CHAPTER V
FINANCIAL MANAGEMENT

by
Original text by Miral Gamradt, M.P.A
Updated in 2019 by Chet McClean, Darla Erickson and Tara Mastel

5.1 INVESTING PUBLIC FUNDS

5.101 Investment of Public Funds- Legal Requirements

Similar to private businesses, local governments must manage their cash. Cash management responsibilities include both cash for which there may be an immediate need as well as cash that may be invested for extended periods of time. State law provides for limits, controls and guidance concerning the local government's cash management responsibilities.

Section 7-6-201, MCA requires local governments to "…deposit all public money…in solvent banks, building and loan associations, savings and loan associations, or credit unions…" Money not necessary for immediate use may be placed in savings or time deposit (CD's) or in repurchase agreements. Section 7-6-202, MCA allows for the investment of public funds in direct obligations of the U.S. government including U.S. treasury bills and bonds, as well as a laundry list of other allowable investments.
Investment in money market funds is permitted only in limited circumstances. Finally, the law specifies the security necessary to ensure the safety and prompt payment of all deposits (7-6-207, MCA).

5.102 Investment Process- a Loser's Game

Investment of public funds can be a highly complex area of responsibility for municipal officials with little or no formal investment training or experience and it is not always clear which investments are permissible under the law. Two Attorney General's Opinions, 42 Op. Attorney Gen. No. 25 (1987) and 44 Op. Attorney Gen. No. 22 (1981), have answered some questions. However, while the Attorney General's Opinions are meant to interpret the law and add clarity, the information is still decidedly technical and difficult to understand for most officials.

It is quite common for local officials to receive phone calls from investment firm representatives promising attractive rates of return on their investments. The representative may or may not understand the investments they are trying to sell or their inherent risks. Even more likely, the investment representative will not know which types of investments are permissible for Montana local governments. Unfortunately, some finance officials have fallen victim to illusions of earning high rates of return for their taxpayers and invested public funds in risky investments that have resulted in substantial losses to their local government.

One unnamed author wrote:

> Imagine the following two scenarios:
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> 1. The city clerk-treasurer, through his/her diligent cash management efforts, increased the city's investment earnings from $30,000 per year to $40,000 per year; or
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> 2. The city clerk-treasurer, in an attempt to increase the city's investment income, invested the city's funds in an illegal investment instrument. The investment is in default and it is likely the city will lose the original principal amount of $10,000.

Which of the two preceding events would result in a headline in the local newspaper? Quite obviously, the prospect of a city or town losing money by investing in an illegal investment instrument would attract a great deal of attention in most Montana communities. Conversely, local government officials rarely receive recognition for their efforts, even when their efforts are exemplary. While we do not suggest elected officials should base investment decisions on reaction of the local media, the point is that consequences of trying to maximize the return on investments may not be worth associated risks.

5.103 Investment Options

Local government officials can fulfill their cash management responsibilities without attempting to maximize the return on their investments. Simple investment options such as purchasing certificates of deposits (adequately secured) from local banks can provide safe and satisfactory rates of return.
Montana local governments also have at their disposal the expertise of highly trained and experienced investment professionals at the state level. The Board of Investments administers the Short-Term Investment Pool (STIP) for state government. State law 17-6-204, MCA allows, but does not require, Montana local governments to use the pool. STIP has several advantages for local governments, including access to competitive rates of return provided by trained investment professionals, assurance the city's funds are adequately secured, and total liquidity provided by such a large investment pool. Unlike a certificate of deposit, which must be invested for a definite period of time, a local government's funds (regardless of the amount) can be deposited in STIP one day and taken out the next while earning competitive rates of return for the period the funds are on deposit.

Elected officials should take an active role in determining where the city's funds should be invested, who may make investment decisions, diversification, what investments are permissible, and the decision latitude of those responsible for investments. These decisions of the elected body can best be implemented through a formalized investment policy.

5.104 Investment Policy

Many governments operate with de facto policies whereby a public official conducts investment operations in a vacuum while everybody else assumes that he or she will act responsibly. Only when something goes awry do elected officials and the press begin to question the investment policy or absence thereof.

The investment process is hardly immune from the delusion that legislation can remedy all problems, but the process is improved when elected officials act responsibly to identify objectives, assign responsibility, and address the problems of risk inherent in the investment of public funds. Conscious collective action is better than no action at all. Formal policies can result in superior performance and improved communication.

A formalized investment policy, adopted by the city council, can provide the necessary guidance to the clerk-treasurer, to ensure their investment decisions are consistent with the council's wishes. The council, through its investment policy can assign responsibility, emphasize safety first, the preservation and protection of capital, and clearly state that speculation is inappropriate in all circumstances.

Sample investment policies can be obtained from the Government Finance Officers' Association, internet searches, and other Montana local governments.

5.2 MANAGING PUBLIC DEBT

5.201 Purpose of Debt

Debt in a municipal government is an effective financial management tool. Active debt management provides fiscal advantages to local governments and its citizens. Debt can serve several different purposes. It is useful in matching costs to benefits of public assets. It is useful as an economic development tool. It allows governments to build and acquire assets that would not otherwise be able to be built or acquired. Debt eliminates the need for governments to build up large reserve balances to build or acquire assets. In other words, debt is not something that should be avoided or eliminated. Rather, debt is something that should be used and managed prudently. Debt can be mismanaged, however. Over-use of debt places a burden on the financial resources of the government and its taxpayers. Thus, it is important to create policies and follow practices to ensure debt is used wisely.

5.202 Types of Local Government Bonds

Debt is often incurred through the issuance of bonds. There are many different types of bonds. The most common types of bonds issued by Montana local governments are described below.

1.General Obligation Bonds (G.O. Bonds)
State law authorizes the issuance of general obligation bonds, 7- 7- 42, MCA. A defining characteristic of general obligations bonds is that they pledge the unlimited taxing power and the full faith and credit of the issuing government to meet the required principal and interest payments. This enhanced level of security provided to investors provides the maximum safety for their investments. Because of the added security that general obligation bonds offer, issuers are able to market this type of bond at very attractive rates, in addition to being a very flexible financing instrument. Because the issuer has the ability to increase taxes to pay debt service, the structure of a G.O. bond is not constrained by a limited flow of available revenues.

