



CITY OF HAYWARD
AGENDA REPORT

AGENDA DATE 01/31/06

AGENDA ITEM _____

WORK SESSION ITEM La

TO: Mayor and City Council
FROM: Acting Director of Finance and Internal Services
SUBJECT: 2004-05 Management Letter and Comprehensive Annual Financial Report

RECOMMENDATION:

It is recommended that the Council review and comment on this report.

BACKGROUND:

The City's audit firm has completed its audit of the City's financial records for the fiscal year ended June 30, 2005. Copies of the audited financial statements have been transmitted to Council under separate cover. In addition to the audited statements, the auditors have completed and provided to the City their management letter for 2004-05.

There are two major objectives of the management letter. The first is to advise the Council of any material weaknesses in the City's systems of internal financial controls. The management letter may also advise the Council of upcoming accounting regulations which may affect the City's financial records. The second objective is to communicate to the Council any opportunities for improved controls or efficiencies that the auditors may have noted during the course of their audit. A copy of the auditor's management letter is attached for Council's review. The following section contains staff's response to the auditor's management letter for 2004-05.

Management Letter Response

First, staff is pleased to report that the auditors report no instances of a material weakness in the City's system of financial controls. The auditors have made other recommendations, however, which they believe would be of benefit to the City, if implemented. Staff's response, which follows, summarizes and discusses each of the auditor's recommendations. The recommendations are addressed in the same sequence as contained in the management letter.

Investment Policy Revision – Federal Agency Investments

The auditors note the current City investment policy may imply that investments in all Federal agencies are fully backed by the U.S. government. The auditors recommend the City to either revise the wording in the investment policy or reduce its investments in Federal agencies in order to meet the policy limits. In the Annual Investment Report presented to the Council on

December 12, 2005, staff recommended that a policy change allowing government *fully sponsored* investments to be treated the same as *fully backed* would be beneficial. This option was researched by staff with a plan to bring forward as a recommendation at a later date. Staff agrees with the audit recommendation to revise the wording in the policy and will implement the change for the next fiscal year.

New Accounting Pronouncement: Impairment of Capital Assets and Insurance Recoveries

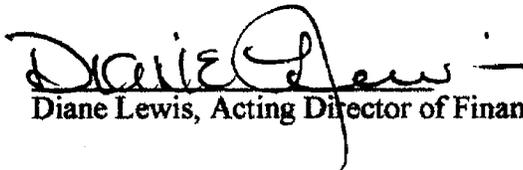
The auditors note new accounting rules effective next year for the recording of capital assets that have become impaired due to damage, obsolescence, or decline in usefulness. Staff understands the new requirement and will prepare for its impact to the City financial statements wherever needed.

Comprehensive Annual Financial Report

As noted above, Council has been provided with the City's audited financial statements for the year ended June 30, 2005 consisting of audits for the Water & Sewer Enterprise Funds, the Redevelopment Agency and others, as well as the City's Comprehensive Annual Financial Report or CAFR. This report includes all funds of the City including the General Fund. As Council is aware, the General Fund accounts for such major public service areas as public safety, public works, community and economic development and administration.

Staff is proud to report that the auditor's opinion on the financial statements for 2004-05 is without exception. That is, the auditor's report is not restricted (qualified) in some manner nor does it take exception to any of the information contained in the City's financial statements. While a qualification or exception is not necessarily detrimental, staff is happy to report that the City's financial statements continue to earn a "clean opinion".

Recommended by:



Diane Lewis, Acting Director of Finance and Internal Services

Approved by:


Jesús Armas, City Manager

MAZE & ASSOCIATES

October 28, 2005

To the City Council of
the City of Hayward, California

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Under generally accepted auditing standards, auditors are encouraged to report various matters concerning an entity's internal control structure noted during an audit, and are required to report certain of those matters. Matters that are required to be reported are significant deficiencies in the design or the operation of the internal control structure that, in the auditor's judgment, could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

As part of our audit of the financial statements of the City of Hayward for the year ended June 30, 2005, we considered the City's internal control structure in determining the scope of our audit procedures for the purpose of rendering an opinion on the financial statements. While our purpose was not to provide assurances on the internal control structure, certain matters came to our attention that we want to report to you. These matters, along with our recommendations, are described in the accompanying memorandum.

