



CITY OF HAYWARD
AGENDA REPORT

AGENDA DATE 02/20/07
AGENDA ITEM _____
WORK SESSION ITEM WS#2a

TO: Mayor and City Council
FROM: Director of Finance and Internal Services
SUBJECT: 2005-06 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, 2006. 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 2005-06.

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 second 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. The management letter may also advise the Council of upcoming accounting regulations, which may affect the City's financial records. 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 2005-06.

Management Letter Comments and Staff's Response

First, staff is pleased to report that the auditors report no instances of a material weakness in the City's system of internal financial controls. The auditors made comments and recommendations based on assessments they made prior to June 30, 2006, 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. In many cases, action has been taken to address the audit comments subsequent to June 2006.

Investment Policy Revision – Federal Agency Investment Concentration

The auditors noted that as of June 30, 2006 the City invested 27% of its portfolio in Federal Agency securities, which exceeded the 25% limit. The auditors recommend that the City either revise the wording in the investment policy or reduce its investments in Federal agencies in order to meet the policy limits.

On January 9, 2007, the Annual Investment Policy was presented to Council. The report included a recommendation to change the maximum allowable percentage of Federal Agencies securities that are Government Sponsored Entities (GSE) from 25 to 50 percent. The recommendation was subsequently approved by Council. Staff would like to note that debt securities issued by GSE's are considered to be of the highest quality and are rated AAA.

Cash Collection Procedures

Each year the auditors select an area to review, which is not normally addressed in the main audit. For 2005-06, the auditors performed a review of the cash collections procedures in the Police Records Division. During their review, the auditors reported no errors or exceptions to procedures; however, they made recommendations regarding how to strengthen internal controls.

One comment was that a cash register was not used to control burglary alarm receipts. They recommend that the cash register be used for all receipts. They also noted that although the daily deposit bag was secured and locked in a drawer, all front counter employees had access to the locked drawer. Although no improprieties or cash impact were identified, they recommend that the City limit the number of employees with access to the daily deposit.

As a result of the audit recommendation, management has reaffirmed the importance of safeguarding cash with the Records Division staff. In order to improve internal control procedures, the cash register has been reprogrammed so it now accommodates the acceptance of burglary alarm receipts. The Division has also reduced the number of employees with access to the daily deposit from 15 to 4 employees. These changes have improved cash collections procedures in the Records Division.

Purchasing

While reviewing procedures for the Purchasing Division the auditors noted five instances in which staff did not follow administrative procedures. Upon review of these discrepancies management confirmed that all but one invoice was properly paid, but without the required purchase order. Subsequent to the findings, purchase orders have been established for these vendors so the error should not be repeated. In the one other situation, a purchase order did exist, but the payment was processed using the wrong form. The amount involved in these instances range from \$1,002 to \$21,641. Management agrees that care should be taken when using open purchase orders, as required by City policies and believes the matter has been corrected.

The auditors also noted that the City had incurred finance charges on two credit card bills. They recommended that management create procedures for usage of credit cards that will avoid the possibility of incurring finance charges.

As a result of these audit recommendations, management has scheduled additional staff training related to processing payments against open purchase orders. Staff has also implemented an on-line credit card reporting procedure to reduce the possibility of finance charges. Procedures have been documented and staff is analyzing other improvements to the credit card process, such as on-line bill paying. Management will continue to monitor credit card usage.

Timecard Authentication

During the auditor's review of payroll records, they verified that salaries were correctly calculated and remitted. They also noted that three employee timecards were not signed by employees. It is recommended by the auditors that Police Department employees sign their timesheets to denote that they have verified the information logged by an administrative staff member responsible for completing timesheets.

As a result of the audit recommendation, the City Manager has asked public safety employees to sign timesheets when possible; however, it should be noted that timesheet signature for public safety employees is a continuing challenge due to changing shifts. In the case that an employee is unavailable, the administrative staff will attach the departmental work schedule log, in-lieu of the timesheet signature. This log is signed by the employee.

New Accounting Pronouncement: Retiree Healthcare Funding and Reporting

As part of the management letter the auditors note new accounting rules effective in the coming year. As has been mentioned to the Council at previous meetings, Governmental Accounting Standards Board Statement 45 (GASB 45) will be required in the June 30, 2007 financial statements. GASB 45 is the reporting of post-employment (retiree) benefits other than pensions, which in most cases are contributions to health insurance premiums.

