

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS
FOR THE YEAR ENDED
JUNE 30, 2014

This Page Left Intentionally Blank

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

For the Year Ended June 30, 2014

Table of Contents

	<u>Page</u>
<i>Memorandum on Internal Control</i>	1
Schedule of Material Weaknesses.....	3
Schedule of Significant Deficiencies	7
Schedule of Other Matters.....	11
Status of Prior Year Schedule of Significant Deficiencies.....	17
Status of Prior Year Schedule of Other Matters	31
<i>Required Communications</i>	41
Significant Audit Findings	41
<i>Accounting Policies</i>	41
<i>Unusual Transactions, Controversial or Emerging Areas</i>	42
<i>Estimates</i>	44
<i>Disclosures</i>	45
<i>Difficulties Encountered in Performing the Audit</i>	45
<i>Corrected and Uncorrected Misstatements</i>	45
<i>Disagreements with Management</i>	46
<i>Management Representations</i>	46
<i>Management Consultations with Other Independent Accountants</i>	46
<i>Other Audit Findings or Issues</i>	46
Other Information Accompanying the Financial Statements.....	46

This Page Left Intentionally Blank

MEMORANDUM ON INTERNAL CONTROL

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

We have audited the basic financial statements of the City of El Cerrito, California, for the year ended June 30, 2014, and have issued our report thereon dated February 24, 2015. In planning and performing our audit of the basic financial statements of the City, 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 that are appropriate in the circumstances for the purpose of expressing our opinions 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.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist and that were not identified. In addition, because of 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. However, we identified certain deficiencies in internal control that we consider to be material weaknesses that are included on the Schedule of Material Weaknesses and the Status of Prior Year Schedule of Material Weaknesses.

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 by 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 and the Status of Prior Year Schedule of Significant Deficiencies.

Included in the Schedule of Other Matters are recommendations not meeting the above definitions that we believe to be of potential benefit to the City.

Management responses included in this report have not been subjected to the audit 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.

A handwritten signature in cursive script that reads "Maze & Associates".

Pleasant Hill, California

February 24, 2015

Accountancy Corporation

3478 Buskirk Avenue, Suite 215

Pleasant Hill, CA 94523

T 925.930.0902

F 925.930.0135

E maze@mazeassociates.com

W mazeassociates.com

This Page Left Intentionally Blank

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

SCHEDULE OF MATERIAL WEAKNESSES

2014-01 General Fund Budgets, Cash and Available Fund Balances

As discussed in prior year comments 2013-03 and 2012-04, the City's General Fund budget and liquidity remain a top priority and the financial health of the Fund has continued to deteriorate. As of June 30, 2014, the General Fund has a cash balance of only \$1 and City-wide, unrestricted cash balances total only \$40,384. In addition, General Fund unassigned fund balances amounted to \$1 million. Unassigned fund balance represents available fund balance and equates to approximately 14 days of General Fund expenditures. This is a very low level of available resources.

The cash balance remained depleted due to short-term cash borrowings from other City funds. The Capital Improvement Fund and other Non-Major Governmental Funds had borrowed \$1,748,211 from the General Fund and other funds, including the Integrated Waste Management Enterprise Fund and other restricted funding sources, and the General Fund had borrowed \$250,000 from the Municipal Services Corporation Special Revenue Fund. Other significant facts we wish to bring to your attention include:

- A. As of June 30, 2014, the balance of the Capital Improvement Fund interfund borrowing was \$1.2 million and, as discussed in current year comment 2014-02 and prior year comment 2011-02, the grant billings continue to lag and therefore, the loaning funds may not be able to collect the amount due from the Capital Improvement Fund in a timely manner.
- B. While General Fund revenues increased by over \$1.2 million and expenditures decreased by \$306 thousand, the fund experienced an operating deficit of \$260 thousand for the third consecutive year and when combined with other activity in the fund, fund balance decreased by \$1.1 million at year end.
- C. The City also has long-term liabilities for unpaid compensated absences approximating \$1.5 million which have not been funded. Further, the amounts do not consider future cost increases for retirement costs which have unfunded liabilities.
- D. Despite the lack of cash available for operations, nearly every fund of the City experienced a net decrease in fund balance. While we understand some of the decreases were intentional one-time uses of fund balance, City staff should ensure that cash is available to fund those one-time uses.
- E. The General Fund had expenditures in excess of budget in all departments, except one, and we understand that one contributing factor to the overruns in at least three of the departments were the result of unbudgeted salary increases.

During this year's audit, we again reviewed the City's financial condition and satisfied ourselves that the City had sufficient resources available to fund operations through June 30, 2015. Although the City continues to issue Tax Revenue Anticipation Notes to supplement cash temporarily during the fiscal year, if spending at current levels without an increase in resources were to continue, it reduces the likelihood that the City will have sufficient cash resources available.

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

SCHEDULE OF MATERIAL WEAKNESSES

2014-01 General Fund Budgets, Cash and Available Fund Balances (Continued)

The City's adopted budget for 2015 projects ending fund balance and net position of all funds as a positive \$3.6 million, however it includes a projected increase in the General Fund of only \$89 thousand and projected *use* of resources of \$337 thousand City-wide during 2015. 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 *must* continue to be employed to ensure further costs reductions are made as necessary. All increases in expenditures should be specifically approved through the budget amendment process to ensure cash resources are available to fund the increase.

Although the 2015 budget acknowledges the City's financial condition and the need to prioritize projects, programs and services to allocate limited resources, the City should also immediately address the timely grant billing in the Capital Improvement Fund and any other funds with reimbursement-based funding so they stop draining the General Fund resources. The City must review the current capital projects outstanding to determine if any of them can be delayed since sufficient funding is not currently available. Any projects that are grant funded must be accompanied by timely grant reimbursement requests to alleviate the cash flow problem.

Management's Response:

Disagree. The City has continually taken steps to shore up the City's finances including reducing pension liabilities, becoming more efficient in providing services and outlining a plan to increasing revenues.

In FY 2013-14, the City, very publically, made a decision to deficit spend, rather than reduce services or layoff staff and the City Council approved a plan to go to the voters to increase sales tax revenues, which ultimately overwhelmingly passed.

Like many Cities, declining revenues related to taxes and the loss of redevelopment have reduced El Cerrito's operating reserve in the General Fund as well as the available cash balances in the special revenue funds. The need to restore reserves has been a topic of discussion at every budget session and with approval of the increase in sales taxes, a portion of the additional revenue can now be dedicated increase reserves within 5 years.

The City has and continues to monitor actual revenues and expenditures to the budget and regularly provides City Council with updates. In FY 2013-14 staff was informed a few months into the fiscal year that property tax revenues would be less than adopted and Council were provided with this update in the December budget review. While Council was notified and this projection was included in the 5 year General Fund forecast, it has been the City's policy not to revise the revenue budget. Had this revision and other significant revenue adjustments been made in the amended budget, actuals would have more closely aligned with the final budget. However, even with close monitoring, there were additional unanticipated changes that occurred at the end of the fiscal year that weren't included in projections. In addition, because the use of fund balance does not get budgeted in revenue, even though Council approved the use of fund balance for a one-time CIP expenditure, expenditures appear to be higher than the annual revenues.

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL
SCHEDULE OF MATERIAL WEAKNESSES

2014-01 General Fund Budgets, Cash and Available Fund Balances (Continued)

As part of the tax anticipation note (TAN) process, staff projects cash needs for the year; however, given the cash shortages experienced throughout the year, the City hired a consultant to complete a more comprehensive review and project cash needs for fiscal year FY 2014-15. This allowed us to restructure the TAN repayments to provide better cash flow throughout the year and understand the funds that are putting the most drain on overall cash. Finance staff is working with the operating departments to address the problem funds as well as stay on top of the reimbursement requests for grant expenditures.

2014-02 Timely Grant Billings

The City has a number of projects that are fully or partially funded by federal, state and local grants on a reimbursement basis. As the City incurs related project costs, timely grant reimbursement requests should be prepared and filed with the grantors 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.

Expenditures in the Capital Improvement Fund exceeded current year revenues in fiscal year 2014 by \$661 thousand due to delayed reimbursement requests. City staff did not file reimbursement requests for approximately \$656 thousand of fiscal year 2014 expenses until October and November 2014. As an example, one of those projects was a Transportation Development Act-funded project that began in June 2013 with expenditures through July 2014, for which a reimbursement request was not filed until October 27, 2014, a delay of three months.

The City must develop procedures to ensure grant reimbursement requests are prepared on a timely basis, at least quarterly, as costs are incurred not only to improve cash flow but to match expenditures with associated revenues in the same period.

Management's Response:

Agree. As of FY 2015, department staff is now carefully considering staff resources to manage grants before applying for additional grants to ensure the grants received are managed and billed in a timely manner. Staff is also reviewing grant contracts such that the deliverables are more incremental/progress based.