A material weakness is a significant deficiency in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses as defined above. However, none of the matters described in the accompanying memorandum is believed to be a material weakness.

The accompanying memorandum on internal control structure is intended solely for the use of management and the City Council. This restriction is not intended to limit the distribution of this letter and the accompanying memorandum which, upon acceptance by the City Council, are a matter of public record. To the extent that the City Council intends to rely upon this letter and the accompanying memorandum, such reliance should take into account the limited basis on which our recommendations were developed, as described above, and the limitations inherent in the internal control structure. In addition, the City Council should understand that the criteria used by us in considering the internal control structure could differ significantly from the criteria the City Council may be using for its purpose.

We wish to express our appreciation for the courtesies and cooperation extended to our representatives during the course of their work. We would be pleased to discuss these recommendations in greater detail or otherwise assist in their implementation.

Maze + Associates

Very truly yours,

CITY OF HAYWARD
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

Investment Policy Revision - Federal Agency Investments

The City's current Statement of Investment Policy includes the following requirements:

- The Diversification Section XIV D(2) states that "Except for deposits in the Local Agency Investment Fund, instruments of the U.S. government or federal agencies fully backed by the U.S. government, and fully collateralized certificates of deposit or fully collateralized medium term notes, no more than 20% of the overall portfolio may be invested in the securities of a single institution."
- The Diversification Section XIV D 3(d) states that no more than "Twenty-five percent in any obligation (with the exception of commercial paper) that does not bear the full faith and credit of the United States government or which is not fully collateralized or insured".

In the June 30, 2005 Investment Report, the City had 31% of its total portfolio invested in Federal agencies. The above policy implies to a reader that all Federal agencies instruments are fully backed by the U.S. government. We also understand that it is also not the City's intent to limit the proportion of its investment in Federal agencies. The City should revise the wording in the policy or reduce its investment in those securities.

New Accounting Pronouncement: GASB #42, Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries

GASB 42 is effective in fiscal 2005-2006 and addresses capital asset impairment and clarifies and establishes accounting requirements for insurance recoveries. The City's significant investment in infrastructure makes their new rules particularly pertinent. A summary of the significant provisions of the GASB are presented below

- A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. Governments are required to address prominent events or changes in circumstances affecting capital assets to determine whether impairment has occurred. Impairment causes may include:
 - Evidence of physical damage,
 - Enactment or approval of laws or regulations or other changes in environmental factors,
 - Technological changes or evidence of obsolescence,
 - Changes in the manner or duration of use of a capital asset, and
 - Construction stoppage.
- A capital asset generally should be considered impaired if both the decline in service utility is large in magnitude, and the event or change in circumstance is outside the normal life cycle of the capital asset.

CITY OF HAYWARD
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

- Impairment losses on capital assets with continued usage should be measured using several approaches including a service units approach, deflated depreciated replacement cost, or a restoration cost approach. If evidence is available to demonstrate that the impairment will be temporary, the capital asset should not be written down. Impaired capital assets that are idle should be disclosed, regardless of whether the impairment is considered permanent or temporary.
- Insurance recoveries should be netted with the impairment loss, but restoration or replacement of the capital asset using the insurance recovery should be reported as a separate transaction.

The City has an extensive capital asset base spread among diverse geographic locations. Accordingly, it should study the possible impact of this Statement and prepare now for its implementation. We will work with staff to ensure a complete evaluation of the impacts of these new rules and a smooth implementation.

DUE TO THE LENGTH OF OUR MATERIALS -
COMPREHENSIVE ANNUAL FINANCIAL
REPORT (CAFR), Financial Audit Reports and the
Management Letter - THEY CAN BE VIEWED IN
THE OFFICE OF THE CITY CLERK AND THE
MAIN LIBRARY