

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS
FOR THE YEAR ENDED
JUNE 30, 2010

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**CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

For the Year Ended June 30, 2010

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MEMORANDUM ON INTERNAL CONTROL

October 29, 2010

To the City Council of
the City of El Cerrito
City of El Cerrito, California

In planning and performing our audit of the financial statements of the City of El Cerrito as of and for the year ended June 30, 2010, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

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 reasonably possibility that a material misstatement of the City'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 to those charged with governance.

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 significant deficiencies or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been identified. In addition, because of the 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. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

Included in the Schedule of Other Matters are recommendations not meeting the above definitions of a significant deficiency or material weakness that we believe to be of potential benefit to the City.

The City's written responses included in this report have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, City Council, others within the organization, and agencies and pass-through entities requiring compliance with generally accepted government auditing standards, and is not intended to be and should not be used by anyone other than these specified parties.

Maze & Associates

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**CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL**

SCHEDULE OF OTHER MATTERS

2010-01 Senior Center Cash Collection Procedures

We reviewed the cash collection procedures at the Senior Center and noted the following:

a. Access to Safe and Cash Collection Batches

The Senior Center should limit the number of employees that have access to the safe which holds the locked bag that contains the daily receipts batches.

The Senior Center keeps its receipts batches in a locked bank bag stored in a safe. All five staff members know the code that opens the safe. Although the Registrar is in charge of the key that opens the bank bag, he keeps the key inside the front drawer of his desk, and all other staff members know the location of the key.

To improve controls over the cash receipts, access to the safe should be limited and the access to the bank bag key should be limited and its location should remain confidential.

b. Account Write-Off Procedures

Seven people have access to the Safari system, and of those people, five are restricted to only being able to create new entries. Those five people cannot make changes to previously posted entries, which would include deleting or writing off a receipt. The two people that can make changes are the Department Head and the Supervisor II. The Department Head reviews the Supervisor II's transactions and any associated write-offs on a monthly basis, and the Supervisor II does the same for the Department Head's transactions and write-offs.

The review and approval of write-offs should be performed on a more frequent basis, preferably upon the occurrence of such a transaction. The Senior Center should review the write-off approval procedures to ensure they provide enough control over the cash receipts process and to reduce the possibility of unauthorized write-offs.

c. Documentation of Review

When the Clerk Specialist reviews the reconciliation of the cash receipts to the register report she should indicate that the review has been completed by initialing or signing the reconciliation and dating it.

When the Registrar reconciles the cash register receipts to the cash totals, we understand a reviewer, usually the Clerk Specialist, is present during the entire time of the procedure. However, the reviewer does not sign off that the review has taken place. Without written documentation of review, there is no evidence that the review took place.

The reviewer should initial or sign the reconciliation when the review has been completed to show that a review has been performed. This will help to prevent any possible alterations to the reconciliation.

Management's Response:

Efforts will be made to implement these recommendations.

**CITY OF EL CERRITO
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SCHEDULE OF OTHER MATTERS

2010-02 Internal Controls – Segregation of Duties

In addition to the items included in the prior year comment 2009-06, during our review of the City's internal controls for proper segregation of duties and procedures, we noted areas in which controls need to be improved and employee's access and/or duties revised. Good internal controls require that employees with access to the City's assets not have access to the City's accounting records for the same assets.

a. Super-User Status in the General Ledger System

Accounting staff should not normally be allowed to have Super-User rights in the City's general ledger system. We noted that three City employees, the Administrative Services Director, the Accounting Supervisor and the Information Services Coordinator have super-user rights to the New World System.

When accounting staff have super-user rights, there is a potential risk of restricting or allowing access to other user's abilities to access the different modules in the accounting system. In addition, unauthorized transactions could be processed without proper review and approval.

While we understand the City has a limited number of staff available to provide system administration functions, and review and approval procedures in critical accounting areas partially mitigate the conflict, the City should consider restricting super user rights to as few employees as possible.

b. Preparing and Processing W-2's

The Payroll Clerk prepares the annual W-2 forms and is responsible for following up on unclaimed W-2's. Since she has access to the payroll system and the Human Resources Module, she has the ability to add an employee or change pay rates. Therefore these two functions should be segregated. The preparation of the annual W-2 forms should be closely monitored and reviewed, and any unclaimed W-2's should be followed up by a person not involved with the payroll function.

c. Accounts Receivable Billings and Collections

The Business License Clerk is involved with the collection function, can adjust the accounts receivable "database," and sometimes prepares the billings for various departments. Personnel involved with the billing function should not also be involved with the collection function, especially when they have access to adjusting the balances.