General obligation bonds are normally used for projects benefiting the entire community and whose costs should be defrayed over a long period of time. State law limits general obligation debt (all outstanding and unpaid indebtedness) to 2.5 percent of assessed valuation, 7-7-4201, MCA.

Voter Approval Required, 7-7-4221, MCA. Whenever the governing body of any municipality considers it necessary to issue bonds pledging the general credit of the municipality for any purpose authorized by law, the question of issuing the bonds must first be submitted to the registered electors of the city or town. An election on the question of issuing bonds may be called by the city or town council or commission on its passage of the necessary resolution or after a petition asking that such election be held, and the question submitted has been presented to the council or commission. However, it is not necessary to submit to the electors the question of issuing refunding bonds to refinance bonds already issued and outstanding.

2. Revenue Bonds
The distinctive feature of revenue bonds is the pledge of a specific revenue stream— usually derived from the project being funded or the enterprise system of which the project is a part. The government's obligation is limited to the revenue stream(s) pledged for the repayment of the bonds. The bonds are issued without the backing of the full faith and credit of the issuing government; thus they are considered limited liability obligations. Revenue bonds are most often sold for systems that have identifiable users. For that reason, revenue bonds are considered to be a very equitable means of financing system improvements, because only the users of the system are required to pay. Financing of water, wastewater, and solid waste improvements are the most common uses of revenue bonds for Montana local governments. Revenue bonds are limited to a term of 40 years and do not require voter approval, although voter approval may be sought at the discretion of the governing body, 7-7-4432 MCA.

Since the use of revenue bonds is applied to self-supporting facilities, only persons directly benefiting from the services provided by the facility must bear the costs. Citizen concern is most often directed at the rates established to pay for the facility. Revenue bond debt is not subject to Montana limitations on bonded indebtedness.

Because revenue bonds are secured by a specific, limited, and usually non-tax source of revenue, they often are less secure than general obligation bonds. Underwriters will usually require the creation of a debt service reserve fund to provide additional security in the event projected receipts fall below the level needed to meet annual debt service requirements. In such cases, the debt service reserve can be used to make the required payment and give the issuer an opportunity to restore its flow of funds. The reserve fund then is replenished to its required level. The debt service reserve is often funded out of proceeds of the bond issue. To provide comfort to prospective investors, an issuer of revenue bonds must demonstrate that sufficient funds will be available to make principal and interest payments in a timely manner. This is done by offering a promise (or covenant) to maintain system rates and charges at a level that will generate revenues in excess of the required debt service payment for each period. For example, a water or sewer system may covenant to generate net revenues (gross revenues less operating and maintenance costs) available for debt service equal to at least 115 percent of annual debt service requirements. Revenue systems with less dependable revenue streams may be required to offer even higher coverage covenants. Such covenants offer the investor some assurance that fluctuations in system usage and revenues will not interfere with the timely payment of principal and interest on the bonds.

Because the repayment of revenue bonds is dependent upon the discretionary use of a facility or system, prospective investors require much more documentation and protection than is found in a G.O. bond offering. Consultants can be hired to perform a feasibility study to describe the likelihood that the system will generate revenues sufficient to meet future operating, maintenance, and debt service requirements. This is often accomplished through the city's consulting engineer. For a water and sewer system, this may be a fairly simple study that demonstrates the reasonableness of rates and the stability of the user base. For a solid-waste disposal facility, however, this study must examine the sensitivity of a much broader range of variables: How much of an impact will the proposed facility have on disposal fees? Do residents have the option of disposing solid waste elsewhere if they object to required fee increases? Will a large fee increase result in illegal dumping, thus creating another problem for government? The type of system and its sensitivity to user discretion will determine the scope and importance of the feasibility study.

3. Special Improvement District (SID) Bonds

Special assessment bonds are issued to finance capital improvements that benefit taxpayers in a particular, carefully defined area of the community. Because the benefit is not enjoyed by the entire community, the justification for use of special assessments is that the cost should be borne only by those who will benefit from the improvement. Principal and interest payments are made by a special assessment on the property benefiting from improvements. The local governments use the assessment revenue to make debt service payments on the bonds. To further enhance the security for SID bonds (beyond the pledge of special assessments), the issuing agency normally pledges support of its SID revolving fund. The authority for, and restrictions on, the use of special improvement district bonds is found in Title 7, Chapter 12, Part 41 and 42.

Some local governments in Montana have financed 100% of the cost of improvements to raw land. When the value of the land fell, property owners (often developers), defaulted on their assessments and the local governments were left with the associated debt (SID bonds) and insufficient assessment revenue to make the required debt service payments. These governments were required to draw upon their SID revolving fund as required by state law and the bond covenants. When this support was still insufficient to honor the bond obligations, the local governments were confronted with a decision; do we default on the bonds or levy additional taxes to meet the debt service payments? These problems have prompted some Montana governments to adopt SID policies, which serve to limit the extent to which SID bonds will be used to finance improvements—often to financing only half of the improvements to raw land. When property owners are forced to "have more skin in the game", the likelihood of their default is reduced considerably, as well as reducing the amount of local government's bonded indebtedness.

5.203 Refunding Bonds

Refunding bonds are issued to retire an already outstanding bond, perhaps to shorten the term of the bond issue, take advantage of more favorable interest rates, eliminate restrictive covenants, reorganize the maturity schedule, or consolidate the community's debt. Generally, issuers want to replace outstanding higher interest rate bonds with lower interest rate obligations and, in some cases, to modify or remove restrictive conditions in existing bond covenants.

In many cases, bonds are not callable for a number of years. Through advanced refunding, refunding bonds are issued and the proceeds are placed in escrow pending their application to the redemption of the outstanding bonds on the first call date. Thus, the advance refunding procedure enables local governments to refund existing debt before the bonds are callable.

