



**A Report to the
Audit Committee**

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Karl Dean

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Audit of General Reserve Funding Process and the Capital Asset Accounting Process

September 4, 2015

Metropolitan
Nashville
Office of
Internal Audit

EXECUTIVE SUMMARY

September 4, 2015



Why We Did This Audit

The audit was initiated based on issues identified with capital assets in previous audits.

What We Recommend

Departments should communicate capital asset acquisitions to the Finance Department and conduct triennial physical inventories. Additionally, the Finance Department Administration should consider increasing the capitalization threshold for fixed assets.

AUDIT OF THE GENERAL RESERVE FUNDING PROCESS AND THE CAPITAL ASSET ACCOUNTING PROCESS

BACKGROUND

Capital assets for the Metropolitan Nashville Government totaled \$5.3 billion in fiscal year 2014 which represents 72 percent of the government's assets. The capital asset accounting process includes the timely and accurate recording of acquisitions, depreciation, transfers, and dispositions, as well as the inventory and protection of capital assets.

The General Reserve Fund (4% Reserve Fund) is derived from four percent of revenues from the General Services District. The Charter specifies that expenditures from the General Reserve Fund be used for the purchase of building repairs and/or equipment. While there is no designation about the number of times appropriations can be made, there are generally between three and four appropriations made each year.

OBJECTIVES AND SCOPE

The objectives of the audit were to determine:

- If controls were in place to ensure the General Reserve Fund was operating in accordance with the Charter of the Metropolitan Nashville and Davidson County Government.
- If controls were in place to ensure fixed assets were safeguarded.
- If the capitalization process was efficient.

The audit scope included January 1, 2013, through December 31, 2014.

WHAT WE FOUND

Controls were in place to ensure the approval process was followed for expenditures from the General Reserve Fund. Expenditures from the fund were for equipment and building repairs as specified by the Metropolitan Nashville Charter.

Communication is lacking between the departments and the Division of Accounts regarding capital asset acquisitions. Additionally, controls should be strengthened around the inventory and disposition of capital assets. The capitalization threshold could potentially be raised without have a material effect on the government's financial statements and prevent additional accounting efforts required for capital assets.

GOVERNANCE

The Director of Finance will recommend appropriations from the General Reserve Fund for the purchase of equipment and/or building repairs. The appropriations must be approved by the Budget and Finance Committee and by the Metropolitan Nashville Council by resolution. Once the appropriations are approved, the Office and Management and Budget will monitor purchases monthly to ensure departments stay within the approved allocation. Department heads are ultimately responsible for ensuring expenditures from the General Reserve Fund are spent correctly.

The Metropolitan Nashville Charter specifies the director of finance or his designated divisional director shall maintain an inventory of public property and equipment. The Finance Department capital assets policy states that the division of accounts is responsible for the overall recordkeeping and financial reporting of the Government's capital assets. However, department heads are responsible safekeeping and inventory of all assets, regardless of dollar amount.

OBJECTIVES AND CONCLUSIONS

1. *Were controls in place to ensure the General Reserve Fund was operating in accordance with the Charter of the Metro Nashville and Davidson County Government?*

Yes.

Supporting Objectives and Conclusions

- a. *Were expenditures from the General Fund Reserve for equipment and building repairs?*

Yes. Requests included on information sheets by department heads met the definition of equipment or building repairs. Actual purchases from the fund were for equipment and building repairs and matched the information provided on the information sheets.

- b. *Was a review and approval process followed for expenditures from the General Reserve Fund?*

Yes. The Office of Management and Budget has detailed procedures in place for the processing of General Reserve Fund allocations. General Reserve Fund resolutions were reviewed and approved by the appropriate individuals and parties.

- c. *Were the sources for the General Reserve Fund accurate?*

Yes. The sources for the General Reserve Fund included all locally generated revenue accounts.

2. *Were controls in place to ensure fixed assets were safeguarded?*

Generally yes. Acquisitions and dispositions were recorded timely and depreciation amounts were being accurately computed. However, communication between departments and the Division of Accounts should be strengthened and periodic physical inventories should be conducted by departments.

Supporting Objectives and Conclusions

- a. *Were acquisitions, dispositions, and transfers accurately and timely recorded?*

Generally yes. New assets were being accurately recorded. However, communication about acquisitions could be strengthened between departments and the Department of Finance. (See Observation A.)

Asset dispositions were recorded timely and accurately. However, a physical inventory of assets found that the master asset listing was not complete and accurate. This was partially due to assets disposed in the past were never removed from the master asset list. This problem would have been corrected if departments conducted periodic physical inventories. (See Observation B.)

b. Were depreciations amounts accurately computed?