Beginning in March 2015, the Finance department will be implementing an Accounts Receivable module and will begin using this system to bill reimbursable grants no later than July 2015. In addition, by April 2015, the Finance department will create a centralized grant tracking inventory that includes all relevant grant information that will be updated on a regular basis. The Finance department also plans to create new funds to track Grants fund by federal, state or local rather than the one central fund currently used. This will make it much easier to monitor expenditures and ensure reimbursements are being billed in a more timely way.

This Page Left Intentionally Blank

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

SCHEDULE OF SIGNIFICANT DEFICIENCIES

2014-03 Incorrect Pay Rate

The payroll register should be monitored in a way that errors in pay rates can be identified and corrected on a timely basis. And, changes to employee pay rates should not be made without proper review and approval.

During the interim phase of our audit, we selected 40 employees for testing of the pay period ending March 1, 2014 and noted a significant difference between one employee's gross payroll in the payroll register compared to our calculation of their gross pay. The pay rate used in our calculation was based on the employee's most recent Personnel Action Form which was a "Step One" rate, but the employee was being paid at a "Step Five" rate.

Upon inquiry of City staff, we found that the erroneous pay rate had begun in October 2013, but it was not discovered by City staff until March 2014. Upon discovery of the error, the City calculated the total amount of overpayment to the employee (\$6,710) and the employee began repayment with the first pay period of April 2014.

Although City staff discovered the error, it continued undetected for six months. City staff indicated that they do not know what caused the original error. It was discovered, because the City has a policy to manually recalculate all employee pay rates whenever there is a Cost of Living Adjustment (COLA) or step increase. This is how the problem was initially detected. However, in the event that City employees go long durations without step or wage increases, there does not appear to be another way City staff could detect an error in pay.

The City must implement procedures, such as spot checks to manually recalculate pay rates more frequently, to ensure that future errors are detected in a timely manner and implement procedures to reduce the likelihood of future pay errors. Until the cause of the original error is known, these additional procedures should continue.

Management's Response:

Agree. While this was a 1-time error, Finance staff determined that there are no payroll audit reports in New World System that would have identified this type of error. As of April 1, 2015, New World released a new update that now includes a payroll audit report. IT staff will implement this update by June 30, 2015. Once this report is available, Finance staff will begin to use this report as part of the standard audit staff conducts to review and confirm each payroll run.

2014-04 Recording Interfund Activity With the City's Component Units

The City's reporting entity includes two legally separate entities that are accounted for in the City's governmental funds: 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.

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

SCHEDULE OF SIGNIFICANT DEFICIENCIES

2014-04 Recording Interfund Activity With the City's Component Units (Continued)

During fiscal year 2014, the Municipal Services Corporation approved a loan of \$500,000 to the City's General Fund. Half of the loan was repaid at the end of fiscal year 2014 and the second half remained outstanding at the fiscal year end. In the General Ledger, the loan repayment was recorded as a reduction of cash and the payable in the General Fund as of June 30, 2014, but the corresponding transaction was not recorded in the Corporation as of June 30, 2014. And, the outstanding balance of the loan was reported in the general ledger as accounts receivable in the Corporation and as accounts payable in the General Fund, rather than as an interfund balance.

In a separate transaction, 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." The return of an unspent portion of those contributions in fiscal year 2014 of \$5 thousand was recorded in the general ledger as expenditures of the Federal, State and Local Grants Special Revenue Fund and revenues to the Corporation.

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, the loan repayment should have been matched in the same period in both the General Fund and in the Corporation, the outstanding balance should have been reported as an interfund receivable/payable, and the return of the unspent 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 a receivable from the City and the return of funds as a contribution.

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 and that any intra-entity transactions are identified at the start of the audit so they can be properly classified in the City's financial statements.

Management's Response:

Partially disagree. Although the City acknowledges the accounting error related to the recording of the loan repayment and will ensure future transactions are recorded in the same accounting period, 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 a vendor-customer relationship, or in this case, a lender-borrower relationship. This approach will enable the Corporation to produce a separate financial statement accurately reflecting its revenues and expenses, liabilities and receivables, 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.

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

SCHEDULE OF SIGNIFICANT DEFICIENCIES

2014-05 Investment Report – Timely Reporting, Accurate Reporting and Compliance with Requirements of Government Code Section 53646 and the City’s Investment Policy

We reviewed the City’s Investment Report for compliance with the Government Code and the Investment Policy reporting requirements and noted the following:

- a. California Government Code Section 53646 (b)(1) requires that the quarterly Investment Report be submitted to the City Council within 30 days following the end of the quarter covered by the report.

The Quarterly Investment Report for the quarter ending June 30, 2014 was not submitted to City Council until September 22, 2014, and the September 2014 Report was not completed as of November 2014.

- b. California Government Code Section 53646 (b)(3) states that “the quarterly report shall include a statement denoting the ability of the local agency to meet its pool’s expenditure requirements for the next six months, or provide an explanation as to why sufficient money shall, or may, not be available” In addition, Section 14 of the City’s Investment Policy also requires the above element to be included on the Investment Report.

Although the City’s June 30, 2014 Investment Report contained the applicable statement above as required by California Code Section 53646 (b)(3) and the City’s Investment Policy, the balance of the pooled unrestricted investments as of that date on the Report were only \$2,703. This does not appear to be sufficient funds to meet the City’s expenditure requirements for the next six months, but the Report did not include a further explanation as required by the Code.

If the pooled unrestricted investments are insufficient to meet the City’s expenditure requirements for the next six months, the Report should provide an explanation as to why sufficient money shall, or may, not be available.

- c. Section 5.1 of the Investment Policy requires written investment policy procedures for the operation of the investment program consistent with the Policy, including reference to safekeeping, wire transfer agreements, banking service contracts and collateral/depository agreements. We understand the City does not have such written procedures.
- d. Section 15.0 of the Policy states that “The City of El Cerrito’s investment policy will continue to be reviewed and adopted by the City Council annually, even if not required by California Government Code 53646.”

Although we understand the Financial Advisory Board reviewed the Investment Policy, the City Council did not review and adopt an Investment Policy during fiscal year 2014. The last policy was adopted by City Council in February 2012. The City did not adopt the Investment Policy in fiscal year 2014.

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

2014-05 Investment Report – Timely Reporting, Accurate Reporting and Compliance with Requirements of Government Code Section 53646 and the City’s Investment Policy (Continued)

The City is not in compliance with the reporting requirements of California Government Code Section 53646 and the City’s Investment Policy. The City should develop procedures to comply with the various provisions of its Investment Policy and the California Government Code, or revise the Policy to reflect the current practices, if and when they are in compliance with the California Government Code.

Management’s Response:

Agree. By April, Finance staff will be submitting the reports in the correct months and will review the government code by June 30, 2015 to determine how to ensure compliance with this section on future reports.

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

SCHEDULE OF OTHER MATTERS

2014-06 Outstanding Checks Listing – Stale Dated Checks

Outstanding checks listed on the City's bank reconciliations as reconciling items should be kept current in order to accurately reflect the City's cash balance. The City's policy is to address checks outstanding for three years.

In reviewing the City's general checking account bank reconciliation dated March 31, 2014, we noted that the City's outstanding check list included 94 checks totaling \$22,462 that were at least three years old, with some dating back to August 2008.

We understand the delay in addressing the old outstanding checks is due to staffing issues and Finance staff is "focusing other more pertinent issues".

The City should develop a process to ensure that stale-dated checks are reviewed on a semi-annual or at least an annual basis to determine whether they can be reissued or reversed.

Management's Response:

Agree. Finance staff has completed a draft of an Unclaimed Property Policy that includes the procedures on outstanding checks. The procedure states that checks drawn on City of El Cerrito bank accounts that remain on the outstanding check reconciliation list after 180 days from check date shall be considered stale dated and shall not be honored by the City of El Cerrito's bank if presented for payment. Stale dated checks shall be voided and removed from the outstanding list. A journal entry shall be prepared to transfer the funds to a liability account. If unclaimed after a period of three years, the funds will be Unclaimed to the City. Once the Policy is finalized, the procedure will be implemented by December 30, 2015.

2014-07 Reviewing Service Organization Internal Control Reports

The AICPA establishes auditing standards to be followed to ensure that any service organization's systems and controls are adequately designed and are operating effectively. The Standards have two parts. Part one is designed to review controls over the service provided at a particular date and to report on whether the design of these controls appear to be adequate on that date. Part two is designed to test these controls over a six month period and to report on whether the design of the controls appears adequate and whether the auditor can reasonably conclude that the controls were operating effectively. The City has third party vendors that process transactions and perform functions on behalf of the City, known as service organizations. The procedures used by these service organizations are outside the scope of City oversight and staff review, and their internal controls are not part of the scope of an audit of the City's financial statements. Typically cities employ a variety of approaches to gain comfort that service organizations are performing their functions in a prudent manner and producing reliable data. For example, fiscal agents manage funds held pursuant to debt indentures, but cities rarely have audits performed as City staff review transactions and verify the trust data. Less frequently special audits are performed to determine adequacy of controls and to verify the data produced. There is a third option which is to request a copy of the entity's review and report on internal controls pursuant to the requirements of the AICPA standards, called a Service Organization Control Report (formerly a SAS70 audit).

