Jefferson County PUD Board training presentation

Olga A. Darlington, Partner

Discussion topics

- Financial policies overview
- How does utility make money
- Financial statements overview
- Governance in the Public Sector

Financial Policies Overview

Adopting Financial Policies

Financial policies are central to a strategic, long-term approach to financial management that help governments:

- ✓ Institutionalize good financial management practices - formal policies promote stability and continuity, and prevent the need to re-invent responses to recurring issues.
- ✓ Clarify and crystallize strategic intent for financial management - help define how the organization will develop its financial practices and manage its resources to provide the best value to the community.
- ✓ Define boundaries - the policy framework provides the boundaries within which staff can innovate in order to realize the organization's strategic intent.
- ✓ Support good bond ratings and thereby reduce the cost of borrowing.
- ✓ Manage risks to financial condition. A key component of governance accountability is not to incur excessive risk in the pursuit of public goals. Financial policies identify important risks to financial condition.

GFOA recommended scope

There are some basic financial policy categories (but not limited to) that all governments should consider adopting.

- *General fund reserves*
- *Debt*
- *Investment*
- *Accounting and financial reporting*
- *Risk management and internal controls*
- *Procurement*
- *Capital assets*
- *Revenues*
- *Expenditures*
- *Operating budget*

Steps to consider

- Presentation - Effective financial policies share some of the following traits ~
  - ✓ All of the financial policies are placed in the same section of the budget document.
  - ✓ The original and revision dates are shown on the individual policies.

- Review - Financial policies are most successful when they are reviewed after being enacted ~
  - ✓ Policies should be monitored, reviewed, and updated as needed in a systematic way.
  - ✓ Analyze the reasons if specific policies are not being followed.

How does a Utility Make Money

Rates

- Rates for services are established by/subject to approval by an independent regulator (Board of Commissioners)
- The set rates are designed to recover the costs of providing the service
- Generally, rates must be sufficient to meet agreed upon obligations and margins

Rate Setting Process

- Starts with the budgeting process
- Uses a variety of information from other departments
- There is a wide range of ideas and methodologies to setting rates

Rate Setting Process

- Evaluation of past costs
  - ✓ Cost of service
  - ✓ Current and future capital costs
  - ✓ Debt service costs

- Evaluation of current deferrals

- Evaluation of changes to operations or capital structure
  - ✓ Budgeting is extremely important for this piece

Rate Setting – General Methods

MUNICIPAL UTILITIES

- Set by the board of directors/commissioners
- May utilize a COSO, however, not required in most states
- Focus is generally on cash flow needs
- Many municipal utilities will fund reserves, as well as debt requirements

Rate Setting Process

- Generally two types of rates
  - ✓ General rate case (GRC)
    - Test year – 12 months – historical
    - Takes into account all operating expenses, past construction (depreciation) and rate of return
    - Classification of expenses is extremely important in look-back period
    - Rate makers expect all potential costs to be anticipated

Rate Setting Process

- Variable costs
  - ✓ PCORC (power cost only rate case)
    - Occurs in between GRC
    - Power cost adjustment (PCA)
    - No returns allowed
    - No transmission or distribution
    - Test period – 12 month period

Rate Setting Process

- Discovery period
  - ✓ Information is submitted to regulatory bodies
  - ✓ Regulatory bodies dispute or approve costs or ask additional questions
- Rate approval
- Rate change notification
- System changes to rates

Regulatory Accounting

Expenses

- Regulated operations give rise to regulatory accounting
  - ✓ ASC 980, *Accounting for the Effects of Certain Types of Regulation*
  - ✓ GASB 65, *Regulated Operations*
- These standards allow for deferral of certain revenues and expenses to future periods

Why?

Matching Principle

- Most basic principle in accounting
- Match revenues and expenses
  - ✓ Example: Personnel expenses with revenue
- Gives rise to regulatory assets and liabilities

Expenses

- Expected expenses – included in PL (normal accrual accounting)
- Unexpected expenses – ***MAY*** be deferred using ASC 980
- Depreciation rates – Must be approved through regulatory process
- Capital vs. expense – risk area

Expenditures must be classified in the right place!!!

What is Regulated Accounting?

How is it used?

