

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS
FOR THE YEAR ENDED
JUNE 30, 2011

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CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS

For the Year Ended June 30, 2011

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MEMORANDUM ON INTERNAL CONTROL

December 14, 2011

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, 2011, 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 reasonable 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. We identified certain deficiencies in internal control that we consider to be significant deficiencies that are included on the Schedule of Significant Deficiencies.

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 SIGNIFICANT DEFICIENCIES**

2011-01 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 prior years (See Memorandum on Internal Control items #2009-02 and 2008-03), we again selected 19 building permit receipts to recalculate the rates charged in accordance with the Council-approved rate schedule and found the following:

- a. One permit was miscalculated due to mathematical errors and the fee being based on the initial project square footage, rather than the larger final square footage. In addition, we noted that the permit had been calculated manually. The errors resulted in the developer being undercharged by \$19,370.

If permits cannot be calculated directly in the billing system, manual calculations should be performed using a spreadsheet with formulas, rather than pencil and paper, to minimize the chance of errors. And, although the City did subsequently bill the developer for the additional fees after we brought the error to the attention of City staff, the fee should have been reviewed and approved in detail to minimize the chance of such a miscalculation.

- b. One permit was miscalculated due to the fee being based on square footage that was not the final project square footage, which resulted in the customer being undercharged by \$625. If permits are to be based on the actual square footage, a process should be put in place to ensure that the final square footage is used and the basis for the fee is reviewed and approved.
- c. Seven permits, including the two above and one of the permits below, overcharged customers a total of \$28 for the California Building Standards Commission (CBSC) Fee. Senate Bill 1473 requires that Cities collect a fee from applicants for building permits. The fee is based on the schedule below obtained from Building Standards Bulletin 08-01:

<u>Permit Valuation:</u>	<u>Fee:</u>
\$1-25,000	\$1
\$25,001-50,000	\$2
\$50,001-75,000	\$3
\$75,001-100,000	\$4

Every \$25,000 or fraction thereof above \$100,000, add \$1.

The seven permits tested were for jobs with valuations over \$100,000, and the CBSC fee is automatically calculated by the permit system based on the entered job valuation. It appears that the formula for calculating the fee for jobs over \$100,000 was input incorrectly, because we recalculated the fees and noted that each permit was overcharged by \$4.

Fee schedules in the system should be reviewed in detail at least annually, and of course each time there is a fee change, to ensure they are accurate and they should be tested to ensure that permits issued are being calculated correctly.

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

SCHEDULE OF SIGNIFICANT DEFICIENCIES

2011-01 Building Permit Fee Calculations and Documentation (Continued)

- d. Supporting documentation for two permits selected for testing could not be located by City staff and therefore we were unable to determine that the correct fees had been calculated and charged. The two permit fees totaled \$14,071. According to City staff, the permits had been finalized and the supporting documentation had not been retained, however we noted that they had expiration dates of 10/25/11 and 10/30/11.

Supporting documentation for fees paid during the fiscal year should be subject to the City's "normal" records retention policy and we would expect that policy would require the retention for at least a year after payment.

This volume of errors in our testing indicates that there continues to be an issue with the permit fee calculation process. As we'd recommended in the prior years, the City must implement procedures to ensure that permit fees are calculated accurately and that all permits are reviewed and approved by a second person. 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 in detail and approved by the Building Official or the Community Development Director.

Management's Response:

The City recognizes that there are issues with the permit fee calculation process. Currently, the City is in the process of upgrading the permitting software, and through this exercise the entire permitting process is being examined to determine the appropriate procedures necessary to prevent errors in the future. Actions have already been taken to prevent calculation errors in the future by not allowing for the adjustment or modification of fees. Additionally, action has been taken on the leadership in the division in order to ensure that the recommendations in this memorandum are addressed and corrected.

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL
SCHEDULE OF SIGNIFICANT DEFICIENCIES

2011-02 Timely Grant Billings and Federal Expenditure Reporting

The City has a number of projects that are fully or partially funded by federal grants on a reimbursement basis. As the City incurs related project costs, timely grant reimbursement requests should be prepared and filed with the grantor to minimize the time between disbursement and reimbursement. Cash management of grant funded projects is vital to the continuation and successful completion of the projects. If grant funds are not requested timely, the funding source may no longer have available funds for reimbursement or funds may be deprogrammed by the grantor.