**CITY OF EL CERRITO
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SCHEDULE OF OTHER MATTERS

2010-02 Internal Controls – Segregation of Duties (Continued)

Management's Response:

- a. Rights for the Administrative Services Director and the Accounting Supervisor will be reviewed and restricted.
- b. The Payroll Clerk's security will be changed so as to restrict access to the Human Resources module.
- c. The Business License Clerk is also the Accounts Receivable Clerk and generates invoices only as instructed by City Staff. For all items except minor amounts, other City staff is reviewing for receipt of the funds. For minor cash payments receipts are given for funds received.

2010-03 Approval of Budgetary Journal Entries

Budget adjustment journal entries are prepared by the Accounting Supervisor and are supposed to be reviewed and initialed by Administrative Services Director. We reviewed the Budget Adjustments Binder for fiscal year 2010 for all twelve adjustments that were completed through March 30, 2010, and found that there was no signature in the approval box indicating that they had been reviewed by the Administrative Services Director.

We understand that since there were very few budget adjustments, the Administrative Services Director intended to review them prior to the year-end closing. However, if budget adjustment journal entries are not reviewed in a timely manner, approved budget adjustments could be misstated or unauthorized adjustments could be posted.

The budget adjustment journal entries should be reviewed and approved in a timely manner, at least quarterly.

Management's Response:

Budget entries will be signed off more frequently as recommended.

2010-04 Purchasing Policy Compliance

The City's Purchasing Policy requires the use of a purchase order for all professional services greater than \$25,000. We selected a sample of seven expenditures relating to the Sales Tax Street Improvement Project to test compliance with the City's purchasing policies and procedures, along with compliance with the Master Installment Sales Agreement. Two of the disbursements tested were related to the same professional services contract in excess of \$25,000, and although the disbursements were approved by appropriate City personnel, and the contract was approved by the City Council, the City had not used a purchase order as required by the Purchasing Policy.

The City's purchasing policy was last revised in August 2006. The City should perform a review of current purchasing procedures in conjunction with the Purchasing Policy and determine whether the Policy should be revised to reflect current practices, or if the Policy requirements should be enforced.

**CITY OF EL CERRITO
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SCHEDULE OF OTHER MATTERS

2010-04 Purchasing Policy Compliance (Continued)

Management's Response:

The items that did not have purchase orders were payments on contracts specifically authorized by the City Council. A revision to the policy is being considered that would exempt contracts from the purchase order requirements.

2010-05 Uninsured and Uncollateralized Bank Accounts

Custodial credit risk is the risk that in the event of a bank failure, the City's deposits may not be returned to it. As of June 30, 2010, \$553,875 of the City's bank balances of \$2,770,578 were exposed to custodial credit risk, because the balances in two fiscal agent accounts related to the 2002 Lease Revenue Bonds were uninsured and uncollateralized. Although the fiscal agent had reported in the prior year that the accounts were invested in money market mutual funds, upon further inquiry in the current year the fiscal agent indicated that the accounts were uninsured and uncollateralized. The City should consider investing these balances in an investment that is not subject to custodial credit risk.

Management's Response:

The funds have been changed to a money market account.

2010-06 Investment Reporting on the Quarterly Investment Report

The City's June 30, 2010 Quarterly Investment Report included an investment titled "Pooled Investment – Inter-fund Loan" in the amount of \$1.1 million. However, this transaction is an internal borrowing by the City's Redevelopment Agency from the City's General Fund. Although it is an asset to the City's General Fund, it is a liability to the Redevelopment Agency Low and Moderate Income Housing Fund and not an investment that should be included on the Quarterly Investment Report. The City should remove internal balances from the Quarterly Investment Report, and if such transactions are to be included in the Report, they should be reported separately from cash and investment balances and clearly labeled as an internal transaction with the inclusion of both the asset and related liability.

Management's Response:

The item will be removed from the Quarterly Investment Report.

2010-07 Capital Assets Inventory

The City should perform regular inventories of its capital assets to verify that each asset is properly recorded in the capital assets system and each asset is still in use and not impaired. We understand the City inventoried vehicles in fiscal year 2007, but has not inventoried other capital assets in a number of years. In addition, it appears that the Finance Department has not been checking with individual departments to determine whether capital assets listed as current assets by the department are still in use.

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SCHEDULE OF OTHER MATTERS

2010-07 Capital Assets Inventory (Continued)

Without performing regular inventories, the City cannot evaluate the most current status of its capital assets. The City should consider performing a physical inventory of all capital assets at least every three years, and in the interim years the Finance Department should send out a capital asset listing to each department to verify the existence of each asset and whether the individual assets have been disposed of or salvaged.