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

SCHEDULE OF OTHER MATTERS

2014-07 Reviewing Service Organization Internal Control Reports (Continued)

During the audit inquired of City staff whether they review the Service Organization Control Reports for its service organizations, such as its fiscal agent Union Bank, but found that the reports were not being reviewed. Should the Service Organization Control Report reveal weaknesses in the service organization's internal controls, those could go unnoticed by the City.

The City should develop procedures to ensure that all service organizations are monitored periodically, such as by reviewing the annual Service Organization Control Reports. The City should request a copy of the most recent Service Organization Control Report from its applicable vendors. Any weaknesses or system problems disclosed by that audit should be addressed and resolved by the contractor to the satisfaction of the City. This process should take place on an annual basis for all of the City's service organizations.

Management's Response:

Agree. Finance staff will review by December 30, 2015 and determine how the City can comply with the finding.

2014-08 Health and Safety Code Expenditure Limitations and Reporting Requirements for the Housing Successor

Senate Bill No. 341 was approved on October 13, 2013 and amended and added to the Health and Safety Code (HSC) effective January 1, 2014 to change provisions relating to the functions performed by a Housing Successor.

The amendments to HSC Section 34176 are minor and primarily include defining the "entity that assumed the housing functions of a former redevelopment agency" as the Housing Successor.

HSC Section 34176.1 is new and imposes spending limitations and reporting requirements related to the housing assets of the former Redevelopment Agency held by the Housing Successor.

The City serves as Housing Successor for the housing activities of the former El Cerrito Redevelopment Agency and the activities of the Housing Successor are reported in the Low and Moderate Income Housing Asset Special Revenue Fund.

The City, as Housing Successor, should develop procedures to ensure ongoing compliance with the provisions of HSC Section 34176.1, including the expenditure limitations and annual reporting requirements.

Management's Response:

Agree. The activities of the Housing Successor are reported in the Low and Moderate Income Housing Asset Special Revenue Fund (LMIHAF). The LMIHAF is managed within the Community Development Department. The Department monitors the use of Housing Assets to ensure they are consistent with the Health and Safety Code provisions. The Community Development department will implement procedures to ensure ongoing compliance with the provisions of HSC Section 34176.1, including the expenditure limitations and annual reporting requirements by December 30, 2015.

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

SCHEDULE OF OTHER MATTERS

2014-09 Information Technology Best Practices Recommendations

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

Currently, there are no Information Technology standards to which local governments are required to conform. Indeed there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments can use to implement appropriate controls to ensure adequate security over information technology. Our Information Technology staff have reviewed these informal guidelines and concluded that the certification and accreditation framework developed by the National Institute of Standards and Technology (NIST) for the Federal Information Security Management Act (FISMA) are the most appropriate for local government. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. 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
- Information systems risk management

While the results of our work did not indicate material weaknesses, we did find exploitable vulnerabilities, and 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” are as follows:

Payment Card Industry Compliance

The City is not in compliance with the Payment Card Industry Data Security Standard (PCI-DSS). Any organization that processes credit cards is required to comply with PCI-DSS, even if the processing is outsourced. Failure to meet compliance requirements results in higher transaction fees and liability if a security breach is found. Because the City accepts credit cards as a form of payment, the City must be compliant with the applicable controls.

Audit/Event Logging

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

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

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL

SCHEDULE OF OTHER MATTERS

2014-09 Information Technology Best Practices Recommendations (Continued)

Shared User Accounts

The City does not require users to use unique logon accounts for the ERP. For accountability there should be no user account on the financial applications that are shared with multiple users. This includes shared accounts for administrative functions such as for root and/or administrator. The City should ensure that employees do not share user accounts for any administrative or financial functions within the financial applications.

Password Management for Operating Systems

The City does not enforce regular password changes or require the use of complex passwords for users. There should be a written policy for the regular changing of operating system account passwords and the use of complex passwords for users. An automatic enforcement of this policy would be optimum. 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 optimum. 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.

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.

General Information Systems Controls

We reviewed the compliance of the City's information systems with the NIST information security standards based on a moderate risk system. We noted a number of controls that were not in place, which have been communicated to the City's IT personnel. Although there is no required IT standard for local governments, NIST encourages state, local and tribal governments to consider the use of these guidelines, as appropriate. In adopting NIST standards the local government demonstrates due diligence in designing and implementing appropriate controls around its information systems. The City should consider reviewing the NIST information security standards to determine if implementation of the controls noted above is appropriate.

Management's Response:

Payment Card Industry Compliance

Agree. By the end of June 30, 2015, IT staff will gather the requirements for PCI compliance.

Audit/Event Logging

Agree, but will not implement. The City's financial system, NWS, doesn't currently have these features, except logging Users Logon and Logoff time. Staff determined this is low risk and will not implement unless NWS adds this feature to this software.

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

SCHEDULE OF OTHER MATTERS

2014-09 Information Technology Best Practices Recommendations (Continued)

Shared User Accounts

Agree, but will not implement. NWS doesn't currently have this feature and staff determined this was low risk. The only shared user accounts are at counter workstations and there are no administrative functions on these shared accounts. The City will not implement unless NWS adds this feature to this software.

Password Management for Operating Systems

Agree. IT staff will partially implement the automatic enforcement of password changes by December 30, 2015.

Session Locks

Agree. IT staff will gather the requirements by December 30, 2015 to determine how the City can implement.

General Information Systems Controls

Agree. IT staff will gather the requirements by December 30, 2015 to determine how the City can implement.

NEW GASB PRONOUNCEMENTS OR PRONOUNCEMENTS NOT YET EFFECTIVE

The following comment represents a new pronouncement taking affect in the next fiscal year. We cite it here to keep you informed of developments:

EFFECTIVE FISCAL 2015:

GASB 71 – Pension Transition for Contributions Made Subsequent to the Measurement Date-an amendment of GASB No. 68

The objective of this Statement is to address an issue regarding application of the transition provisions of Statement No. 68, *Accounting and Financial Reporting for Pensions* discussed in the Current Status of Prior Year Schedule of Other Matters section below. The issue relates to determining the beginning balances of deferred inflows and outflows required under the provisions of GASB Statement No. 68 and amounts associated with contributions, if any, made by a state or local government employer or non-employer contributing entity to a defined benefit pension plan after the measurement date of the government's beginning net pension liability.

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL

SCHEDULE OF OTHER MATTERS

GASB 71 – Pension Transition for Contributions Made Subsequent to the Measurement Date-an amendment of GASB No. 68 (Continued)

Statement 68 requires a state or local government employer (or non-employer contributing entity in a special funding situation) to recognize a net pension liability measured as of a date (the measurement date) no earlier than the end of its prior fiscal year. If a state or local government employer or non-employer contributing entity makes a contribution to a defined benefit pension plan between the measurement date of the reported net pension liability and the end of the government's reporting period, Statement 68 requires that the government recognize its contribution as a deferred outflow of resources. In addition, Statement 68 requires recognition of deferred outflows of resources and deferred inflows of resources for changes in the net pension liability of a state or local government employer or non-employer contributing entity that arise from other types of events. At transition to Statement 68, if it is not practical for an employer or non-employer contributing entity to determine the amounts of all deferred outflows of resources and deferred inflows of resources related to pensions, paragraph 137 of Statement 68 required that beginning balances for deferred outflows of resources and deferred inflows of resources not be reported.

Consequently, if it is not practical to determine the amounts of all deferred outflows of resources and deferred inflows of resources related to pensions, contributions made after the measurement date of the beginning net pension liability could not have been reported as deferred outflows of resources at transition. This could have resulted in a significant understatement of an employer or non-employer contributing entity's beginning net position and expense in the initial period of implementation.

This Statement amends paragraph 137 of Statement 68 to require that, at transition, a government recognize a beginning deferred outflow of resources for its pension contributions, if any, made subsequent to the measurement date of the beginning net pension liability. Statement 68, as amended, continues to require that beginning balances for other deferred outflows of resources and deferred inflows of resources related to pensions be reported at transition only if it is practical to determine all such amounts.

The provisions of this Statement are required to be applied simultaneously with the provisions of Statement 68.

How the Changes in This Statement Will Improve Financial Reporting

The requirements of this Statement will eliminate the source of a potential significant understatement of restated beginning net position and expense in the first year of implementation of Statement 68 in the accrual-basis financial statements of employers and non-employer contributing entities. This benefit will be achieved without the imposition of significant additional costs.

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

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

2013-01 Journal Entry Review and Approval Process

Journal entries should be reviewed and approved by a second employee to ensure they are accurate, accompanied by supporting documentation and are posted correctly to the general ledger.