Refunding bonds offer the opportunity for flexibility in modifying the debt structure of the community. They are not subject to debt limitations and a bond election is not required. Generally, any bond that can be legally issued can be legally refunded. The issuing agency will save interest expenses by issuing new lower-yield bonds to pay off higher-yield bonds; however, cost savings must be significant enough to offset the accompanying administrative costs.

5.204 Bond Ratings

Bond ratings reflect the relative strength of the government's financial management and planning capabilities, the quality of its elected and administrative leadership, as well as its wealth and social characteristics. Bond ratings serve as a statement of a locality's economic, financial and managerial condition and represent the business community's assessment of the investment quality of a local government. Highly-rated bonds are more competitive in the market and thereby help lower interest costs paid by residents. High-grade ratings reduce the cost of raising capital for projects, and create a substantial savings for the taxpayers.

The cost of obtaining a bond rating must be weighed against the anticipated benefits (reduced interest rates) in order to determine whether or not the local government should have their bonds rated. General obligation bonds are the most likely type of bonds to be rated, while SID bonds are rarely rated.

5.3 ACCOUNTING

5.301 Accounting Principles

Montana local governments are required to manage and account for their financial activities in accordance with Generally Accepted Accounting Principles (GAAP), as set forth by the Governmental Accounting Standards Board (GASB) (2-7-504 MCA, 2.4.401 and 2.4.411 A.R.M). GASB is the recognized authority with respect to governmental accounting. Managing the local government's finances in accordance with GAAP and with the rules set forth by GASB, provides the citizens assurance that their public funds are being accounted for in a proper manner. Compliance with GASB's standards is enforced through the audit process, when auditors render an opinion on the fairness of the financial statement presentations in conformity with GAAP.

The information needs of the users of government financial statements are different from the needs of the users of private company financial statements. A government's performance cannot be assessed by profit, which is the main objective of businesses. Governments have objectives other than profit maximization. Therefore, governments need accounting principles and reporting systems that differ from those of businesses.

5.302 Basis of Accounting

Basis of accounting determines when transactions are recognized. Under an *accrual basis*, an expenditure is recognized when a bill is incurred, whereas on a cash basis, the expenditure is recognized when the bill is paid. Most local governments maintain accounting records for general governmental operations on a modified accrual basis, with revenues recorded when available and measurable, and expenditures recorded when services or goods are received, and liabilities incurred. Accounting records for enterprise funds are maintained on an accrual basis, with all revenues recorded when earned and expenses recorded at the time liabilities are incurred, without regard to receipt or payment of cash.

Local governments maintain their accounts in accordance to the principle of *fund accounting* to ensure that limitations and restrictions on available resources are observed and adhered to. Fund accounting classifies resources into funds or account groups with respect to the intended activities or objectives specified by those resources for accounting controls and financial reporting purposes. Governments use several funds to account for their resources and activities.

> **Fund** is a fiscal and accounting entity with a self-balancing set of accounts for recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations. The most common reason for establishing a fund is to separately account for restricted-use revenue or to comply with state or federal law.
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> There is no limit to the number of funds that a government may establish and maintain for accounting and financial reporting. A generally- practiced governmental accounting guideline is that a government should use the smallest number of individual funds as possible, consistent with its particular circumstances, and that individual funds are closed when the intended purpose no longer exists.
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> **Account** is an organizational or budgetary breakdown which is found within the government's funds. Each department serves a specific function as a distinct organizational unit of government within the given fund. Its primary purpose is organizational and budgetary accountability. An example of an account is public safety - for the police department. Additional sub-numbers can be used to further classify the account such as the detective division within the police department.
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> **Object of expenditure** refers to specific, detailed expenditure classification. It relates to a specific type of item purchased or service obtained. Examples of objects of expenditure include salaries, supplies, purchased/contracted services, capital outlay and travel.

5.303 Types of Government Funds

Most general-purpose governments engage in three broad categories of activities:

- **Governmental** activities are those financed predominantly through taxes and intergovernmental grants commonly referred to as non-exchange transactions.
- **Business-type** activities are those financed predominantly through user charges.
- **Fiduciary** activities are those for which the government acts as a trustee or agent for individuals, external organizations, or other governments.

All of the government's funds fall within these three categories. Examples of each follow:

1. **Governmental funds** are those through which most governmental functions are financed. The following are examples of governmental funds

   - ***General fund*** — accounts for all financial resources except those required to be accounted for in another fund. The General Fund is the government's primary operating fund.
   - ***Special revenue funds*** — account for the proceeds of specific revenue sources that are legally restricted by an outside third party to expenditures for specified purposes (other than for major capital projects). Examples include: state and federal grants, gas tax, street maintenance district, tree maintenance district, etc.
   - ***Capital project funds*** - account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds.) Examples include: City Hall renovation, police station construction, etc.
   - ***Debt service fund****s* - account for the accumulation of resources for and the payment of, principal and interest on general long-term debt. Examples include: city hall debt repayment, police station debt repayment, etc.

2. **Proprietary Funds** are used to account for the business---type activities of a government—those that are similar to activities carried out in the private sector. There are two types of proprietary funds:
   - ***Enterprise Funds*** — account for operations that are financed and operated in a manner similar to private business enterprises, where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges; or where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes. Enterprise funds include: water, wastewater and solid waste.
   - ***Internal Service Funds*** — account used to account for business---type activities in which the customers are other government departments or agencies.

3. **Fiduciary Funds** are used to account for resources held by the government but that are intended to benefit parties other than the government itself. There are two types of fiduciary funds.
   - ***Trust Funds*** — are used to account for assets that the government holds as a trustee for the benefit of parties other than the government itself.
   - ***Agency Funds*** —are generally used to account for assets that a government temporarily holds as an agent for other parties.

5.4 CLAIMS FOR PAYMENT

5.401 The Claims Process

Montana law 7-6-4301, MCA requires that all claims for payment by a city or town must be presented to the council for approval in an itemized format within one (1) year from the date the claim accrued.

