CITY OF EL CERRITO

MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS

FOR THE YEAR ENDED
JUNE 30, 2012

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AND
REQUIRED COMMUNICATIONS

For the Year Ended June 30, 2012

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MEMORANDUM ON INTERNAL CONTROL

December 18, 2012

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, 2012, 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.

SCHEDULE OF OTHER MATTERS

2012-01 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 #2011-01, 2009-02 and 2008-03), we again selected 15 building permit receipts to recalculate the rates charged in accordance with the Council-approved rate schedule. Although the errors were not up to the magnitude of prior year errors, we found the following:

a. Two permits paid in July and October 2011 were each undercharged the Travel and Documentation fee by $5 because the change to the Travel and Documentation fee in the 2012 Master Fee Schedule was not updated in the system until late October 2011.

   The City should implement procedures to review the annual system update of the Master Fee Schedule in detail to ensure all associated fees are updated correctly and all fees reflect those in the current Schedule.

b. Two permits overcharged customers a total of $4 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:

Permit Valuation:	Fee:
$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.

   We had noted this same error in the prior year testing (see prior year comment 2011-01) and it appears that the system has not been corrected.

   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.

c. One permit for the fire department review fee of $441 was charged based upon a memo from the Fire Department to the Building Official that indicates the review fee should be 50% of the building plan fees of $882. The fee does not appear to be included on the Master Fee Schedule.

   All building permit fees should be included on the Master Fee Schedule to ensure that there is no confusion and that fees are charged to customers in a consistent manner.

2012-01 Building Permit Fee Calculations and Documentation (Continued)

Again, although these errors are not material errors like we have seen in the past, this volume of errors in our testing (4 of 15) indicates that there continues to be an issue with the permit fee calculation process and it appears to continue to be a significant deficiency. 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 and the fees in the system agree to the Master Fee Schedule.

Management's Response:

The City has made progress in addressing issues with the permit fee calculation process. The City will ensure that current fees are reflected accurately in the system at the annual update and that they are the fees being charged to customers. Recent changes in leadership in the division provide an opportunity for better oversight and consistency.

2012-02 Recording Interfund Activity Between the City's Component Units

The City's reporting entity includes three legally separate entities that are accounted for in the City's governmental funds: the former El Cerrito Redevelopment Agency, the El Cerrito Public Financing Authority, and the El Cerrito Municipal Services Corporation. Although they are separate legal entities, the City is financially accountable for their activities and City Council serves as the Board or the majority of the Board for each entity and they are reported as blended component units of the City. Blended component units are in substance part of the City's operations and are reported as an integral part of the City's financial statements. Transactions between these entities that are not those of a vendor-customer relationship should be reported as interfund transactions (transfers in and transfers out) in the City's financial statements.

During fiscal year 2012, the Municipal Services Corporation approved contributions to the City's General Fund and Federal, State and Local Grants Special Revenue Fund totaling $2 million to fund a consulting services agreement and grants for projects and programs "consistent with the Corporation's charitable purposes and goals." These contributions were recorded in the general ledger as expenditures of the Corporation and revenues to the General Fund and the Federal, State and Local Grants Special Revenue Fund.

We understand that City staff recorded the transactions in this manner, because City staff views the Corporation as a separate entity. However, since the Corporation is a blended component unit of the City, these contributions should have been recorded as interfund transfers between the funds. In the separately issued financial statements of the Corporation, the transactions can be reported as contributions or expenditures.

City staff should review future transactions between the City and its blended component units to ensure that they are properly reported in the City's general ledger and financial statements.

Management's Response:

The City is aware of the reporting distinctions for legally separate entities that are blended component units. However, since the El Cerrito Municipal Services Corporation maintains its own banking accounts and has its expenditure authority through a separate board of directors, City staff treated transactions between the Corporation and other entities as those of a vendor-customer relationship. This approach will enable the Corporation to produce a separate financial statement accurately reflecting its revenues and expenses, as well as provide the necessary information for year-end adjustments to the general ledger so that the City can produce a Comprehensive Annual Financial Report that reflects the Corporation as a blended component unit.

2012-03 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 comments 2011-06 and 2010-05, the City had bank balances exposed to custodial credit risk as of June 30, 2011 related to an escrow account for the Recycling Center Capital Lease. In response to that comment, the City intended to transfer the funds to an FDIC insured and collateralized account. Although the funds were transferred to the new account in fiscal year 2012 as intended, $209,479 of the City's bank balances of $3,676,191 was exposed to custodial credit risk, because the new escrow account was uncollateralized beyond the FDIC insurance of $250,000. City staff was not aware that the new account was 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 in detail for custodial credit risk to the City's balances on deposit.

