

This letter contains redacted information which refers to details of control weaknesses that were communicated to locality management and governance but are FOIAE under Code of Virginia §2.2-3705.2 due its sensitivity and description of security controls or mechanisms.

**TOWN OF WARRENTON, VIRGINIA**

**COMMENTS ON INTERNAL CONTROL AND  
OTHER SUGGESTIONS FOR YOUR CONSIDERATION**

**June 30, 2018**



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## INDEPENDENT AUDITOR'S REPORT ON COMMENTS AND SUGGESTIONS

To the Honorable Members of the Town Council  
Town of Warrenton, Virginia

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Town of Warrenton, Virginia (the "Town") as of and for the year ended June 30, 2018, in accordance with auditing standards generally accepted in the United States of America, we considered its internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in circumstances for the purpose of expressing our opinion on the financial statements and to comply with any other applicable standards, such as *Government Auditing Standards*, but not for the purpose of expressing an opinion on the effectiveness of the Town's internal control. Accordingly, we do not express an opinion on the effectiveness of the Town's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. 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. A *significant deficiency* is 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.

If material weaknesses or significant deficiencies were identified during our procedures they are appropriately designated as such in the *Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards* which should be read in conjunction with this report.

Additionally, during our audit, we may have become aware of certain other matters that provide opportunities for improving your financial reporting system and/or operating efficiency. Such comments and suggestions regarding these matters are included in the attached report, but are not designated as a material weakness or significant deficiency. Since our audit is not designed to include a detail review of all systems and procedures, these comments should not be considered as being all-inclusive of areas where improvements might be achieved. We also have included information on accounting and other matters that we believe is important enough to merit consideration by management and those charged with governance. It is our hope that our suggestions will be taken in the constructive light in which they are offered.

We have already discussed these comments and suggestions with management, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

This communication is intended solely for the information and use of the Town Council, management, and the appropriate state and federal agencies and is not intended to be, and should not be, used by anyone other than these specified parties.

*Brown, Edwards & Company, L.L.P.*

CERTIFIED PUBLIC ACCOUNTANTS

Roanoke, Virginia  
November 28, 2018

## PRIOR YEAR COMMENTS AND SUGGESTIONS

### SEGREGATION OF DUTIES (Significant Deficiency in 2017, Control Deficiency in 2018)

One of the most important aspects of any internal control system is the segregation of duties. In an ideal system of internal controls, no individual would perform more than one duty in connection with any transaction or series of transactions. In particular, no one individual should have access to both physical assets and the related accounting records. Such access may allow errors or irregularities to occur and either be concealed or remain undetected.

Decisions about controls and processes always should be made in the light of the net benefit of the various solutions – and there may be times when management concludes that the cost of a control is not worth its benefit. Areas where improvements could be made are as follows:

- The Accounting Supervisor has the ability to initiate and approve wire transfers, responsible for preparing the bank reconciliation, and complete general ledger access. Ideally an individual with general ledger access would not prepare bank reconciliations and initiate wires.
- The payroll technician has the ability to add employees, modify pay rates, and then process payroll. The individuals responsible for approving and recording payroll also have access to the employee master file. Ideally an individual independent of payroll processing, approving, and recording will add employees, make modifications to payroll information, and have access to the employee master file. Also, a payroll exception report that identifies any changes that is reviewed during approval process.
- The accounts payable technician has access to the vendor master file, access to blank check stock, records invoices, prepares checks for mailing, and controls mailing after checks are signed. The compensating control is that the technician is not an authorized signer. Ideally the individual responsible for recording and processing payables would not have access to the vendor master file and that would be handled by an individual independent of this process.
- Various employees have the ability to prepare bills, collect accounts receivable, post cash receipts to the accounts receivable subledger, and authorize write offs of delinquent accounts. We recommend those individuals with access to perform write-offs do not have access to collecting and posting cash receipts.
- The director of finance and human resources and accounting supervisor have administrative rights to the system, post and approve journal entries, as well as holding a key position in the finance department. We would recommend that administrative rights to system be held outside of the finance department. Also, those with the ability to approve journal entries would not have the ability to post those entries.

**Current status:** *During fiscal year 2018, the accounting supervisor and director of finance and human resources' ability to post journal entries were removed. The Town generates a wire transfer user report and all wires are now approved by the Town Manager prior to execution. In addition, a copy of the approved wire transfer is transferred included with all bank reconciliations. The Town implemented a payroll change report that identifies all payroll changes during the period that is reviewed during the payroll approval process. Also, the accounts payable technician's ability to modify the vendor master file was removed. A vendor request form must be completed and approved for the tax administrator to add new vendors. Finally, the accounting supervisor, accounting technician, and director of finance and human resources no longer have access to cash receipts. The remaining conditions still exist, however, the severity of these matters are no longer deemed a significant deficiency due to the controls implemented by the Town in the current year.*

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## **PRIOR YEAR COMMENTS AND SUGGESTIONS**

### **BANK RECONCILIATIONS**

During the audit, we noted that there is no formal review of bank reconciliations. We recommend that an individual other than the bank reconciliation preparer review the reconciliation for errors or unusual items and subsequently approve the reconciliation, once any questions are resolved.

We also noted where the reconciliation preparer does not formally date the reconciliation, as to the date it was prepared. We recommend the preparer date the reconciliation, once it is complete, to ensure that reconciliations are being performed timely, to assist in identifying and resolving any errors or unusual items.

