



CITY OF
HAYWARD
HEART OF THE BAY

WS 2

DATE: March 17, 2009
TO: Mayor and City Council
FROM: Director of Finance
SUBJECT: Transmittal of the Comprehensive Annual Financial Report, for the Year Ended June 30, 2008; and of the "Communication of Internal Control Related Matters" and "Communication With Those Charged With Governance"

RECOMMENDATION

That Council receives transmittal of the City's Comprehensive Annual Financial Report (CAFR); and reads and comments on this report and the attached "Communication of Internal Control Related Matters" and "Communication With Those Charged With Governance."

DISCUSSION

The City's audit firm has completed its audit of the City's financial records for the fiscal year ended June 30, 2008. In addition to the audited financial statements, the auditors have completed and provided the required letters entitled Communication of Internal Control Related Matters (Attachment B) and Communication With Those Charged With Governance (Attachment C).

Comprehensive Annual Financial Report

The City's Comprehensive Annual Financial Report (CAFR) (Attachment D) includes all funds of the City including the General Fund, Redevelopment Agency, water, sewer, airport, and all other funds.

Staff is pleased to report that, as in previous years, the auditor's opinion on the financial statements for 2008 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 pleased to report that the City's financial statements continue to earn a "clean opinion."

This Report has been submitted to the Government Finance Officers Association (GFOA) award program, which is a prestigious national award recognizing conformance with the highest standards for preparation of local government financial reports. The City of Hayward has received this award for the last twenty-two consecutive years.

FY 2008 General Fund Financial Results – The FY 2008 budget was presented and adopted in June 2007. The adopted budget estimated a \$3.8 million shortfall, which was revised to a \$10.7 million shortfall at midyear. Based on the actual revenues and expenditures the net effect of income and spending resulted in a \$6.9 million deficit; which was less than the shortfall estimated at midyear.

As a result of the year end audit, there were two significant adjustments to the prior year general fund. The first included a charge for \$1.2 million due to a change in the basis of accounting, in which the payroll for the last week of FY2007 was accrued; the second included an \$11 million increase in reserved fund balance to record the RDA Repayment Agreement Loan. The net effect of the \$6.9 million current year deficit offset with the audit prior year adjustments results in a \$3 million increase to fund balance.

A summary of the General Fund activity for FY 2008 is reflected in Attachment A.

Communication Letters from Auditors

New auditing standards require auditors to formally communicate with the governing body. The purpose being to establish direct and effective two-way communication with the Council and staff, to convey audit matters, the scope of work, difficulties, adjustments to financial statements, or disagreements with management. The *Communication of Internal Control Matters* outlines several corrections or adjustments to the financial statements as noted in Attachment C and summarized below:

- A change in the way year-end payroll expenditures were recorded, since the bi-weekly payroll was split over the two fiscal years;
- Recording the loan between the Redevelopment Agency and the General fund as a long-term receivable, due to the amendment to the Repayment Agreement that established terms for repayment to the General Fund;
- Adjustments to general liability claims, which increased our claim reserves;
- Changing RDA pass-thru payments from cash basis to accrual basis, so they are recorded as liabilities at year-end.

Two major objectives of the *Communication of Internal Control Related Matters* are (1) to advise the governing body or City Council of any significant deficiencies or material weaknesses in the City's systems of internal financial controls; and (2) to communicate to the Council any opportunities for improved controls or efficiencies that the auditors may have noted during the course of their audit. This letter may also advise the Council of upcoming accounting regulations, which may affect the City's financial records. Staff's responses to the auditor's comments and recommendations are noted in the Letter (Attachment B).

Staff is pleased to report that the auditors did not identify any deficiencies that would be considered a material weakness in the City's system of internal controls. The auditors made comments and recommendations based on assessments made during the audit, which they believe would be of benefit to the City, if implemented.

The recommendations made by the auditors can be summarized into two areas: 1) improvements to the City's financial systems, and 2) the need for additional review of financial data, in a timely manner.

Our auditor's stated that our internal controls are currently structured to provide assurances that any errors would be detected; however, they could be improved so that errors would be more likely to be prevented. The City's independent auditors often can provide assistance in meeting internal-control related responsibilities, but their contribution can never be substituted for management's direct and involvement with internal controls.

Staff agrees that there is a need for improvements to our financial system which will improve internal controls, reduce the potential for data entry errors, and reduce processing time. The Finance and Technology Services Departments have been developing strategies to address these needs in the Technology Strategic Plan.

Time to provide thorough and timely review of all financial transactions will require additional Finance staff. We are fortunate that the current finance employees are dedicated and accurate; however, additional controls and review over expenses, accounts receivable, purchasing, asset management, and project accounting would provide more internal checks and balances. This can be accomplished with additional technical staff in the Finance Department. The City Manager has asked the Director of Finance to provide an analysis of the staffing needs for the Finance Department in order to improve internal controls and detection of fraud.

PUBLIC CONTACT

Staff presented the CAFR and Internal Control letters to the Council Budget and Finance Committee on February 25, 2009.