Management's Response:

In September 2012, nearly all funds in the Escrow account in question were drawn down to close out the Recycling Center project, leaving a remaining balance of $1,294.62, thereby falling within the FDIC insurance coverage. In the future, any bank accounts established will be reviewed in detail to ensure there is not custodial credit risk to City's balances on deposit.

2012-04 General Fund Budgets and Available Fund Balances

The City's General Fund budget and liquidity remain a top priority. When we began the year end audit, the General Fund had a deficit cash balance of $50 thousand. After the City recorded a post-closing adjusting journal entry to record the administrative cost funding from the Successor Agency to the Redevelopment Agency, as of June 30, 2012, General Fund cash balances amounted to only $199 thousand, and General Fund unassigned fund balances amounted to $2.6 million. Unassigned fund balance represents available fund balance and equates to approximately 37 days of General Fund expenditures. Although the unassigned fund balance is comparable to the prior fiscal year, the cash balance declined $1.6 million from the prior year due to short-term cash borrowings from other City funds. Other significant facts we wish to bring to your attention include:

A. As of June 30, 2012, the balance of the Capital Improvement Fund borrowing from the General Fund was $1.3 million and, as discussed in prior year comment 2011-02, the grant billings continue to lag and therefore, the General Fund may not be able to collect the amount due from the Capital Improvement Fund in a timely manner.

B. While revenues and expenditures in the General Fund both increased by $1.6 million, there was an operating deficit of $1.8 million and when combined with other activity in the fund, including the return of land held for redevelopment to the former Redevelopment Agency, fund balance decreased by $3.2 million at year end.

C. The City also has long-term liabilities for unpaid compensated absences approximating $1.6 million. Further, the amounts do not consider future cost increases for retirement costs which have unfunded liabilities.

During this year's audit, we reviewed the City's financial condition and satisfied ourselves that the City had sufficient resources available that it could continue as a going concern through June 30, 2013. However, if deficit spending were to continue, it reduces the likelihood that the City will be able to continue as a going concern, meaning the City is able to pay its bills on time. With our next audit we will again be required to review the City's financial condition and determine the likelihood of the City's status as a going concern.

Although the City's adopted budget for 2013 projects ending fund balance and net assets of all funds as a positive $13.4 million, it includes a projected increase in the General Fund of only $172 thousand and projected use of resources of $640 thousand City-wide during 2013. The City should continue to monitor actual revenues and expenditures to ensure they are in line with expected results. Close management and comparison of actual activity against the budget will be needed to ensure further costs reductions are made as necessary. The City should address the timely grant billing in the Capital Improvement Fund and any other funds with reimbursement-based funding so there is a clearer picture of the General Fund's long-term available resources. Lastly, staff should determine a minimum cash balance needed for the "dry spell" and to finance cash flows for the overall City. The City must ensure this minimum cash balance requirement is not depleted.

Management's Response:
OPEN

2012-05 Monitoring Expenditures of the Municipal Services Corporation, Successor Housing ~~Successor~~Agency, and Redevelopment Agency Successor Agency, and Ensuring Compliance with the Dissolution Laws

In fiscal year 2011, the Redevelopment Agency entered into a cooperation agreement, ~~and~~an assignment and assumption agreement, and purchase and sale agreements (Agreements) with the Municipal Services Corporation. ~~and~~Pursuant to the Agreements, the Agency provided funding and ~~transferred~~ conveyed land held for redevelopment to the Corporation for redevelopment purposes consistent with the California Redevelopment Law and to implement and carry out the Redevelopment Plan~~s~~ for the Project ~~area~~Area. Prior to its dissolution, the~~The~~ Redevelopment Agency provided additional project funding under the ~~Agreements~~ cooperation agreement to the Corporation during fiscal year 2012.

The Redevelopment Agency was dissolved as of January 31, 2012 and certain dissolution laws enacted by AB x1 26 require the return of unexpended Redevelopment Agency funds to the Successor Agency to the Redevelopment Agency as of that date. Although certain assets of the former Redevelopment Agency were transferred to the Successor Agency, the City contends that the Agreements were lawfully executed and still valid as of that date and the Corporation retained the assets it held and continued to expend funds under the Agreements. This matter has not yet been settled with the State Department of Finance. Therefore, the City should closely monitor the expenditures of the Corporation to ensure they are made in compliance with California Redevelopment Law as required by the Agreements.