**Current status:** *Recommendations were implemented during fiscal year 2018.*

### **APPROVAL OF JOURNAL ENTRIES**

During our review of a sample of ten general journal entries we noted five entries that lacked proper approval by an individual other than the preparer. Lack of review and approval increases the risk for unauthorized entries remaining undetected. We recommend all journal entries be reviewed and approved by an individual other than the preparer. All entries should be initialed by the preparer and the individual approving them in order to attribute responsibility to the appropriate individuals.

**Current status:** *Recommendations were implemented during fiscal year 2018.*

### **TRAVEL AND CREDIT CARD APPROVAL**

During our review of a sample of credit card and travel transactions, an instance was noted where the expenditure was not approved by an individual in a supervisory role. We recommended that all expenditures are approved by a supervisor and not a subordinate.

**Current status:** *No similar instances were noted during our testing in fiscal year 2018.*

### **WIRE TRANSFER AUTHORIZATION**

During our review of wires, it was noted that wire transfers can be initiated and executed without authorization from an employee in a supervisory role. We recommend that the Town require a supervisory employee to authorize a wire transfer, before it can be executed by an employee. We did note that detective controls are in place as notifications are received by an individual not involved in the transaction however that is after the transaction is complete.

**Current status:** *Recommendations to require supervisory approval of wires before execution was implemented during fiscal year 2018.*

## PRIOR YEAR COMMENTS AND SUGGESTIONS

### INVENTORY PROCEDURES

During our inventory observation, we noted where there were items at inventory locations that were not reflected in the accounting records or inventory listings. We recommend the Town implement procedures, such as regular test counts from the floor of inventory locations to the inventory listings, to ensure that all purchases of inventory are captured and recorded in the accounting records, to ensure the completeness and accuracy of inventory listings and accounting records.

We also noted where certain obsolete or older items of inventory were not clearly marked as obsolete, during our tour and test counts of inventory locations. We recommend the Town implement procedures to clearly mark these items as obsolete, so these items are not counted by Town employees and a value is not reflected in inventory listings and accounting records for items that have no value.

**Current status:** *Recommendations were implemented during fiscal year 2018.*

[REDACTED]

[REDACTED]

[REDACTED]

### ADDITIONAL OBSERVATIONS TO CONSIDER

During our procedures, we noted areas for improvement that can be considered while weighing the cost and benefit. We hope these suggestions are taken in the constructive light they are offered:

- It was noted that a formal method of communicating fraud, violations, or any other recommendations was not present. We would recommend a formal policy and possibly a fraud hotline that will provide an official avenue for communications.
- It was noted during inquiries that limited staffing created difficulties for timely financial reconciliation and reporting in certain areas. This is consistent with the segregation of duties comment above.

**Current status:** *Conditions still exist in fiscal year 2018, however, the Town is continuing to evaluate the suggestions.*

## ACCOUNTING AND OTHER MATTERS

### NEW GASB PRONOUNCEMENTS

In this section, we would like to make you aware of certain confirmed and potential changes that are on the horizon that may affect your financial reporting and audit.

The GASB issued **Statement No. 83, *Certain Asset Retirement Obligations*** in November 2016. This Statement addresses accounting and financial reporting for certain asset retirement obligations (AROs). An ARO is a legally enforceable liability associated with the retirement of a tangible capital asset. A government that has legal obligations to perform future asset retirement activities related to its tangible capital assets should recognize a liability based on the guidance in this Statement.

This Statement establishes criteria for determining the timing and pattern of recognition of a liability and a corresponding deferred outflow of resources for AROs. This Statement requires that recognition occur when the liability is both incurred and reasonably estimable. The determination of when the liability is incurred should be based on the occurrence of external laws, regulations, contracts, or court judgments, together with the occurrence of an internal event that obligates a government to perform asset retirement activities. Laws and regulations may require governments to take specific actions to retire certain tangible capital assets at the end of the useful lives of those capital assets, such as decommissioning nuclear reactors and dismantling and removing sewage treatment plants. Other obligations to retire tangible capital assets may arise from contracts or court judgments. Internal obligating events include the occurrence of contamination, placing into operation a tangible capital asset that is required to be retired, abandoning a tangible capital asset before it is placed into operation, or acquiring a tangible capital asset that has an existing ARO.

This Statement requires the measurement of an ARO to be based on the best estimate of the current value of outlays expected to be incurred. The best estimate should include probability weighting of all potential outcomes, when such information is available or can be obtained at reasonable cost. If probability weighting is not feasible at reasonable cost, the most likely amount should be used. This Statement requires that a deferred outflow of resources associated with an ARO be measured at the amount of the corresponding liability upon initial measurement.

This Statement requires the current value of a government's AROs to be adjusted for the effects of general inflation or deflation at least annually. In addition, it requires a government to evaluate all relevant factors at least annually to determine whether the effects of one or more of the factors are expected to significantly change the estimated asset retirement outlays. A government should remeasure an ARO only when the result of the evaluation indicates there is a significant change in the estimated outlays. The deferred outflows of resources should be reduced and recognized as outflows of resources (for example, as an expense) in a systematic and rational manner over the estimated useful life of the tangible capital asset.

A government may have a minority share (less than 50 percent) of ownership interest in a jointly owned tangible capital asset in which a nongovernmental entity is the majority owner and reports its ARO in accordance with the guidance of another recognized accounting standards setter. Additionally, a government may have a minority share of ownership interest in a jointly owned tangible capital asset in which no joint owner has a majority ownership, and a nongovernmental joint owner that has operational responsibility for the jointly owned tangible capital asset reports the associated ARO in accordance with the guidance of another recognized accounting standards setter. In both situations, the government's minority share of an ARO should be reported using the measurement produced by the nongovernmental majority owner or the nongovernmental minority owner that has operational responsibility, without adjustment to conform to the liability measurement and recognition requirements of this Statement.

