CITY OF OAKLAND

Required Communications
and Recommendations

Fiscal Year Ended
June 30, 2007

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Fiscal Year Ended June 30, 2007

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Honorable Mayor and Members of the City Council
City of Oakland, California

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund and the aggregate remaining fund information of the City of Oakland as of and for the year ended June 30, 2007, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our 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 would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

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. We consider the deficiencies as listed as findings #1 through #4 to be significant deficiencies in internal control. In addition, we noted a compliance finding and one other matter that we have reported to management as listed in the table of contents.

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. However, we believe that none of the significant deficiencies listed as findings #1 through #4 are material weaknesses.

The City's written response to the findings identified in our audit is described in the Schedule of Comments and Responses. We did not audit the City's responses and, accordingly, we express no opinion on them. In addition, we have already discussed our comments and recommendations with various City personnel, and we would be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing these recommendations.

Additionally, we have included in this letter a report on communications with the City Council as required by auditing standards generally accepted in the United States of America.

This communication is intended solely for the information and use of management, 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

Very truly yours,

MACIAS GINI & O'CONNELL LLP

Macias Gini & O'Connell LLP

Certified Public Accountants
Walnut Creek, California

December 4, 2007, except for the single audit
which is dated as of December 16, 2007

CITY OF OAKLAND

Required Communications and Recommendations
Fiscal Year Ended June 30, 2007

REQUIRED COMMUNICATIONS

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Oakland (the City), which collectively comprise the City's basic financial statements for the year ended June 30, 2007, and have issued our report thereon dated December 4, 2007. In addition to the City's basic financial statements (BFS), we audited the financial statements of the governmental activities and each major fund of the Redevelopment Agency of the City of Oakland (the ORA) as of and for the year ended June 30, 2007. Professional standards require that we provide you with the following information related to our audit.

I. The Auditor's Responsibility Under U.S. Generally Accepted Auditing Standards and *OMB Circular A-133*

As stated in our engagement letter dated April 20, 2007, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance that the financial statements are free from material misstatements and are fairly presented in accordance with U.S. generally accepted accounting principles. Because an audit is designed to provide reasonable, but not absolute assurance and because we did not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us.

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 controls 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 misstatements, 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 each of its major federal programs 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.

II. Other Information in Documents Containing Audited Financial Statements

During the year, the City included audited financial statements in various debt offering documents (e.g., Official Statements.) We do not have an obligation to perform any procedures to corroborate other information contained in such debt offering documents. We were not associated with and did not have any involvement with such documents. Accordingly, we did not perform any procedures on these documents and provide no assurance as to the other information contained in the debt offering documents.

REQUIRED COMMUNICATIONS (Continued)

III. Significant Accounting Policies

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our contract with the City, 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 2 to the City's basic financial statements. No new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2007.

In addition, the City presents the Port of Oakland (Port) in a unique manner as compared to other local governmental entities with port operations. All local government entities we sampled reflect their ports as departments of the organization rather than as a discretely presented component unit. Some of these ports have similar management structures with a Board of Commissioners appointed by the sponsoring city's mayor/city council to oversee the operations of the port. Management's representation to us was that the Port operates with a separate legal standing (i.e. using its own corporate powers) under the Charter, which would allow for this presentation. In addition, the City Attorney's Office has represented that the Port operates very similar to a corporation with the Charter acting as its Articles of Incorporation and By-Laws. Ultimately, the City's presentation of the Port makes it less comparable to other cities that have port operations, thus, being a unique presentation.

We noted no transactions entered into by the City during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

IV. Accounting Estimates

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. The most sensitive estimates affecting the financial statements were:

- *Fair value of investments*. The City's investments are generally carried at fair value, which is defined as the amount that the City could reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller and is generally measured by quoted market prices.
- *Estimated allowance for losses on accounts receivable*. The allowance for losses on accounts receivable was based on management's estimate regarding the likelihood of collectibility.
- *Estimated allowance for losses on loans receivable*. The allowance for losses on loans receivable was based on the types of loan (e.g., forgivable, deferred, grant or amortizing) and management's estimate regarding the likelihood of collectibility based on loan provisions and collateral.
- *Useful life estimates for capital assets*. The estimated useful lives of capital assets were based on management's estimate of the economic life of the assets.

REQUIRED COMMUNICATIONS (Continued)

IV. Accounting Estimates (Continued)

- *Valuation of the net pension asset*. The net pension asset is the amount that exceeded the City's actuarially determined annual required contribution, which is based upon certain approved actuarial assumptions. This amount is then amortized over the amortization period used by the actuary to recognize the excess contribution as pension costs over time.
- *Estimated claims liabilities*. Reserves for estimated claims liabilities were based on actuarial evaluations using historical loss, other data and attorney judgment about the ultimate outcome of the claims.
- *Annual required contributions to pension plans*. The City is required to contribute to its pension plans at an actuarially determined rate, which is based upon certain approved actuarial assumptions.

We evaluated the key factors and assumptions used to develop these accounting estimates in determining that they are reasonable in relation to the financial reporting units that collectively comprise the City's basic financial statements.

