



# Wicomico County, Maryland

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### **Internal Auditor's Consultation Report**

The County Council and County Executive of Wicomico County, Maryland:

The Office of the Internal Auditor (IA) has conducted a study of selected Wicomico County enterprise funds. The Wicomico County Council requested a review of the financial statements and analysis for the following:

- Wicomico Regional Airport
- Wicomico County Solid Waste
- Wicomico County Nursing Home

The attached document was created for the County Executive, and the County Council to assist in their understanding of the status of the enterprise operations. We employed selected financial ratio analysis, trend analysis, and conducted interviews in effort to present a financial picture of the selected enterprises. IA chose what we considered the most relevant information for inclusion in the report. Other information is available upon request.

Respectfully submitted,

J. Stephen Roser, CPA  
Internal Auditor

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## Consultation Report

### Background - Enterprise Funds Defined

Rules and procedures for government accounting are considerably different from those for private sector accounting in the United States. Government uses enterprise fund accounting for those entities within government structure that operate similarly to for-profit entities. That is, in an ideal situation, a government enterprise generates its own revenue through the sale of services (fees), and in some cases, goods. Government enterprise entities must therefore use an accounting system that is a hybrid between government and private sector accounting.<sup>1</sup>

### Objectives

The objectives of the consultation were to perform a high-level analysis of the financial position and performance for the following enterprise funds:

1. Wicomico County Solid Waste
2. Wicomico County Regional Airport
3. Wicomico County Nursing Home

### Scope

The engagement was a consultation with primary focus on the financial analysis of the aforementioned enterprise funds. Observations and inquiries with appropriate personnel were conducted, as well as examination of various documents:

- Audited Financial Statements FY2005 through FY2014
- Other documentation and accounting records
- Available published industry analysis

We performed financial analysis including trend and ratio analysis in effort to understand the direction of the enterprise operations and address going-concern<sup>2</sup> issues. Scope and objectives of this consultation study were adjusted as deemed necessary. This is a high-level study. IA can perform more in-depth analysis at the direction of the County Council.

### Measurement of Performance

We present performance measurements graphically in the following sections of this report. Please note that the years contained on the x-axis represent fiscal years corresponding to the County government-wide financial statements. Additionally, we present each measurement parameter for all three enterprises. IA cautions readers of this report to avoid comparing County enterprises to each other within a particular section. The three enterprises are vastly different in structure, purpose, and operation. That is, head-to-head comparison among the three enterprises is unrealistic.

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<sup>1</sup> The best source for additional information concerning government enterprise fund accounting is Government Accounting, Auditing, and Financial Reporting (GAFFR), also known as The Blue Book, revised and printed annually by the Government Finance Officers Association

<sup>2</sup> Going-concern is a financial term... a going-concern is a business expected to function without the threat of liquidation for at least 12 months

## Industry Analysis

IA reviewed some of the available published industry analysis and determined that inclusion in this report did not add significant value to the analysis. Industries associated with the three enterprise funds under discussion vary widely by region and size distorting any averages calculated<sup>3</sup>. We chose instead to concentrate on the trends for our enterprises over a considerable amount of time (ten years).

## Trending

We employ trend analysis to track performance over the last ten years. Trends can give us an indication of how an enterprise may perform in the future. Coefficient of determination ( $R^2$ ) is included where appropriate. Although the coefficient may be an indication of the regression line accuracy, it should not be assumed that a high coefficient indicates certain future performance.

## Depreciation

Most assets designed to last more than one year and placed in service are capital assets subject to depreciation expense. In the private sector, a capital asset is considered to be impaired (depreciated) when its carrying (booked) value exceeds expected cash flows resulting from its use. Many of the capital assets in the public sector do not generate positive cash flows (roads and bridges, for example). If we apply private sector rules to public sector assets fitting this description, assets would be written off upon acquisition. However, Government Accounting Standards require inclusion of depreciation expenses in the direct costs of the function or program that uses the asset.

We must then consider the fact that the entities under discussion here are enterprise funds located within County government that require accounting methodology representing a hybrid between private and public sector accounting. To ignore depreciation, or to write off capital assets when placed in service, would distort profit and loss reporting for the enterprise. Medical equipment, vehicles, buildings, and runways all generate revenue and must eventually be replaced.

## Financial Measurement and Trends

### Current Ratio

Current ratio gives us some idea of the enterprise's ability to pay short-term liabilities with short-term assets and is expressed as a ratio of short-term assets to short-term liabilities. It is an important indication of short-term financial health. It also gives us a sense of the efficiency of the enterprise's operating cycle. All three enterprises show a high current ratio indicating they have the means to pay short-term obligations. Please see Appendix I for the current ratio calculations of all three enterprises.

