components

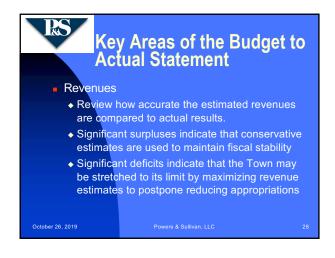
Independent Auditor's Report
Management's Discussion and Analysis
Entity-wide Financial Statements
Governmental Fund Based Financial Statements
Proprietary Financial Statements
Fiduciary Financial Statements
Budgetary Financial Statements
Notes to Financial Statements
Required Supplementary Information

How Do I Start My Review? The best place to start the review is the financial statement that is most familiar to you – The General Fund Budget to Actual Statement The next statement is the General Fund within the Governmental Funds. Next is the Major and Nonmajor Governmental Funds

How Do I Start My Review? Next is the Governmental Activities on the Entity-wide Statements To understand the changes between the modified accrual and full accrual governmental activities use the Reconciliation Statements. Move to the Internal Service Funds which most times is an Self-insured Health Trust fund.

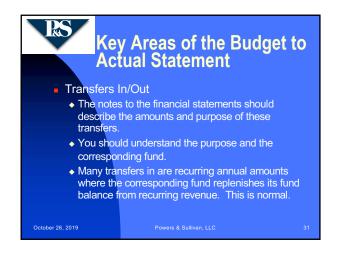
How Do I Start My Review? The last financial statement to review are the Enterprise funds (Water/Sewer etc.) Finally read the MD&A, Notes and Required Supplementary Information.



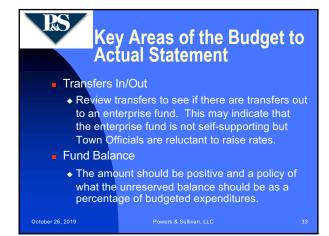


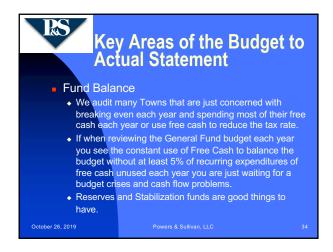
Key Areas of the Budget to Actual Statement Expenditures Review Original and Final Budget Amounts to see if any significant changes occurred A significant increase in an appropriation can indicate that the Town under-budgeted the ATM amounts and waited for free cash to be certified to bump it up to the proper level. If free cash came in at a lower level the Town may be forced to cut annual appropriations several months into the year. This is a recipe for disaster.











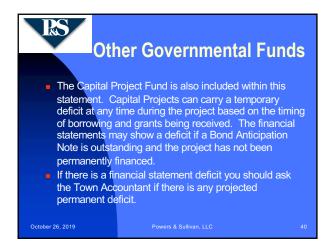
General Fund Key Areas The Fund Based General Fund revenues, expenditures and transfers should be close to the budgetary results. However GAAP throws a couple of curve balls to complicate the comparison. Most of the key analysis of this fund was accomplished in the budget/actual statement.

General Fund Key Areas GAAP requires that most stabilization funds be combined with the General Fund for the fund based presentation. The rational is the Stabilization Fund is just a sub-fund of the General Fund since it is usually funded by GF contributions. Therefore the Fund Balance will look a lot higher than your free cash calculation. The Notes should detail these amounts.

General Fund Key Areas	
Balance Sheet	
 The Balance Sheet should be reviewed with the last few years. The Town services provided is usually pretty consistent year-to-year and therefore the balance sheet amounts should be consistent. 	
 Focus your review on any significant changes. 	
 Recently I completed a forensic audit on a Town that show outstanding receivable balances increasing by significant amounts over the past several years. This was a red flag the 	
funds were being stolen however it went undetected.	
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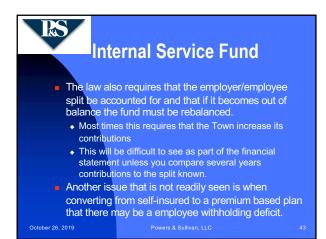
Stabilization Funds As just stated the Stabilization Funds are combined with the General Fund for financial statement purposes. Read the notes and MD&A to determine how these funds are either accumulating or depleting. It may be best to receive this information directly from the Town Accountant.

Other Governmental Funds • Within the Governmental Fund Based Statements are Special Revenule, Capital Projects, Debt Service and many Trust Funds. • The special revenue and trust activity are usually self-supporting and recurring such as school state and federal grants. These should not cause much concern unless there are significant accumulated surpluses or deficits. • If there are any significant deficits then the notes are required to disclose these amounts. If there is not a future revenue source then the General Fund will have to fund the deficit. • Any significant surplus will be difficult to find by just reviewing the financial statements so you should request a fund analysis from the Town Accountant.