During the year end audit, it came to our attention that reimbursement requests for the City's various grant-funded street and other related projects are not being prepared timely as evidenced by the year end fund balance deficit in the Capital Improvement Capital Projects Fund of \$835,000. In addition, if reimbursement requests are not filed timely, the annual Single Audit of the City's federal award grants may not include federal expenditures in the proper period, because the City normally prepares the Schedule of Expenditures of Federal Awards included in the Single Audit based on revenues received, rather than expenditures incurred. The City should develop procedures to ensure grant reimbursement requests are prepared on a timely basis, at least quarterly, as costs are incurred not only to improve cash flow but to match expenditures with associated revenues in the same period.

Management's Response:

The City relied on an outside construction and grant administration firm who prepared the required submittals. The City now more fully understands the requirements of the grant agreements, and will monitor more closely the actions of any outside consultants.

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CITY OF EL CERRITO
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SCHEDULE OF OTHER MATTERS

2011-03 Monitoring Current and Future Redevelopment Agency-Related Transactions

During fiscal year 2011, the Redevelopment Agency initiated a number of transactions that included making certain findings required by the Health and Safety Code and entering into a Cooperation Agreement with the City for implementation of the Agency's Redevelopment Plan. The City later assigned its rights and responsibilities under the Agreement for redevelopment and public improvement projects, but not affordable housing projects, to the El Cerrito Municipal Services Corporation, and the Agency consented to that assignment. Separately, the Agency made certain findings required by the Health and Safety Code and conveyed real property assets to the City subject to the requirement that they be developed with affordable housing consistent with the Agency's Redevelopment Plan and subject to an exclusive negotiating agreement for the property with a developer already in place. The Agency also made certain findings and conveyed real and personal property assets to the El Cerrito Municipal Services Corporation subject to the requirement that they be developed in accordance with the Agency's Redevelopment Plan or operated in accordance with previous Agency actions consistent with the Redevelopment Plan. Although the transactions appear to have been completed in compliance with current Redevelopment Law, the City, Corporation and Agency must develop new policies and procedures to ensure that all future transactions continue to be in compliance with those laws. During the audit, we noted the following:

- **Assets Derived from Property Held for Resale and Capital Assets Must be Restricted**

Under the terms of the conveyance agreement between the Agency and the City, land held for resale with a total book value of \$3,950,000, previously recorded in the Agency's 2004 Bond Series A Capital Projects and Low and Moderate Income Housing Funds, was conveyed to the City during the fiscal year recorded in the Governmental Activities as of June 30, 2011 as land held for resale in the General Fund. In accordance with the agreements that authorized the conveyance, the assets are to be used for development of affordable housing as required in the section of the Health and Safety Code applicable to the conveyance agreement.

Under the terms of the conveyance agreements between the Agency and the El Cerrito Municipal Services Corporation, capital assets with a book value of \$5,533,530 and land held for resale with a book value of \$4,634,789, previously recorded in the Agency's Redevelopment Capital Projects Fund, were conveyed to the Corporation during the fiscal year and recorded in the Governmental Activities as of June 30, 2011 as capital assets and land held for resale in the El Cerrito Municipal Services Corporation Special Fund. In accordance with the agreements that authorized the conveyances, the assets are to be used for those redevelopment projects or activities required in the sections of the Health and Safety Code applicable to each of the conveyance agreements.

The Agency should establish procedures to ensure that any assets derived from the use of these properties, such as sales proceeds or other income, are segregated and restricted for purposes consistent with those sections of the Health and Safety Code under which the assets were conveyed.

- **Continuous Monitoring of Agency-Funded Projects is Necessary**

Under the terms of the Cooperation Agreements, the City and Corporation expend funds on capital projects on behalf of the Agency. Any transactions by the City or Corporation funded by the Agency pursuant to the Agreements are subject to Health and Safety Code requirements pertaining to the use of redevelopment funds. Should legislation enacted by the State on June 28, 2011 result in dissolution of the Agency, any transactions of the Agency may be subject to detailed scrutiny by the State and others for consistency with the revised Health and Safety Code requirements.