Payment of claims against a city or town may be authorized by the council when:

- payee-signed claims have been issued to the city or town and the payee has attested in the claim to its accuracy and that the payee has not received the claimed amount; or
- the payee has provided the city or town with an invoice or other document identifying the quantity and total cost for each item included on the invoice.

All bills, claims, accounts, or charges for materials of any kind that are purchased by and on behalf of a city or town by its department heads or officers must be reviewed by the city or town finance director or the city or town clerk before submission to the council.

5.402 Liability for False Claims

Montana Code Annotated 7-6-4311 provides that:

- A person who knowingly presents or causes to be presented a false, fictitious, or fraudulent claim for allowance or payment to any city or town or its contractors forfeits the claim, including any portion that may be legitimate, and in addition is subject to a penalty of not to exceed $2,000 plus double the damages sustained by the city or town as a result of the false claim, including all legal costs.
- The forfeiture and the penalty may be claimed in the same suit.

5.403 Claim Forms to Detect Fraudulent Claims

An effective internal control to provide a complete paper trail to account for disbursements and thus detect fraudulent claims against the city or town is the use of a properly designed *claim form*. A model to implement policy and a claim form follow this page.

Attachment 5.1
Model Claims Policy

RESOLUTION NO:______

A RESOLUTION OF THE CITY/TOWN COUNCIL OF THE CITY/TOWN OF_________________, MONTANA, ESTABLISHING A POLICY CONCERNING THE PROCESSING OF ALL CLAIMS FOR PAYMENT AGAINST THE CITY/TOWN, CREATING A STANDARD CLAIM FORM AND ESTABLISHING CERTAIN INTERNAL CONTROLS FOR PURCHASES AND DISBURSEMENTS.

WHEREAS, Montana law 7-6-4301, MCA requires the establishment of certain procedures and internal controls to ensure that public funds are lawfully disbursed; and

WHEREAS, the______________City/Town Council desires to ensure that all purchases made by city/town employees are duly authorized and that all goods and services purchased are, in fact, received by the city/town and that no disbursement of city/town funds is made without final approval by the mayor and city/town council; and

WHEREAS, the Mayor of_____________desires to establish business-like procedures for ordering, receiving and paying for only those goods and services actually required for the safe and efficient operation of all city/town departments and the efficient delivery of essential city/town services.

NOW THEREFORE BE IT RESOLVED by the City/Town Council of City/Town of________, Montana that:

Section 1. It is the policy of the City/Town of________________that:

1. All disbursements of city/town funds, except for payroll, shall be documented with a city/town Claim Form, a copy of which is included as attachment to this resolution. Said Claim Form shall include:
    a. specific approval of the purchase by a designated city/town official;
    b. the signed certification of the vendor verifying that the claim for payment is true and correct and that payment has not been previously received by the vendor;
    c. certification by a designated city/town official that the purchased goods or services have, in fact, been received by the city/town, and
    d. that the city/town council has approved the claim for payment pursuant to law.
        i. Disbursements to be made pursuant to an existing contract that has been approved by the city/town council do not require completion of Section III, "Vendor Certification" of the Claim Form. However, the purpose and date of the contract *(e.g. MMIA insurance assessment, June 30, 2019)* must be entered in Section II of the Claim Form and all other sections of the form must be completed.
        ii. Copies of all completed Claim Forms with original signatures shall be filed sequentially by date that the claim was approved for payment by the city/town council. A new and separate file shall be initiated for each fiscal year such that any disbursement of city/town funds may be readily cross checked with the minutes of the city/town council meeting at which the claim for payment was approved by the city/town council.
        iii. Claim Forms are public records and shall be retained for not less than five years following the official audit conducted for the fiscal year in which the Claim Form was approved for payment. Claims associated with a contract must be retained fora period of not less than eight years.

2. The specific written approval of the mayor of the city/town of____shall be required prior to the purchase or agreement to purchase any good or service that costs more than $1,000. Section I of the Claim Form may be used to record such approval.

3. Any vehicle or item of equipment, machinery, construction, repairs or professional services with a cost in excess of $80,000 must follow the bid process established by law 7-5-4302, MCA. Purchases of less than $80,000 but in excess of $10,000 should be considered for a bid process, which may be waived by the mayor with council approval.

4. All claims must be signed by two city/town employees attesting to the fact that the goods or services have been received by the city/town.

Section 2. It is the policy of the City/Town of_______________that:

1. No employee of the city/town of____________shall have any pecuniary interest in or benefit from any contract or purchase agreement entered into by the city/town nor shall any city/town official contract with or purchase goods or services from any firm or business enterprise that is owned by a city/town employee or close relative of a city/town employee.

2. No City/Town employee shall receive any commission, profit, gratuity or gift as a result of any contract or purchase made by the city/town.

3. A waiver of the provisions of Section 2(1) and 2(2) above can only be granted if approved by the affirmative vote of a majority of the city/town Council before the purchase or contract has been entered into by a city/town employee.

Effective Date

Section3. This resolution shall be in full force and effect immediately upon approval by the city/town Council.

References:

7-6-4301, MCA and 2-2-1, MCA, “Code of Ethics” Montana Code Annotated.

PASSED AND ADOPTED by the City/Town Council of_______________the City/Town of___________ , Montana at a regular session thereof held on the_______________day of_______________, 20____.