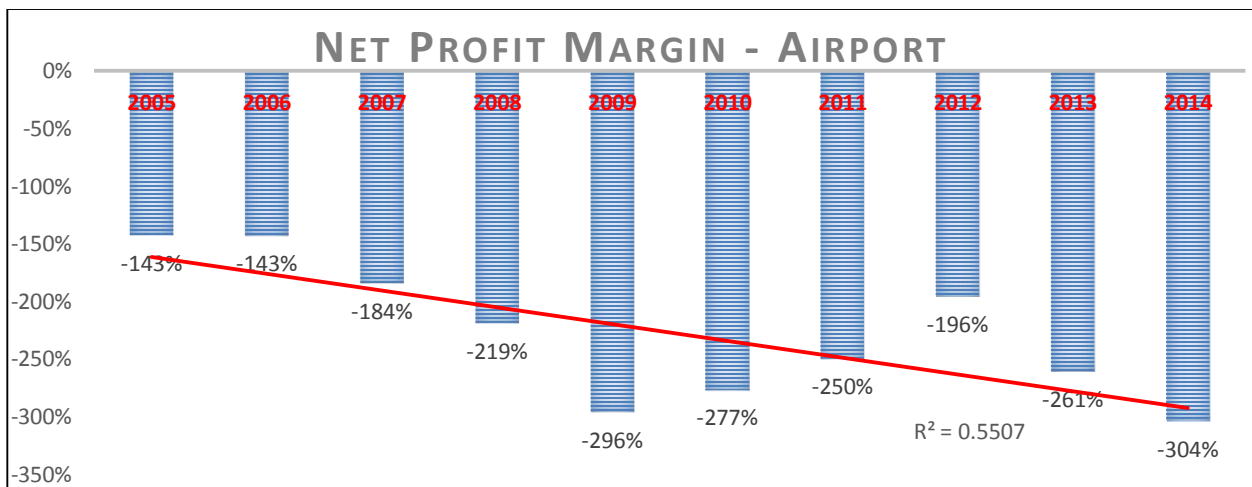
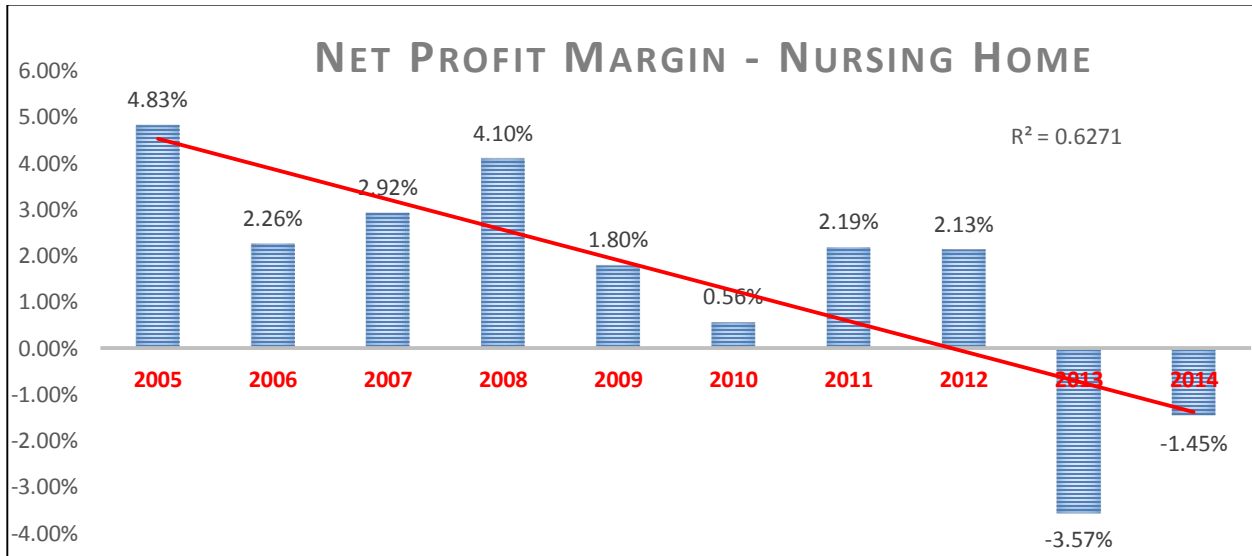
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<sup>3</sup> It should be noted, however, that industry analysis provided by the Nursing Home's financial auditors revealed that the Nursing Home showed little variance from regional and industry benchmark data for non-metro facilities

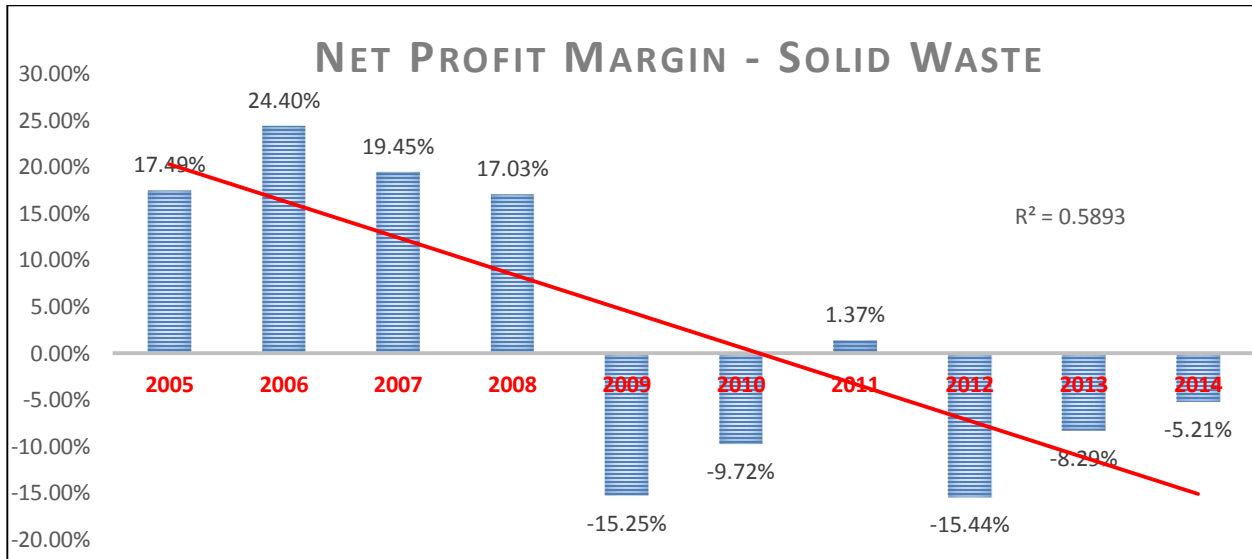
**Income Statement Analysis<sup>4</sup>**