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## ACCOUNTING AND OTHER MATTERS

In some cases, governments are legally required to provide funding or other financial assurance for their performance of asset retirement activities. This Statement requires disclosure of how those funding and assurance requirements are being met by a government, as well as the amount of any assets restricted for payment of the government's AROs, if not separately displayed in the financial statements.

This Statement also requires disclosure of information about the nature of a government's AROs, the methods and assumptions used for the estimates of the liabilities, and the estimated remaining useful life of the associated tangible capital assets. If an ARO (or portions thereof) has been incurred by a government but is not yet recognized because it is not reasonably estimable, the government is required to disclose that fact and the reasons therefor. This Statement requires similar disclosures for a government's minority shares of AROs.

***The requirements of this Statement are effective for periods beginning after June 15, 2018.***

The GASB issued **Statement No. 84, *Fiduciary Activities*** in January 2017. The objective of this Statement is to improve guidance regarding the identification of fiduciary activities for accounting and financial reporting purposes and how those activities should be reported.

This Statement establishes criteria for identifying fiduciary activities of all state and local governments. The focus of the criteria generally is on (1) whether a government is controlling the assets of the fiduciary activity and (2) the beneficiaries with whom a fiduciary relationship exists. Separate criteria are included to identify fiduciary component units and postemployment benefit arrangements that are fiduciary activities.

An activity meeting the criteria should be reported in a fiduciary fund in the basic financial statements. Governments with activities meeting the criteria should present a statement of fiduciary net position and a statement of changes in fiduciary net position. An exception to that requirement is provided for a business-type activity that normally expects to hold custodial assets for three months or less.

This Statement describes four fiduciary funds that should be reported, if applicable: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds generally should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria.

A fiduciary component unit, when reported in the fiduciary fund financial statements of a primary government, should combine its information with its component units that are fiduciary component units and aggregate that combined information with the primary government's fiduciary funds.

This Statement also provides for recognition of a liability to the beneficiaries in a fiduciary fund when an event has occurred that compels the government to disburse fiduciary resources. Events that compel a government to disburse fiduciary resources occur when a demand for the resources has been made or when no further action, approval, or condition is required to be taken or met by the beneficiary to release the assets.

***The requirements of this Statement are effective for periods beginning after December 15, 2018.***

## ACCOUNTING AND OTHER MATTERS

The GASB issued **Statement No. 87, *Leases*** in June 2017. The objective of this Statement is to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments. This Statement increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under this Statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources, thereby enhancing the relevance and consistency of information about governments' leasing activities.

### ***Definition of a Lease***

A lease is defined as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction. Examples of nonfinancial assets include buildings, land, vehicles, and equipment. Any contract that meets this definition should be accounted for under the leases guidance, unless specifically excluded in this Statement.

### ***Lease Term***

The lease term is defined as the period during which a lessee has a noncancelable right to use an underlying asset, plus the following periods, if applicable:

- a. Periods covered by a lessee's option to extend the lease if it is reasonably certain, based on all relevant factors, that the lessee will exercise that option.
- b. Periods covered by a lessee's option to terminate the lease if it is reasonably certain, based on all relevant factors, that the lessee will not exercise that option.
- c. Periods covered by a lessor's option to extend the lease if it is reasonably certain, based on all relevant factors, that the lessor will exercise that option.
- d. Periods covered by a lessor's option to terminate the lease if it is reasonably certain, based on all relevant factors, that the lessor will not exercise that option.

A fiscal funding or cancellation clause should affect the lease term only when it is reasonably certain that the clause will be exercised.

Lessees and lessors should reassess the lease term only if one or more of the following occur:

- a. The lessee or lessor elects to exercise an option even though it was previously determined that it was reasonably certain that the lessee or lessor would not exercise that option.
- b. The lessee or lessor elects not to exercise an option even though it was previously determined that it was reasonably certain that the lessee or lessor would exercise that option.
- c. An event specified in the lease contract that requires an extension or termination of the lease takes place.

## ACCOUNTING AND OTHER MATTERS

### ***Short-Term Leases***

A short-term lease is defined as a lease that, at the commencement of the lease term, has a maximum possible term under the lease contract of 12 months (or less), including any options to extend, regardless of their probability of being exercised. Lessees and lessors should recognize short-term lease payments as outflows of resources or inflows of resources, respectively, based on the payment provisions of the lease contract.

### ***Lessee Accounting***

A lessee should recognize a lease liability and a lease asset at the commencement of the lease term, unless the lease is a short-term lease or it transfers ownership of the underlying asset. The lease liability should be measured at the present value of payments expected to be made during the lease term (less any lease incentives). The lease asset should be measured at the amount of the initial measurement of the lease liability, plus any payments made to the lessor at or before the commencement of the lease term and certain direct costs.

A lessee should reduce the lease liability as payments are made and recognize an outflow of resources (for example, expense) for interest on the liability. The lessee should amortize the lease asset in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset. The notes to financial statements should include a description of leasing arrangements, the amount of lease assets recognized, and a schedule of future lease payments to be made.

### ***Lessor Accounting***

A lessor should recognize a lease receivable and a deferred inflow of resources at the commencement of the lease term, with certain exceptions for leases of assets held as investments, certain regulated leases, short-term leases, and leases that transfer ownership of the underlying asset. A lessor should not derecognize the asset underlying the lease. The lease receivable should be measured at the present value of lease payments expected to be received during the lease term. The deferred inflow of resources should be measured at the value of the lease receivable plus any payments received at or before the commencement of the lease term that relate to future periods.