The City's process for journal entries is that the Finance Manager prepares and posts journal entries to the general ledger and files them in a binder, which he keeps in his office. The Finance Director/City Treasurer later reviews the binder to approve and sign off on the journal entries.

We selected forty journal entries for testing of compliance with the City's policies and supporting documentation, and noted that thirty-nine of the journal entries tested were prepared by the Finance Manager, but none of them had been reviewed and approved by the former Administrative Services Director or the current Finance Director/City Treasurer. We also tested two budget adjustment journal entries and noted that they were not reviewed or approved.

We understand that the former Administrative Services Director would review all of the journal entries at one time, but did not do so prior to her departure in March 2013, and the duty was not assumed by the new Finance Director/City Treasurer.

Without proper approval of journal entries, the likelihood of an error or improper accounting treatment is increased. The Finance Director/City Treasurer should ensure all journal entries are properly reviewed, approved, and signed off.

Update for 2014 Audit: We selected forty general ledger journal entries for testing of compliance with the City's policies and supporting documentation, and noted that all of the entries included a review signature but no date of when the review was completed. We also tested two budget adjustment journal entries and noted that one of the entries was not reviewed or approved. We selected four additional general ledger journal entries for testing and noted they did not include an indication that they had been reviewed. We then checked the folder containing general ledger journal entries that were posted during the fiscal year and noted that none of the entries in the folder included an indication that they had been reviewed.

As noted in above, without review and approval of journal entries, the likelihood of an error or improper accounting treatment is increased. The Finance Director/City Treasurer *must* ensure all journal entries are properly reviewed, approved, and signed off. In the event the Finance Director/City Treasurer cannot complete the review, the duty should be assigned to another appropriate employee.

Current Status:

Management agrees with this finding, but has been unable to completely implement this finding. Recent staff changes in the Finance Department have allowed the department to review and reorganize many of the business practices including the approval levels in the financial system. Staff is working with IT Manager to have the financial system require two approvals before a Journal entry can be posted. This will ensure a second review is done timely as a journal entry can't be posted until the second approval is complete. The goal is to have this fully implemented by the end of next fiscal year.

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

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

2013-02 Timely Review of the Bank and Investment Reconciliations

Bank and investment reconciliations should be prepared, reviewed, and approved within 30-45 days after month end.

We reviewed the bank reconciliations for January, February, March, and April 2013, and the investment reconciliation for March 2013 and noted that although they were prepared timely, they were not reviewed and approved by the Finance Director/City Treasurer as of July 2, 2013. And, as of October 2013, the June 2013 bank and investment reconciliations did not contain any evidence that they had been reviewed and approved.

Without a review, instances of errors by the preparer during the bank reconciliation process could go undetected.

While we understand reviews had fallen behind after December 2012 and the Finance Director/City Treasurer started with the City in March 2013, bank and investment reconciliations should be reviewed and approved within the 30-45 days after month end, and evidence of the review should be documented in a formal manner.

Update for 2014 Audit: We reviewed the bank reconciliations for October 2013, November 2013, January 2014, March 2014 and June 2014 and noted that although they were prepared timely, the November 2013 and March 2014 bank reconciliations were reviewed but the date of the review was not documented. The October 2013, January 2014 and June 2014 bank reconciliations did not appear to have been reviewed. We reviewed the September 2013, March 2014 and June 2014 investment reconciliations and noted they were prepared timely, but the review of the March 2014 reconciliation was not dated and the September 2013 and June 2014 reconciliations did not appear to have been reviewed.

We did note that only the reconciliations that had been selected for testing in our Interim Checklist request had been reviewed and the additional reconciliations selected for testing did not contain an indication that they had been reviewed.

As noted above, bank and investment reconciliations should be reviewed and approved within the 30-45 days after month end, and evidence of the review *must* be documented in a formal manner.

Current Status:

Management agrees with this finding, but has been unable to completely implement this finding. Recent staff changes in the Finance Department have allowed the department to review and reorganize many of the business practices such as bank reconciliations. Staff anticipates this will be implemented by the end of next fiscal year.

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

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

2013-03 General Fund Budgets, Cash and Available Fund Balances

As discussed in prior year comment 2012-04, 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 \$540 thousand. After the City recorded post-closing adjusting journal entries to record the August 2013 loan of \$575 thousand from the Municipal Services Corporation as a fiscal year 2013 transaction and an adjustment to fiscal agent cash of \$327 thousand, as of June 30, 2013, General Fund unrestricted cash balances amounted to only \$362 thousand, and General Fund unassigned fund balances amounted to \$1.2 million. Unassigned fund balance represents available fund balance and equates to approximately 16 days of General Fund expenditures. This is a very low level of available resources. Unassigned fund balance declined \$1.1 million from the prior fiscal year, and the cash balance remained depleted 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, 2013, the balance of the Capital Improvement Fund borrowing from the General Fund was \$525 thousand 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 over \$620 thousand, there was a second year of the operating deficit of \$1.8 million and when combined with other activity in the fund, fund balance decreased by \$945 thousand at year end.
- C. The City also has long-term liabilities for unpaid compensated absences approximating \$1.5 million. Further, the amounts do not consider future cost increases for retirement costs which have unfunded liabilities.

During this year's audit, we again 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, 2014. However, if deficit spending continues at the same level as the last two fiscal years, 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. Although the City continues to issue Tax Revenue Anticipation Notes to supplement cash temporarily during the fiscal year, if deficit spending were to continue, it also reduces the likelihood that the City will be able to continue as a going concern. 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 2014 projects ending fund balance and net assets of all funds as a positive \$5.2 million, it includes a projected increase in the General Fund of only \$25 thousand and projected use of resources of \$2.4 million City-wide during 2014. 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.

Current Status:
See Comment 2014-01

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

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

2013-04 **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. Most of these issues were provided in the fiscal year 2012 Memorandum on Internal Control as prior year comments #2010-02 and #2009-06 and have not been implemented.

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 Finance Director, the Finance Manager and the Information Services Coordinator have super-user rights to the New World General Ledger 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 lack of review in approval in other critical areas pose a significant control risk and the City should consider restricting super user rights to as few employees as possible.

b. Payroll Review, Accounts Payable Review and Super-User Status

The payroll edit report (payroll register) and the accounts payable check 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 or the accounts payable module. The Finance Manger reviews the payroll edit report and the accounts payable check register; however he has access to the payroll system, accounts payable system, and has access to the check stock and the signature plate. In addition, he is a system "super user" as noted above. An independent review of changes to the payroll database (new employees, pay rate changes, etc.) or vendor database (new/ revised vendors, etc.) should be performed by an employee not involved with the processing and review above.

c. 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.

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

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

2013-04 Internal Controls – Segregation of Duties (Continued)

d. 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 also has access to the payroll system, 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, such as the Human Resources department.

e. 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 Finance Manager 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.

f. 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.

g. Accounts Payable Processing and Vendor Database

The Accounts Payable Clerk and the Payroll Clerk have access to vendor database and could make changes such as adding a vendor or changing vendor contact information. The Payroll Clerk performs accounts payable processing functions when the Accounts Payable Clerk is not available.

The City should either remove their access to the vendor database or determine whether a report of changes to the vendor database can be generated with each check run and reviewed and approved by an employee independent of the function.

Management of the City must develop procedures to review the City's internal controls, starting with the duties of each employee to see if they conflict with the employees' access to the City's various assets. Where conflicts exist, if mitigating controls cannot be put in place to reduce the internal control risk, then either the ability to process the transaction or the access to the asset should be transferred to another appropriate employee.

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

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

2013-04 Internal Controls – Segregation of Duties (Continued)

Update for 2014 Audit: In response to the above comments, City staff indicated that the super user status would be revised, other system access rights would be reviewed to ensure they were appropriate, and certain responsibilities would be reallocated to address the internal control weaknesses noted. We did not see any change during our interim work and the City should review procedures and processes to determine what mitigating controls could be implemented.

In addition, we reviewed six Payment Batch Registers for non-utility vendors and four Payment Batch Registers for utility vendors and noted that two of the four utility vendor Registers did not contain evidence that they had been reviewed by a second person. City staff must implement procedures to ensure that review and approval of all Payment Batch Registers is completed.

Current Status:

- a. The City will remove the Finance Director's super-user rights which will bring the number of super users to two. The IT Manager assumes almost all of the system maintenance and access duties and the Finance Manager acts as his back up.
- b. Due to limited number of staff, the Finance Manager is the most appropriate person to review payroll and accounts payable and ensure that it is done in a consistent and timely manner.
- c. Since the payroll technician needs access to Workforce Administration in the HR module in order to process employees' direct deposits and garnishments, she also has access to change employee rates. The City will review access rights within the Finance Department and determine if it is possible for staff to be denied access to certain fields in Workforce Administration, such as employee rates, without losing access to areas needed to process payroll.
- d. The City will reassign the responsibility of following up on unclaimed W-2's from the Payroll Technician in the Finance Department to the Personnel Technician in the Human Resources Department. Currently, the finance system does not have a report that tracks changes to the payroll database.
- e. The Finance Department plans on implementing the Accounts Receivable module in FY15 which will allow the department to better track the City's receivables and changes to the database.
- f. See response to item e. above.
- g. In order to process accounts payable efficiently, the Accounts Payable (A/P) Technician and her back-up, the Payroll Technician, both need access to creating vendors. Due to the limited number of staff, it is not practical to segregate the duty of creating vendors from the A/P function. A report of changes to the vendor database is not available.