ATTEST:

____

City/Town Clerk

APPROVED AS TO FORM:

____

City Attorney

Attachment 5.2
City/Town Model Claim Form

CITY/TOWN OF_______________, MONTANA

Must be completed prior to all disbursements other than payroll pursuant to 7-6-4301, MCA. Attach vendor invoice or receipt

I. Vendor Information:	
Pay To: (Name and address)	Total:
Taxpayer ID Number*:	
The City/Town must have an invoice or receipt and the TIN or SSN of the vendor before this claim will be processed.	
Date of Purchase:	
For Department:	
Approved By*:	
Mayor's signature required for all purchases in excess of $1,000.	
II. Goods or Services Purchased:	
Description of Goods or Services Purchased*:	
Include Serial Number of Equipment. Invoices may be attached in lieu of descriptions.	
III. Vendor's Certification:	
I, the undersigned, do solemnly swear that I am the vendor or vendor's agent of the above described Goods or Services and that the amount claimed is wholly unpaid and is a true and lawful claim against the City/Town of____________________.	
Signature of Vendor:	Date:
IV. Certification by City/Town Officials That Goods or Services Have Been Received by the City/Town of___________:	
*I, **(signature)**_______________________________do hereby certify that the Goods or Services described above have been received by the City/Town of______________.*	
*I, **(signature)**_____________________________do hereby certify that the Goods or Services described above have been received by the City/Town of__________.*	
V. Approval by City/Town Council:	
The above described claim for payment has been reviewed by the City/Town Clerk-Treasurer and was submitted to and approved by the_______________City/Town Council meeting in regular/special session on___________.	
Signature of City/Town Clerk-Treasurer:	Date:
VI. Accounting:	

Fund Name	Account Code	Date Booked	Check Number

5.5 THE AUDIT

5.501 Purpose of an Audit

For many of us, the thought of an audit strikes a feeling of fear. We become fraught with images of an Internal Revenue Agent with beady eyes, sporting a dark three-piece suit, auditing our last tax return to determine if we owe additional income taxes. Despite our worries, an audit of our local government should be welcomed rather than feared. Unlike an audit we may undergo as individuals, an audit of our local government has an entirely different purpose. The objectives of an audit of our local government include:

1. Are the government's financial statements fairly presented in accordance with Generally Accepted Accounting Principles?
2. Did the government comply with applicable laws and regulations?
3. Does the government have an adequate system of internal controls?

The auditor's primary objective is to *determine if the government's financial statements are fairly presented*. A favorable opinion does not mean that the government's financial statements are free of errors. The term fairly presented means that the financial statements are not so materially misstated or misleading that they do not present fairly the government's financial information. The auditor's conclusions are presented as an opinion, rather than a statement of absolute fact or guarantee. Despite this lack of certainty, government officials should welcome an audit, look forward to passing all of the auditor's tests, and gain assurance that the government's financial records are reasonably accurate.

Governmental audits are often referred to as "*financial and compliance*" *audits* because governmental auditing standards require auditors to test both financial and compliance requirements. The financial portion of the audit is meant to determine if the financial statements are fairly presented in accordance with accounting standards. The compliance portion of the audit refers to whether the government followed applicable laws and regulations. A listing (a "Compliance Supplement") of many city/town's compliance requirements can be found on the Montana Department of Administration's website http://sfsd.mt.gov/LGSB/Audit-Financial-Review-Resources/4_ComplianceSupplement.

Auditors are required by their auditing standards to evaluate the government's system of *internal controls.* Internal controls (also referred to as a system of checks and balances) are intended to provide reasonable, but not absolute, assurance that the government's assets are protected. Guaranteed protection is impossible. Segregation of duties is one of the most powerful aspects of internal control. The overriding principle is: *no one person should ever be placed in a situation to carry out or conceal an error or irregularity without timely detection by others in the normal course of their responsibilities.*

Many mistakenly believe that an audit is designed to detect fraud, if it exists. This is simply not the case. While the detection of fraud could possibly be an outcome of an audit, fraud is rarely detected by an audit. The system of checks and balances that governments implement serve to prevent these problems from occurring, which is obviously far better than discovering problems after the fact through an audit or other means. Governing bodies are responsible for ensuring auditor's recommendations for improvements in internal controls are implemented and should also consider an even stricter system of checks and balances than the auditors may recommend. Many audit firms will provide specialized engagements at a reasonable cost designed solely for the purpose of improving a government's system of internal controls. Given the public's expectation of a frugal and efficient government, it is difficult for elected officials to expend additional money to prevent problems, when most feel no problems exist. However, there are a multitude of government officials who have experienced fraud and embezzlement and have wished they had expended a relatively small amount of money to improve their system of internal controls. Problems of this nature, regardless of severity, serve to erode the public's trust in government.

5.502 Auditor Selection

State law 7-5-4301, MCA exempts professional services (including audit services) from bidding requirements.

Section 2.4.407 of the Administrative Rules of Montana enumerates a series of criteria that local governments must consider in the selection of an audit firm. These criteria are:

1. Listing on department's roster of independent auditors authorized to conduct local government audits;
2. Independence, as defined by applicable auditing standards;
3. Demonstrated understanding of the work to be performed;
4. Technical experience of the independent auditor in conducting similar types of local government entity audits;
5. Qualifications of staff to be assigned to the audit;
6. Work history of the independent auditor; and
7. The proposed audit fees.

Typically, local governments seek proposals from audit firms that are interested in performing their audit. This is generally done through a Request for Proposal (RFP) process. Sample RFP's can be obtained from several sources, including major Montana cities, internet searches, and the Government Finance Officers' Association (GFOA). Regardless of the RFP form used, the contents must address the auditor selection criteria stated above. Once the government selects an audit firm, an audit contract, lasting up to three consecutive fiscal years, is required in a form prescribed by the Department of Administration.

State law does not require an RFP and it is not uncommon for local governments to renew their audit contracts without seeking new proposals. A level of efficiency may be gained by utilizing the same audit form for multiple years, since the auditors are familiar with the local government, their staff, and accounting system.

5.503 Auditor's Opinion

The audit culminates in an auditor's opinion on the government's financial statements. The auditor's opinion is generally no more than a sentence or two long and is embodied in a letter to the government officials entitled Independent Auditor's Report. All governments seek to obtain an "Unqualified Opinion" also referred to as a clean opinion. A clean opinion means that the government's financial statements are fairly stated in all material respects in relation to the financial statements taken as a whole. It basically means that the auditors did not find any errors that were so significant and their effect so great, as to cause the government's financial statements to be misleading.