A lessor should recognize interest revenue on the lease receivable and an inflow of resources (for example, revenue) from the deferred inflows of resources in a systematic and rational manner over the term of the lease. The notes to financial statements should include a description of leasing arrangements and the total amount of inflows of resources recognized from leases.

### ***Contracts with Multiple Components and Contract Combinations***

Generally, a government should account for the lease and nonlease components of a lease as separate contracts. If a lease involves multiple underlying assets, lessees and lessors in certain cases should account for each underlying asset as a separate lease contract. To allocate the contract price to different components, lessees and lessors should use contract prices for individual components as long as they do not appear to be unreasonable based on professional judgment, or use professional judgment to determine their best estimate if there are no stated prices or if stated prices appear to be unreasonable. If determining a best estimate is not practicable, multiple components in a lease contract should be accounted for as a single lease unit. Contracts that are entered into at or near the same time with the same counterparty and that meet certain criteria should be considered part of the same lease contract and should be evaluated in accordance with the guidance for contracts with multiple components.

## ACCOUNTING AND OTHER MATTERS

### *Lease Modifications and Terminations*

An amendment to a lease contract should be considered a lease modification, unless the lessee's right to use the underlying asset decreases, in which case it would be a partial or full lease termination. A lease termination should be accounted for by reducing the carrying values of the lease liability and lease asset by a lessee, or the lease receivable and deferred inflows of resources by the lessor, with any difference being recognized as a gain or loss. A lease modification that does not qualify as a separate lease should be accounted for by remeasuring the lease liability and adjusting the related lease asset by a lessee and remeasuring the lease receivable and adjusting the related deferred inflows of resources by a lessor.

### *Subleases and Leaseback Transactions*

Subleases should be treated as transactions separate from the original lease. The original lessee that becomes the lessor in a sublease should account for the original lease and the sublease as separate transactions, as a lessee and lessor, respectively.

A transaction qualifies for sale-leaseback accounting only if it includes a sale. Otherwise, it is a borrowing. The sale and lease portions of a transaction should be accounted for as separate sale and lease transactions, except that any difference between the carrying value of the capital asset that was sold and the net proceeds from the sale should be reported as a deferred inflow of resources or a deferred outflow of resources and recognized over the term of the lease.

A lease-leaseback transaction should be accounted for as a net transaction. The gross amounts of each portion of the transaction should be disclosed.

***The requirements of this Statement are effective for periods beginning after December 15, 2019.***

The GASB issued **Statement No. 88, *Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements*** in March 2018. The primary objective of this Statement is to improve the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements. It also clarifies which liabilities governments should include when disclosing information related to debt.

This Statement defines debt for purposes of disclosure in notes to financial statements as a liability that arises from a contractual obligation to pay cash (or other assets that may be used in lieu of cash) in one or more payments to settle an amount that is fixed at the date the contractual obligation is established.

This Statement requires that additional essential information related to debt be disclosed in notes to financial statements, including unused lines of credit; assets pledged as collateral for the debt; and terms specified in debt agreements related to significant events of default with finance-related consequences, significant termination events with finance-related consequences, and significant subjective acceleration clauses.

For notes to financial statements related to debt, this Statement also requires that existing and additional information be provided for direct borrowings and direct placements of debt separately from other debt.

***The requirements of this Statement are effective for periods beginning after June 15, 2018.***

## ACCOUNTING AND OTHER MATTERS

The GASB issued **Statement No. 89, *Accounting for Interest Cost Incurred before the End of a Construction Period*** in June 2018. The objectives of this Statement are (1) to enhance the relevance and comparability of information about capital assets and the cost of borrowing for a reporting period and (2) to simplify accounting for interest cost incurred before the end of a construction period.

This Statement establishes accounting requirements for interest cost incurred before the end of a construction period. Such interest cost includes all interest that previously was accounted for in accordance with the requirements of paragraphs 5–22 of Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which are superseded by this Statement. This Statement requires that interest cost incurred before the end of a construction period be recognized as an expense in the period in which the cost is incurred for financial statements prepared using the economic resources measurement focus. As a result, interest cost incurred before the end of a construction period will not be included in the historical cost of a capital asset reported in a business-type activity or enterprise fund.

This Statement also reiterates that in financial statements prepared using the current financial resources measurement focus, interest cost incurred before the end of a construction period should be recognized as an expenditure on a basis consistent with governmental fund accounting principles.

***The requirements of this Statement are effective for periods beginning after December 15, 2019. The requirements of this Statement should be applied prospectively.***

The GASB issued **Statement No. 90, *Major Equity Interests, an amendment of GASB Statements No. 14 and No. 61*** in August 2018. This Statement improves the consistency and comparability of reporting a government's majority equity interest in a legally separate organization and improves the relevance of financial statement information for certain component units. It defines a majority equity interest and specifies that a majority equity interest in a legally separate organization should be reported as an investment if a government's holding of the equity interest meets the definition of an investment. A majority equity interest that meets the definition of an investment should be measured using the equity method, unless it is held by a special-purpose government engaged only in fiduciary activities, a fiduciary fund, or an endowment (including permanent and term endowments) or permanent fund. Those governments and funds should measure the majority equity interest at fair value.