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

SCHEDULE OF OTHER MATTERS

- **Continuous Monitoring of Agency-Funded Projects is Necessary (Continued)**

Under the terms of the Cooperation Agreement with the Municipal Services Corporation, the Agency transferred \$1,350,893 to the Corporation and agreed to transfer future tax increment revenue to fund current and future projects. The Agency should review each Agency-funded project undertaken by the Corporation to ensure the funding has been or will be provided in accordance with the restrictions in the Agreement. In addition, the Agency must establish procedures to ensure that all Agency-funded projects implemented by the Corporation continue to comply with current redevelopment law and any unspent project funds are tracked and accounted for separately, so that any unspent funds are returned to the Agency.

Under the terms of the Cooperation Agreement with the City, the Agency agreed to transfer future tax increment revenue to fund current and future projects. The Agency should review each Agency-funded project undertaken by the City to ensure the funding has been or will be provided in accordance with the restrictions in the Agreement. In addition, the Agency must establish procedures to ensure that all Agency-funded projects implemented by the City continue to comply with current redevelopment law and any unspent project funds are tracked and accounted for separately, so that any unspent funds are returned to the Agency.

Management's Response:

The City agrees that any property conveyed must maintain the restrictions originally associated with the property, and will ensure that the property is segregated and restricted for those purposes.

As of February 1, 2012 the Redevelopment Agency was dissolved.

2011-04 Terminated Employee in Active Payroll Records

During our testing of eight terminated employees to ensure they were removed from the payroll system in a timely manner, we noted one employee that received his last check on November 5, 2010 was not officially terminated until January 1, 2011 and was not removed from the payroll system until February 3, 2011. Although the employee did not receive any payments subsequent to his November check, terminated employees should not remain in the active payroll records.

The City should develop procedures to ensure that subsequent to receiving their last paycheck, terminated employees are immediately removed from the payroll system.

Management's Response:

The employees that were listed as active, but were not receiving paychecks, were all part time recreation employees. It is a normal practice to rehire part time recreation employees after a period of time where they receive no pay, but there have been instances where it is forgotten that they are still active in the system. To address this concern in May 2011 we began providing a list of active employees to the Recreation department every pay-period. They return the list as a cover sheet for their submitted timecards and provide direction to Employee Services on when to terminate employees.

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

SCHEDULE OF OTHER MATTERS

2011-05 Collection Procedures at the Community Center

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

- a. We understand that the Management Assistant performs a reconciliation of the cash receipts to the register report up to four times a day, but there is no formal documentation of the reconciliation, such as an initial and date to show that it was completed. Both the preparer and reviewer do sign off on the reconciliation when Community Center staff performs the end of day reconciliation before taking the deposit to the Finance Department. All reconciliations should be subject to the same review and approval controls and documentation.
- b. The Administrative Clerk Specialist prepares bills for accounts receivable on a monthly basis, however there is no review process in place to review the bills for accuracy prior to mailing. All billings should be reviewed for accuracy and approved by a second employee prior to mailing.

The City should review the cash collection procedures at the Community Center to ensure that proper review and approval procedures are in place and that there is documentation of the review.

Management's Response:

- a. A reconciliation log will be maintained showing the date, time, both staff members initials and the results of the reconciliation.
- b. With the new RecTrac software that was implemented during FY11-12, a summary report can be generated for the monthly billing and will be researched for this purpose.

2011-06 Uninsured and Uncollateralized Bank Account

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 we had noted in prior year comment 2010-05, the City had bank balances exposed to custodial credit risk as of June 30, 2010, because the balances in two fiscal agent accounts related to the 2002 Lease Revenue Bonds were uninsured and uncollateralized. Although those accounts were not exposed to custodial credit risk as of June 30, 2011, the City had a different account related to the Recycling Center Capital Lease that was exposed. As of June 30, 2011, \$2,957,694 of the City's bank balances of \$4,056,184 were exposed to custodial credit risk, because the balance in the Recycling Center Capital Lease fiscal agent account was uninsured and uncollateralized.