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SCHEDULE OF OTHER MATTERS

The housing assets of the former Redevelopment Agency as of January 31, 2012, excluding unencumbered cash balances, were transferred to the City as ~~Housing~~ Successor Housing Agency. After January 31, 2012, the ~~Housing~~ Successor Housing Agency may use proceeds from the housing assets only for low and moderate income housing purposes in accordance with California Redevelopment Law. The City must develop procedures to closely monitor the expenditures of the Low/Mod Income Housing Asset Special Revenue Fund (~~Housing~~ Successor Housing Agency Fund) to ensure they are made in compliance with California Redevelopment Laws.

Finally, City staff must continue to closely review all expenditures of the Successor Agency to the Redevelopment Agency to ensure they are only for Oversight Board approved and Department of Finance approved items deemed enforceable obligations.

Management's Response:
~~OPEN~~
City staff is monitoring the Corporation's use of funds paid by and of land held for redevelopment conveyed by the Redevelopment Agency are consistent with California Redevelopment Law, as outlined in the terms of the Agreements. The City is monitoring the use of Housing Assets to ensure it is consistent with California Redevelopment Law.

City staff reviews all expenditures by the Successor Agency to ensure they are for approved enforceable obligations.

2012-06 Purchasing Policy Compliance – Use of Purchase Orders/Informal Bidding and Contracts

The City's Purchasing Policy includes the following documentation and approval requirements:

- Purchases of goods and services valued at $5,000 or more and must be made with a purchase order.
- Informal bidding is required for purchases between $2,500 and $25,000.
- Purchases made from a single vendor (either individually or collectively within one fiscal year) over $25,000 require City Council approval.

We selected a sample of forty-six disbursements to test the compliance with the City's purchasing policies and procedures and noted the following:

- No Contract and No Council Approval:
  - Adamson Police Products, $1,967, year to date expenditures as of April 2012 of $27,059 (purchase of police ammunition)
  - All Points Petroleum, $15,093, year to date expenditures as of April 2012 of $217,375 (gasoline and fuel purchase). Informal bids were received, but a contract was not established.

- No Purchase Order:
  - Adamson Police Products

Procedures should be established to periodically review the year-to-date expenditures for vendors to determine whether Council approval is required for expenditures that would bring the total disbursements to more than $25,000.

The City's Purchasing Policy was last revised in August 2006. As we have recommended in prior years, 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.

Management's Response:
OPEN

2012-07 Terminated Employees in Active Payroll System

Terminated employees should be removed from the payroll system immediately upon receiving their last paycheck. During our testing of ten employees terminated during fiscal year 2012 to ensure they were removed from the payroll system in a timely manner, we noted the following:

- Four police employees were not terminated from the system until up to 7 months after the date of their last paycheck.

- One recreation employee was not terminated from the system until 2.5 months after the date of last paycheck.

We understand the police employees were left as active in the system until they received their last retroactive FLSA payment, which is only processed a few times during the year, usually every six months. We understand the recreation employee was a part-time employee that the department thought may return for other projects.

Although it appears that the employees did not receive any payments subsequent to their last paychecks other than the police FLSA payments noted above, 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 active payroll system. In the event the employee is expected to return, the City should determine whether a procedure could be developed to deactivate the employee in the system and then re-activate the employee only upon appropriate approval (i.e. the payroll clerk should not be able to re-activate employees) only long enough to issue the applicable checks and then again deactivate them.

Management's Response:
OPEN

2012-08 Journal Entry Review Documentation

Under the City's review process for journal entries, the Accounting Supervisor prepares and post journal entries to the general ledger and files them in a binder, which he keeps in his office. The Administrative Services Director, periodically reviews the binder, approves, and signs off on the journal entries.

SCHEDULE OF OTHER MATTERS

We selected 25 City-wide journal entries for testing and 8 Redevelopment Agency journal entries for testing compliance with the City's policies and adequate supporting documentation. We noted two journal entries were prepared by the Accounting Supervisor, but there was no documentation they had been reviewed, approved or signed by the Administrative Services Director.

We understand the Administrative Services Director only reviews, approves, and signs off the journal entries once a month or every other month and these entries may have been overlooked during that process. The Administrative Services Director should ensure that all journal entries are reviewed and approved and that evidence of that review is clearly documented.

Management's Response:
OPEN

2012-09 Timely Submission of the Treasurer's Report to City Council

California Government Code Section 53646 requires that the quarterly Treasurer's Report be submitted to the City Council within 30 days following the end of the quarter covered by the report. The Quarterly Treasurer's Report for the quarter ending December 31, 2011 was submitted to the City Council on April 3, 2012, which is more than 30 days after the quarter end. The City should submit the quarterly reports within the 30 day requirement.