For all other holdings of a majority equity interest in a legally separate organization, a government should report the legally separate organization as a component unit, and the government or fund that holds the equity interest should report an asset related to the majority equity interest using the equity method. This Statement establishes that ownership of a majority equity interest in a legally separate organization results in the government being financially accountable for the legally separate organization and, therefore, the government should report that organization as a component unit.

This Statement also requires that a component unit in which a government has a 100 percent equity interest account for its assets, deferred outflows of resources, liabilities, and deferred inflows of resources at acquisition value at the date the government acquired a 100 percent equity interest in the component unit. Transactions presented in flows statements of the component unit in that circumstance should include only transactions that occurred subsequent to the acquisition.

***The requirements of this Statement are effective for periods beginning after December 15, 2018. The requirements should be applied retroactively, except for the provisions related to (1) reporting a majority equity interest in a component unit and (2) reporting a component unit if the government acquires a 100 percent equity interest. Those provisions should be applied on a prospective basis.***

## ACCOUNTING AND OTHER MATTERS

### GOVERNMENTAL INDUSTRY UPDATES

#### SUPREME COURT LEVELS PLAYING FIELD FOR RETAILERS

On June 21, in a 5-4 decision, the Supreme Court overturned precedent in favor of state and local governments in a major tax case, *South Dakota v. Wayfair*. The court said governments can require remote retailers with no physical presence in their state to collect and remit sales taxes.

The ruling follows what local governments viewed as years of congressional inaction on discrepancies between the tax treatment of online retailers versus “Main Street,” or brick-and-mortar businesses.

The case produced curious alliances, with Justice Anthony Kennedy writing the majority opinion and being joined by Justices Ruth Bader Ginsberg, Samuel Alito, Neil Gorsuch, and Clarence Thomas. Chief Justice John Roberts wrote for the minority and was joined by Justices Stephen Breyer, Sonia Sotomayor, and Elena Kagan.

#### *What the Supreme Court Said*

The majority said the requirement of physical presence for tax purposes established in *National Bellas Hess v. Illinois* (1967) and affirmed in *Quill v. North Dakota* (1992) was both “unsound and incorrect.” The majority said that in today’s growing e-commerce environment, the physical presence test was an unnecessarily strict threshold for determining whether a state or local government can require sales tax collection from a retailer.

In addition, while the physical presence test was meant to prevent discrimination between intrastate and interstate commerce, it effectively discriminated by creating a tax shelter for businesses that sell goods and services to the state’s consumers, but do not maintain a physical presence in the state.

There is one important caveat to the ruling, which is otherwise a significant win for local governments. The case has been remanded to South Dakota courts for further proceedings, meaning that South Dakota’s taxation law is still subject to other aspects of Commerce Clause review.

In particular, the South Dakota courts may consider whether the taxation scheme places undue burden on online retailers. The Government Finance Officers Association’s federal liaison center noted that the court emphasized that the question of undue burden on businesses has not yet been resolved.

#### *Impact on Local Governments*

Forty-five states impose a sales tax. Only Alaska, Delaware, Montana, New Hampshire, and Oregon do not. In addition, local sales taxes are collected in 38 states. Sales tax is the second-largest revenue source for counties nationwide, and uniform enforcement and collection is a top priority for county governments.

The ruling is expected to result in anywhere from \$8 billion to \$33.9 billion in additional annual sales tax revenue for state and local governments. The large variation is based on estimates from different survey groups. For instance, the Government Accounting Office estimates state and local governments lose \$8 billion to \$13.4 billion a year in uncollected taxes from online sales, while the International Council of Shopping Centers and the National Conference of State Legislatures estimated in 2015 that the difference in treatment of state and local governments cost \$26 billion.

Some deviation in potential receipts is expected in the near term because not all states have set a date when they will implement the Supreme Court ruling.

## ACCOUNTING AND OTHER MATTERS

### *Impact on Local Governments (Continued)*

The National League of Cities suggests that, in the future, having a substantial economic presence in a state will likely be sufficient grounds for a state and local government to require a retailer to collect and remit sales taxes. It is important to remember that the case is not about imposing new taxes on retailers, but rather about treating businesses similarly, allowing state and local governments to collect billions in lost revenue each year.

### *Moving Forward*

Some states have been working on laws similar to South Dakota's, and more will take up the issue as a result of the *Wayfair* decision. Local governments can work with their state municipal leagues, county associations, and state legislatures to ensure that methods for collecting local sales taxes are included in any proposed legislation.

Twenty-four states have adopted the Streamlined Sales and Use Tax Agreement, which offers a model for how states can simplify and centralize their tax collection methods. More states are expected to adopt the agreement.

The agreement is a cooperative effort of 44 states, the District of Columbia, local governments, and the business community to simplify and make more uniform the sales and use tax collection and administration by retailers and states. The agreement minimizes costs and administrative burdens on retailers that collect sales tax and encourages "remote sellers" to collect tax in states that have adopted it.

Information on the agreement and which states have adopted it can be found at <http://www.streamlinedsalestax.org/>.

### *Conclusion*

The recently decided *Wayfair* case has been remanded for further proceedings not inconsistent with the court's opinion. While it is worthwhile for local governments to move forward with activities related to encouraging state or local action with respect to sales tax collection, tax and legal professionals will need time to digest the opinion and consider its application in different scenarios.

Also, to the extent states wish to adopt tax statutes like South Dakota's, it will bear watching to see whether other applications of Commerce Clause review will invalidate all or some of South Dakota's law.

It is still possible that Congress will take action addressing the issue of online taxation. Local governments should monitor congressional developments and be prepared to make their views known if legislation begins to move this fall.