GASB 45 is attempting to require cities to record retiree health care benefits much like cities already account for pension benefits. Currently, cities record these benefits based on the amount actually paid. GASB is requiring cities to determine their "annual required contribution" or present value of future benefits, which is calculated by an actuarial valuation. Cities will be required to record a liability for any amount in which the "annual required contribution" is greater than the amount actually paid. The actuarial valuation is required every two years. Staff understands the new requirement and is preparing for its impact to the City financial statements by first conducting an actuarial valuation to determine the City's liability. GASB does not require cities to fund these amounts, although many cities may choose to reserve certain amounts to offset these liabilities, which can be significant.

Comprehensive Annual Financial Report

Council has been provided with the City's audited financial statements for the year ended June 30, 2006 known as the City's Comprehensive Annual Financial Report (CAFR). This report includes all funds of the City including the General Fund, Redevelopment Agency, water, sewer and other funds.

Staff is pleased to report that, as in previous years, the auditor's opinion on the financial statements for 2005-06 is without exception or unqualified. 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".

This report includes the implementation of the new statistical section requirements in accordance with GASB Statement 44. The objective of GASB 44 is to develop consistency in financial trend data; and provide demographic, economic, revenue, and debt capacity information. This information is provided in the last section of the CAFR.

FY 2005-06 General Fund Results

The 2005-06 fiscal year budget was presented and passed in June 2005. The budget estimated a \$2.1 million dollar revenue shortfall, with a decision to make up the shortfall from the City's undesignated contingency reserves.

Subsequently, in January 2006, during consideration of the 2006-07 budget, because of the projected increase in revenues, staff modified this figure, forecasting a revised shortfall of approximately \$500,000.

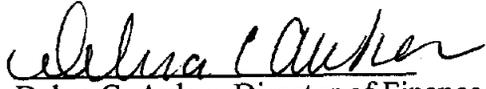
Revenues for 2005-06 were estimated at \$101.3 million, including transfers. However, revenues actually came in at \$103.2 million or \$1.9 million more than the budget, as expected.

- Real Property Transfer Tax – This revenue showed a 14.2% increase over budget as the housing market and sales prices remained stronger than predicted. .
- Other Taxes – The Emergency Services Facilities Tax increased 14.2% due to an increase in our collections effort of past due accounts.
- Charges for Services – Fees and Services – The 25.6% increase over budget in this category was due primarily to building-related fees collected on new construction within the City.
- All Other Sources – Interest Income was 23.5% less than projected; and revenue from Permits and Licenses was about 12.4% below budget due to timing of new construction.

Actual expenditures for 2005-06 were \$103.7 million, including transfers and interdepartmental charges. Based on the actual revenues and expenditures the net effect of income and spending resulted in a \$520,000 shortfall. This amount is approximately what staff projected and has been allocated from the General Fund contingency reserves as planned and approved by Council.

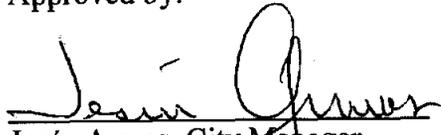
A summary of the General Fund activity for FY 2005-06 is reflected in Attachment A.

Recommended by:



Debra C. Auker, Director of Finance and Internal Services

Approved by:


Jesús Armas, City Manager

Attachments

FY 2005-06 General Fund Overview
(\$ in 000's)

Attachment A

	Actual FY 2004-05	Approved Adopted (Adj) FY 2005-06	Actual FY 2005-06
Resources			
Sales Tax	27,155	27,295	26,686
Property Tax	18,860	20,500	21,446
Real Property Transfer Tax	9,726	8,500	9,708
Other Taxes	13,075	13,083	13,682
All Other Sources	11,218	11,362	10,671
Vehicle License Fee	9,337	12,932	12,886
Charges for Services	3,119	2,493	3,132
Subtotal	92,490	96,165	98,211
Transfers to General Fund	5,246	5,131	4,966
Total Resources	<u>97,736</u>	<u>101,296</u>	<u>103,177</u>
Operating Requirements			
Employee Services	76,538	80,880	81,323
Maintenance & Utilities	4,452	3,900	4,614
Supplies & Services	10,144	9,901	10,253
Capital Expense	270	225	506
	91,404	94,906	96,696
Transfers from General Fund	5,144	6,938	7,001
Total Expenditures	<u>96,548</u>	<u>101,844</u>	<u>103,697</u>
Excess Revenue (Expenditure)	1,188	(548)	(520)
General Fund Balance			
Beginning Fund Balance	20,983	23,085	23,085
Incr (Decr) of Deposit Funds	914	0	503
Incr (Decr) of Contingency Funds	1,188	(548)	(520)
Total	23,085	22,537	23,068
Other Deposit Funds	191	0	694
Reserved, Encumbered, etc.	1,063	1,063	925
Economic Uncertainty	7,000	7,000	7,000
Liquidity	3,500	3,500	3,500
RDA Loan	1,336	1,336	1,336
Public Safety Radio System	1,980	380	380
Hotel Conference Center	1,250	1,250	1,250
Contingency	6,765	8,008	7,983
Ending Fund Balance	<u>23,085</u>	<u>22,537</u>	<u>23,068</u>