Management's Response:

OPEN

2012-10 Investment Policy Compliance and Reporting

We reviewed the City's Investment Policy for compliance with the California Government Code requirements and we reviewed the City's Treasurer's Report for compliance with the Government Code and the Investment Policy reporting requirements and noted the following:

- Investment Policy Requires Diversification - Section 12.0 of the City's Investment Policy ***requires*** diversification "by investment type, issuer, maturity dates and broker/dealer." As of June 30, 2012, the City had only invested in the Local Agency Investment Fund. If the City intends to continue to invest only in LAIF, the City should consider revising the wording in Section 12.0 to reflect the current practice.

- Internal Controls are to be Audited Annually - Section 13.0 (Internal Controls) of the City's Investment Policy adopted on February 23, 2012 requires "the City Treasurer will maintain a system of internal controls to ensure compliance with investment procedures of the City of El Cerrito and the California Government Code and these controls will be audited annually by the City's external audit firm." We have not been notified or engaged to audit the City's system of internal controls as required by Section 13.0 of their Investment Policy. The City should either notify us to perform a review of the internal controls to ensure compliance with investment procedures or the City should remove this section from the policy.

SCHEDULE OF OTHER MATTERS

- Reporting Must Include Type of Investment - California Code Section 53646 and the Investment Policy Section 14.0 (Reporting), the quarterly Treasurer's Report shall include the type of investment and the issuer of each investment. We noted that the June 30, 2012 Quarterly Treasurer's Report listed the City Hall Debt Fund as invested in Money Market Funds, however the name of the fund was listed as "Union Bank/US Treasuries." The name of the Fund should be updated to the Blackrock Institutional Money Market Fund. In addition, the Investment Report indicated that the Integrated Waste Management Fund was invested in a Capital One Bank money market fund with Deutsch Bank, however it was actually a cash deposit with Deutsch Bank. Investments should be reviewed in detail to ensure the quarterly Investment Report reflects the specific investments held at the end of each quarter.

  Management's Response:
  OPEN

2012-11 <u>Payroll Processing – Rotation of Duties</u>

During an employee's absence, another employee should assume the duties and complete the applicable processing. We understand the payroll clerk has not taken vacation during fiscal year 2012 and has not been absent more than 1-2 days at a time. Therefore, another employee has not had the opportunity to assume the payroll duties in her absence.

In the event the payroll clerk does not take an extended vacation, another appropriate employee should assume the duties periodically (without warning).

Management's Response:
OPEN

2012-12 <u>Independent Contractors and Contract Documentation</u>

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 fiscal year 2011 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 continued to use employee for the same services in fiscal year 2012 and although a contract had been established, it had been signed only by the contractor and not the City, and City staff did not have a copy of the contract until we inquired about the status.

If contract maintenance is going to be decentralized, the contracts should be readily available upon request and fully executed copies should be retained in City files. The City should complete the execution of the contract with the former employee.

Management's Response:
OPEN

SCHEDULE OF OTHER MATTERS

2012-13 <u>Information Technology Best Practices Recommendations</u>

We again conducted an Information Systems Review with our audit which encompassed the City's financial information system and the network environment that houses it. In addition to the issues discussed in prior year comment 2011-08, we noted a few additional areas which could be improved to conform to NIST guidelines. A summary of these additional recommendations which we believe are "best practices" follows:

2012-13 <u>Information Technology Best Practices Recommendations (Continued)</u>

Audit/Event Logging
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.[1]

Session Locks
The City does not have session locks turned on for the financial application or the workstation operating systems. A session lock is a temporary lockout of the operating system or financial application when a user stops work and typically moves away from the immediate physical vicinity of the computer. Generally, employees may leave their workstation for lunch or break and not log off or log out of the application. This leaves the operating system or financial application open and available to any passerby. Any person with physical access would be able to perform any tasks the absent user has privileges or rights to do. At the very least workstations should be set to lock out the workstation after a period of inactivity. Best practice would be to have both the operating system and financial application have lockouts after a period of inactivity.