Most governments are able to receive an unmodified opinion. There are times, however, when a government may receive a modified opinion. This may be due to an accounting requirement that the government failed to implement. Or, it could be that the government's financial records are inaccurate or misleading. In these instances, the auditors may issue a modified opinion. Their choices consist of: an adverse opinion (do not present fairly), a disclaimer of opinion (decline to give an opinion), or a qualified opinion (fairly presented, except for). Which of these opinions an auditor may issue revolves around the auditor's judgment and is dependent upon facts and circumstances. If a governmental entity receives anything other than an unmodified (clean) opinion, immediate steps should be taken to correct the problem.

5.504 Actions by Governing Bodies

Section 2-7-515, MCA requires the governing bodies of each audited local government entity to review the contents of the audit within 30 days and to notify the department in writing as to what action they plan to take on any deficiencies or recommendations contained in the audit report. The local government entity shall adopt measures to correct the report findings and submit a copy of the corrective action plan to the Department of Administration.

5.505 Importance of Audited Financial Statements

Frequently, the audit report is viewed by the city council and staff as highly technical and serving only the needs of higher authorities. All too often, once the audit report is received, it is placed on the shelf with the audits of all prior years and begins to gather dust. However, the information contained in the audit report is imperative to obtaining an accurate picture of the government's financial wellbeing.

For example, auditors routinely adjust the government's financial information when preparing the audited financial statements. The adjustments generally fall into two categories: adjustments due to erroneous misstatements and adjustments due to intentional misstatements. Erroneous misstatements are likely the result of accident. Intentional misstatements, on the other hand, are the result of willful decisions, such as choosing not to apply an accounting standard or attempting to conceal fraudulent activities. In either case, by having the financial statements verified by an independent, external party, the audited financial statements should present information that is more faithfully representative of the actual financial position of the government.

Furthermore, the audited financial statements present the ideal opportunity for the clerk-treasurer to perform his/her annual financial trend monitoring. It is also an ideal time for the council members to educate themselves on the formal financial statements of their government, becoming aware of any emerging trends and improving their understanding of the "big picture" of their local government's finances.

5.6 FINANCIAL TREND MONITORING

5.601 Importance of Financial Analysis

Perhaps the most important responsibility of a local government's finance professional, other than the preparation of the budget, is financial analysis. Financial analysis can encompass many areas. Our focus here is financial analysis designed to determine the financial health of the local government, if it is getting better or worse, and identify emerging trends the council should be addressing. Unfortunately, this highly critical area of responsibility is often neglected or simply not performed at all. If a local government's clerk-treasurer or city/town council is not fully aware of the municipality's financial health, does not know if its financial health is getting better or worse, and is unable to identify emerging trends affecting its financial health, who is in control? This lack of attention to one of the most important responsibilities of the local finance official can cause problems ranging from unexpected budget problems to actual insolvency.

5.602 What to Analyze

A local government's financial trend monitoring system can be wide-ranging and cover a multitude of variables or it can be quite simple. Simple monitoring systems can be very effective, especially for small governmental entities. At a minimum, the clerk-treasurer should establish a formalized annual monitoring system of the financial position of its major funds. This analysis will assist the clerk-treasurer in understanding the "big picture" of his/her government's finances and will act as an early warning mechanism for emerging problems. Financial trend monitoring books are available and provide examples of the many kinds of analyses that can be performed. However, once the local finance professional is able to master monitoring of the city's financial position, monitoring of other variables becomes increasingly easy and is just an extension of the same principles.

The financial position of a local government is best measured by what accountants call fund balance. Fund balance is defined as the assets of a fund (primarily cash & accounts receivable) less liabilities of a fund (primarily accounts payable). In other words, fund balance essentially means the net worth of a fund at any given point in time- typically at the end of the fiscal year. However, the trend of the financial position of a fund is much more important than its absolute value, thus, setting up the need for a multi-year trend analysis.

The term fund balance applies only to governmental funds, which includes the city's general fund, special revenue funds, debt service funds, and capital project funds. Accounting requirements for the city's proprietary funds (enterprise funds) are different and so is the financial analysis that is needed for these funds. The best measure of the financial position of an enterprise fund is working capital. Working capital is defined as the current assets (primarily cash & accounts receivable) of the fund, less current liabilities (primarily accounts payable) of the fund. Current means due within one year. Therefore, a wastewater system's physical plant would be excluded from the calculation as would the associated debt (bonds payable) of the wastewater plant. The end result is the fund's liquid net worth. The city's audited financial statements will separately identify the current assets of an enterprise fund as well as the current liabilities, making this analysis relatively easy.

In lieu of evaluating fund balance and working capital levels, some local governments (primarily smaller units), opt for a simpler approach- that is simply monitoring cash balances. While analyzing cash balances may occasionally omit some critical information, such as a large payment the government is due or a large disbursement that just occurred after year-end, the simple monitoring of each fund's cash balance can provide the smaller local governments with an effective alternative to evaluating fund and working capital balances. Regardless of the approach, it is critically important that the clerk-treasurer perform a financial trend analysis of its entity's financial position on an annual basis, develop a multi-year trend analysis and regularly present this information to the city council. This information is absolutely critical to an elected official's understanding and management of the city or town's finances.

Once the financial analysis is performed and any unwanted or danger trends are revealed, the next step is to identify the primary causes of the changes in financial position. For example, fund balance in the general fund could be declining for three or four years in a row. The fact that fund balance is declining does not automatically indicate a problem. The government could be making a concerted effort to repair or replace needed equipment, fully understanding the impact on its general fund. Assuming the government has adequate reserve levels; this situation does not necessarily indicate an impending problem. The reason is that the expenditures causing the decline in fund balance levels can easily be eliminated in subsequent years. On the other hand, fund balance in the general fund could be declining due to increased on-going/recurring costs, which poses an entirely different situation, resulting in a structural imbalance in the budget.