**CITY OF HAYWARD
MANAGEMENT LETTER
FOR THE YEAR ENDED JUNE 30, 2006**

MAZE & ASSOCIATES

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The City Council of the
City of Hayward, California

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, 2006, 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 operations 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 significant deficiencies described in the accompanying memorandum is believed to be a material weakness.

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

October 27, 2006

Retiree Healthcare Funding

As a follow-up to our prior year comment and conversations with staff concerning GASB 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, we have included additional comments below concerning the funding options available to the City.

A key assumption in an actuary study is the rate of return on plan assets. Plan assets limited by Government Code Section 53601, which does not permit investments in equity securities and limits fixed income securities to five year maturities, will bear a rate of return that will be much less than that earned by a retirement trust portfolio. Assets held in a trust are governed by a separate investment policy not subject to Government Code Section 53601, and the assumed rate of return would be substantially higher than that of a short term fixed income portfolio. This in turn means cash contribution required by the City would be substantially less. This trust option represents a substantial costs savings to the City. You should inform the actuary about your funding option as that will impact the assumed rate of return needed for the study and will significantly impact the annual required contribution needed from the City.

If the City establishes a trust, then GASB 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, will apply and the implementation date for new financial reporting and funding requirements moves up one year earlier to fiscal 2006-2007.

Federal Agency Investment Concentration

In the June 30, 2006 Investment Report, the City invested 27% of its total portfolio in Federal Agency securities. However, the City's Investment Policy allows investing in the Federal Agency securities not backed by the full faith of the US Government of only 25% of the total portfolio. The City should diversify or reallocate its investments to comply with current Investment Policy. This issue was identified last year and since that time staff have been diversifying the City's portfolio by allowing Federal Agencies Securities to mature and then reinvesting those proceeds into other security types. This strategy will allow the City to minimize the risk of loss of principal due to selling the securities prior to maturities.

Special Emphasis - Cash Collection Procedures of the Police Records Division

With every audit, we place extra emphasis on areas normally not addressed through routine financial statement audit procedures. This year we selected the Police Records Division and reviewed the procedures used for processing cash collections. A summary of our review and recommendations follows:

- ❖ We noted that Burglary alarm receipts are not controlled by the cash register and are held in the unlocked "alarm" desk during business hours. The desk can be accessed by all employees in the records division. All cash receipts including receipts for burglary alarm payments should be controlled by the cash register.

- ❖ The locked deposit bag is kept in the locked drawer in the Records Division. However, we noted that all fifteen front counter employees have access to the key to open the desk drawer where the deposit bag containing the previous day's cash receipts is kept. The City should limit the number of employees having access to the key for the locked drawer.

Purchasing

We selected thirty disbursements for testing of purchasing controls. Of that sample we noted the following:

Open Purchase Orders:

- ❖ Three disbursements for continuing services were paid using a Claim for Payment form, but not supported by an open purchase order as required by the City's Purchasing Policy and Procedures.
- ❖ Two disbursements were paid against open purchase orders that expired on either July, 31 2004 or July 1, 2002.

Open purchase orders should be obtained and maintained in accordance with the purchasing policy requirements.

Credit Card Purchases:

We included credit card purchases in our disbursement tests although not a material series of transactions when compared to total expenditures.

- ❖ Of the three credit card claims for payment, two included finance charges. The City's current purchasing policy does not include any procedures on credit card usage. Payments should be made timely to avoid finance charges.

Timecard Authentication - We selected a sample of twenty-five employees from the March 19, 2006 payroll register to verify that salaries were correctly calculated and remitted.

Of our sample, three timecards from the Police Department were completed by Supervisors or secretaries instead of the employees and they did not have an employee signature on them. We recommend that these timecards be verified and signed by the employees themselves.