GAAP requires that any "Major" Fund be presented in its own column based on certain criteria. What is normally seen is a Major Capital Project such as a new high school or Community Preservation. All other funds are accumulated in the single column for Nonmajor funds. Unless you prepare a CAFR this detail will not be found. These funds are not budgeted and most times are not part of a Finance Committee review. You may want to request the detail to see if any other available funds are available.

Internal Service Fund Internal Service Fund This is usually a Self-Insured Health Insurance Trust. Here is an instance where the Budgetary Basis is the same as full accrual GAAP. A liability must be recorded for an estimate of the future payments of benefits commonly referred to as Incurred But Not Reported (IBNR). MGL requires that any deficit be raised on the RECAP without exception. Revenues are mainly employer and employee contributions at a specific rate (75/25).



Enterprise Funds Each Enterprise Fund is required to be Budgeted and recorded on the RECAP. Unlike the General Fund, GAAP does not allow a budget-to-actual statement to be presented. This makes the analysis of what you are familiar with extremely difficult. The main problem is that the budgeted operating activity is commingled with capital activity, long-term liabilities and long-term assets.

Process Sullivan, LLC Enterprise Funds The information presented on the financial statements is useful to determine the long-term financial viability of the enterprise similar to a commercial enterprise. However for most finance committees the focus is more on the current budget. It is not feasible to try to extract this information back to the budget. The statement of cash flows will show the operating cash results separate from the capital and financing activity but you need to be experienced to analyze the results. It may be best to use the Town ledgers and not the financial statements.

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Enterprise Funds

- The purpose of an Enterprise Fund is to be selfsupporting but if it is not you should look to see what the General Fund contribution is.
- This information is best seen by reviewing the RECAP as the amount must be included if there is support.
- On the financial statements you will see this as part of Transfers In.
- The other form of support can be not charging indirect costs or paying debt service on be-half of the enterprise.



Pension and OPEB Trusts

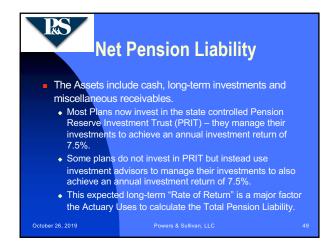
- These funds are set aside and can only be spent on retiree's pension and health insurance. The funds cannot be accessed by the General Fund.
- These funds are meant to be measured with a longterm perspective since they are being accumulated for long-term liabilities.
- Investment performance is measured on both a short and long term basis but the actuarial valuations use long-term rates of return.

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Net Pension Liability

- Starting in FY2014 governments were required to start implementing the Pension Related GASBs.
- GASB 67 Financial Reporting for Pension Plans required any community with a Pension Plan to report the activity and the statement of net position in accordance with the new standard.
- If your community did not have a Pension Trust Fund you did not have to do anything.
- The Pension Plan receives member assessments, employee pension withholdings and other contributions.
- The Plan paid retiree benefits and administrative expenses



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Net Pension Liability

- GASB 68 Accounting and Reporting for Pensions relates to how to report the Net Pension Liability on the financial statements of the Employers.
- The underlying process has many factors that require a lot of explanation but for the purposes of this presentation I will highlight the key elements only.
- The ability to have a Net Pension Liability (Unfunded Liability) is unique to governments and really cannot happen in the private sector.
- Why is that? Risk of Payment and Discount Rate.

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Net Pension Liability

- The actuary uses the census data from the employer and retirement system to project total future benefits for the current employees and retirees.
- They then discount these future payments using a discount rate to the current present value.
- Governments can use a discount rate equal to or less than the expected rate of investment return.
- Private companies must use a "Risk Free Rate" which is a lot lower. The Lower the rate the higher the liability.

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Net Pension Liability

- It is illegal for Private Companies to have an unfunded liability because it shifts the burden of investment returns to the employee/retiree among other things. They also can go out of business.
- For Massachusetts governments the payment of pensions is law and must be honored by the state and local
- The risk of payments is minimal since in 100 years there still will be a State of Massachusetts and the Town of Andover. It is illegal for a community to go bankrupt
- The Town may have to forego services if the investment returns are insufficient but the retirees will still be paid.



Net Pension Liability

- Since the risk of payment is minimal, the discount rate used and be higher and reduce the liability.
- The Net Pension Liability (NPL) is simply the Total Pension Liability less the Total Net Position. The % Funded is just the Net Position divided by the Total Pension Liability.
- What should you look for and where is the information?
- There is a long footnote that describes the NPL. You will see the NPL calculation and % Funded.