5.603 Structural Balance

Staff members from New York City wrote about what they termed “Structural Balance”. The author describes structural balance as: “*the situation in which the structure of the revenue budget and the structure of the expenditure budget are sufficiently complementary: of similar size and growth rate over time.*” In other words, the ongoing revenues of a fund should be able to support the on-going expenditures of a fund. One-time expenditures are not part of a structural balance analysis, nor are one-time revenue sources. For example, it would be prudent for a city council to add a new police car to its fleet with a one-time $40,000 revenue source. In a subsequent year, when the revenue disappears, the city simply eliminates that capital purchase. Imagine, however, the consequences of a city council adding a new *police officer* with this same one-time revenue source. The budget will balance in the first year, but what will happen in subsequent years? Quite simply, the government would unknowingly place its general fund in a state of structural imbalance. On-going revenues will not support on-going expenditures, setting up the council for a budget that is out-of-balance.

Structural balance sounds logical, simple and easy to understand, so why would such an easy concept require the publication of an extensive paper? Only someone intimately familiar with public budgeting can fully appreciate the concept of structural balance and the full range of implications. When crafting a government budget, the finance professional deals with literally hundreds, if not thousands of variables. Each of these variables can affect the city’s finances in different ways. Some variables are clearly one- time revenues or one-time expenditures. Just as often, however, many of the variables fall into a gray area, not fitting neatly into either the one- time or the on-going category. Combine these complexities with the sheer volume of issues and data inherent in the budgeting process and the simple concept of structural balance becomes lost. Structural balance must be at the forefront of the finance professional’s thought process and most importantly, throughout the development of the budget.

Furthermore, it is difficult to take one budget in isolation and determine if it is structurally balanced or not- giving rise to a multi-year trend analysis, as described above. A structurally balanced budget or financial plan may produce surpluses in some years and deficits in others. The term deficit implies something is awry. However, there will undeniably be times when reserve levels will decline (i.e. the expenditures of a fund will exceed the revenues of a fund), causing a deficit for that particular year. The key is in knowing what is causing a reduction in a fund’s financial position and to be able to take action, if necessary, to remedy the situation in a timely manner. A financial structure that is balanced at one point in time can become unbalanced when underlying circumstances change.

5.604 Concepts and Definitions

Revenue Structure

The revenue structure of a budget is described by the types of revenues, their shares in the total budget, and the reliability and rapidness with which different revenues grow over time.
A structure dominated by tax revenue, for example, creates a strong dependence between city revenues and health of the local economy. When the economy turns down, tax revenues may not keep pace and expenditures that were affordable during strong economic growth will be insupportable in economic recession.

On average, local governments around the nation raise about 40 percent of their revenues from taxes and about 25 percent from user fines, fees, and charges. Their reliance on federal and state aid averages 35 percent. There are important merits to a tax-dominated structure:

- A tax system, as opposed to a fee-based system, separates the use of public services from the ability of users to pay for those services.
- A tax-based system can place a relatively greater financial burden on prosperous citizens in order to lessen the financial burden of government on poor citizens.
- A tax system can match or exceed the growth of an expanding economy.
- Unfortunately, this structure succeeds in balancing budgets only in strong economic expansions. When the economy slows down, taxes slow down, but social services expenditures generally accelerate.

Tax Structure

The link between the tax structure and the local economy is critical in determining the level of government expenditures that can be supported. In general terms, one can characterize a tax structure by dividing it into *income-based taxes, sales and consumption taxes, and real property taxes.*

1. **Income-based taxes,** which include personal and business income taxes, are typically the most sensitive to the economy and will exhibit strong growth in economic expansions and sharp slowdowns in economic recessions.
2. **Sales and consumption taxes** generally show less volatility, yet still accelerate and slow down as the economy rises and falls.
3. **Real property taxes,** which in general grow at a fairly steady rate in both expansions and contractions, show the least responsiveness to the local economy.

Local governments typically raise about 75 percent of their tax revenues from the real property tax, about 20 percent from sales and consumption taxes, and the remainder from income taxes.
In a period of sharp economic expansion, this traditional structure will show limited acceleration in growth. If the growth in the economy creates strong demands for growth in expenditures, this revenue structure will create sizeable budget pressures. On the other hand, in a period of economic decline, this revenue structure will show a very limited decrease.

Obviously, complete stability is not the sole desirable characteristic of a revenue structure. The ability to grow with the economy, low cost of collection, and reasonable assurance that poor taxpayers do not bear a disproportionate share of the tax burden are also important. A predominantly stable expenditure structure with a volatile tax structure is prone to substantial deficits in economic recessions.

Expenditure Structure

The structure of the expenditure side of the budget is a characterization of the types of services that are produced. What types of spending grow faster than the economy and what types grow more slowly? Personnel costs for police, fire, corrections, and sanitation are services commonly provided by local governments and may be loosely characterized as "fundamental" local services that citizens expect to receive routinely wherever they live. A further refinement of the data might add water and sewer spending, emergency medical services, and possibly some portions of public hospital services or transportation services, among others. Debt service includes interest and principal for city general obligation short-term and long-term debt.

Structural Balance

Structural balance describes the situation in which the structure of the revenue budget and the structure of the expenditure budget are sufficiently complementary; of similar size and growth rate over time. Without structural balance, deficits will persist and will overwhelm any surpluses created in years of exceptional economic strength.

Since budgets must balance each year, structural deficits will often be financed with nonrecurring revenues or deferrals of expenses, which are not part of the structure of the budget and therefore do not contribute to restoring structural balance. To the extent that temporary or non-recurring revenues or expenditure savings are used to restore recurring expenses, however, the financial plan will not be structurally balanced and the re-established service levels will not be sustainable over time. Therefore, budget-balancing efforts like those that merely slipped costs would not be considered restructuring of expenditures or revenues.

Structural balance can be restored only by changing the revenue structure so that recurring revenues are larger and/or grow more rapidly over time, or by changing the expenditure structure so that recurring expenditures are smaller and/or grow more slowly over time. In the past, expenditures have been restructured by changing the types of services that the city provides, such as scaling back on capital spending or shifting some social services expenses to the state or federal government.

5.605 Critical Factors in Creating and Maintaining Structural Balance

Structural balance is a moving target that requires continual re-evaluation and high-level attention on a permanent basis. Sustained effort, or stability in basic services, means avoiding not only sharp spending reductions during economic downturns but also sharp expansions when the economy is growing rapidly, and tax revenues are yielding budget surpluses.