- An accounting vehicle used to match revenues with expenses
- Applicable to enterprises with regulated operations (most often, utilities)
- Benefit to use is that costs or revenues can be deferred to future periods

Benefits to Regulatory Accounting Implementation

- During periods of extraordinary expense or revenues, charges can be deferred to future periods
- Effect of “smoothing” results of operations
- Can reduce burden on rate payers in the short term
- Debt covenant ratios can be healthier

Downside to Regulatory Accounting Implementation

- If used extensively, can be costly in terms of personnel costs as it creates accounting complexities
- Cash flow is not improved in the short term

Regulated Operations

- The utility must meet ALL of the following to be eligible for regulatory accounting treatment
  - ✓ Rates for services are established by/subject to approval by an independent regulator
  - ✓ The set rates are designed to recover the costs of providing the service
  - ✓ It is reasonable to expect that the rates set will be high enough to recover such costs (Future changes in competition or demand must be anticipated)

Rate Action By Regulator

- Regulator action must be documented
  - ✓ Acknowledge use of ASC 980 or deferral accounting
  - ✓ Specify time period of deferral
  - ✓ Specify types of deferred charges or amount
  - ✓ Documentation not required under GASB, however is a best practice
- Designated portion of future revenue must be at least equal to the deferral amount
- Future revenue increase must be for purpose of cost recovery, not to provide for future expected costs

Accounting Mechanics

- A regulatory asset (the deferral of charges) or liability (deferral of revenue) is set up on the balance sheet
- The amortization against this asset or liability is charged in the period of rate recovery
- The regulatory assets or liabilities must be analyzed each year for reasonableness
- On the income statement, amortization is shown in the same place it was deferred from

Deferrals

- Most states have “commonly” approved events
  - ✓ Catastrophic events are generally approved
- Regulators can always deny deferrals or portions of deferrals
  - ✓ Non-prudent costs are found
  - ✓ Costs should have been expected and known by the utility
- Important take-aways
  - ✓ Utility is only allowed to recover “prudent” costs
    - Everyone should be fighting spending too much or any unnecessary costs

How does a Utility Make Money

Answer: Rates!

Basic Financial Statements Presentation and Disclosure

What is Accrual Accounting?

- Accrual accounting does not take into account cash flow
- Revenue is recorded when earned
- Expenses are recorded when incurred
- Accruals are based on estimates

Why Does Accrual Accounting Make Sense?

- Matching of revenues and expenses in the same period
- How do you budget?
  - ✓ When you expect to incur the cost (when the work is done), or
  - ✓ When you expect the cash to be paid (what if the contractor doesn’t invoice the utility for 6 months)

Financial Statements

- Management Discussion & Analysis
- Balance Sheet or Statement of Net Position
- Income Statement or Statement of Revenues, Expenses and Changes in Net Position
- Statement of Cash Flows
- Notes to Financial Statements
- Required Supplementary Information

Management's Discussion &Analysis

- Written by management
- Document that explains what is going on with the District
- Differences
  - ✓ Publicly traded entity
  - ✓ GASB follower – prescribed format

Balance Sheet

- Financial presentation “as of” a point in time
- Assets
- Liabilities
- Net Position

- GASB
  - ✓ Calls this statement the “Statement of Net Position”
  - ✓ Added “Deferred outflow and inflow of resources”

Balance Sheet

- Accrual basis of accounting
- Reflects financial activities since inception of the entity
- Classified balance sheet (current and long-term)
- Shows resources vs. claims, or “what we own” vs. “what we owe”

Income Statement

- Summary of transactions for a period of time
- Operating revenue
- Operating expense
- Operating income (gross profit)
- Non-operating income
- Non-operating expense
- Net income

- GASB
  - ✓ Calls this statement “Statement of Revenues, Expenses and Changes in Net Positon”
  - ✓ Contributions In Aid of Construction – presented as revenue

Changes in Net Position

- Connects the Income Statement to the Balance Sheet
- Shows activity in equity accounts – issue of stock, payment of dividends
- Also known as Statement of Retained Earnings (in corporate world)

- GASB
  - ✓ Generally this is shown as a part of the Statement of Revenues, Expenses and Changes in Net Position due to the fact that there are very few transactions outside of net income (generally, only restatement related)

Net Position (Equity)

- The monetary value of a business or property which exceeds the claims and or liens against it by others

Equity = Assets – Liabilities

Net Position = Assets + Def. Outflows – Liabilities – Def. Inflows

Statement of Cash Flows

- Summary of cash movement for a period of time (same period as income statement)
- Definition of cash – 90 day threshold
- Shows sources and uses of cash during the reporting period by type
  - ✓ Cash flow from operating activities,
  - ✓ Cash inflows & outflows from investing activities
  - ✓ Cash inflows & outflows from financing activities
-

Statement of Cash Flows

- Definition of cash – 90 day threshold
- The net change in the cash position of the business is the summation of:
  - ✓ Cash flow from operating activities,
  - ✓ Cash inflows & outflows from investing activities
  - ✓ Cash inflows & outflows from financing activities

Notes to Financial Statements

- Provides context to certain numbers on the statements
- Integral part of the financial statements
- Significant Accounting Policies
- Classification of Capital Assets
- Long-term Debt
- Pension and Post-retirement obligations
- Other obligations and potential liabilities (off balance sheet risks)

Governance in Public Sector and Internal Controls

Corporate Governance

Background

- SARBANES OXLEY ACT OF 2002 ESTABLISHED THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)
  - Applies to public companies and their auditors
  - Established new roles for audit committees and relationship to auditors
  - Trickle down effect to private companies and governmental entities

Implication to Non-Public Companies and Municipal Entities

- INCREASED FOCUS ON CORPORATE GOVERNANCE
  - Establishment of Audit Committee
  - Understanding of risk management and internal control considerations
- RELATIONSHIP TO AUDITOR SHOULD BE CONSIDERED
  - Audit partner rotation
  - Board approval of auditor services
  - More interaction with auditor

What are the Risk Management Fundamentals?