Prepared by:



Debra C. Aufer, Director of Finance

Approved by:



Gregory T. Jones, City Manager

- Attachments:
- A. General Fund Overview for FY 2008
 - B. Communication of Internal Control Related Matters
 - C. Auditor Communication to Those Charged With Governance
 - D. Comprehensive Annual Financial Report (CAFR) located on the city website
http://www.hayward-ca.gov/departments/finance/documents/COH_2008_CAFR.pdf

General Fund Overview For FY 2008

(\$ in millions)

ATTACHMENT A

Resources	Actual FY 2007	Revised Budget FY 2008	Actual FY 2008
Property Tax	\$34,640	\$36,810	\$39,135
Sales Tax	28,858	28,930	29,233
Vehicle License Fee	870	932	671
Real Property Tfr Tax	7,120	6,200	5,077
Franchise Tax	6,972	8,347	8,698
All Other	25,955	20,837	22,638
Subtotal	104,415	102,056	105,452
Transfers In	5,042	5,141	6,708
Total Resources	<u>\$109,457</u>	<u>\$107,197</u>	<u>\$112,160</u>

Operating Requirements

Employee Services	\$86,305	\$95,169	\$95,944
Maintenance and Utilities	4,853	4,196	4,271
Supplies and Services	11,444	12,254	12,568
Capital Expense	348	463	730
Subtotal	102,950	112,082	113,513
Transfers Out	6,050	5,726	5,606
Total Expenditures	<u>\$109,000</u>	<u>\$117,808</u>	<u>\$119,119</u>
Excess of Revenues Over (Expenditures)	\$457	(\$10,611)	(\$6,959)

General Fund Balance

Beginning Fund Balance	\$23,068	\$23,525	\$23,525
Adjustments to Prior Year:			
Last Week of Payroll Accrual			(1,220)
RDA Repayment Loan			11,186
Beginning Fund Balance (Restated)	<u>\$23,068</u>	<u>\$23,525</u>	<u>\$33,491</u>
Ending Fund Balance	23,525		26,532

Reserves and Designations:

Other Deposit Funds	(185)		0
Encumbrances	502		776
Inventory and Prepaid Expenses			52
Advances To Other Funds			10,386
Economic Uncertainty	7,000		7,000
Liquidity	3,500		3,500
RDA Loan	1,336		0
Police Safety	1,000		1,000
Retirement Reserve	0		1,122
Hotel Conference Center	1,250		1,000
Contingency	9,122		1,696
Total Fund Balance	<u>\$23,525</u>	<u>\$0</u>	<u>\$26,532</u>

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The Honorable Mayor and City Council
City of Hayward, California

In planning and performing our audit of the financial statements of the City of Hayward as of and for the year ended June 30, 2008, in accordance with auditing standards generally accepted in the United States of America, we considered the City of Hayward's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or a combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Material Weaknesses

None noted

Significant Deficiencies

None noted

Control Deficiencies**(1) Enhancement of Purchasing Controls**

During our review of the City's purchasing controls, we noted that the Purchasing System is an access database that is not integrated with the accounting system. As a result, the City is unable to utilize purchase orders to control City purchases and ensure purchases do not exceed departmental budgets. As a system work around, the City has created an Encumbrance control in the accounting system to communicate to Department Heads that unspent funds have been encumbered through purchase orders.

(1) Enhancement of Purchasing Controls, (Continued)

Recommendation

We recommend that City evaluate the current Purchasing System to determine if it is sufficient to control expenditures and ensure that expenditures do not exceed the approved budget.

Management's Comments

The City agrees that integration of the Purchasing system with Accounting (G/L) is important. This undertaking will be added to the City's list of priority Information Technology projects which may be addressed in the future. This was the first year that the City launched the encumbrance control process. While mostly manual, the results were very useful in pointing out critical over budget conditions before an actual disbursement was made.

(2) Controls Over Vendor Creation

Currently, the accounts payable clerk has both the ability to enter a new vendor into the accounting system and also process a check for that vendor. The Accounting Manager reviews the preliminary check register and reviews invoice support for large or unusual disbursements. The accounts payable clerk could create a fictitious vendor, process an invoice, and mail the check to an address under her control. While each Department Head's review of department budget vs. actual reports would detect a material unauthorized disbursement, a small misappropriation may go undetected by management.

Recommendation

If it is impractical to remove the accounts payable clerks's ability to add or change vendors, the Accounting Manager should periodically review a vendor change report and ensure that all new vendors are legitimate.

Management's Comments

Allowing the accounts payable clerk access to set up and maintain vendors is a necessary duty in order to pay vendors promptly. In order to enhance internal control, the Accounting Manager will receive a separate vendor change report as recommended to review for any inappropriate changes.

(3) Decentralized Timesheet Entry

The City has over 800 employees who each create a manual timesheet each pay period. The payroll personnel manually input each timesheet into the payroll system, which is a time intensive process that is susceptible to human error.