**Net Profit Margin**

We calculate net profit margin as a ratio of operating profit to operating revenues. The purpose of these ratios as presented is to observe the trend over the ten-year period. Net Profit margin for all three enterprises breakout as follows:



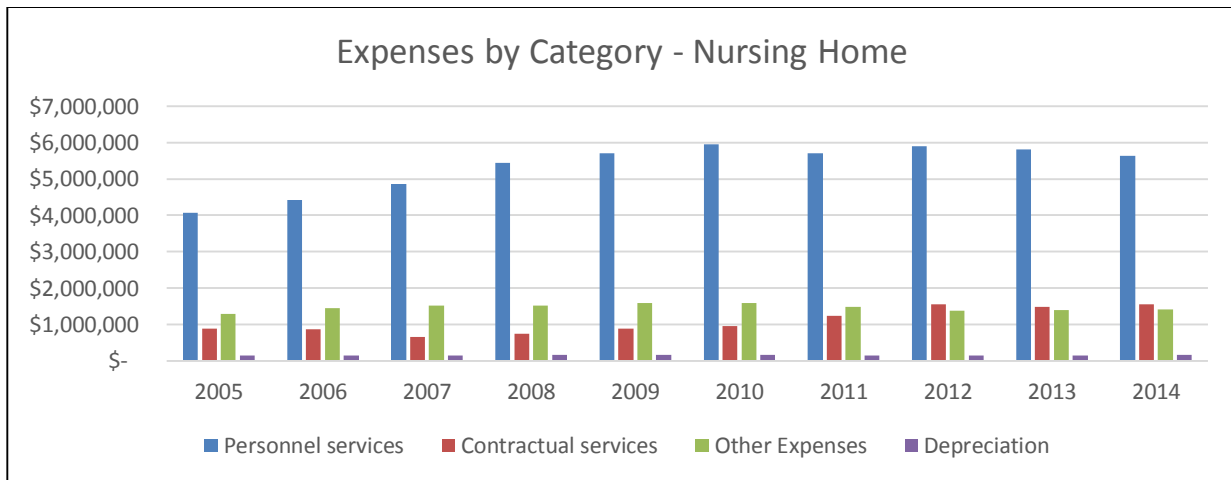
<sup>4</sup> This is an analysis of Statements of Revenues, Expenses, and Changes in Net Position (Income Statement Equivalent)

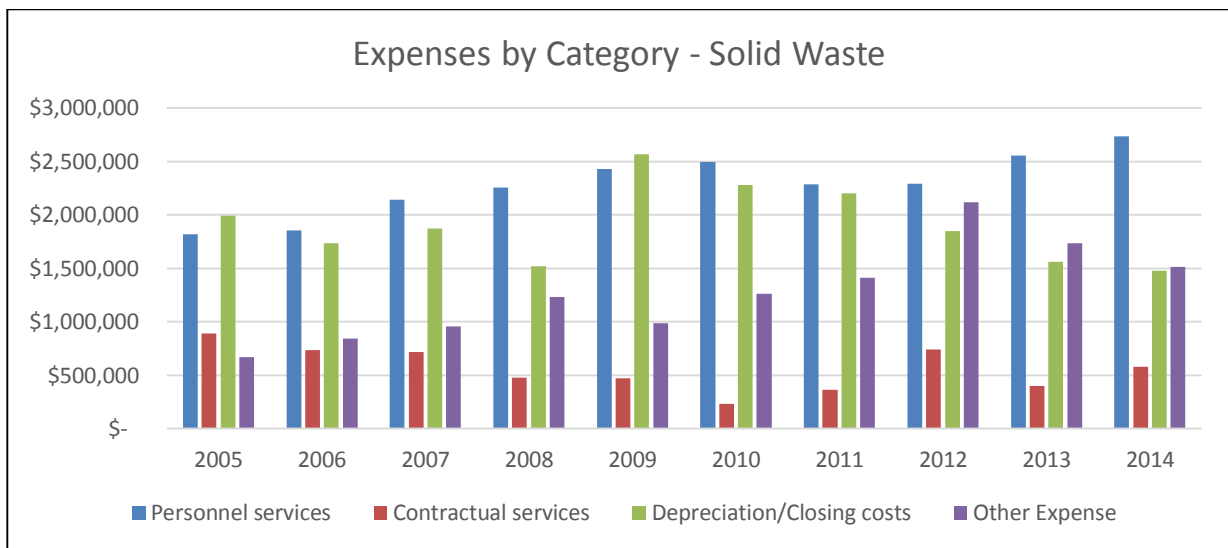


All enterprises trend steeply negative for profit margin.