Management's Response:

The recommendation is under review and will be considered in accordance a cost/benefit analysis.

2010-08 Police Reserves Bank Account

The Police Department has a Police Reserves Bank Account with Mechanics Bank that was established using the City's tax identification number. The balance in the account at June 30, 2010 was \$737. We understand that the funds in the account are not the responsibility or assets of the City. However, since the account was established in the City's name and signers on the account include City officials, the City should consider including the activity and balance of the account in the general ledger. In the future, departmental personnel should be required to inform the Finance Department prior to establishing new bank accounts.

In addition, the City's former City Treasurer is listed as a signer on the Police Reserves bank account as of June 30, 2010. The City should update the authorized personnel for all bank accounts immediately when there are changes to applicable City staff.

Management's Response:

This account will either be recorded on the City's balance sheet for next year or will be changed to a new Tax ID number.

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**CITY OF EL CERRITO
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STATUS OF PRIOR YEAR SCHEDULE OF SIGNIFICANT DEFICIENCIES

2009-01 Accounting for Loans Receivable

Long-term agreements should be reviewed by the City and the Redevelopment Agency to ensure they are properly accounted for in the general ledger. Prior to the interim audit, we requested information so we could plan the audit approach and determine what footnote disclosures needed to be revised, what long-term documents needed to be reviewed, etc. During the interim audit, we were told that there were no Redevelopment Agency loans outstanding. However, upon our review of the Council minutes, we found that during fiscal year 2009 the Agency had approved a predevelopment, acquisition and construction loan agreement with Ohlone Gardens, L.P. for \$3,500,000 to assist with the acquisition and construction of an affordable housing development. During the year end phase of the audit, we found that the loan had been disbursed in the amount of \$3,022,703, but it had not yet been recorded in the general ledger as a loan receivable, because staff believed the transaction was to be accounted for as a grant to the developer.

In addition, to the Ohlone loan above, during the fiscal year 2009 audit we were told that the Agency had entered into an Owner Participation Agreement for Idaho Apartments in 1997 in which the Agency agreed to make a loan to the project in the future. In August 2000, the Agreement was amended to reaffirm the Agency's commitment to make a loan of up to \$350,000. In accordance with its 1997 and 2000 commitments, the Agency disbursed \$350,000 to the developer during the year ended June 30, 2009. This loan is repayable in 126 months from the date of occupancy, but it too had not been recorded as a loan receivable when we started the audit, again because staff believed the transaction was to be accounted for as a grant to the developer.

Without direction from Council regarding the treatment of loans, City staff should record loan transactions as they are specified in the loan documents and not assume they will be reverted to a grant.

Staff should review all agreements to ensure that documentation is accurate and that all approved transactions are recorded in the general ledger correctly and summarized for disclosure in the financial statements. In addition, significant commitments, such as the original Idaho Apartments loan commitment, should be disclosed in the financial statements when the agreements are executed.

Current Status:

During the interim phase of the audit, there were questions regarding the proposed Ohlone Gardens development that caused Redevelopment staff to question whether the development would ever be approved. Since no funds had been disbursed, the Redevelopment staff was unsure if there was an agreement to discuss. After the interim phase, when the agreement was finalized and the payment made to the developer, it was the Administrative Services Director's incorrect determination that recorded the activity as a grant instead of as a loan. Any further activities of this type will be recorded as a loan.

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**CITY OF EL CERRITO
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STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2009-02 Building Permit Fee Calculations and Documentation

Building permit fees should be calculated using the City's Master Fee Schedule. Due to the results of our building permits testing in the prior year (See 2008-03), we selected 30 building permit receipts to recalculate the rates charged in accordance with the Council approved rate schedule and found the following:

- a. The fees for two permits were reduced from the master fee schedule due to the scope of work being smaller than that anticipated in the master fee schedule. The reductions totaled \$3,630.
- b. One permit fee had been reduced by the Community Development Director by \$440 due to an "unhappy customer". This fee reduction also affected the other fees that are based on the permit fee. Therefore, the total reduction for this permit amounted to \$531.
- c. Three of the permits were calculated using the wrong fee schedule. The 2008 fee schedule was used, but the permits were initiated during 2009 and should have used that fee schedule. The errors totaled \$217.
- d. Five permits included fees related to the Fire Department and were coded on the permit as fire review fees, however those fees were recorded in the building permit revenue account. Only one other of our tested permits had the fire review fee and that fee *was* recorded in the fire review fee account.
- e. The City began splitting the permit fee between plan check and building fee 60/40, however that change was not consistently applied throughout the fiscal year. In only 12 of the 18 applicable permits tested, was the correct 60/40 split applied to the two revenue codes. In most of the 6 exceptions, the plan check was calculated at a 1 hour fee rate and the balance of the permit was applied to building. The 60/40 split should be incorporated into the permit system so it is not a manual process.