> ***Management's Response:***
> OPEN

<u>NEW GASB PRONOUNCEMENTS OR PRONOUNCEMENTS NOT YET EFFECTIVE</u>

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

EFFECTIVE FISCAL 2012/13:

GASB 60 - *<u>Accounting and Financial Reporting for Service Concession Arrangements</u>*

The objective of this proposed Statement is to establish accounting and financial reporting requirements for service concession arrangements (SCAs), which are a type of public-private or public-public partnership arrangement. As used in this proposed Statement, an SCA is an arrangement between a transferor (a government) and an operator (governmental or nongovernmental) in which:

[1] For more information on Audit/Event log management see NIST SP 800-92 Guide to Computer Security Log Management.

a. The transferor conveys to the operator the right and related obligation to provide public services through the operation of a capital asset (referred to in this standard as "facility").

b. The operator collects and is compensated with fees from third parties.

c. The transferor is entitled to significant residual interest in the service utility of the facility at the end of the arrangement.

GASB 60 - ***Accounting and Financial Reporting for Service Concession Arrangements (Continued)***

d. The transferor determines or has the ability to modify or approve what services the operator is required to provide, to whom the operator is required to provide the services, and the prices or rates that can be charged for the services.

Service Concession Arrangements include, but are not limited to:

a. Arrangements in which the operator will design and build a facility and will obtain the right to collect fees from third parties (for example, construction of a municipal complex for the right to lease a portion of the facility to third parties)

b. Arrangements in which the operator will provide an up-front payment or a series of payments in exchange for the right to access an existing facility (for example, a parking garage) and collect fees from third parties for its usage

c. Arrangements in which the operator will design and build a facility (for example, a new toll way), finance the construction costs, provide the associated services, collect the associated fees, and convey the facility to the government at the end of the arrangement.

The following information should be disclosed in the notes to financial statements of transferors and governmental operators for SCAs:

a. A general description of the arrangement in effect during the reporting period, including management's objectives for entering into it and, if applicable, the status of the project during the construction period

b. The nature and amounts of assets, liabilities, and deferred inflows of resources related to an SCA that are recognized in the financial statements

c. The nature and extent of rights retained by the transferor or granted to the governmental operator under the arrangement.

GASB 61 ***The Financial Reporting Entity – Omnibus – An Amendment for GASB Statement No. 14 and No. 34 – Component Unit Focus***

This Statement modifies certain requirements for inclusion of component units in the financial reporting entity. **For organizations that previously were required to be included as component units by meeting the fiscal dependency criterion, a financial benefit or burden relationship also would need to be present between the primary government and that organization for it to be included in the**

reporting entity as a component unit. Further, for organizations that do not meet the financial accountability criteria for inclusion as component units but that, nevertheless, should be included because the primary government's management determines that it would be misleading to exclude them, this Statement clarifies the manner in which that determination should be made and the types of relationships that generally should be considered in making the determination.

GASB 61 ***The Financial Reporting Entity – Omnibus – An Amendment for GASB Statement No. 14 and No. 34 – Component Unit Focus (Continued)***

This Statement also amends the criteria for reporting component units as if they were part of the primary government (that is, blending) in certain circumstances. **For component units that currently are blended based on the "substantively the same governing body" criterion, it additionally requires that (1) the primary government and the component unit have a financial benefit or burden relationship or (2) management (below the level of the elected officials) of the primary government have operational responsibility (as defined in paragraph 8a) for the activities of the component unit. New criteria also are added to require blending of component units whose total debt outstanding is expected to be repaid entirely or almost entirely with resources of the primary government.** The blending provisions are amended to clarify that funds of a blended component unit have the same financial reporting requirements as a fund of the primary government. Lastly, additional reporting guidance is provided for blending a component unit if the primary government is a business-type activity that uses a single column presentation for financial reporting.

GASB 62 ***Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements***

The objective of this Statement is to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in the following pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements:

1. Financial Accounting Standards Board (FASB) Statements and Interpretations
2. Accounting Principles Board Opinions
3. Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure.

This Statement also supersedes Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting, thereby eliminating the election provided in paragraph 7 of that Statement for enterprise funds and business-type activities to apply post-November 30, 1989 FASB Statements and Interpretations that do not conflict with or contradict GASB pronouncements. However, those entities can continue to apply, as other accounting literature, post-November 30, 1989 FASB pronouncements that do not conflict with or contradict GASB pronouncements, including this Statement.

The provisions of this Statement are organized by topic. Each topic contains provisions derived from FASB and AICPA pronouncements that address the subject matter. The order in which the topics are presented corresponds to the order of the primary locations within the GASB *Codification of Governmental Accounting and Financial Reporting Standards*, where the topics are codified.