The City should consider investing the balance in an investment that is not subject to custodial credit risk and in the future new accounts established should be reviewed for custodial credit risk to the City's balances on deposit.

Management's Response:

As of the writing of this response, March 2012, there is \$460,690 in the Escrow account relating to the construction of the recycling center. The Capital One Investment account was discussed with the trustee who provided an attorney's letter analyzing the appropriateness of the Capital One Fund but not providing complete assurance with compliance so the funds were requested to be transferred to a Deutsche Bank deposit where no interest is earned, but the full amount is FDIC insured and collateralized.

**CITY OF EL CERRITO
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SCHEDULE OF OTHER MATTERS

2011-07 Independent Contractors

In prior years we have inquired as to whether the City had former employees working for the City under contract. We were told that the City had two former police employees working on special projects in prior years, but the use of those employees had been minimal and contracts had not been established. In the current year we again inquired about former employees working for the City and found that the City was still using one of the above employees and paid him a total of \$8,000 in fiscal year 2011 for performing background check services. The City does not have a contract in place with this former employee.

The City should review the "Employer's Supplemental Tax Guide", located on the IRS website, to determine whether the former employees should be paid as an independent contractor or as an employee paid through payroll. If the former employee qualifies as an independent contractor, the City should establish a contract with him to clearly establish the terms of the work to be performed for the City.

Management's Response:

As of the date of this response a contract with the former employee has been created and approved. His work meets all of the requirements for an Independent Contractor as defined in the contract for private investigative services.

2011-08 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. Our work goes 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 government¹. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. NIST recommends these for state and 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

¹ "State, local, and tribal governments, as well as private sector organizations are encouraged to consider using these guidelines, as appropriate." NIST SP 800-37 Rev 1 pg 11

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL

SCHEDULE OF OTHER MATTERS

2011-08 Information Technology Best Practices Recommendations (Continued)

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:

Payment Card Industry Compliance

Any organization that processes credit cards is required to comply with the Payment Card Industry Data Security Standard (PCI-DSS), even if the processing is outsourced. Because the City accepts credit cards as a form of payment, the City must be compliant with the applicable controls. The City is not in compliance with the Payment Card Industry Data Security Standard (PCI-DSS) that requires, at a minimum, the completion of a Self Assessment Questionnaire. The City should contact its processing bank to determine if there are any additional compliance requirements. Failure to meet compliance requirements results in higher transaction fees and liability if a security breach is found.

Regular Password Change for Operating Systems

The City does not enforce regular password changes for users. There should be a written policy for the regular changing of operating system account passwords and automatic enforcement of this policy should be implemented. There should be enforced password complexity for the operating system to reduce the risks of easy guessing and brute force attacks against the passwords. Required use of unique alpha numeric and special character combinations along with a password length of at least 8 characters is best, and there should be a policy that requires a limit on repeating operating system account passwords. This will stop users from circumventing password change controls. An automatic enforcement of this policy would be optimum. Users should not share passwords with other users nor use password easily guessed by other users.

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 Information Technology and Finance personnel. We recommend the City choose an appropriate industry standard like NIST to help plan, organize and review information security.

Management’s Response:

The City has limited resources and a small Information Technology staff. Every effort has been done to protect personal information from credit card payments and comply with the PCI standards. There have been no instances of non compliance and the transaction fees have not been affected. In regards to the passwords, there is a process in place regarding passwords expiring after six months in the New World finance system.

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

STATUS OF PRIOR YEAR 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.

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

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2010-01 Senior Center Cash Collection Procedures (Continued)

Current Status:

- a. Batches are being processed more frequently to keep from having them locked in the safe because it is impossible to keep the bank bag key more secure with the small staff.
- b. The Safari system was replaced by RecTrac in FY 2011-12 and all procedures are being reviewed for efficiencies and internal controls.
- c. This recommendation has been implemented.

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
MEMORANDUM ON INTERNAL CONTROL

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

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

Current Status:

- a. Rights for the Administrative Services Director and the Accounting Supervisor will be reviewed and restricted in fiscal year 2012.
- b. The Payroll Clerk's security will be changed so as to restrict access to the Human Resources module in fiscal year 2012.
- 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.