#### Expenses by Category

Actual expenses by selected categories breakout are as follows:

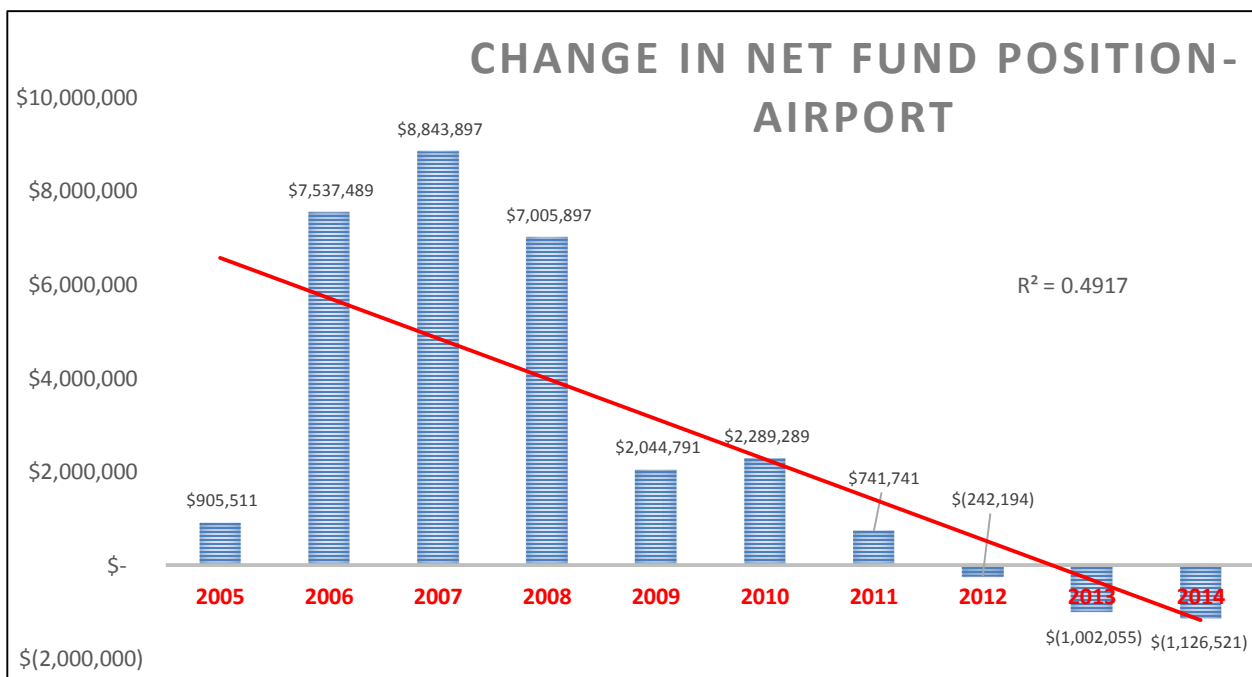
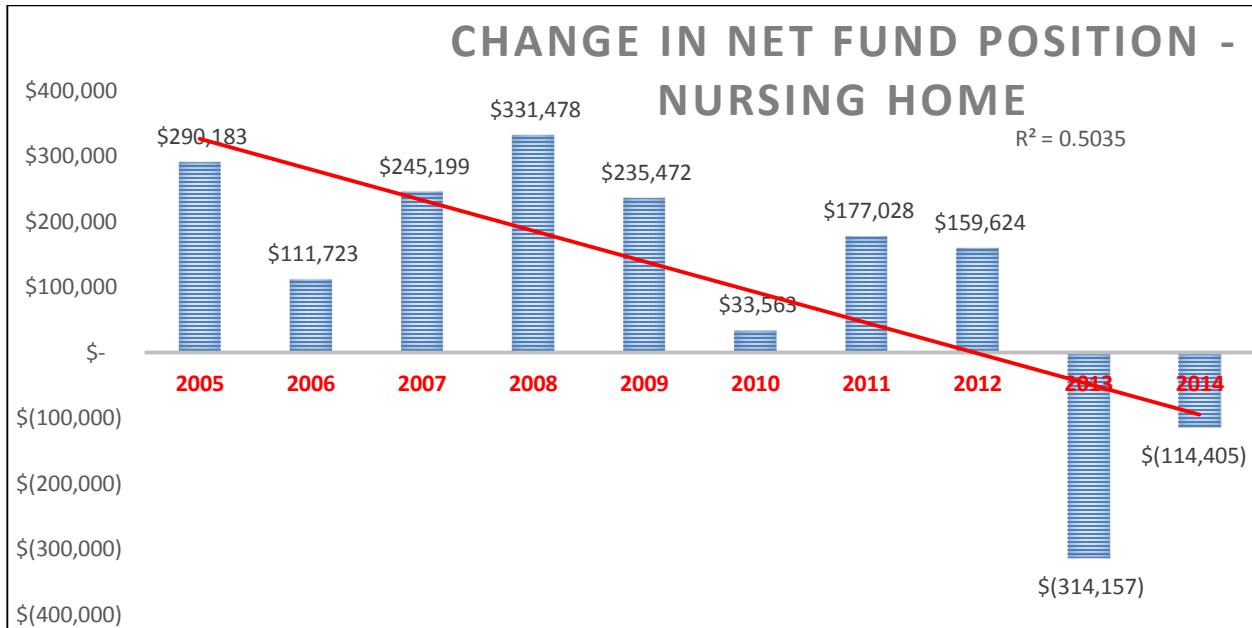