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

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

2013-05 Payroll Review When Accounting Supervisor Processes Payroll

As discussed in 2013-04 above, 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. And, when the Finance Manager processes payroll as a backup for the Payroll Clerk, it is imperative that someone else perform his normal review of the payroll register.

During testing of payroll registers, we noted that for the pay period from August 19, 2012 through September 1, 2012, the register dated September 4, 2012 was processed by the Finance Manager who is also in charge of the reviewing process. After the register was processed, a second person did not review it for accuracy and whether amounts were being paid to only valid employees.

Without review and approval by a second appropriate employee, there is a possibility that payroll registers could contain errors in the check amounts or checks written to individuals who were not actual employees of the City for that time period.

We understand the Payroll Clerk responsible for payroll was on vacation during this time, therefore the Finance Manager processed the payroll and therefore could not also review the payroll register. An independent review of the payroll register should still be performed by an employee who did not process the same register.

Current Status:

In the future, when the Finance Manager processes payroll in the absence of the Payroll Technician, he will have the Finance Director, Human Resources Manager or another staff member from Finance or Human Resources review his work.

2013-06 Recycling and Environmental Resource Center Cash Collection Procedures

All of the City's departments that collect payments from customers should have procedures in place to ensure proper segregation of duties are maintained throughout the billing and collection process.

At the City's Recycling and Environmental Resource Center (RERC), there should be proper segregation of duties among the employees which delineates the authority to access and update the billing spreadsheet, open checks and post them to the billing spreadsheet, enter information into the general ledger, review accounts for collectability, reconcile cash and billings, and deliver cash collections to the Finance Department.

We reviewed the cash collection procedures at the RERC and noted that similar duties are shared by many of the employees, and that there is no segregation for many of the duties. The issues we noted were as follows:

- All four of the administrative employees have access to the Excel spreadsheet used to track the Center's billings for rental fees and materials sales. Anyone can make changes to the spreadsheet, including the ability to: input a billing, delete a billing, or edit a billing.

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

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

**2013-06 Recycling and Environmental Resource Center Cash Collection Procedures
(Continued)**

- All four of the administrative employees can collect cash and checks from customers at the center, can post the receipt in the general ledger system, and can void a transaction. No approval by a second employee is required prior to processing a voided receipt.
- Two of these employees can collect cash, enter the collections into the general ledger system, reconcile cash and billings, and deliver the collections to the Finance Department for deposit.

The RERC began operations in its new facility within the last year it appears that they have not yet reviewed cash collection procedures to ensure that they include proper segregation of duties among the employees.

City staff should review the cash collection procedures at the RERC to ensure that employees with the access to prepare or adjust customer billings do not also collect customer payments, adjustments to a customer billing are approved by a second employee, and voided receipts require the approval of a second employee. In addition, the ability to collect customer payments should be limited to one employee at a time, and the daily collections should be reconciled by that employee and the reconciliation reviewed and approved by a second employee not involved with the collection.

Current Status:

An Excel spreadsheet "Materials Database" is used to track loads of recyclable materials the City sells to buyers, and is an internal tracking of loads as based on paper weight tag/Bill of Lading records that are retained by the City's Operations + Environmental Services Division. These paper records are generated when the City ships a load of recyclables for sale, and are then submitted to the Division's recycling Management Assistant who inputs them into the Materials Database for tracking purposes. The City retains paper records for all loads that are shipped by the Division.

After shipment, the City receives check payments from buyers; some payments are per load based on market rates, and others are for multiple loads based on contracted rates. Because these payments are variable by market or include payment for multiple shipments, and are subject to adjustments on payment for individual loads, it is not feasible to use the City's New World Systems Accounts Receivable functionality to track these payments. Instead, the City uses the Materials Database to match payments to loads shipped and confirm that the City has received payment for all loads shipped. The Management Assistant matches check payments to loads shipped and inputs payments into New World Systems for inclusion in a batch reconciliation. This is reviewed and approved by the Division Manager. Because inputting load shipment records into the Database and matching check payments with load shipments in the Database requires intimate knowledge of the City's recycling operations, and because there is only one full time administrative staff person assigned to the Division, it is not feasible to segregate these two duties between two employees at this time (though the Division does employ part-time Administrative Clerks, it is not feasible for them to input shipping data or check data, as the Database requires consistency in order to be effective).

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

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

**2013-06 Recycling and Environmental Resource Center Cash Collection Procedures
(Continued)**

However, because the paper records received by the City as documentation of loads shipped are also retained by buyers, the City can receive reports of load shipments and payments from buyers on a regular basis; these statements may serve as a double-check against the information entered into the Database by the Management Assistant. The City proposes to request that all buyers make regular quarterly reports documenting all loads shipped and all payments made. These reports would go to the Division Manager, who could then perform a check against the Materials Database to ensure that all loads and payments have been included in the database.

It should be made clear that entries into the Materials Database do not constitute a "billing". Instead, it is merely a tracking system for materials sold, the main intent of which is to account for the total amount of materials sold, and to ensure that the City receives payment for all materials sold. Entering, deleting, or modifying lines in the Database does not add, delete, or alter billings in any way. Instead, the act of "billing" for materials sold is inherent in the delivery of the goods shipped, and payment is made based on the City's Agreement with the buyer.

The City is changing the functionality of New World System such that approval by a second employee is required prior to processing a voided receipt. Customer service operations at the Recycling + Environmental Resource Center often require the main customer service staff (full-time Management Assistant or part-time Administrative Clerks) to leave the front counter to assist customers. When this occurs, other staff are required to fill in and process transactions. As such, many RERC staff are trained to collect cash and checks and input them into the general ledger system.

Cash and billing reconciliation currently requires approval by a second employee (Operations + Environmental Services Division Manager) prior to completing the reconciliation process. The Manager then delivers collection to the Finance Department. As per the above, given limited staffing and high customer flow at the RERC, it is not feasible to limit collection of customer payments to one employee at a time. However, the Division's policy at the front counter is to utilize a hand written, serially number, duplicate receipt for all cash/check transactions (which does not include sales of recyclable materials shipped), provide a copy of that receipt to the customer, and file the remaining copy (with receipt from New World Services) with the cash/check. During the reconciliation and batching process, all receipts are reviewed by the Division Manager to ensure that there are no gaps in the serial numbers provided or investigate why any gaps exist. This investigation may include use of the RERC's CCTV system which overlooks the cashier area. The Division Manager will re-train all staff to ensure that the serial receipts are used in all transactions, and that customers must always be provided the receipts.

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

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

2013-07 Building Permits Calculations

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 2012-01, 2011-01, 2009-02 and 2008-03), we again selected twenty-five building permit receipts to recalculate the rates charged in accordance with the Council-approved Master Fee Schedule adopted with Resolution # 2012-33. Although the errors were not to the magnitude of prior year errors, we again noted calculation errors as follows:

- a. Three permits included a fee for the fire department's review of plans in the amounts of \$380, \$377, and \$377. However, the fire department's plan review fee is not included on the Master Fee Schedule and is based on a memorandum from the Fire Department to the Building Official that indicates the review fee should be 50% of the building plan fee.
- b. One permit for the installation of new windows in a residential remodeling project in the amount of \$339 for the installation and \$935.50 for the building plan check fee appeared to have been miscalculated and should have charged \$289 for the installation and \$936 for the plan check fee, a difference of \$49.50.
- c. Three permits did not include the mandated Strong Motion Instrumentation fee in the amounts of \$1.34, \$0.88 and \$0.68.

All building permit fees, including the fire department plan review, should be included in the Master Fee Schedule to ensure there is no confusion and that fees are charged to customers in a consistent manner, and all fees should be accurately calculated and charged to the customers.

Again, although these errors are not material errors like we have seen in the past, this volume of errors in our testing (7 of 25) 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.

Current Status:

- a. Implemented with the 2015 Master Fee Schedule. The Fire Department plan review fees are listed in the Fire section of the Master Fee Schedule, which the Building Department collects after the Fire Department completes its review. (The Fire Plan Review is not 50% of the building plan fee.) The Building section of the Master Fee Schedule was revised to refer the reader to the Fire section of the schedule for easier calculation.

For building permits, the department calculates plan check and inspection fees separately, but collects 50% of the combined amount when an application is received, which is applied first to plan check fees and the remainder to inspection fees. It appears that the amount showing as a plan check fee is the amount collected for the two combined.