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Net Pension Liability

- There also is a schedule that is called a Sensitivity of the NPL to Changes in the Discount Rate.
- Communities can use a wide range of rates which currently range from 6.0% to 8.0% with most between 7.0% and 7.5%
- The schedule shows the NPL with the rate used, for Andover 6.25%, and what it would be if the discount rate was 1.00% higher or 1.00% lower.
- The liability increased by 23.4% at 5.25% and decreased by 19.6% at 7.25%.
- If you compare 2 communities make sure you know the Discount Rates



Net Pension Liability

- The next place to review is the Required Supplementary Information Section following the Notes:
- If your Town has a pension trust you will find a 10 year schedule of changes in the NPL and related ratios.
- This is the best way to measure your funding progress. The top section shows the changes in the Total Pension Liability and the bottom sections shows the changes in the Net Position.
- Investment income is volatile year-to-year but over a long-period should come close to that 7.00% range. A 10 year Schedule of Investment Returns is included.

This can explain wide swings between years.

Net Pension Liability

- If you are member of a Regional Retirement System there is not a Pension Trust and schedule to indicate the change in NPL.
- You will see a 10 year Schedule of the Town's Proportionate Share of the NPL.
- This shows your proportionate percentage; your share of the NPL; covered payroll; NPL as a % of covered payroll; and the Plan's % funded.
- Currently there are 104 Retirement Systems and the Funding % range from 30% to 100%. Law requires that each system is fully funded by 2040. The notes should disclose when you system is expected to be funded.



Net Other Post Employment Benefit (OPEB) Liability

- Each Town has their own plan and there is no proportionate share allocation.
- Not all Towns have established an OPEB Trust and even the Towns that did have not made a significant dent in Funding the liability.
- The GASB does not allow the Town to use a higher discount rate as their funding plan is not sufficient to eventually pay for all of the future payments.
- They use a risk-free rate equal to the rate on a AA rated 20 year Municipal Bond Index or a blended rate.



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Debt

- Towns issue debt for a variety of reasons. Some reasons are for sound financial purposes while the need for others may indicate financial weakness.
- Revenue Anticipation Notes These are normally for short-term cash flow needs. These are required to be paid down completely by year end. You will not see them on the Balance Sheet or Statement of Revenues and Expenses and you will not know they were issued unless you review the Notes.
- We normally do not see this debt recently but if they are issued it is usually an indication of insufficient General Fund Balance. You should find out why.

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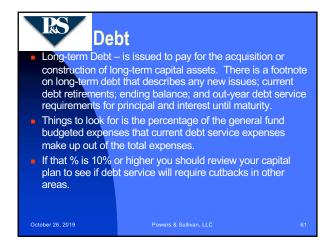


Debt

- Grant Anticipation Notes these are usually done for a sound reason such as Chapter 90 deficits at year-end that will reduce free cash unless the funds are borrowed and MSBA school construction where the cost reimbursement submittals may take a month or two to receive the capital grant revenue.
- You will find this activity in the Notes to the Financial Statements and a description of the purpose of the note. These are usually not an indication of a problem.
- Bond Anticipation Notes these are issued as temporary financing on major capital projects to cover the cash flow needed until the long-term debt is issued.

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Capital Assets

- Capital Assets The value of the capital assets are tied in directly to long-term debt. The higher the capital asset net book value the higher debt should be.
- The entity-wide full accrual statements will capture within the Net Position section the difference between the NBV of Capital Assets less the outstanding debt used to acquire them. This is the Town's Investment in Capital Assets.
- If the NBV of Capital Assets are low this may be an indication of old buildings and infrastructure that may need to be replaced soon.
- But you should know this You live in the Town.

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Entity-Wide Financial Statements

- The entity-wide financial statements are the full accrual statements and are broken down by Governmental Activities and Business Type Activities.
- The Business Type Activity are the same as the Enterprise Funds except they are in a different format. Not need to review these again.

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Entity-Wide Financial Statements The Governmental Activities are created by adding long-term assets and liabilities along with removing deferred revenues from the Governmental Funds discussed earlier. The easiest way to review these statements is to review the two reconciliation statements that detail the difference between the two bases of accounting.

Entity-Wide Financial Statements In these statements will present the financial position of the Town and break down the balances into: Net investment in Capital Assets Restricted net position for trusts, grants and similar accounts Unrestricted The major concern is how these long-term liabilities and assets will affect future budgets.