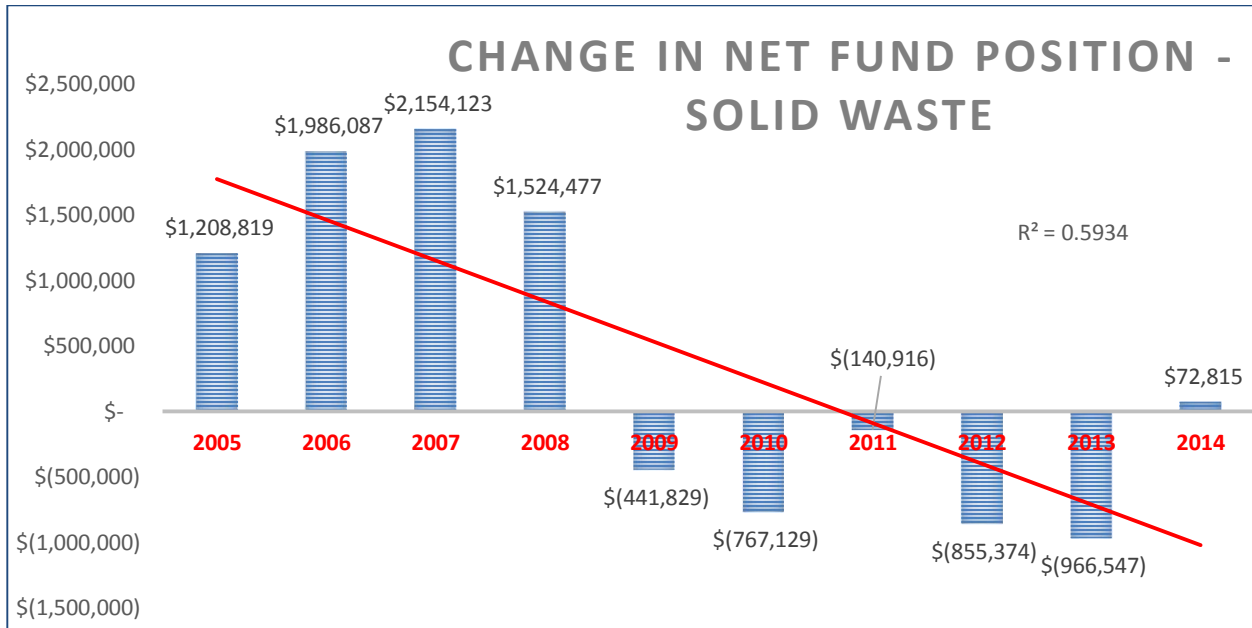
Personnel services represent the largest expense for the Nursing Home and Solid Waste. Depreciation figures prominently for the Airport and the Landfill due primarily to a large amount of equipment and infrastructure used for revenue generation.

***Change in Net Position***

Net position is the residual of all other financial elements presented in a statement of financial position. Financial position is roughly comparable to equity in private-sector accounting. Year-over-year change in net fund position for the enterprise funds over the period follows:





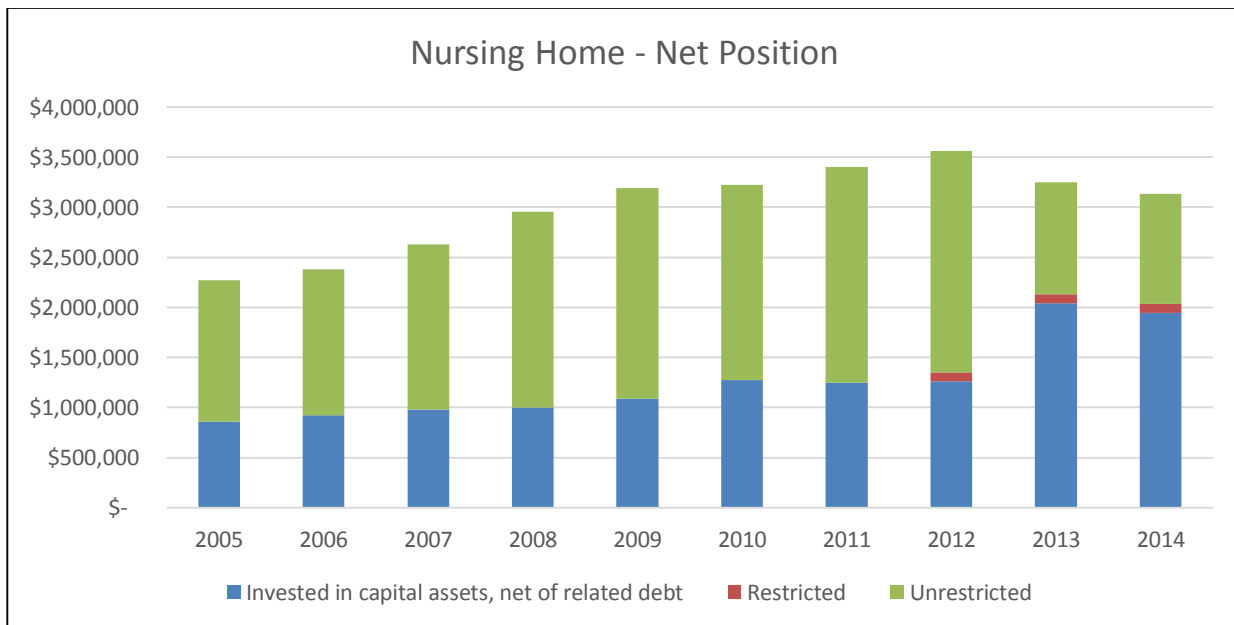


As we can see, the trend for dollar change in net fund position mirrors profit margins and shows similar trends for the enterprise funds. The Nursing Home and Solid Waste show a reversal for FY2014. The reversals from 2010 to 2011 did not hold.