- b. The Department will implement procedures to ensure that permit fees are calculated accurately, permits are reviewed and approved by a second person, and the fees in the system reflect those approved in the Master Fee Schedule.
- c. Not yet implemented.

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

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

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:

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

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

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.

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

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

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.

Current Status:

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.

See also Current Status of comment 2013-07.

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.

Current Status:

See 2014-04.

**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:

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

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

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

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

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

**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 Status of Comment 2012-01 and 2013-07.

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

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

2013-08 Purchasing Policy Compliance – Purchase Orders and Contracts

Section C2 of the City's July 2011 Purchasing Policy requires that purchases of goods and services valued at \$15,000 or more must be made with a purchase order, and the Purchasing by Formal Competitive Bid section of the Policy requires that purchases of supplies or equipment in excess of \$25,000 that are not subject to exemptions elsewhere in the Policy are subject to formal bidding.

We selected a sample of forty disbursements to test the effectiveness of disbursement processing, procedures, and compliance with the Policy and noted the following:

- One disbursement for goods and services in the amount of \$16,512 for landscaping services did not have a purchase order. The City spent a total of \$126,000 with the vendor during fiscal year 2013.
- One disbursement in the amount of amount of \$52,500 for maintenance of the City's radios did not have a purchase order and was not subject to competitive bidding.
- One disbursement in the amount of \$29,135 for the purchase of fuel for City vehicles was not subject to competitive bidding and the City did not have a contract with the vendor. The City spent a total of \$238,457 with the vendor during fiscal year 2013.

Although the above disbursements were approved by City staff, none of the transactions appear to meet the exceptions to the purchase order, contract or competitive bidding requirements of the City's Purchasing Policy. The City should either revise its procedures to comply with the requirements of the Purchasing Policy, or revise the Purchasing Policy to reflect current practices.

Current Status:

The Finance Department is reviewing the current purchasing policies and practices. We have convened a multi-department purchasing committee that will be reviewing items such as the City's purchase order requirements, procurement practices and pricing for most frequently used vendors as well as implementing blanket purchase orders for recurring expenses such as utilities.

2013-09 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 twelve terminated employees to ensure they were removed from the payroll system in a timely manner, we noted that one recreation employee was not terminated from the system until two months after the date of their last paycheck.

We understand the recreation employee was a part-time employee that the department thought may return for other projects.

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

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

2013-09 Terminated Employees in Active Payroll System (Continued)

Although the employee did not receive any payments subsequent to their last paycheck, terminated employees should not remain in the active payroll records. As we recommended in prior year Memorandum on Internal Controls comments 2012-07 and 2011-04, 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).

Current Status:
Implemented.

2013-10 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 Investment Report for compliance with the Government Code and the Investment Policy reporting requirements and noted the following:

- a. California Government Code Section 53646 (b)(1) requires that the quarterly Investment Report be submitted to the City Council within 30 days following the end of the quarter covered by the report. The Quarterly Investment Reports for the quarters ending December 31, 2012 and March 31, 2013 were not submitted to the City Council as of July 2, 2013, and the June 30, 2013 Report was not submitted to the City Council until September 17, 2013. The City should submit the quarterly reports within the 30 day requirement.
- b. California Code Section 53646 (b)(3) states that "the quarterly report shall include a statement denoting the ability of the local agency to meet its pool's expenditure requirements for the next six months, or provide an explanation as to why sufficient money shall, or may, not be available" In addition, Section 14 of the City's Investment Policy also requires the above element to be included on the Investment Report.

Per review of the City's December 31, 2012 Investment Report it did not contain the applicable provision above as required by California Code Section 53646 (b)(3) and the City's Investment Policy. Although the statement was added back to the March 2013 Investment Report, the City should ensure continual compliance with the reporting requirements of its Investment Policy and the Government Code.

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

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

2013-10 Investment Policy Compliance and Reporting (Continued)

- c. 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 or another firm to perform a review of the internal controls to ensure compliance with investment procedures or the City should remove this section from the policy.
- d. Section 5 of the City's Investment Policy delegates the investment function to the City Treasurer under California Government Code Section 53607; however this section of the Code requires *monthly* reporting of investment transactions to the legislative body as follows:

The authority of the legislative body to invest or to reinvest funds of a local agency, or to sell or exchange securities so purchased, may be delegated for a one-year period by the legislative body to the treasurer of the local agency, who shall thereafter assume full responsibility for those transactions until the delegation of authority is revoked or expires, and shall make a monthly report of those transactions to the legislative body. Subject to review, the legislative body may renew the delegation of authority pursuant to this section each year."

The City currently reports investment balances to City Council on a quarterly basis, but not transactions. The City should report the transactions to the City Council on a monthly basis in compliance with the requirements Government Code Section 53607. This reporting does not have to be in the form of an Investment Report, it need only include the investment transactions or a notation that there were no such transactions for the month.

The City should develop procedures to comply with the various provisions of its Investment Policy and the California Government Code, or revise the Policy to reflect the current practices, if and when they are in compliance with the California Government Code.

Current Status:

Items A & B have been corrected and should not appear as a future finding.

Item C will be referred to the City's Financial Advisory Board to determine a set of appropriate internal controls that will ensure compliance.

Item D The only investment transactions that are occurring are related to the scheduled debt service payments. These transactions will be included as part of the regular investment reports including the corresponding dates of transactions.

See also current year comment 2014-05.

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

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

2013-11 Recycling and Environmental Resource Center – Develop Uncollectible Accounts Policy

During our review of the cash collection procedures at the Recycling and Environmental Resource Center, we noted that the Center does not have a formal policy for addressing uncollectible accounts. We understand the Environmental Analyst looks at the Excel spreadsheet that is used to track the materials sales and rental fees billings and collections to determine what bills are overdue and then calls the customer to remind them of their overdue bill. However, determining which bills are overdue is subjective and not standard each time the billing spreadsheet is reviewed.

The City should establish a formal uncollectible accounts policy for the Recycling and Environmental Resource Center, or subject the Center to the City's other uncollectible accounts policies.

Current Status:

The vast majority of materials sold by the City are subject to the terms of recycling purchase agreements, wherein terms of non-payment are specified. The RERC will be subject to the City's uncollectible account policies, and will implement those policies for any past due amounts identified during quarterly review of the Materials Database against records provided directly by the materials buyers.

NEW GASB PRONOUNCEMENTS OR PRONOUNCEMENTS NOT YET EFFECTIVE

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 2014:

GASB 70 - *Accounting and Financial Reporting for Nonexchange Financial Guarantees*

Some governments extend financial guarantees for the obligations of another government, a not-for-profit entity, or a private entity without directly receiving equal or approximately equal value in exchange (a nonexchange transaction). As a part of this nonexchange financial guarantee, a government commits to indemnify the holder of the obligation if the entity that issued the obligation does not fulfill its payment requirements. Also, some governments issue obligations that are guaranteed by other entities in a nonexchange transaction. The objective of this Statement is to improve accounting and financial reporting by state and local governments that extend and receive nonexchange financial guarantees.

This Statement requires a government that extends a nonexchange financial guarantee to recognize a liability when qualitative factors and historical data, if any, indicate that it is more likely than not that the government will be required to make a payment on the guarantee. The amount of the liability to be recognized should be the discounted present value of the best estimate of the future outflows related to the guarantee expected to be incurred. When there is no best estimate but a range of the estimated future outflows can be established, the amount of the liability to be recognized should be the discounted present value of the minimum amount within the range.

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

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

GASB 70 - Accounting and Financial Reporting for Nonexchange Financial Guarantees (Continued)

This Statement requires a government that has issued an obligation guaranteed in a nonexchange transaction to recognize revenue to the extent of the reduction in its guaranteed liabilities. This Statement also requires a government that is required to repay a guarantor for making a payment on a guaranteed obligation or legally assuming the guaranteed obligation to continue to recognize a liability until legally released as an obligor. When a government is released as an obligor, the government should recognize revenue as a result of being relieved of the obligation. This Statement also provides additional guidance for intra-entity nonexchange financial guarantees involving blended component units.

This Statement specifies the information required to be disclosed by governments that extend nonexchange financial guarantees. In addition, this Statement requires new information to be disclosed by governments that receive nonexchange financial guarantees.

The provisions of this Statement are effective for reporting periods **beginning after June 15, 2013**. Except for disclosures related to cumulative amounts paid or received in relation to a financial guarantee, the provisions of this Statement are required to be applied retroactively. Disclosures related to cumulative amounts paid or received in relation to a financial guarantee may be applied prospectively.

How the Changes in this Statement Will Improve Financial Reporting

The requirements of this Statement will enhance comparability of financial statements among governments by requiring consistent reporting by those governments that extend nonexchange financial guarantees and by those governments that receive nonexchange financial guarantees. This Statement also will enhance the information disclosed about a government's obligations and risk exposure from extending nonexchange financial guarantees. This Statement also will augment the ability of financial statement users to assess the probability that governments will repay obligation holders by requiring disclosures about obligations that are issued with this type of financial guarantee.