To achieve such stability requires a meticulous approach to financial planning and fiscal management, and the ability to restrain spending and set aside surpluses in good times for use in maintaining basic services in difficult times.

Sustaining Multi-Year Plans

One of the most difficult tasks in governmental fiscal management is sustaining a multi-year plan. The demand for services will always exceed the ability to provide these services so that there is a constant competition for resources. Multi-year plans are also difficult to sustain because they are effectuated by a budget appropriation process that deals with just one year at a time. A multi-year undertaking that is initiated in one adopted budget could be canceled in any successive adopted budget. Thus, legally the financial commitment has at most a one-year horizon. The inherent difficulty of sustaining financial commitments over a multi-year framework is, of course, compounded when elections change the council or the administration changes.

Avoiding Overexpansion

Overexpansion during periods of strong economic growth is one of the primary causes of structural imbalance and therefore must be avoided. The difficulty is that, in an urban environment with strong demands for services, avoiding expansion beyond the sustainable financial capacity of the revenue structure means that some service demands must be denied even when current funding is available. The reason is that new, recurrent spending can be funded for only that brief time in which the local economy is at its maximum growth over the business cycle. When that growth tapers off, the tax revenues supporting that spending will quickly disappear.

If overexpansion is inevitable, several factors could make it less consequential. The first would be a well-defined sense of basic fundamental services that should be provided at all points in the business cycle versus optional services that will be temporarily provided during flush times and jettisoned during declines. The second would be a well-developed contingency planning process that incorporated plans to expand temporarily when unanticipated funds materialized as well as plans to contract temporarily when anticipated funds failed to materialize. The third would be a well-developed stabilization reserve or rainy-day fund that accumulated revenues in each year of expansion for use in years of contraction or other mechanisms to stabilize finances.

Adequate Funding of Stabilization Reserves
Once a balanced structure of revenues and expenditures is established, the structure must be preserved during economic declines. As a result, funding must be available to support basic expenditures without the need to change the revenue structure. The amount of funding that would be adequate to achieve this stability is difficult to establish but certain parameters are clear. Money set aside in a stabilization fund must be utilized to maintain the basic expenditure structure during an economic downturn, not to sustain overexpansion as the downturn begins to emerge.

5.606 Purpose of Fund Balance and Working Capital

As previously described, fund balance and working capital are the best measures of a fund's financial position for governmental funds and enterprise funds, respectively. A fund's financial position basically reflects the net available resources of a fund. It is necessary for governments to maintain adequate levels of available resources (also referred to as reserves) in their funds for a variety of reasons. Reserves, act like a shock absorber, guarding against unforeseen events. Listed below are the primary reasons governments need to maintain reserves in their operating funds:

- To mitigate revenue shortfalls.
- To mitigate unanticipated expenditures.
- To ensure stable tax rates.
- To assist in long---term financial planning.
- Cash flow purposes.
- Equipment acquisition and replacement.
- Credit rating agencies monitor fund balance & working capital levels to evaluate a government's continued creditworthiness. The result of their analysis is often reflected in their bond ratings.

As described by the Government Finance Officers' Association, those interested primarily in a government's creditworthiness or economic condition (e.g., rating agencies) are likely to favor increased levels of fund balance. Opposing pressures often come from unions, taxpayers and citizens' groups, which may view high levels of fund balance as "excessive."

5.607 What Level of Fund Balance Should be Maintained?

If a government is going to evaluate its financial position, the natural question is, what should the city's financial position be? There is no right or wrong answer to this question. Furthermore, the answer is dependent upon the fund in question, the type of revenues of the fund, the type of expenditures of the fund, and a sense of the local government's future needs.

State law 7-6-4034(2)(b) MCA places a limit on the amount of reserve a city may budget for its tax supported funds equal to 50% of the total amount appropriated and authorized to be spent from the fund during the current fiscal year. Therefore, if the city council appropriates $500,000 from its general fund, the maximum balance the city may include in its general fund budget is $250,000.

Some simple principles will assist the finance professional and the city council with gauging whether or not they have adequate reserve levels. The higher the volatility of a fund's revenues or expenditures, the higher the reserve levels are prudent. Conversely, the more stable the revenues and expenditures of a fund, the less reserve levels are needed. Higher reserve levels are needed for enterprise funds, due to the fact that they are infrastructure intense. Infrastructure needs are not only costly, but generally they are sporadic as well, thus resulting in wide swings in the financial position of enterprise funds, requiring higher peaks (and possibly lower troughs) in the reserve levels. Funds that are personnel intense (those consisting primarily of city staff), require a lesser reserve level, because of the stability and predictability of the expenditures. As a general rule, the city's general fund will consist mainly of personnel and the principal revenue source will be property taxes, both of which are highly predictable.

As stated previously, the trend of a fund's financial position is much more important than the absolute value. The key element in managing the city's financial position is to ensure future revenue sources are sufficient to adequately fund future expenditure needs and to do so with a minimum amount of disruption to normal operations. A well-managed city will have a very good understanding of the volatility or stability of its revenue and expenditures in each of its funds, as well as a good understanding of its future capital needs. A Capital Improvement Plan is one of the very best ways of addressing these responsibilities.

The Government Finance Officers' Association (GFOA) routinely disseminates recommended practices to local government finance officers. The GFOA prepared a recommended practice on the level of general fund reserves in 2002 and 2009 and stated that the adequacy of unreserved fund balance be assessed based on a government's own specific circumstances. That being said, the GFOA went on to recommend that:

> *"…governments maintain an unreserved fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures… 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."*

Comparisons with other cities and towns can also provide a useful analysis to gauge the adequacy of a city or town's general fund reserves. The level of general fund balance can be stated as a percentage of general fund expenditures, thus allowing comparisons to any city, regardless of size. However, because of similarities in tax structure and services offered, it is most useful to compare fund balance levels with other Montana cities of similar size or possibly look to some of the larger cities for guidance.

Attachment 5.3
Model Financial Trend Monitoring Graphs