How is Risk defined?

RISK

Risk is the uncertainty that is inherent in the range of possible outcomes (losses or gains) which occur as a result of the choices and decisions required throughout an extended enterprise.

What is Risk Management?

RISK MANAGEMENT

Mechanism that creates stability in the organization by enabling the identification, prioritization, mitigation and measurement of the implications of each decision.

What is Internal Control?

INTERNAL CONTROL

A process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives

- *Effectiveness and efficiency of operations*
- *Compliance with applicable laws and regulations*
- *Reliability of financial reporting*

* *Internal Control – Integrated Framework, Committee of Sponsoring Organizations (COSO) of the Treadway Commission*

What are the Types of Risk?

- ***Financial* – *primarily relate to risks and activities that impact the reliability of financial statements, financial reporting disclosures and other financial impacts***
- ***Operational* – *primarily relate to risks and activities that impact the efficiency and effectiveness of business operations***
- ***Compliance* – *primarily relate to risks and activities that impact adherence to applicable laws and regulation***
- ***Strategic* – *primarily relate to risks and activities that impact the achievement of an organizations business objectives. Often neglected area of risk, with potential for high return***

* *Internal Control – Integrated Framework, Committee of Sponsoring Organizations (COSO) of the Treadway Commission*

Risk Management for the Board and Audit Committee

"The audit committee should understand the corporation's risk profile and oversee the corporation's risk assessment and management practices."

The Business Roundtable
Principles of Corporate Governance

Internal Control and Compliance Considerations

Objectives:

1. Transactions are properly recorded and accounted for to –
    - Permit the preparation of reliable financial statements and federal reports
    - Maintain accountability over assets
    - Demonstrate compliance with laws, regulations, and other requirements
2. Transactions are executed in compliance with –
    - Laws, regulations and the provisions of contracts and grants
3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition

Internal Control and Compliance Considerations (continued)

Components:

1. **Control Environment** sets the tone of an organization influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

2. **Risk Assessment** is the entity's identification and analysis of relevant risks to the achievement of it's objectives, forming a basis for determining how risks should be managed.

3. **Control Activities** are the policies and procedures that help ensure that management's directives are carried out.

4. **Information and Communication** are the identification, capture and exchange of information in a form and time frame that enable people to carry out their responsibilities.

5. **Monitoring** is a process that assesses the quality of internal control performance over time.

What is Internal Control?

- The plan of organization and the methods a business uses to
  - ✓ safeguard assets,
  - ✓ provide accurate and reliable information,
  - ✓ promote operational efficiency, and
  - ✓ ensure that procedures are followed

Internal Control Structure...?

- The policies and procedures established to provide a reasonable level of assurance that the organizations specific objectives will be achieved

Internal Control Terms

- **Threat** – Any potentially adverse occurrence or unwanted event that could damage the AIS or the organization
- **Exposure** – Potential $ lost from a threat
- **Risk** – Probability the threat will occur (e.g. internet/web access)
- **Controls** – Measures taken to eliminate/reduce risk of exposure to a threat

Threats and Risks

- Threats
  - ✓ Disaster
  - ✓ Malfunction
  - ✓ Error/mistake
  - ✓ Crime/fraud
- Risks
  - ✓ Identify, assess, and quantify risk factors
  - ✓ Examples – lack of segregation of duties, cash is not reconciled timely

Purpose of Internal Controls

- Preventive controls – Deter problems before they happen
- Detective controls – Discover problems when they happen
- Corrective controls – Remedy problems after they are detected
  - ✓ Identify cause, correct the problem, alter system to prevent recurrence

Risk Assessment

- Identify threats
- Estimate risk
- Estimate exposure
- Identify controls
- Estimate costs and benefits
  - ✓ Expected loss = risk x exposure
- Determine cost-benefit effectiveness

Information and Communication

- What accountants must understand:
- What AIS do:
  - ✓ Identify and record all valid transactions
  - ✓ Properly classify transactions
  - ✓ Record transactions at proper $ value
  - ✓ Record transactions in proper period
  - ✓ Properly present and disclose in financial statement

Monitoring Performance

- Effective supervision
- Responsibility accounting
- Internal auditing

Questions or comments?

Olga.Darlington@mossadams.com | (425) 551-5712

Thank you!