Yes. Depreciation for 47 capital assets was recomputed and compared to depreciation amounts calculated within the Metropolitan Nashville Government accounting system, EnterpriseOne. Depreciation was accurately computed for all assets in the sample.

c. Were assets physically protected?

Yes. Out of 79 capital assets physically observed, 76 (96 percent) were protected against theft and damage from the elements. The three assets that were not protected were kept in maintenance building where the door was left open when not in use.

3. Was the \$5,000 capitalization threshold efficient?

Generally no. A benchmarking study found that the Metropolitan Nashville Government's capitalization threshold was consistent with peer cities. However, the capitalization threshold could be raised. Raising the capitalization \$5,000 threshold would reduce the number of annual additions to the fixed asset master without materially impacting the overall total dollar value of capitalized assets for the Metropolitan Nashville Government. (See Observation C.)

AUDIT OBSERVATIONS

The Committee of Sponsoring Organizations of the Treadway Commission, Internal Control – Integrated Framework (COSO), Control Environment component recommends management and the board of directors establish mechanisms to communicate and hold individuals accountable for performance of internal control responsibilities and implement corrective action as necessary. The audit observations listed are offered to assist management in fulfilling their internal control responsibilities.

Observation A: Capital Asset Acquisitions

Metropolitan Nashville Government departments were not consistently communicating fixed asset acquisition to the Division of Accounts. The Finance Department Capital Assets Policy requires departments to notify the Division of Accounts within five days of a capital asset acquisition. The Division of Accounts will add the asset to the Master Fixed Asset Listing and issue a tag to be placed on the asset. Due to the lack of communication between the departments and the Division of Accounts, the fixed asset accounting staff will perform a weekly review of purchase orders to locate assets to be added and tagged.

The risk of a capital asset being left off the Master Asset Listing increases when the departments do not communicate acquisitions to the Division of Accounts. The weekly review of purchase orders should be viewed as a detective internal control and not the sole method of identifying capital asset acquisitions.

Criteria:

- COSO, Information and Communication—Principle 14—The organization internally communicates information, including objectives and responsibilities for internal controls, necessary to support the functioning of internal control.
- Finance Department Policy – Division of Accounts #14 – Capital Assets

Recommendation for management of the Finance Department to:

Reiterate to department heads capital asset acquisitions should be communicated to the Division of Accounts within five days of receipt.

Observation B: Periodic Physical Inventories

A total of 46 assets (24 percent) could not be verified from a physical inventory of 188 assets conducted in the buildings, land, machinery, equipment, vehicle, and computer categories. A random sample was selected for verification by the Office of Internal Audit in each of the categories.

Category	Verified	Not Verified	Not Applicable*	Total
Buildings & Land	40	2	5	47
Fully Depreciated Machinery & Equipment	24	23	0	47
Machinery & Equipment with Net Book Value	27	20	0	47
Vehicles	46	1	0	47

* These assets were incorrectly classified (building improvements classified as buildings).

The number of assets that could not be verified implies that periodic physical inventories to reconcile capital assets with the master asset listing in EnterpriseOne were not taking place or only partially completed. Assets could not be verified for a variety of potential reasons including being stolen, but still on the master asset listing, being previously disposed, but still on the master asset listing, and not being able to be located because the capital asset record did not include any identifiable information.

Conducting a physical inventory is an important way for departments to determine if internal controls around capital assets are working. In addition, inventories will locate assets that are on the master asset listing, but do not exist and capital assets that exist, but are not longer on the master asset listing. Having assets that are on master asset listing, but no longer exist can affect productivity as assets will not be in place when needed by management. The risk of theft increases when assets owned by a department are not included on the master asset listing.

The *Internal Control Manual for Tennessee Municipalities* states that annual physical inventories should be performed, documented, and reconciled to the property records. The Finance Department’s Capital Asset Policy released in July 2014 lengthens the time between periodic physical inventories to every three years. The Division of Accounts will send the department’s management a capital asset listing to help facilitate the physical inventories.

Criteria:

- COSO, Information and Communication—Principle 14—The organization internally communicates information, including objectives and responsibilities for internal controls, necessary to support the functioning of internal control.
- The Internal Control Manual for Tennessee Municipalities, Title 5, Chapter 24 – Capital Assets and Expenditures
- Finance Department Policy – Division of Accounts #14 – Capital Asset
- Government Finance Officers Association Recommended Practices, Periodic Inventories

Recommendation for management of the Finance Department to:

Reiterate to departments that physical inventories should be performed and documented at a minimum three year rotation.