EFFECTIVE FISCAL 2015:

GASB 68 - Accounting and Financial Reporting for Pensions (an amendment of GASB 27)

This Statement will have material impact on the City's financial statements. The primary objective of this Statement is to improve accounting and financial reporting by state and local governments for pensions.

This Statement establishes standards for measuring and recognizing liabilities, deferred outflows of resources, and deferred inflows of resources, and expense/expenditures. For defined benefit pensions, this Statement identifies the methods and assumptions that should be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service.

Note disclosure and required supplementary information requirements about pensions also are addressed. Distinctions are made regarding the particular requirements for employers based on the number of employers whose employees are provided with pensions through the pension plan and whether pension obligations and pension plan assets are shared.

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL

STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS

**GASB 68 - Accounting and Financial Reporting for Pensions (an amendment of GASB 27)
(Continued)**

The following are the major impacts:

- This Statement requires the liability of employers and nonemployer contributing entities to employees for defined benefit pensions (**net pension liability**) to be measured as the portion of the present value of projected benefit payments to be provided through the pension plan to current active and inactive employees that is attributed to those employees' past periods of service (**total pension liability**), less the amount of the pension plan's **fiduciary net position**.
- Actuarial valuations of the total pension liability are required to be performed at least every two years, with more frequent valuations encouraged. If a valuation is not performed as of the measurement date, the total pension liability is required to be based on update procedures to roll forward amounts from an earlier actuarial valuation performed as of a date no more than 30 months and 1 day prior to the employer's most recent year-end).
- The actuarial present value of projected benefit payments is required to be attributed to periods of employee service using the entry age actuarial cost method with each period's service cost determined as a level percentage of pay. The actuarial present value is required to be attributed for each employee individually, from the period when the employee first accrues pensions through the period when the employee retires.

Single and Agent Employers

- In financial statements prepared using the economic resources measurement focus and accrual basis of accounting, a single or agent employer that does not have a special funding situation is required to recognize a liability equal to the net pension liability. The net pension liability is required to be measured as of a date no earlier than the end of the employer's prior fiscal year (the measurement date), consistently applied from period to period.
- The pension expense and deferred outflows of resources and deferred inflows of resources related to pensions that are required to be recognized by an employer primarily result from changes in the components of the net pension liability—that is, changes in the total pension liability and in the pension plan's fiduciary net position.
- This Statement requires that most changes in the net pension liability be included in pension expense in the period of the change. For example, changes in the total pension liability resulting from current-period service cost, interest on the total pension liability, and changes of benefit terms are required to be included in pension expense immediately. Projected earnings on the pension plan's investments also are required to be included in the determination of pension expense immediately.

CITY OF EL CERRITO
MEMORANDUM ON INTERNAL CONTROL

STATUS OF PRIOR YEAR
SCHEDULE OF OTHER MATTERS

GASB 68 - Accounting and Financial Reporting for Pensions (an amendment of GASB 27)
(Continued)

- The effects of certain other changes in the net pension liability are required to be included in pension expense over the current and future periods. The effects on the total pension liability of (1) changes of economic and demographic assumptions or of other inputs and (2) differences between expected and actual experience are required to be included in pension expense in a systematic and rational manner over a closed period equal to the average of the expected remaining service lives of all employees that are provided with benefits through the pension plan (active employees and inactive employees), beginning with the current period. The effect on the net pension liability of differences between the projected earnings on pension plan investments and actual experience with regard to those earnings is required to be included in pension expense in a systematic and rational manner over a closed period of five years, beginning with the current period. Changes in the net pension liability not included in pension expense are required to be reported as deferred outflows of resources or deferred inflows of resources related to pensions.
- Employer contributions subsequent to the measurement date of the net pension liability are required to be reported as deferred outflows of resources.
- In governmental fund financial statements: A net pension liability should be recognized to the extent the liability is normally expected to be liquidated with expendable **available** financial resources. Pension expenditures should be recognized equal to the total of (1) amounts paid by the employer to the pension plan and (2) the change between the beginning and ending balances of amounts normally expected to be liquidated with expendable available financial resources.
- Notes to financial statements of single and agent employers include descriptive information, such as the types of benefits provided and the number and classes of employees covered by the benefit terms. Single and agent employers also should disclose the following information:
 - For the current year, sources of changes in the net pension liability
 - Significant assumptions and other inputs used to calculate the total pension liability, including those about inflation, salary changes, ad hoc postemployment benefit changes (including ad hoc COLAs), and inputs to the discount rate, as well as certain information about mortality assumptions and the dates of experience studies.
 - The date of the actuarial valuation used to determine the total pension liability, information about changes of assumptions or other inputs and benefit terms, the basis for determining employer contributions to the pension plan, and information about the purchase of allocated insurance contracts, if any.

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

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

**GASB 68 - Accounting and Financial Reporting for Pensions (an amendment of GASB 27)
(Continued)**

- Required Supplementary Information: Single and agent employers are required to present in required supplementary information the following information, determined as of the measurement date, for each of the 10 most recent fiscal years:
 - Sources of changes in the net pension liability
 - The components of the net pension liability and related ratios, including the pension plan's fiduciary net position as a percentage of the total pension liability, and the net pension liability as a percentage of covered-employee payroll.
 - Schedule covering each of the 10 most recent fiscal years that includes information about the actuarially determined contribution, contributions to the pension plan, and related ratios. If the contributions of a single or agent employer are not actuarially determined but are established in statute or by contract, the employer should present a schedule covering each of the 10 most recent fiscal years that includes information about the statutorily or contractually required contribution rates, contributions to the pension plan, and related ratios.
 - Significant methods and assumptions used in calculating the actuarially determined contributions, if applicable, should be presented as notes to required supplementary information. In addition, the employer should explain factors that significantly affect trends in the amounts reported in the schedules, such as changes of benefit terms, changes in the size or composition of the population covered by the benefit terms, or the use of different assumptions.

Cost-Sharing Employers

- Government-wide and accrual basis of accounting financial statements: A cost-sharing employer that does not have a special funding situation is required to recognize a liability for its **proportionate** share of the net pension liability (of all employers for benefits provided through the pension plan)—the collective net pension liability. An employer's proportion is required to be determined on a basis that is consistent with the manner in which contributions to the pension plan are determined, and consideration should be given to separate rates, if any, related to separate portions of the collective net pension liability. The use of the employer's projected long-term contribution effort as compared to the total projected long-term contribution effort of all employers as the basis for determining an employer's proportion is encouraged.
- A cost-sharing employer is required to recognize pension expense and report deferred outflows of resources and deferred inflows of resources related to pensions for its proportionate shares of collective pension expense and collective deferred outflows of resources and deferred inflows of resources related to pensions.

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

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

**GASB 68 - Accounting and Financial Reporting for Pensions (an amendment of GASB 27)
(Continued)**

- In addition, the effects of (1) a change in the employer's proportion of the collective net pension liability and (2) differences during the measurement period between the employer's contributions and its proportionate share of the total of contributions from employers included in the collective net pension liability are required to be determined. These effects are required to be recognized in the employer's pension expense in a systematic and rational manner over a closed period equal to the average of the expected remaining service lives of all employees that are provided with pensions through the pension plan (active employees and inactive employees). The portions of the effects not recognized in the employer's pension expense are required to be reported as deferred outflows of resources or deferred inflows of resources related to pensions. Employer contributions to the pension plan subsequent to the measurement date of the collective net pension liability also are required to be reported as deferred outflows of resources related to pensions.
- In governmental fund financial statements, the cost-sharing employer's proportionate share of the collective net pension liability is required to be recognized to the extent the liability is normally expected to be liquidated with expendable available financial resources. Pension expenditures should be recognized equal to the total of (1) amounts paid by the employer to the pension plan and (2) the change between the beginning and ending balances of amounts normally expected to be liquidated with expendable available financial resources.
- Notes to financial statements of cost-sharing employers include descriptive information about the pension plans through which the pensions are provided. Cost-sharing employers should identify the discount rate and assumptions made in the measurement of their proportionate shares of net pension liabilities, similar to the disclosures about those items that should be made by single and agent employers. Cost-sharing employers, like single and agent employers, also should disclose information about how their contributions to the pension plan are determined.
- This Statement requires cost-sharing employers to present in required supplementary information 10-year schedules containing (1) the net pension liability and certain related ratios and (2) if applicable, information about statutorily or contractually required contributions, contributions to the pension plan, and related ratios.

This Page Left Intentionally Blank

REQUIRED COMMUNICATIONS

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

We have audited the basic financial statements of the City of El Cerrito for the year ended June 30, 2014. Professional standards require that we communicate to you of the following information related to our audit under generally accepted auditing standards, *Governmental Auditing Standards* and OMB Circular A-133.

Significant Audit Findings

Accounting Policies

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 to the financial statements.