When we selected the sample of 30 permits for testing and attempted to recalculate the fees using only the Master Fee Schedule, we found that it was not possible for 29 of the permits. While we understand that permit fees may be payable under a different rate schedule, depending on when the original permit application was filed, we found that most of the permits tested required additional documentation from City staff in order to recalculate the permits. The documentation for manual calculations or reductions was not readily available in the permit system.

City staff indicated that the fee reductions were based on wording in the "general provisions" of the Master Fee Schedule which states "in cases where the permit fee calculations are overly complex, the actual charge may be subject to determination and adjustment by the Building Official." Although all of the fee reductions noted above were approved by the Building Official or the Community Development Director, the situation reveals three issues:

1. The City's Master Fee Schedule does not provide for flexibility when a project is smaller than the original scope anticipated
2. The permit system does not retain enough information to tell how the fee was calculated when a manual override of the fee has taken place
3. Approvals of the manual override of the fees are not documented in the permit system.

The City retains a Permit Fee Estimate Worksheet in the paper files, but without that worksheet it is unclear in the permit system how the fees were calculated. And the City retains a permit approval "green sheet" in the permit files, but that is also maintained outside of the permit system.

**CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2009-02 Building Permits – Manual Calculations (Continued)

The City should consider revisiting its Master Fee Schedule to determine whether certain fees could include minor fee categories for smaller jobs, which would reduce or even eliminate the need for manual calculations and reductions. Manual reductions in the fees lead to the potential for miscalculations and questions about the basis on which the fees were reduced. In the absence of a change to the Master Fee Schedule, the City should determine whether the fee adjustments, or at least the documentation of the calculation and approval, could be incorporated into the permit system, which would reduce the need for manual calculations and manual approval worksheets. In addition, the City should continue to ensure that any manual overrides of fees in the permit system are well documented and that they are reviewed and approved by the Building Official or the Community Development Director.

As for the fire fee coding error, it was determined to be a system problem, because staff had selected the correct fire review fee code, but the general ledger account associated with that fee was incorrectly linked to the building permit revenue account. However, the City should develop procedures to review the system coding when they are initially input into the base system application to ensure all items have been correctly coded so there are not errors in the functionality of the system.

Finally, when the City implements a change in the application of fees between plan check and building, such as 60/40, a review of the execution of that fee split should be reviewed to ensure it is taking place. Although we understand that the City has since changed to a 50/50 split, if an hour of time is charged to plan check at the start of the permit process, someone needs to ensure that at the end of the permit cycle the fees are split 50/50 between plan check and building.

Current Status:

The City has taken this recommendation very seriously and reviewed these issues with staff and our legal counsel to determine the extent of the issue. Procedures have been and are being put into place in accordance with the recommendation. A simplified fee schedule is being considered that would make it easier to use, test and review.

The City revised its Master Fee Schedule for FY2010-11 to include minor fee categories for smaller jobs, which reduce the need for manual calculations and reductions. In addition, the City shall continue to ensure that any manual overrides of fees in the permit system are well documented and that they are reviewed and approved by the Building Official or the Community Development Director.

**CITY OF EL CERRITO
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STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2009-03 Documentation of the Review of Daily Community Development Receipts

We reviewed the cash collection procedures at the Building/Community Development counter and noted the following:

- a. At the close of the business day, a Finance Department employee reconciles the daily cash collections from the binders to the Payment Edit Report. The cash receipts and reports are then reviewed by the Finance Department's Accounting Supervisor for accuracy and completeness. After review by the Accounting Supervisor, the reports are returned to the Finance Department employee to be input into the finance system. However, the review by the Accounting Supervisor is not indicated on the documents. Evidence of the review should be clearly indicated on the face of the document or in a log system that shows the reports were reviewed by a second person.
- b. We understand that checks received for which the account coding is unknown are not deposited until the coding can be determined. City staff should be informed that all checks are to be deposited immediately upon receipt. In the event the initial coding of a receipt is unclear, it should be posted to a clearing account in the general ledger until the correct coding can be determined.
- c. The cash receipts (checks) collected over the counter are placed in a plastic zipper pouch inside a binder that contains the activity information for the day. Although the checks are restrictively endorsed upon receipt, the City should consider the use of a cash register system or some other more secure method of handling the daily cash receipts.

The City should review the cash collection procedures to ensure that proper review and approval procedures are in place and cash collections are kept secure from time of receipt to deposit with the bank.