Recommendation

We recommend that the City evaluate the possibility of a decentralized payroll timesheet entry system. If each employee, or a designed individual in each department, were to input timesheet information, it would eliminate the duplication of efforts in the Finance Department and allow the payroll personnel to act in more of a review function instead of a data entry function.

(3) Decentralized Timesheet Entry, (Continued)

Management's Comments

Entry of timesheet information at a departmental level is a common practice at many organizations, which helps to streamline payroll processing and maximizes review time. The City agrees with the recommendation and will begin design specifications and request Information Technology to address in the near future.

(4) Developer Fees

The City collects a deposit for planning application reviews in the Developer Reimbursement Costs fund. Additional time and material costs spent by the City in excess of the original deposit are billed to the developer. At June 30, 2008, there is a deficit cash balance in this fund of approximately \$166,000. The deficit is an indication that the City has not billed all incurred time and materials to the developers.

Recommendation

We recommend that ongoing developer projects be periodically reviewed to determine if costs incurred require billing to developers. Developer billing should be done in a timely manner to ensure collectability.

Management's Comments

The City agrees with the recommendation and will also ascertain that appropriate up-front deposit payments are more realistic to the amount of staff hours performed.

(5) Monitoring City Expenditures

The Finance Department is comprised of twenty-five employees. Due to staffing cut-backs, some finance personnel are required to carry an unusually heavy workload and some finance responsibilities are now handled by non-finance personnel (e.g. information technology personnel are performing payroll timesheet data entry). As a result of limited staffing, the Finance Department must also rely heavily on City Department Heads to monitor adherence to City purchasing policies, proper approval of vendor invoices, and compliance with departmental budgets. While the finance personnel do a great job processing City transactions efficiently, they do not always have adequate time to perform the necessary monitoring of departmental expenditures or performing internal checks and balances. Additionally, without a sufficiently staffed Finance Department, more pressure is placed upon upper management and City Council to monitor the fiscal activity of the City.

Recommendation

We recommend that the City determine if the current level of monitoring City transactions by the Finance Department is sufficient to protect and maintain the City's assets and assess the possible need for additional staffing in the Finance Department.

(5) Monitoring City Expenditures, (Continued)

Management's Comments

The City welcomes the recommendation and continuously provides frequent financial reporting information to senior management, department heads, and analysts as well as possible. Additionally, ongoing training sessions are offered throughout the year to help end users become adept at accessing information from Finance Management Information System (FMIS).

The City's written comments to the issues identified in our audit have not been subjected to the audit procedures applied in the audit of financial statements and, accordingly, we express no opinion on them.

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

Mayer Hoffman McLean P.C.

Irvine, California
February 25, 2009



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Attachment C

The Honorable Mayor and City Council
City of Hayward, California

We have audited the financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the City of Hayward ("City") for the year ended June 30, 2008, and issued our report February 25, 2009. Professional standards require that we provide you with the following information related to our audit.

***Our Responsibilities under U.S. Generally Accepted Auditing Standards
and OMB Circular A-133***

Our responsibility, as described by professional standards, is to express opinions about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles. Our audit of the financial statements does not relieve you or management of your responsibilities.

Our responsibility is to plan and perform the audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement. In planning and performing our audit, we considered the City's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with U.S. Office of Management and Budget (OMB) Circular A-133.

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit. Also in accordance with OMB Circular A-133, we examined, on a test basis, evidence about the City's compliance with the types of compliance requirements described in the OMB Circular A-133 Compliance Supplement applicable to its major federal program for the purpose of expressing an opinion on the City's compliance with those requirements. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination on the City's compliance with those requirements.

Planned Scope and Timing of the Audit

We performed the audit according to the planned scope and timing previously communicated to you in our letter dated September 18, 2008.

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. We will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the City are described in Note 1 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during the year. We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's 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 significantly from those expected.

Examples of significant judgments and estimates reflected in the City's financial statements include:

- Judgments involving the useful lives and depreciation methodology to use for capital assets, including infrastructure
- Judgments involving collectability of outstanding receivables

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 trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. Material misstatements detected during the audit process included:

- Adjustment to record payroll through the last week of the fiscal year ended June 30, 2008 which resulted in a one-time increase in expense of \$1,220,100 to the General Fund and \$920,523 to all other funds. In years past, this last week of payroll was normally expensed in the following fiscal year to match the calendar pay periods and maintain consistency with the City budget.
- Adjustment to record an inter-fund advance between the General Fund and Redevelopment Agency for \$11,186,217 that should have been recorded in prior years audit report.

- Adjustment of \$740,020 against the general liability fund for claims existing on outstanding claim registers but not on the general ledger.
- Adjustment to accrue \$1,185,692 in pass-through increment payments incurred in the fiscal year for Redevelopment Agency but paid in arrears.
- Adjustments to correct accounting of a State Water loan increasing expense to the Sewer Fund by \$279,558.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as 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 requested certain representations from management that are included in the management representation letter dated February 25, 2009.

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 City'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.

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

Mayor Hoffman McCann P.C.

Irvine, California
February 25, 2009