Observation C: Capitalization Threshold

The capitalization process was inefficient as accounting resources were used to capitalize lower cost assets that represent an immaterial incremental percentage of total asset value. The capitalization threshold for the Metropolitan Nashville Government was \$5,000.

A benchmarking study found that the majority (92 percent) of peer cities also have a capitalization threshold of \$5,000. However, an analysis of capitalization threshold showed the threshold amount could be raised without having a material effect on the Metropolitan Nashville Government’s financial statements. The analysis showed that assets with an original cost between \$5,000 and \$10,000 represented 29 percent of the total number of purchased assets, but the dollar amount of those assets only represented 0.39 percent of the total dollar amount of capitalized assets. This analysis implies a considerable amount of accounting hours were spent on adding, depreciating, and disposing of assets that represent an immaterial dollar amount of total capitalized assets.

Additionally, the Pareto Principle suggests that a capitalization threshold should be set that capitalizes 20 percent of all potential assets that constitute 80 percent of the dollar volume of all potential assets. The total number of assets capitalized in fiscal years 2013 and 2014 were 92 percent and 89 percent, respectively. Raising the capitalization threshold will bring those capitalization percentages closer to 80 percent.

Criteria:

- COSO, Control Activities—Principle 10—The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
- Government Finance Officers Association Recommended Practices, Capitalization Thresholds

Recommendation for management of the Finance Department to:

Analyze the capitalization threshold to determine if establishing a \$10,000 or higher threshold would have a material impact on the users of the Metropolitan Nashville Government’s financial reports.

GOVERNMENT AUDITING STANDARDS COMPLIANCE

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our observations and conclusions based on our audit objectives.

METHODOLOGY

To accomplish our audit objectives, we performed the following steps:

- Interviewed key personnel within the Department of Finance.
- Physically observed capital assets.
- Reviewed and analyzed documentation for compliance with the Tennessee Code Annotated, Metropolitan Nashville Code of Laws, and other applicable laws, regulations, and policies.
- Evaluated internal controls currently in place.
- Considered risk of fraud, waste, and abuse.
- Considered information technology risks.

AUDIT TEAM

Mark Swann, CPA, CISA, CIA, ACDA, Metropolitan Auditor

Seth Hatfield, CPA, CIA, In Charge Auditor

APPENDIX A – MANAGEMENT RESPONSE AND CORRECTIVE ACTION PLAN



METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY

KARL F. DEAN
MAYOR

DIRECTOR OF FINANCE
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September 3, 2015

Mr. Mark Swann
Metropolitan Auditor
Office of Internal Audit
1417 Murfreesboro Road
Nashville, TN 37217

Dear Mr. Swann:

This letter acknowledges the Finance Department's receipt of the "audit of capital assets." We have reviewed the findings and recommendations and have incorporated our responses in Appendix A to the attached report.

We appreciate the work you have done to help us improve our processes and internal controls, and we appreciate the professionalism of the Internal Audit staff in conducting the work.

Sincerely,

A handwritten signature in blue ink, appearing to read "Richard M. Riebeling".

Richard M. Riebeling
Director of Finance

Attachment

Copy: Kim McDoniel
Tom Eddlemon
Jeff Gossage

APPENDIX A – MANAGEMENT RESPONSE AND CORRECTIVE ACTION PLAN

We believe that operational management is in a unique position to best understand their operations and may be able to identify more innovative and effective approaches and we encourage them to do so when providing their response to our recommendations.

Recommendation	Concurrence and Corrective Action Plan	Proposed Completion Date
Management of the Department of Finance should:		
A. Reiterate to department heads capital asset acquisitions should be communicated to the Division of Accounts within five days of receipt.	Agree. The Finance Director will emphasize this issue in conjunction with the release of this audit report.	October 31, 2015
B. Reiterate to departments that physical inventories should be performed and documented at a minimum three year rotation.	Agree. The Finance Director will emphasize this issue in conjunction with the release of this audit report. Additionally, the discrepancies noted in this audit are being communicated with the applicable departments to ensure their departmental capital asset records are corrected.	October 31, 2015 and December 31, 2015
C. Analyze the capitalization threshold to determine if establishing a \$10,000 or higher threshold would have a material impact on the users of the Metropolitan Nashville Government’s financial reports.	Agree. A revision to the capitalization threshold in the capital asset policy will be considered.	March 31, 2016