Current Status:

- a. The business license/cash receipts clerk does the reconciliation and the Accounting Supervisor reviews and signs off on the reconciliation sheet. The clerk then inputs the information from CRW into the finance system. Evidence of the review is now shown.
- b. There is usually a less than 24 hour turnaround on a very small amount of checks.
- c. Since there is a very limited amount of cash collected over the counter and the checks are restrictively endorsed upon receipt the City is not currently considering utilizing a cash register for the permit counter at this time. With the use of the two different systems it would make the reconciliation process even more difficult. With the implementation of the new .Net version of our finance system we are planning on developing a bridge that would bring CRW data into New World and at that time we will consider a cash register system for permits.

**CITY OF EL CERRITO
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STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2009-04 Purchasing Policy Compliance

The City's Purchasing Policy requires the use of a purchase order for all purchases of equipment and supplies greater than \$5,000. We selected thirty-one disbursements for testing of compliance with the City's purchasing policies and procedures and noted that purchase orders were used in only 6 of the 13 disbursements that appeared to require the use of purchase orders. The City's purchasing policy was last revised in August 2006. The City should perform a review of current purchasing procedures in conjunction with the Purchasing Policy and determine whether the Policy should be revised to reflect current practices, or if the Policy requirements should be enforced.

Current Status:

A purchasing policy revision was completed in 2011, however see also 2010-04.

2009-05 Journal Entry Review

We selected a sample of twenty-five journal entries to test the effectiveness of journal entry processing, procedures and adequacy of documentation. One of the journal entries tested was both prepared and approved by the Administrative Services Director without a second person's review. Although the journal entry was posted to the general ledger system by the Accounting Supervisor, to ensure proper control over journal entries and segregation of duties, the City should designate a second person, such as the Accounting Supervisor, to review and approve the entries initiated by the Administrative Services Director.

Current Status:

That policy has been implemented.

2009-06 Internal Controls – Segregation of Duties

During our review of the City's internal controls for proper segregation of duties and procedures, we noted areas in which controls need to be improved and employee's access and/or duties revised. Good internal controls require that employees with access to the City's assets not have access to the City's accounting records for the same assets.

a. Payroll Review and Super-User Status

The payroll edit report (payroll register) should be reviewed by a second person to verify all checks are accurate and only authorized amounts are paid. This review should be performed by an employee that does not have access to the payroll module. The Accounting Supervisor reviews the payroll edit report, however he has access to the payroll system and has access to the check stock and the signature plate. In addition, he is a system "super user". An independent review of changes to the payroll database (new employees, pay rate changes, etc) should be performed by an employee not involved with the processing and review above.

**CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2009-06 Internal Controls – Segregation of Duties (Continued)

b. Access to Payroll System and Human Resources Module

We understand that due to a system limitation, the payroll function and the Human Resources function are combined into one module. Therefore, the payroll clerk has access to the payroll database and could make changes such as adding an employee or changing pay rates. Again, the City should determine whether a report of changes to the payroll database can be generated with each check run and reviewed and approved by an employee independent of the function.

c. Accounts Receivable Adjustments and NSF Checks

The Business License Clerk has access to the accounts receivable “database” and is responsible for processing NSF checks. And, the Accounting Supervisor can adjust accounts receivable balances and also has access to NSF checks. Employees with access to the NSF checks should not be involved with the cash collection or receivable procedures.

In addition, we understand that the “Customer Database” used to track customer billings is only an excel spreadsheet, not an actual system, therefore any adjustments to the receivables cannot be tracked. The City should consider the use of a database system to tighten controls over cash collection and billing procedures. If that is not possible, the responsibility for maintaining the “database” should be transferred to an employee that is not involved with the cash collections, and access to that database should be restricted.

Current Status:

- a. The Employee Services Manager position has been filled but the account clerk position in Employee Services is vacant and we are not planning on filling it in the near future. The Employee Services Manager is reviewing the payroll changes and does not have access to the database or the check stock.
- b. The new .Net system has much better security and this will no longer be a problem.
- c. We do not have anyone else to do the NSF checks. For the database, we are purchasing New Worlds .Net product for Miscellaneous Receivables that will replace the excel spreadsheet.

See also comment 2010-02.

2009-07 Monitoring Contractors Processing Transactions

Statement on Auditing Standards #70—Service Organizations (SAS 70) establishes auditing standards to be followed to ensure that any service organization’s systems and controls are adequately designed and are operating effectively. SAS 70 has two parts. Part one is designed to review controls over the service provided at a particular date and to report on whether the design of these controls appear to be adequate on that date. Part two is designed to test these controls over a six month period and to report on whether the design of the controls appears adequate and whether the auditor can reasonably conclude that the controls were operating effectively.

**CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2009-07 Monitoring Contractors Processing Transactions (Continued)

The City has a third party fiscal agent, Union Bank of California, that manages the City's debt service transactions and investment of bond proceeds. The procedures used by these service organizations are outside the scope of City oversight and staff review, and these controls are not part of the scope of an audit of the City's financial statements. Typically cities employ a variety of approaches to gain comfort that service organizations are performing their functions in a prudent manner and producing reliable data. For example, fiscal agents manage funds held pursuant to debt indentures, but cities rarely have audits performed as City staff review transactions and verify the trust data. Less frequently special audits are performed to determine adequacy of controls and to verify the data produced. There is a third option which is to request a copy of the entity's review and report on internal controls pursuant to the requirements of SAS 70.

Should the SAS 70 audit reveal weaknesses in the service organization's internal controls, those could go unnoticed by the City. The City should request a copy of the most recent SAS 70 report from its third party fiscal agent, especially in light of the change in fiscal agent during the current fiscal year. It would be preferable if the contractor had both parts of a SAS 70 audit performed and that the report be furnished directly to the City for review. Any weaknesses or system problems disclosed by that audit should be addressed and resolved by the contractor to the satisfaction of the City. This process should take place on an annual basis for all of the City's service organizations.

Current Status:

The most current SAS 70 report was obtained from Union Bank of California and reviewed. The City has made a request to be on the annual dissemination listing for future SAS 70 reports.

Per Union Bank the requests are so few for this report they do not have a distribution list. We will continue to request and review it each year.

2009-08 OPEB Implicit Rate Subsidy and Potential New OPEB Plan

Although the City does not directly provide post-retirement healthcare benefits, the City does allow retirees to purchase health care coverage through the City's plan. The difference between the group premium rate paid by those retirees and the rate they would pay if they were to obtain the healthcare as a separate group is termed an implicit rate subsidy and is subject to the GASB Statement 45 reporting requirements.

The City should determine whether the potential liability of the implicit rate subsidy is material, and if so, the City should consider obtaining an actuarial study. The City has approximately 30 retired employees purchasing coverage through the group plan, but current employees eligible to participate also need to be factored into the calculation. One method of determining whether the amount is material is to complete the calculation using the "alternative measurement method" as described in GASB Statement 45. There are also a number of websites that can be used to calculate the liability under the alternative measurement method online.

The City should determine whether the implicit rate subsidy needs to be disclosed in accordance with the requirements of GASB Statement 45. If so, the City is a "Phase 3" government and would be required to implement the provisions of GASB Statement 45 in fiscal year 2010.

**CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2009-08 OPEB Implicit Rate Subsidy and Potential New OPEB Plan (Continued)

Finally, the City should determine whether the new Employer Participation Agreement for the Post Employment Health Plan for Collectively Bargained Public Employees (Fire) approved in April 2008 is subject to the GASB 45 provisions. Again, if this Plan is subject to GASB Statement 45, the City will need to implement the provisions of the Statement in fiscal year 2010, which could include the need for an actuary study if the Alternative Measurement Method cannot be used for this Plan.

Current Status:

The City obtained the actuary report and implemented the provisions of GASB Statement 45 during the year ended June 30, 2010.

2009-09 Information Technology Best Practices Recommendations

We conducted an Information Systems Review with our audit which encompassed the City's financial information system and the network environment that houses it. We expanded our work in previous years beyond simply looking at financial information systems as a result of greater risks of unauthorized access caused by overall industry growth of web-based commerce and internet based financial systems. Internal controls that are present in the overall network environment have become more important and relevant to understanding the internal controls over the financial system. We believe Information System controls must be continuously improved and enhanced to stay ahead of the ever increasing sophistication of hackers and criminals.

Currently, there are no Information Technology standards to which local governments are required to conform. Indeed there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments can use to implement appropriate controls to ensure adequate security over information technology. Our Information Technology staff have reviewed these informal guidelines and concluded that the certification and accreditation framework developed by the National Institute of Standards and Technology (NIST) for the Federal Information Security Management Act (FISMA) are the most appropriate for local government. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. We understand the U.S. Department of Justice recommends these for local governments. Our procedures included performing an external network scan based on NIST criteria and in determining that internal control provides for:

- Internet access defenses including hacker prevention, detection and deterrent systems
- Security of data from physical or network access
- Adequately protecting data from unauthorized internal access
- Reasonable measures to ensure continuation of service

While the results of our work did not indicate material weaknesses we noted a few areas which could be improved to conform to NIST guidelines. A summary of these recommendations which we believe are "best practices" as follows:

**CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2009-09 Information Technology Best Practices Recommendations (Continued)

- *Payment Card Industry Compliance* – The City has point-of-sale credit card processing. The City is not in compliance with the Payment Card Industry Data Security Standard (PCI-DSS). Any organization that processes credit cards is required to comply with PCI-DSS, even if the processing is outsourced. Failure to meet compliance requirements results in higher transaction fees and liability if a security breach is found. Because the City accepts credit cards as a form of payment, the City must be compliant with the applicable controls.
- *Audit/Event Logging* - We believe this is one of the more important standards of NIST. The City does not appear to have audit logs on the financial application server, such that any change, addition or deletion of user accounts within the application are tracked and monitored. The City should have audit/event logs of any addition, deletion or change in financial application user accounts and that log should be monitored by someone without the rights to effect such changes. In addition, any administrative access such as upgrades or application modifications by IT personnel, outside consultants or vendors should also be logged and reviewed.
- *General Information Systems Controls* – We reviewed the compliance of the City’s information systems with the National Institute of Standards and Technology (NIST) information security standards based on a moderate risk system. We noted a number of controls that did not appear to be in place. A separate report of those controls was provided to the City’s IT and Finance personnel. We recommend the City choose an appropriate industry standard like NIST to help plan, organize and review information security.

Current Status:

PCI Compliance –The City has completed the self-assessment questionnaire and will maintain it in-house for review by any acquiring banks. Additional training has been scheduled to assure we are in compliance with the new regulations.

Audit/Event Logging – Our current financial system does not maintain records of the changes that could be reviewed with the log activity and the ability to change user accounts is restricted to the IT department. We will make this a requirement of any new system selected.

General Information Systems Controls – The City will review the report of controls provided and determine if any of those controls should be implemented.

**CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2009-10 Asset Seizure Special Revenue Fund

The City established the Asset Seizure Special Revenue Fund in fiscal year 2005. However, the Fund has had no expenditure activity to date and has fund balance of \$209,065 at June 30, 2009. We made this same recommendation in the prior year (see 2008-08), but attain the fund had no activity. The City should determine whether these funds may be applied to existing public safety expenditures or whether there are any time limits on use of the funds.

Current Status:

The monies were used in FY 2010-11 to purchase a vehicle with the specified requirements for a K-9 unit as well as other one-time expenditures consistent with the funds regulations.

**CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

NEW GOVERNMENTAL ACCOUNTING STANDARDS BOARD PRONOUNCEMENT:

The following comment represents a new pronouncement taking affect in the next few years. We cite it here to keep you abreast of developments:

2009-11 GASB Statement No. 54 - Fund Balance Reporting and Governmental Fund Type Definitions (Effective for fiscal 2010/11)

This Statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds.

The initial distinction that is made in reporting fund balance information is identifying amounts that are considered **nonspendable**, such as fund balance associated with notes receivable. This Statement also provides for additional classifications as **restricted, committed, assigned, and unassigned** based on the relative strength of the constraints that control how specific amounts can be spent.

The **restricted** fund balance category includes amounts that can be spent only for the specific purposes stipulated by constitution, external resource providers, or through enabling legislation.

The **committed** fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of the government's highest level of decision-making authority. Amounts in the **assigned** fund balance classification are intended to be used by the government for specific purposes but do not meet the criteria to be classified as restricted or committed. In governmental funds *other than the general fund*, assigned fund balance represents the remaining amount that is not restricted or committed.

Unassigned fund balance is the residual classification for the government's general fund and includes all spendable amounts not contained in the other classifications. *In other funds*, the unassigned classification should be *used only to report a deficit balance* resulting from overspending for specific purposes for which amounts had been restricted, committed, or assigned. Governments are required to disclose information about the processes through which constraints are imposed on amounts in the committed and assigned classifications.

Disclosure of the policies in the notes to the financial statements is required.

This Statement also provides guidance for classifying stabilization amounts on the face of the balance sheet and requires disclosure of certain information about stabilization arrangements in the notes to the financial statements.

The definitions of the general fund, special revenue fund type, capital projects fund type, debt service fund type, and permanent fund type are clarified by the provisions in this Statement. Interpretations of certain terms within the definition of the special revenue fund type have been provided and, for some governments, those interpretations may affect the activities they choose to report in those funds. The capital projects fund type definition was also clarified for better alignment with the needs of preparers and users. Definitions of other governmental fund types also have been modified for clarity and consistency.

Current Status:

The City will implement the provisions of the Statement in fiscal year 2011.