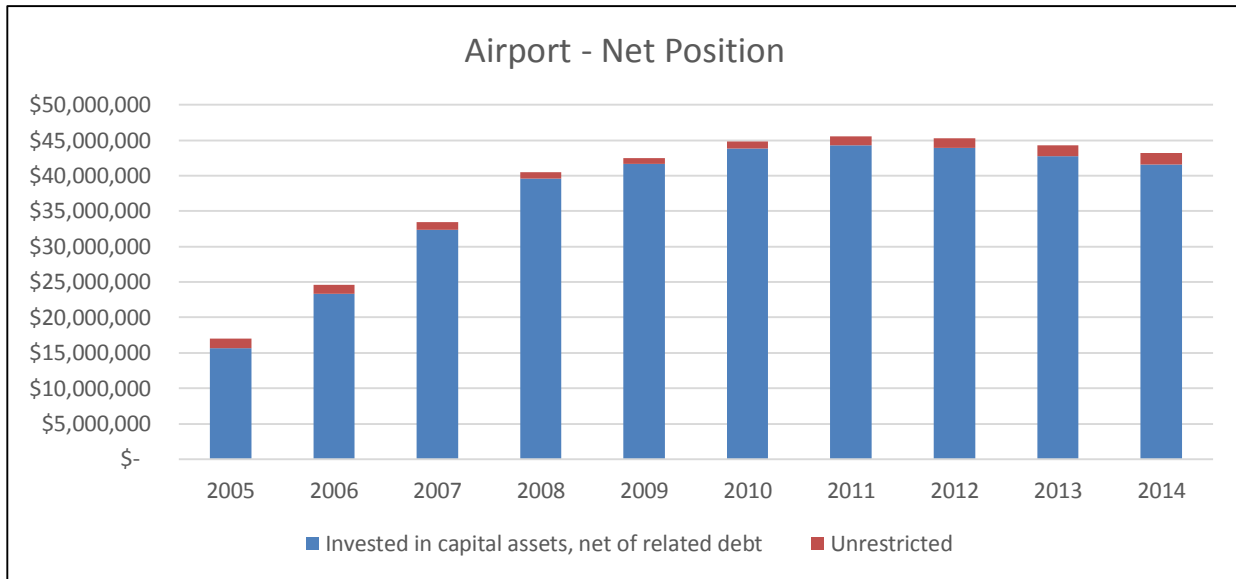
### Balance Sheet Analysis

#### Net Position

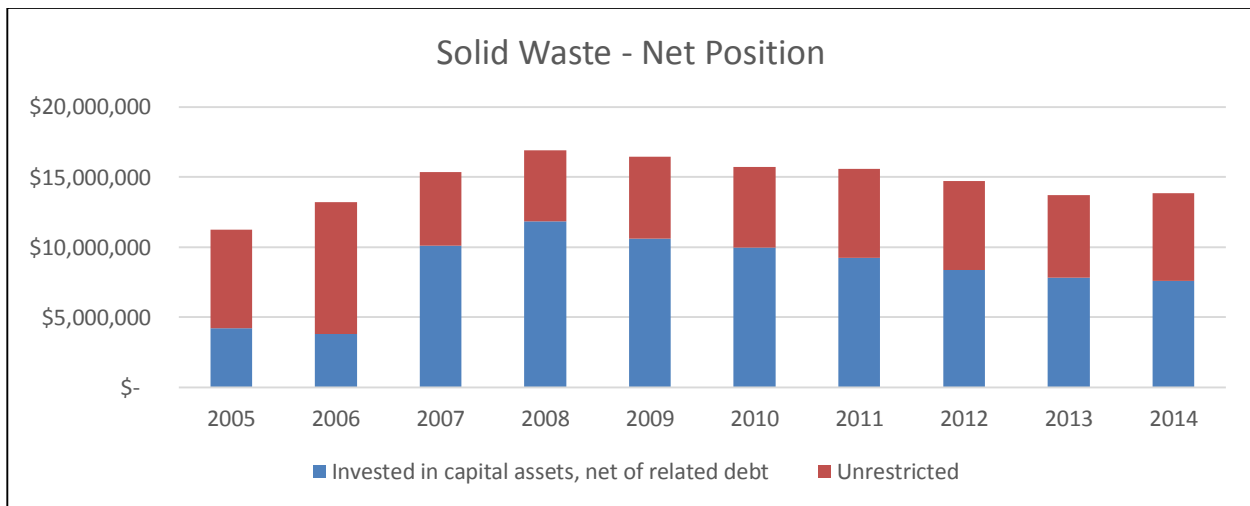
Net position as stated on government financial statements is similar to stockholders' equity on business financial statements. That is, net position is comparable to net worth for our purposes. Breakout of net position for the period divided into components is as follows:



The shift in net position for the Nursing Home from cash to capital assets, occurring in FY2013, is the result of a mortgage payoff. We see a downward trend in overall net position beginning after FY2012.



The Airport is heavily invested in capital assets, as depreciation expense would indicate. Airport cash and cash equivalents on 6/30/2014 were \$1,569,545 representing 3.5% of total assets.



At solid Waste, we have a slight increase in net position (.85%) for FY2014.