Current Status:

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
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2010-04 Purchasing Policy Compliance (Continued)

Current Status:

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.

Current Status:

See 2011-07.

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.

Current Status:

Implemented.

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.

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL

STATUS OF PRIOR YEAR 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.

Current Status:

No change from prior comment

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.

Current Status:

This account was closed in September 2011.

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 Senior Accountant 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 report requested regarding changes from the prior period does not exist in the current system. We are upgrading to the Next Gen version of New World HR module in the next few months and will try to address this concern with the implementation.
- b. Same as “a” above.
- c. No change from prior year comment.

REQUIRED COMMUNICATIONS

December 14, 2011

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, 2011 and have issued our report thereon dated December 14, 2011. 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. 54 – Fund Balance Reporting and Governmental Fund Type Definitions
– 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.

CITY OF EL CERRITO

REQUIRED COMMUNICATIONS

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

As discussed in Note 8 to the financial statements, the City implemented the provisions of the Statement during the year ended June 30, 2011.

GASB Statement No. 59 - *Financial Instruments Omnibus* – The objective of this Statement is to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. This is a technical clean up pronouncement that had no material impact to the financial statements.

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 2011.

As discussed in Note 16 to the financial statements, prior to June 30, 2011, in an effort to balance its budget, the State passed ABx1 26, which substantially changes California redevelopment law, suspends redevelopment activities and dissolves redevelopment agencies effective October 1, 2011. The State also passed ABx1 27 which provided a voluntary program under which agencies may opt out of the mandatory dissolution provided they pay substantial annual contributions to local schools and special districts. Concurrently with these two measures were the passing of various budget and trailer bills that are related and collectively constitute the Redevelopment Restructuring Acts. In addition, the Acts give the State the power to review transactions on or after January 1, 2011 between the Redevelopment Agency and City and to require the return of assets by the City to the Redevelopment Agency if it finds violate the provisions of the Acts.

On July 18, 2011, the California Redevelopment Association, the League of California Cities and other parties filed suit with the California Supreme Court challenging the validity and constitutionality of the measures and sought a stay of the provisions of the Acts until the Court renders a decision on the case. On August 11, 2011, as modified on August 17, 2011, the Court granted a hearing and issued a partial stay regarding suspension of the effectiveness of ABx1 26-27 until it can rule on the validity and constitutionality of these two bills. A ruling is expected by January 15, 2012.

As of the date of our report, although the City has adopted an opt-in ordinance electing participation in the voluntary program, the court has not ruled on the case.

CITY OF EL CERRITO

REQUIRED COMMUNICATIONS

These facts indicate that there is more than a remote possibility the Redevelopment Agency may not continue as a going concern beyond October 1, 2011. The continuation of the Redevelopment Agency beyond October 1, 2011 will initially depend on whether the court rules in favor of the petitioners. Should the court uphold the provisions of the Acts, the Redevelopment Agency's continuation will then depend on whether the City enacts the opt-in ordinance electing participation in the voluntary program, pays the 2011-12 annual contributions of \$1,847,232, as estimated by the State, as well as meeting any other provisions of the Acts which may be upheld by the court.

The provisions of ABx1 26, the Dissolution Act, are more severe. If upheld, it requires Redevelopment Agencies to preserve assets and revenues and minimize obligations and liabilities and expressly states that enforceable obligations to be paid by successor agencies created under the Acts to assume Redevelopment activities, do not include agreements, contracts or arrangements between Redevelopment Agency and the City and that there should be no asset transfers from a Redevelopment Agency to the City after January 1, 2011. Prior to dissolution, any transfers of Agency assets subsequent to January 1, 2011 to the City and the Municipal Services Corporation, including those discussed in Notes 1G, 4, 6 and 12, that were not obligated to third parties or encumbered may be subject to the State Controller's review discussed above and required to be returned to the Agency. Asset transfers may occur under certain conditions provided there is a third party commitment or outstanding encumbrances.

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, 2011, the City held approximately \$11.5 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, 2011. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2011.

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 propose audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the City's financial reporting process related to recording of the City's capital assets that are described in item 2011-02 of the Memorandum on Internal Control.

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.

Maze & Associates