The requirements in this Statement will improve financial reporting by contributing to the GASB's efforts to codify all sources of generally accepted accounting principles for state and local governments so that they derive from a single source. **This effort brings the authoritative accounting and financial reporting literature together in one place**, with that guidance modified as necessary to appropriately recognize the governmental environment and the needs of governmental financial statement users. It will eliminate the need for financial statement preparers and auditors to determine which FASB and AICPA pronouncement provisions apply to state and local governments, thereby resulting in a more consistent application of applicable guidance in financial statements of state and local governments.

GASB 63 - *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*

This Statement provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. *Concepts Statement No. 4, Elements of Financial Statements*, introduced and defined those elements as a consumption of net assets by the government that is applicable to a future reporting period, and an acquisition of net assets by the government that is applicable to a future reporting period, respectively. Previous financial reporting standards do not include guidance for reporting those financial statement elements, which are distinct from assets and liabilities.

Concepts Statement 4 also identifies net position as the residual of all other elements presented in a statement of financial position. This Statement amends the net asset reporting requirements in *Statement No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and other pronouncements by incorporating deferred outflows of resources and deferred inflows of resources into the definitions of the required components of the residual measure and **by renaming that measure as net position, rather than net assets.**

The objective of this Statement is to provide guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position and related disclosures.

State and local governments enter into transactions that result in the consumption or acquisition of net assets in one period that are applicable to future periods. *Concepts Statement No. 4, Elements of Financial Statements*, identifies those consumptions or acquisitions as deferred outflows of resources and deferred inflows of resources, respectively, and distinguishes them from assets and liabilities. This Statement provides guidance for reporting deferred outflows of resources and deferred inflows of resources balances.

Concepts Statement 4 identifies net position as the residual of all other elements presented in a statement of financial position. It is the difference between (a) assets and deferred outflows of resources and (b) liabilities and deferred inflows of resources. This Statement provides guidance for reporting net position within a framework that includes deferred outflows of resources and deferred inflows of resources, in addition to assets and liabilities.

SUMMARY:

- *Statement of Net Position* The statement of net position should report all assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position. Governments are encouraged to present the statement of net position in a format that displays assets, plus deferred outflows of resources, less liabilities, less deferred inflows of resources, equals net position, although a balance sheet format (assets plus deferred outflows of resources equals liabilities plus deferred inflows of resources, plus net position) may be used. Regardless of the format used, the statement of net position should report the residual amount as net position, rather than net assets, proprietary or fiduciary fund balance, or equity. Net position represents the difference between all other elements in a statement of financial position and should be displayed in three components—net investment in capital assets; restricted (distinguishing between major categories of restrictions); and unrestricted.

GASB 63 - *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position – (Continued)*

- *Net Investment in Capital Assets Component of Net Position* The net investment in capital assets component of net position consists of capital assets, net of accumulated depreciation, reduced by the outstanding balances of bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction, or improvement of those assets or related debt also should be included in this component of net position. If there are significant unspent related debt proceeds or deferred inflows of resources at the end of the reporting period, the portion of the debt or deferred inflows of resources attributable to the unspent amount should not be included in the calculation of net investment in capital assets. Instead, that portion of the debt or deferred inflows of resources should be included in the same net position component (restricted or unrestricted) as the unspent amount.

- *Restricted Component of Net Position* The restricted component of net position consists of restricted assets reduced by liabilities and deferred inflows of resources related to those assets. Generally, a liability relates to restricted assets if the asset results from a resource flow that also results in the recognition of a liability or if the liability will be liquidated with the restricted assets reported.

- *Unrestricted Component of Net Position* The unrestricted component of net position is the net amount of the assets, deferred outflows of resources, liabilities, and deferred inflows of resources that are not included in the determination of net investment in capital assets or the restricted component of net position.

- *Financial Reporting for Governmental Funds* Deferred outflows of resources and deferred inflows of resources that are required to be reported in a governmental fund balance sheet should be presented in a format that displays assets plus deferred outflows of resources, equals liabilities plus deferred inflows of resources, plus fund balance.

EFFECTIVE FISCAL 2013/14:

GASB 65 - *Items Previously Reported as Assets and Liabilities*

This Statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities.

SCHEDULE OF OTHER MATTERS

GASB 65 - *Items Previously Reported as Assets and Liabilities (Continued)*

Concepts Statement No. 4, *Elements of Financial Statements,* introduced and defined the elements included in financial statements, including deferred outflows of resources and deferred inflows of resources. In addition, Concepts Statement 4 provides that reporting a deferred outflow of resources or a deferred inflow of resources should be limited to those instances identified by the Board in authoritative pronouncements that are established after applicable due process. Prior to the issuance of this Statement, only two such pronouncements have been issued. Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments,* requires the reporting of a deferred outflow of resources or a deferred inflow of resources for the changes in fair value of hedging derivative instruments, and Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, requires a deferred inflow of resources to be reported by a transferor government in a qualifying service concession arrangement. This Statement amends the financial statement element classification of certain items previously reported as assets and liabilities to be consistent with the definitions in Concepts Statement 4.