## STATE AND LOCAL PENSIONS IN CONTEXT: HISTORY AND CURRENT TRENDS

Addressing the budgetary effects of current and future pension obligations is high on the list of concerns for local government financial officers and elected officials. While retirement system costs remain a relatively small portion of state and local government budgets (on average 4 to 9 percent), more than 40 percent of cities reported a rise in costs associated with pensions in the last year.

A recent National League of Cities [survey](#) found that the cost of employee/retiree pensions ranks third – after infrastructure and public safety needs – as the most negative factor affecting city budgets.

In addition to the growing costs and fees associated with pension funds, local governments face demographic challenges in reaching or sustaining full funding because fewer active workers are available to provide contributions that support benefit payments to current retirees.

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## ACCOUNTING AND OTHER MATTERS

Currently, the U.S. averages 1.53 current state or local government workers to 1 retiree. However, there is a lot of variation, and some states – Nebraska, Texas, and Utah – have more than two active workers per retiree, while others have less than one worker per retiree (Alaska, Michigan, and Pennsylvania).

Local governments need to carefully evaluate their investment strategies to address these challenges.

### *Pension Composition and Investment History*

Beginning in the 1970s, state and local pension funds began to take steps to advance-fund their pensions. Public pension plans started shifting funds away from low-risk, fixed-income investments to equities and alternative investments. According to the Urban Institute, pension plans receive most of their annual income from investments rather than contributions. In 2013, 71 percent of total pension plan revenue came from net investment earnings, 20 percent came from employer contributions, and 8 percent came from employee contributions.

Alternative investments include private equity, hedge funds, real estate, and commodities. These can be more difficult to value than stocks or bonds and generally carry higher fees. They can be used to diversify investment portfolios or achieve higher rates of return, but also come with higher levels of risk.

Many public plans exceeded their investment return targets in the 1990s, and by 2000, most public plans were nearly 100 percent funded. Unfortunately, the last decade of economic upheaval and stock market volatility reduced pension assets and rates of return. This led to higher pension costs for state and local budgets, and resulted in pension plans no longer being fully funded.

### *Alternative Investments and Pension Yields*

State-sponsored pension plans, in which many local governments participate rather than maintain their own plans, use a wide range of investment strategies. A 2017 Pew Charitable Trusts [survey](#) of investment data for the 73-largest public funds found that use of alternative investments ranges from zero to more than 50 percent of fund portfolios, depending on the fund. Several public pension funds surveyed are interesting noteworthy for their investments and returns.

For example, the Washington Department of Retirement Systems (WDRS) is among the highest-performing public funds. WDRS, one of the earliest adopters of alternative investments, began investing in private equities in 1981. In 2014, the WDRS had 36.3 percent of total investments in alternative asset classes, including 22.3 percent in private equity, 12.4 percent in real estate, and 1.6 percent in other alternatives. Notably, it does not hold any hedge funds. Because of its holdings, WDRS's 10-year returns were among the highest in the data Pew surveyed, reaching 7.6 percent in 2015.

By comparison, the three funds with the weakest 10-year performance made some of the largest and most recent shifts to alternative investments. Additionally, their hedge fund allocations are significantly more than the hedge fund allocations for WDRS. An independent audit of the South Carolina Retirement System's (SCRS), one of the three funds with the weakest performance, suggests that rapid diversification into alternative investments with large hedge fund investment was overly challenging for a new, under-resourced program.

By way of further comparison, some plans, unlike WDRS or SCRS, have consistently achieved relatively high returns without a heavy reliance on alternatives. The two Oklahoma state-sponsored retirement systems in the Pew survey are robust examples of this approach. One of the plans has lower-than-average allocations to alternatives while the other holds no alternatives, yet both plans have performed better than the average fund performance of 6.6 percent over 10 years.

(Continued)

## ACCOUNTING AND OTHER MATTERS

The Oklahoma Teachers Retirement System (OTRS) had a 10-year return of 8.3 percent in 2015 and holds only 17 percent of its assets in alternatives, well below the average of 25 percent. Diversifying within its equity portfolio, employing low-fee strategies, and cutting operating costs are key features of its overall strategy.

The Oklahoma Public Employees Retirement System (OPERS), on the other hand, holds no alternative investments. OPERS's investment principles are guided by long investment horizons and a focus on long-term results. The system incorporates diversification passive investment management, except in less-efficient markets where it implements a more active strategy.

### ***Long-Term Fiscal Benefit***

Local officials should understand the specific pension needs of their communities and how to evaluate the health of their individual plans. In addition, they should understand not only the investment vehicles they choose for plans they administer, but also the investment vehicles of their state plans and how their experience compares to other states. In this way they can make better-informed decisions and influence the path forward for their investments to meet the challenges pension plan funding poses to local budgets.

## **KENTUCKY TAKES NEW ROUTE TO WIDER BROADBAND ACCESS**

Many Americans, especially those in poor or rural areas, do not have access to high-speed internet services – at a time when wireless connectivity is becoming an integral part of everyday life.

FCC Chairman Ajit Pai announced in January that he was seeking an additional \$500 million to be used to bring down the cost of deployment in high-cost rural areas and that he was seeking reforms in the high-cost program to promote efficiency while minimizing potential abuse. “We need more deployment in sparsely populated rural areas if we are going to extend deployment to all Americans,” Pai said.

Groups like the National League of Cities, National Association of Counties, and the National Association of Towns and Townships agree that both rural America and poor urban areas suffer from significant gaps in accessibility. These groups, in concert with the National Association of Telecommunications Officers and Advisors and others, have long advocated for more funding and better legislative solutions, whether at the FCC, in Congress or in various states.