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REQUIRED COMMUNICATIONS

October 29, 2010

To the City Council of
the City of El Cerrito
City of El Cerrito, California

We have audited the financial statements of the City of El Cerrito as of and for the year ended June 30, 2010 and have issued our report thereon dated October 29, 2010. Professional standards require that we advise you of the following matters relating to our audit.

Financial Statement Audit Assurance: Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit in accordance with generally accepted auditing standards does not provide absolute assurance about, or guarantee the accuracy of, the financial statements. Because of the concept of reasonable assurance and because we did not perform a detailed examination of all transactions, there is an inherent risk that material errors, fraud, or illegal acts may exist and not be detected by us.

Other Information Included with the Audited Financial Statements: Pursuant to professional standards, our responsibility as auditors for other information in documents containing the City's audited financial statements does not extend beyond the financial information identified in the audit report, and we are not required to perform any procedures to corroborate such other information. Our responsibility also includes communicating to you any information that we believe is a material misstatement of fact. Nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements. This other information and the extent of our procedures is explained in our audit report.

Accounting Policies: Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note 1 to the financial statements. As described in notes to the financial statements, during the year, the City implemented the following standards:

GASB Statement No. 45 - Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions

GASB 45 uses Pension Accounting (GASB 27) to change the accounting for Other Post Employment Benefits (OPEB) to full accrual at the Entity-wide and proprietary funds financial statement levels. Under the concepts in GASB 45 an actuarial study or simplified measurement method calculation is performed to determine an Annual Required Contribution (ARC). So long as employers contribute this amount every year, no accrual adjustment is needed in the financial statements.

CITY OF EL CERRITO

REQUIRED COMMUNICATIONS

As discussed in Note 9C to the financial statements, during the year ended June 30, 2010, the City implemented the provisions of GASB 45. There was no cumulative effect of the accounting change as of the beginning of the year.

GASB Statement No. 51 - Accounting and Financial Reporting for Intangible Assets – This Statement establishes and clarifies financial reporting of intangible assets. There was no material effect on the financial statements from the implementation of this statement.

GASB Statement No. 53 Accounting and Financial Reporting for Derivative Instruments – This Statement improves how state and local governments report information about derivative instruments in their financial statements. The City does not have any derivative instruments as of June 30, 2010; therefore there was no effect on the financial statements from the implementation of this statement.

Unusual Transactions, Controversial or Emerging Areas: No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2010.

Estimates: Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The most sensitive accounting estimates affecting the financial statements are depreciation and compensated absences.

Estimated Fair Value of Investments: As of June 30, 2010, the City held approximately \$12.4 million of cash and investments as measured by fair value as disclosed in Note 3 to the Financial Statements. Fair value is essentially market pricing in effect as of June 30, 2010. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2010.

Estimated Depreciation: Management's estimate of the depreciation is based on useful lives determined by management. These lives have been determined by management based on the expected useful life of assets as disclosed in Note 6 to the financial statements. We evaluated the key factors and assumptions used to develop the depreciation estimate and determined that it is reasonable in relation to the basic financial statements taken as a whole.

Estimated Compensated Absences: Accrued compensated absences, which are comprised of accrued vacation and sick leave, is estimated using accumulated unpaid leave hours and hourly pay rates in effect at the end of the fiscal year, and are disclosed in Note 1H to the financial statements. We evaluated the key factors and assumptions used to develop the accrued compensated absences and determined that it is reasonable in relation to the basic financial statements taken as a whole.

CITY OF EL CERRITO

REQUIRED COMMUNICATIONS

Estimated Net OPEB Obligation: Management's estimate of the net OPEB obligation is disclosed in Note 9C to the financial statements and is based on actuarial study determined by a consultant, which is based on the experience of the City. We evaluated the key factors and assumptions used to develop the estimate and determined that it is reasonable in relation to the basic financial statements taken as a whole.

Disagreements with Management: For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

Retention Issues: We did not discuss any major issues with management regarding the application of accounting principles and auditing standards that resulted in a condition to our retention as the City's auditors.

Difficulties: We encountered no serious difficulties in dealing with management relating to the performance of the audit.

Audit Adjustments: For purposes of this communication, professional standards define an audit adjustment, whether or not recorded by the City, as a proposed correction of the financial statements that, in our judgment, may not have been detected except through the audit procedures performed. These adjustments may include those proposed by us but not recorded by the City that could potentially cause future financial statements to be materially misstated, even though we have concluded that the adjustments are not material to the current financial statements.

We did not propose any audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the City's financial reporting process.

Uncorrected Misstatements: Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. We have no such misstatements to report to the Council.

This report is intended solely for the information and use of the audit committee, City Council, and management and is not intended to be and should not be used by anyone other than these specified parties.

Mare & Associates

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