This Statement also provides other financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflows of resources, such as changes in the determination of the major fund calculations and limiting the use of the term *deferred* in financial statement presentations.

How the Changes in This Statement Will Improve Financial Reporting

The requirements of this Statement will improve financial reporting by clarifying the appropriate use of the financial statement elements deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting.

GASB 66 - *Technical Corrections—2012—an amendment of GASB Statements No. 10 and No. 62*

The objective of this Statement is to improve accounting and financial reporting for a governmental financial reporting entity by resolving conflicting guidance that resulted from the issuance of two pronouncements, Statements No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, and No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements.*

This Statement amends Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, by removing the provision that limits fund-based reporting of an entity's risk financing activities to the general fund and the internal service fund type. As a result, governments should base their decisions about fund type classification on the nature of the activity to be reported, as required in Statement 54 and Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.*

This Statement also amends Statement 62 by modifying the specific guidance on accounting for (1) operating lease payments that vary from a straight-line basis, (2) the difference between the initial investment (purchase price) and the principal amount of a purchased loan or group of loans, and (3) servicing fees related to mortgage loans that are sold when the stated service fee rate differs significantly from a current (normal) servicing fee rate. These changes clarify how to apply Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases,* and result in guidance that is consistent with the requirements in Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues,* respectively.

GASB 66 - *Technical Corrections—2012—an amendment of GASB Statements No. 10 and No. 62 (Continued)*

How the Changes in This Statement Improve Financial Reporting

The requirements of this Statement resolve conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting and thereby enhance the usefulness of the financial reports.

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL

STATUS OF PRIOR YEAR
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:

Permit Valuation:	Fee:
$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.

STATUS OF PRIOR YEAR
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.

Current Status:
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.

See also Current Year Comment 2012-01

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.

**STATUS OF PRIOR YEAR
SCHEDULE OF SIGNIFICANT DEFICIENCIES**

2011-02 <u>Timely Grant Billings and Federal Expenditure Reporting (Continued)</u>

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.

Update for 2012 – Grant reimbursements continue to lag behind expenditures and the fund balance deficit in the Capital Improvement Capital Projects Fund was $525,000 at June 30, 2012, which resulted in the need to borrow $1.3 million from the General Fund to cure the cash deficit in the fund.

Current Status:
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.

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL

STATUS OF PRIOR YEAR
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.

**STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS**

2011-03 Monitoring Current and Future Redevelopment Agency-Related Transactions (Continued)

- **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.

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.

Current Status:
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.

See also Comment 2012-05

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.

STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS

2011-04 Terminated Employee in Active Payroll Records (Continued)

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

Current Status:
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.

See also Current Year Comment 2012-07.

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.

Current Status:
Implemented

STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS

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.

Current Status:
See Comment 2012-03.

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.

Current Status:
Implemented

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.

**STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS**

2011-08 **<u>Information Technology Best Practices Recommendations (Continued)</u>**

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[2]. 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

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.

[2] "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

STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS

2011-08 **Information Technology Best Practices Recommendations (Continued)**

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.

Current Status:
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.

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.

Update for 2012 – the City had indicated that the access would be reviewed and restricted, but we did not see any change. In addition, we also noted that the Accounting Supervisor has access to the Accounts Payable module.

STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS

2010-02 **<u>Internal Controls – Segregation of Duties (Continued)</u>**

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.

Current Status:

a. Rights for the Administrative Services Director and the Accounting Supervisor will be reviewed and restricted in fiscal year 2013.

b. The Payroll Clerk's security will be changed so as to restrict access to the Human Resources module in fiscal year 2013.

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.

2010-04 **<u>Purchasing Policy Compliance</u>**

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.

STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS

2010-04 <u>Purchasing Policy Compliance (Continued)</u>

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:***
> 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.
>
> See also Comment 2012-06.

2010-05 <u>Uninsured and Uncollateralized Bank Accounts</u>

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 2011-06.

2010-07 <u>Capital Assets Inventory</u>

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.

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

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL

STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS

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.

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. Not implemented.