The groups also lobby for the ability of local governments to provide broadband services, much as they do other utilities and infrastructure, such as water and sewer, electricity, roads, and bridges.

However, the legislatures in approximately 20 states have chosen to restrict or prohibit elected leaders from acting to improve coverage for their businesses and residents. Kentucky is not one of those states.

## ACCOUNTING AND OTHER MATTERS

### *Kentucky Promotes Public-Private Partnership*

The public-private partnership Kentucky has created may serve as a model for governments in other states to bring broadband to underserved communities, whether at the state or local level. KentuckyWired plans to bring high-speed access to the entire state, including its most underserved and geographically inaccessible areas.

Kentucky's abundant limestone and dolomite deposits make burying cable or fiber a challenge. The Appalachian Mountains also present obstacles for stringing wire over poles, making it financially infeasible for most private telecommunications companies to provide service.

While residents in some areas may be able to access social media or even stream videos, for much of the state – east Kentucky in particular – the broadband infrastructure can't support high-tech business ventures or educational needs that rely on high-speed internet capacity.

KentuckyWired's goal is to provide the “middle mile” of broadband infrastructure for all 120 counties, without becoming an internet service provider. KentuckyWired expects to give direct broadband access to public schools and universities, state agencies, and other public institutions, while leasing access to private interests. To date, the project has built out about 600 miles of fiber and acquired leases for 50,000 of the 59,000 poles it needs for attachment.

Progress has been slowed because of delays in obtaining the necessary approvals from local governments and telecommunications providers alike. The slow roll has caused Kentucky taxpayers to assume the added contractual costs related to the delays. However, supporters hope once negotiations for the final portions of the project are complete, KentuckyWired will showcase the state as a technological pioneer in the provision of low-cost broadband services.

KentuckyWired may have its problems and cost overruns, but its potential transformative value is enormous. If successful, it will be a model to address the problem local elected officials face in working with telecommunications providers, whose financial interests cannot directly support an infrastructure investment. A well-structured public-private partnership, whether local, regional, or statewide, may provide a solution.

## CPAs and cybersecurity: Helping you build trust and transparency

Stolen data. System shutdowns. Widely publicized breaches. High-dollar lawsuits.

Is your organization prepared for a cybersecurity attack? Boards of directors, senior management and other stakeholders are requesting more information than ever before about organizations' cybersecurity risk management programs.

Using the AICPA's SOC for Cybersecurity framework, CPAs can provide assurance over the effectiveness of controls within your organization's cybersecurity risk management program, helping build trust and transparency for customers, investors and leadership.



4 of the leading 13 information security and cybersecurity consultants are CPA firms.

CPA firms deploy multidisciplinary teams composed of licensed CPAs and information technology and security specialists to ensure a comprehensive and thorough evaluation of your cybersecurity risk management program and its effectiveness in meeting your organization's cybersecurity objectives.

## What is SOC for Cybersecurity?

The SOC for Cybersecurity examination provides an independent, entity-wide assessment of your organization's cybersecurity risk management program.

- Appropriate for businesses, not-for-profits and virtually any other type of organization
- Helps reduce uncertainty and build resilient organizations by evaluating effectiveness of existing cybersecurity processes and controls
- Permits flexibility by not constraining management to a particular security management framework or control framework
- Results in a general use report on whether:
  - The description of an entity's cybersecurity risk management program is presented in accordance with description criteria and
  - The controls within that program were effective in achieving the entity's cybersecurity objectives



# 62%

of executives expect to see an increase in reporting requests from their board of directors on cybersecurity program effectiveness.

(Source: Deloitte, 2018. "Corporate Boards May Be More Likely Than Regulators to Scrutinize Cybersecurity Program Effectiveness This Year.")

# AICPA cybersecurity risk management reporting framework

The AICPA cybersecurity risk management reporting framework helps organizations communicate about the effectiveness of their cybersecurity risk management programs via three components:

- **Description Criteria for Management's Description of an Entity's Cybersecurity Risk Management Reporting Program** — This is used by management to provide transparency regarding its cybersecurity risk management program and used by CPAs to report on management's description. Management's description provides users of the report with information that can help them understand the entity's cybersecurity risks and how it manages those risks. Description criteria includes considerations on the nature of an entity's business and operations, factors affecting inherent cybersecurity risk, risk governance and assessment process and the monitoring of the cybersecurity program, among other criteria.
- **2017 Trust Services Criteria for Security, Availability, Processing Integrity, Confidentiality and Privacy** — This is used by management to evaluate the effectiveness of controls and used by CPAs providing advisory or attestation services to evaluate and report on the effectiveness of controls within the cybersecurity risk management program.
- **AICPA Guide Reporting on an Entity's Cybersecurity Risk Management Program and Controls** — This attestation guidance assists CPAs engaged to examine and report on an entity's cybersecurity risk management program (SOC for Cybersecurity). This guide also contains information that can assist management in understanding the SOC for Cybersecurity engagement and its responsibilities with respect to the engagement.