The following pronouncements became effective, but did not have a material effect on the financial statements:

GASB 70 - *Accounting and Financial Reporting for Nonexchange Financial Guarantees*

Some governments extend financial guarantees for the obligations of another government, a not-for-profit entity, or a private entity without directly receiving equal or approximately equal value in exchange (a nonexchange transaction). As a part of this nonexchange financial guarantee, a government commits to indemnify the holder of the obligation if the entity that issued the obligation does not fulfill its payment requirements. Also, some governments issue obligations that are guaranteed by other entities in a nonexchange transaction. The objective of this Statement is to improve accounting and financial reporting by state and local governments that extend and receive nonexchange financial guarantees.

This Statement requires a government that extends a nonexchange financial guarantee to recognize a liability when qualitative factors and historical data, if any, indicate that it is more likely than not that the government will be required to make a payment on the guarantee. The amount of the liability to be recognized should be the discounted present value of the best estimate of the future outflows related to the guarantee expected to be incurred. When there is no best estimate but a range of the estimated future outflows can be established, the amount of the liability to be recognized should be the discounted present value of the minimum amount within the range.

Unusual Transactions, Controversial or Emerging Areas

We noted no transactions entered into by the governmental unit during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period. However, the dissolution of the former Redevelopment Agency continued to have a material impact to the financial statements of the City and its component units, and the State Board of Equalization's sales tax adjustment has an impact on the financial statements of the City:

Redevelopment Agency Dissolution

As discussed in Note 15 to the financial statements, pursuant to ABx1 26 adopted by the State of California which was validated by the California Supreme Court on December 28, 2011, the El Cerrito Redevelopment Agency was dissolved and its assets turned over to and liabilities assumed by Successor Agencies effective February 1, 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. Certain transactions undertaken by the El Cerrito Redevelopment Agency prior to the date of dissolution may be subject to review by the State as discussed in Note 15, but the effect of that review cannot be determined as of June 30, 2014.

In fiscal 2011 and 2012, pursuant to a cooperation agreement and assignment and assumption agreements, the former Redevelopment Agency transferred \$12,550,552 of assets to the El Cerrito Municipal Services Corporation, a component unit of the City. ABx1 26 and AB 1484 contain provisions that such transfers are subject to a review by the State Controller's Office. According to Health and Safety Code 34167.5, if such an asset transfer did occur during that period and the government agency that received the assets is not contractually committed to a third party for the expenditure or encumbrance of those assets, to the extent not prohibited by state and federal law, the Controller shall order the available assets to be returned to the Successor Agency. As of June 30, 2014, assets totaling \$10,279,207, comprised of current assets of \$4,752,073 and capital assets of \$5,527,134, were held by the Municipal Services Corporation, but the City, Successor Agency and the Municipal Services Corporation are in litigation with the State Controller as to whether the Corporation is subject to this provision of the Health and Safety Code. The State Controller's Office has completed its asset transfer review of the former Agency and released its final report in July 2014. The final report indicates the former Redevelopment Agency made unallowable transfers to the Municipal Services Corporation in fiscal years 2011 and 2012 totaling \$12,550,551, consisting of cash of \$2,382,232, land held for redevelopment of \$4,634,789 and capital assets of \$5,533,530. These transfers were also deemed unallowable by the Department of Finance as discussed below, disputed by the City, Successor Agency and Corporation, and subject to litigation as discussed below. Therefore, the amount, if any of assets that may be required to be returned to the Successor Agency cannot be determined at this time.

Prior to the Redevelopment Agency dissolution, the Agency Board approved various agreements which obligated it to repay certain advances from the Agency's Low and Moderate Income Housing Fund to make payments required by the State to the Educational Revenue Augmentation Fund (ERAF) and Supplemental ERAF from tax increment revenue received. The advance was assumed as a receivable 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 time frame for repayment by the Successor Agency from redevelopment property tax is not determinable at this time.

AB1484 requires the Successor Agency to complete two Due Diligence Reviews (DDR) to determine the amount of the remaining assets that should be transferred by the City to the Successor Agency or by the Successor Agency to the County for distribution to the affected taxing entities. The DDR for cash balances in the Low and Moderate Income Housing Fund indicated that there were no balances available for distribution to the affected taxing entities. In April 2013, the State Department of Finance (DOF) completed its review of this DDR and concurred with its findings. In June 2013, the DOF completed its review of the DDR of all other funds of the former Redevelopment Agency. The DDR indicated there were no assets available for allocation to the affected taxing entities, but that amount was adjusted by the DOF to \$1,981,989. In addition, the DOF demanded the City reverse \$10,168,319 of property conveyances executed in fiscal year 2012 and a payment of \$400,243 of bond proceeds to the Municipal Services Corporation. The City, Successor Agency and Municipal Services Corporation are disputing the adjustment and demand in litigation against the DOF.

Also as discussed in Note 14, prior to its dissolution, the Redevelopment Agency obligated certain Redevelopment funds pursuant to a cooperation agreement with the City that was partially assigned to the Municipal Services Corporation. Subsequent to dissolution, the cooperation agreement was rejected by the DOF. The Successor Agency and DOF have met and conferred to settle the matter and the Department determined that it is not an enforceable obligation of the Successor Agency at this time. Management continues to believe the transactions are valid and the City, Successor Agency and Municipal Services Corporation have included this matter in the litigation against DOF.

On September 3, 2014, the Court ruled against the City, Successor Agency and Municipal Services Corporation regarding the transfers and the cooperation agreement. The City, Successor Agency and Municipal Services Corporation have appealed the decision, as discussed in Note 15.

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.

The City's position on these matters is not a position of settled law and there is considerable legal uncertainty regarding these matters. It is possible that a legal determination may be made at a later date by an appropriate judicial authority that would resolve this issue favorably or unfavorably to the City. No provision for liabilities resulting from the outcome of these uncertain matters has been recorded in the financial statements.

State Board of Equalization Sales Tax Adjustment

As discussed in Note 13B to the financial statements, in October 2013, the BOE found that the City's historical sales tax revenues had been misallocated by \$2,499,975 and would withhold that amount from the December 2013 remittance. This finding did not include any adjustments for the sales tax sharing agreement the City has with the City of Richmond and payments that had been made by the City under that agreement in the current and prior fiscal years. The City had requested documentation from the BOE to support its calculation and obtained an extension to April 30, 2014 for the opportunity to appeal the decision while management reviews BOE's methodology and calculations. The BOE did not withhold the amount from the December remittance, pending the City's review and potential appeal.

In October 2014, the BOE rescinded the demand letters and agreed to implement the sales tax sharing agreement between the cities with regard to sales taxes. The BOE indicated that it will not implement an agreement regarding district taxes, so the cities are preparing a separate agreement to address maintaining the 70% - 30% split of district taxes after the BOE begins administering the sales tax sharing agreement.

The City recalculated the historical actual allocations of sales and district taxes for the commercial property to each City for fiscal years 2006 to 2014 and the sales tax sharing payments during that period and determined that the City owes the City of Richmond \$1,037,862. The BOE and the City of Richmond agreed that the City will repay the amount due from future sales tax revenues. Therefore, the City has recorded an accrued liability in that amount that is included in the Statement of Net Position.

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, 2014, the City held approximately \$5.0 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, 2014. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2014.

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 1I 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.

Disclosures

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosure affecting the financial statements was the disclosure of the Redevelopment Agency dissolution and former Redevelopment Agency funds held by the Municipal Services Corporation in Note 15 to the financial statements and the State Board of Equalization's sales tax adjustment disclosed in Note 13B to the financial statements. See discussion under *Unusual Transactions, Controversial or Emerging Areas* above regarding the unsettled law and highly contingent nature of these matters.

The financial statement disclosures are neutral, consistent, and clear.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are clearly trivial, and communicate them to the appropriate level of management. Management has corrected certain such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole, except for the adjustments to record grants receivable for reimbursement requests filed after the fiscal year end and to offset those grants receivable and others that were not collected during the accrual period with unavailable revenue since the grant reimbursements hadn't been filed timely as discussed in item 2014-02 of the Memorandum on Internal Control, the adjustment to record the corrections and reclassifications related to transactions between the Municipal Services Corporation and other City funds as discussed in item 2014-03 of the Memorandum on Internal Control, and to the adjustment to record the fiscal year capital asset depreciation expense.

Professional standards require us to accumulate all known and likely uncorrected 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 City Council.

Disagreements with Management

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations

We have requested certain representations from management that are included in a management representation letter dated February 24, 2015.

Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the governmental unit's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

Other Information Accompanying the Financial Statements

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

With respect to the required supplementary information accompanying the financial statements, applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We did not express an opinion nor provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

The Introductory and Statistical Sections included as part of the Comprehensive Annual Financial Report have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we did not express an opinion nor provide any assurance on them.

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

Mane & Associates

Pleasant Hill, CA
February 24, 2015

This Page Left Intentionally Blank