REQUIRED COMMUNICATIONS

December 18, 2012

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, 2012 and have issued our report thereon dated December 18, 2012. 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. The following pronouncement became effective but did not have a material effect on the financial statements:

GASB 64 - ***Derivative Instruments: Application of Hedge Accounting Termination Provisions, an amendment of GASB Statement No. 53***

Some governments have entered into interest rate swap agreements and commodity swap agreements in which a swap counterparty, or the swap counterparty's credit support provider, commits or experiences either an act of default or a termination event as both are described in the swap agreement. Many of those governments have replaced their swap counterparty, or swap counterparty's credit support providers, either by amending existing swap agreements or by entering into new swap agreements. When these swap agreements have been reported as hedging instruments, questions have arisen regarding the application of the termination of hedge accounting provisions in Statement No. 53, Accounting and Financial Reporting for Derivative Instruments. Those provisions require a government to cease hedge accounting upon the termination of the hedging derivative instrument, resulting in the immediate recognition of the deferred outflows of resources or deferred inflows of resources as a component of investment income.

The objective of this Statement is to clarify whether an effective hedging relationship continues after the replacement of a swap counterparty or a swap counterparty's credit support provider. This Statement sets forth criteria that establish when the effective hedging relationship continues and hedge accounting should continue to be applied.

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 2012. However, the dissolution of the Redevelopment Agency had a material impact to the financial statements of the City and its component units:

As discussed in Note 16 to the financial statements, the State enacted laws which dissolved Redevelopment Agencies effective January 31, 2012. The City elected to become the Housing Successor to the Redevelopment Agency and pursuant to the laws it received the encumbered housing assets of the former Redevelopment Agency. Certain other assets were distributed to and all of the Redevelopment Agency's debts were assumed by a Successor Agency governed by an Oversight Board. This Successor Agency is reported as a private purpose trust fund.

Also as discussed in Note 16, the Agency had transferred assets, including capital assets, totaling $ 14,118,319 to the City and to the Municipal Services Corporation during fiscal year 2011 under the terms of various agreements. However, under the provisions of Health and Safety Code Section 34171(d)(2) that was created by AB x1 26, agreements between the City and the Agency that were executed after December 31, 2010 are no longer enforceable obligations, and Health and Safety Code Section 34167.5 requires that if the entity that received the assets is not contractually committed to a third party for the expenditure or encumbrance of those funds that they be returned to the Successor Agency.

Health and Safety Code Sections 34167.5 and 34178.8 specifically direct the State Controller to review the activities of all redevelopment agencies to determine whether an asset transfer between an agency and any public agency occurred on or after January 1, 2011. If an asset transfer did occur and the public agency that received the asset is not contractually committed to a third party for the expenditure or encumbrance of the asset, the legislation purports to require the State Controller to order the asset returned to the redevelopment agency.

The City returned land held for resale of $3,950,000 to the Agency's Low and Moderate Income Housing Special Revenue Fund. The balance of assets held by the Municipal Services Corporation totaled $11,755,812 as of June 30, 2012, comprised of current assets of $6,333,197 and capital assets of $5,422,615. The City has not received the results of the State Controller's asset transfer review and the amount of assets to be returned is not determinable at this time.

Prior to the Redevelopment Agency dissolution, the Agency board approved various agreements which obligated it to repay certain advances to the Agency's Low and Moderate Income Housing Fund. The advance was assumed by the City as Housing Successor, and the advance is now payable to the City's Low and Moderate Income Housing Asset Fund. Repayment of these agreements is subject to certain administrative procedures and review and approval by the California Department of Finance and/ or the Oversight Board, and as a result the amount disallowed is not determinable at this time.

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:

Estimated Fair Value of Investments: As of June 30, 2012, the City held approximately $9.0 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, 2012. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2012.

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.

Estimated Net OPEB Obligation: Management's estimate of the net OPEB obligation is disclosed in Note 10C 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.

As discussed in Note 16 to the financial statements, the State enacted ABx1 26 and AB1484 (Dissolution Laws) which dissolved California redevelopment agencies effective January 31, 2012. The provisions of the Dissolution Laws are extremely complex and contain provisions requiring the unwinding of transactions recorded in prior years and remeasurement of amounts due to the City. The Dissolution Laws also give the State Controller's Office and Department of Finance approval powers over transactions and asset transfers and require a plethora of filings, processes and special procedures to be performed by external audit firms. These matters required an exorbitant amount of staff's time and attention. This in turn had an adverse effect on audit timing and effort.

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 interfund transactions that are described in item 2012-02 of the Memorandum on Internal Control.

CITY OF EL CERRITO

REQUIRED COMMUNICATIONS

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.

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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.