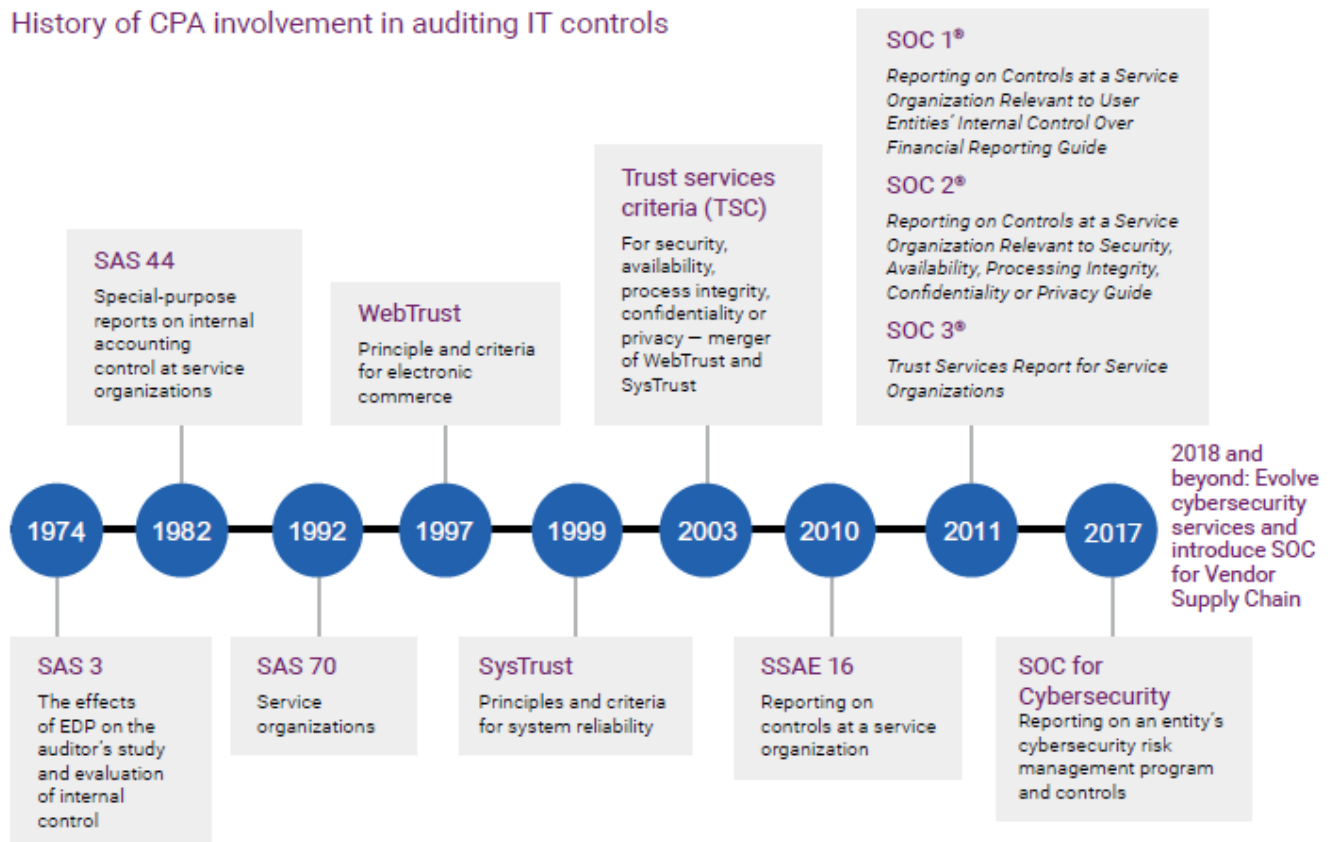
## Why CPA firms? Education. Experience. Expertise.

The education, experience and expertise of CPAs position them as the premier providers of SOC for Cybersecurity services.

- Knowledge of relevant IT systems and technology, including mainframes, networking, firewalls, network management systems, security protocols and operating systems
- Understanding of IT processes and controls — such as management of operating systems, networking and virtualization software and related security techniques; security principles and concepts; software development; and incident management and information risk management
- Experience with common cybersecurity publications and frameworks (NIST CSF, ISO 27001/27002, 2013 COSO *Internal Control — Integrated Framework*, COBIT 5, etc.)
- Expertise in evaluating processes, control effectiveness and providing advisory services relating to these matters
- Multidisciplinary teams that incorporate certified information security professionals such as Certified Information Systems Security Professionals (CISSP), Certified Information Systems Auditors (CISA) and Certified Information Technology Professionals (CITP®)
- Proficiency in measuring performance against established criteria, applying appropriate procedures for evaluating against those criteria and reporting results
- Strict adherence to service-specific professional standards, professional code of conduct and quality control requirements
- Holistic understanding of entity's industry and business, including whether the industry in which the entity operates is subject to specific types of or unusual cybersecurity risks and uses specific industry technology systems
- Objectivity, credibility and integrity
- Independence, professional skepticism and commitment to quality
- Strong analytical skills
- International perspective for global organizations

## CPAs: Forerunners in the cybersecurity movement

### History of CPA involvement in auditing IT controls



**1970s** – CPAs required to consider effects of electronic data processing on the evaluation of internal control in financial statement audits.

**1990s** – CPAs begin performing SAS 70 audits to report on the effectiveness of internal control over financial reporting.

**2000s** – CPAs begin using the trust services criteria for evaluating controls relevant to security, availability, processing integrity, confidentiality and privacy and issuing SOC reports to address vendor management needs related to outsourced services.

**2017** – Introduction of SOC for Cybersecurity attestation services for CPAs to report on the effectiveness of controls within an organization's cybersecurity risk management program.

**2018 and beyond** – Continue to evolve cybersecurity services and introduce SOC for Vendor Supply Chain to enable users of products produced, manufactured and distributed by an entity to better understand and manage risks, including cybersecurity risks, arising from their business relationships with the entity.