## Issues Affecting Performance

### Nursing Home

According to Nursing Home management, the Nursing Home has three major issues affecting performance:

1. The State of Maryland taxes nursing home facilities based on average census known as a “bed tax.” Facilities were to receive increased Medicaid reimbursements designed to offset the tax. According to Nursing Home management, the reimbursements have not covered the tax increases.
2. Delays in Medicaid reimbursements, present a problem. Processing by some state agencies is very slow causing increases in receivables. A statement contained in the notes to the financial statements issued by the facility’s external auditor states: “The Facility’s financial position and change in net position may be effected by the reimbursement process, which in the Facility’s industry is complex and can involve lengthy delays between the time that revenue is recognized and the time that reimbursement amounts are settled.”<sup>5</sup>
3. A small facility such as Wicomico Nursing Home does not enjoy economies of scale available to larger facilities and chain operations.

**Airport – Further Analysis**

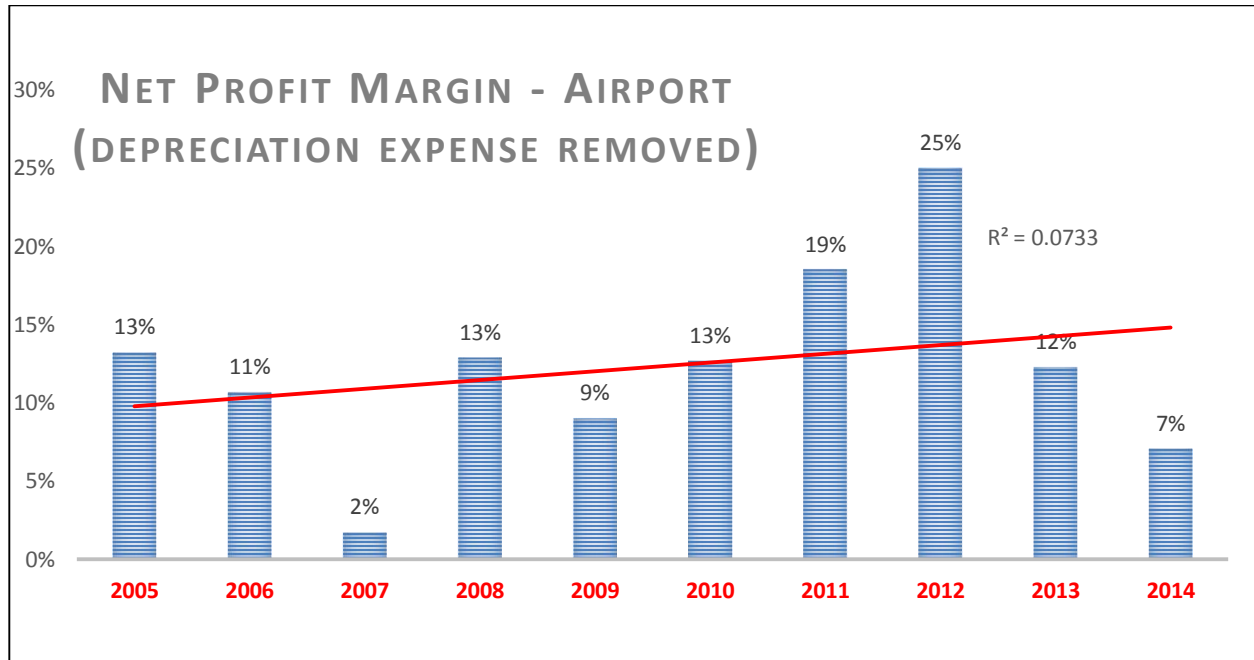
The Airport, as an outlier, reveals the following:



Net operating income for the entire period is negative and shows a \$2.35m decrease over the ten-year period.

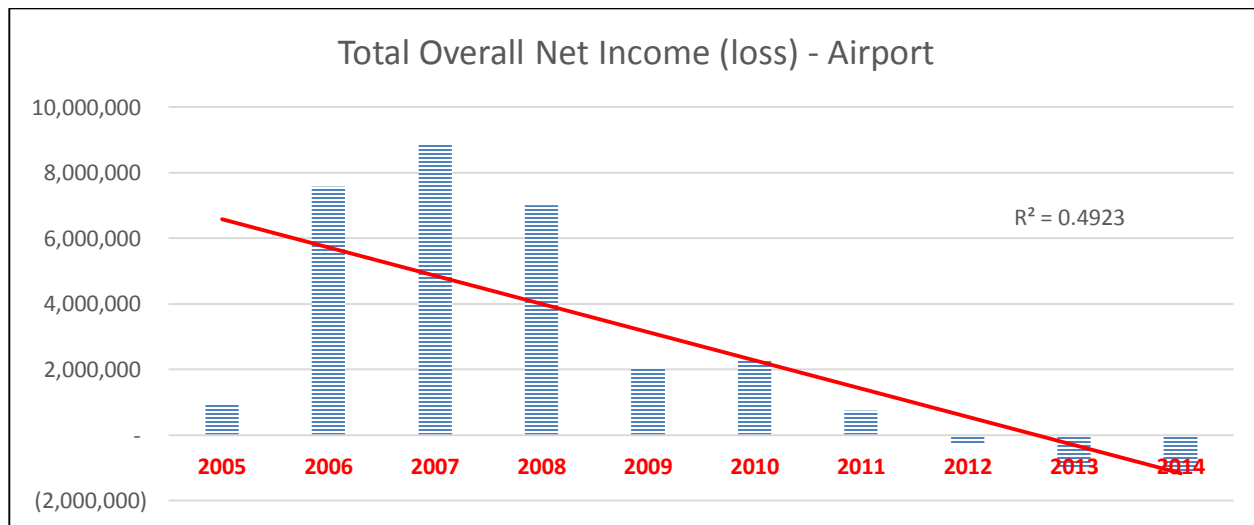
If we remove depreciation (a major expense), as some have suggested, the Airport profit margins improve dramatically:

<sup>5</sup> Wicomico Nursing Home, Notes to Financial Statements (issued October 17, 2014 by Gross Mendelsohn CPAs and Advisors) p10



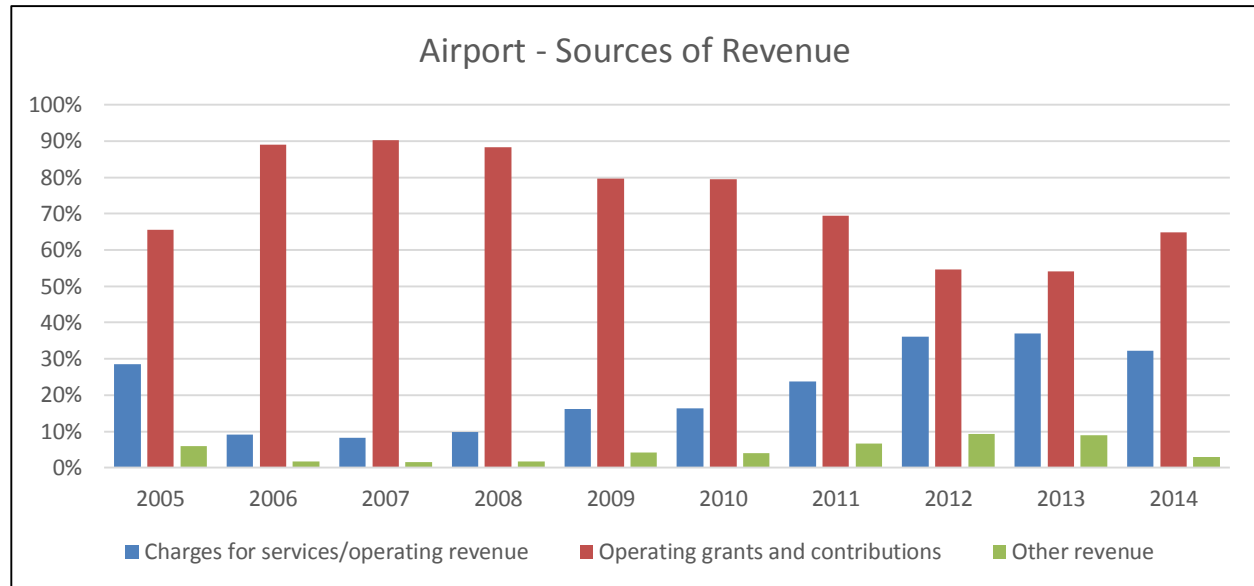
As mentioned in Measurement and Performance – Background (Depreciation) section above, this analysis represents a distortion of the Airport’s performance by removing the cost associated with assets used for revenue generation. Additionally, we see very little trend in the distorted analysis.

If we include all sources of revenue and expense (including non-operating) for the Airport we have the following:



This analysis includes *all* (as opposed to *operating*) revenue and expenses before contributions and transfers. For example, the overall net income (loss) analysis includes all operating grants and passenger facility charges. We still see a sharp negative trend.

Finally, it may be instructive to analyze sources of revenue for the Airport. Entities that rely solely on a single source of revenue run increased going-concern risks. Airport sources of revenue are as follows:



We see that the Airport is trending away from operating grants to charges for services/operating revenue. We suggest that management may want to investigate the development of a business plan designed to exploit the trend. According to Airport management, inquiries from outside entities occur occasionally concerning the possibility of establishing operations on Airport property. Lack of facilities and adequate sources of water are a hindrance to such expansion. Additionally, the Federal Aviation Administration (FAA) restricts ancillary Airport operations to some degree.

### **Solid Waste**

According to Solid Waste Management, at least three issues affecting performance exist:

1. The landfill must plan for replacement of equipment and adequate provision for closing costs. Various regulations and accounting rules demand a provision for closing costs.<sup>6</sup>
2. The long-range plan for the landfill must be adjusted. Current management would like to concentrate on long-term cost-effective solutions in lieu of waste to energy solutions.
3. Maryland Department of the Environment heavily regulates the landfill. Management must constantly remain aware of and develop efficient and effective compliance arrangements for changing regulations.

### **Conclusion**

Wicomico County has at least three options for dealing with negative trends in its enterprise functions:

1. Develop a robust business plan and carefully monitor and adjust it to reverse the declines
2. Convert or sell the enterprise (if permitted by law) to private concerns

<sup>6</sup> Please see Governmental Accounting Standards Board (GASB) Statement No. 18 for more information

3. Develop a plan to “wind down” and eventually close the enterprise (again, if permitted by law)

Additionally, the County should not ignore measurements of success other than financial. We should analyze financial targets and cash limits along with the volume and quality of service provided by our enterprises.

### **Auditor’s Closing Remark**

The office of the Internal Auditor would like to thank Management from the three enterprise funds for their candid assessment of their operations and assistance with the gathering of information.

### Appendix I - Current Ratio