V. Audit Adjustments

For the purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the City's financial reporting process (that is, cause future financial statements to be materially misstated). Adjustments for recording proceeds related to capital leases and perspective differences for advances made from the City to ORA were identified and proposed. The above adjustments, in our judgment, indicate matters that could have a significant effect on the City's financial reporting process.

VI. Disagreements with Management

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

VII. 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.

REQUIRED COMMUNICATIONS (Continued)

VIII. Issues Discussed with Management Prior to Our Retention

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.

IX. Difficulties in Performing the Audit

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

SCHEDULE OF COMMENTS AND RESPONSES

INTRODUCTION

In May 2006, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (SAS112). SAS112 was designed to make the standards consistent with those already in place for publicly traded companies by establishing a standard for determining seriousness of a control issue and classifying it into one of three categories:

- Control deficiency
- Significant deficiency (replaces old term "reportable condition")
- Material weakness.

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 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.

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.

These definitions redefined and/or replaced the old definitions – management letter comment, reportable condition and material weakness as follows.

Old Definitions	New Definitions
Material weakness	**Material weakness**
Reportable condition	**Significant deficiency**
Management letter comment (under Yellow Book only)	**Other matters related to internal control**

This new pronouncement significantly increases the likelihood that an auditor may be required to report either a "significant deficiency" or a "material weakness" in conjunction with the financial statement audit.

SCHEDULE OF COMMENTS AND RESPONSES

Finding No. 1 – City Audit – Significant Deficiency

Recording Perspective Differences Between the City and the Oakland Redevelopment Agency

The City advanced funds to the Oakland Redevelopment Agency (the Agency), which in turn were used to make loans for redevelopment projects. The City decided to record an allowance for uncollectible loans to the Agency since they were determined likely to be uncollectible. The amounts that remain recorded on the books of the Agency represent perspective differences in the financial statements reported by the City compared to the stand-alone financial statements reported by the Agency. The Agency reports the interfund borrowing as a government-wide long-term liability, while the City discloses the loans in the footnotes but does not record them. The perspective difference was not updated in the City's general ledger as of June 30, 2007.

The City has recorded an entry to correct the presentation of the loans made to the Agency and the remaining perspective difference at June 30, 2007 was approximately $429,000.

We recommend the City include a reconciliation process as part of the year-end close for capturing any changes in the perspective differences to ensure that it is reported accurately in the financial statements.

Management Response:

Management acknowledges the finding and the correction was made accordingly. The Accounting Division staff of the Finance and Management Agency will include the reconciliation of the perspective difference between the City and the Agency in its year end closing schedule.

Finding No. 2 – City Audit – Significant Deficiency

Internal Service Funds

The City reports five internal service funds, Equipment, Radio, Facilities, Reproduction and Central Stores. Governments often use internal service funds to centralize certain services and then allocate the costs of those services within the government. U.S. generally accepted accounting principles permit the use of internal service funds to be used to report any activity that provides goods or services to the government on a cost reimbursement basis. That is, the goal of an internal service fund should be to measure the full cost (including cost of capital assets) of providing goods or services for the purpose of fully recovering that cost though fees or charges. Therefore, if the City does not intend to recover the full cost of providing goods or services, then the use of internal service funds would not be appropriate.

We are becoming increasingly concerned with the growth in both the deficits of certain internal service funds and the interfund loans used to support those services. The City's General Fund has loaned $39,719,000 to the Equipment, Facilities and Central Stores internal service funds in order to cover the shortfall of charges to the General Fund, which have not adequately covered the operating and capital costs. The internal service funds have basically borrowed money to cover its full costs, as opposed to charging the departments using the services. The current loan balance from the General Fund represents an increase of $5,110.000 from a year ago and $9,583,000 from two years ago, as the amount loaned as of June 30, 2005 was $30,136,000.

The City has attempted to cure the internal service fund deficits by increasing the charges to the departments; however, those increases have not kept up with the increases in actual costs. The Equipment, Facilities and Central Stores internal service funds have net asset deficits of $1,841,000, $20,607,000 and $3,731,000, respectively.

We recommend the City review its current budget repayment plan and revise it to cure the deficit over a reasonable period of time, such as three to five years.

Management Response:

The City adopted the FY 2007-09 policy budget, which includes a rebalancing plan for internal service funds to be achieved by FY 2014-15. Management will review the rebalancing plan during the Mid-Cycle budget review and recommend appropriate adjustments for City Council's consideration.

Finding No. 3 – Single Audit – Significant Deficiency

Negative Expenditure Balances

In the process of reconciling the federal expenditures reported in the Schedule of Expenditures of Federal Awards (SEFA) to the City's general ledger, we noted projects that had negative expenditures. These negative amounts relate to recording of 100% of project costs as federal expenditures rather than splitting costs between federal and other funding sources, such as local matching. This method of recording project costs causes the federal portion of expenditures to be overstated until the matching calculation is made and recorded. Total negative expenditures for FY2007 amounted to $1,509,748 and corresponded to the following projects:

PROJECT	DESCRIPTION	CFDA No.	AMOUNT
H954XX	3RD ST EXTENSION	20.205	$ (204,322)
H95510	PANORAMIC WAY SLIDE	20.205	(489,410)
H95610	MONTEREY BLVD	20.205	(666,552)
H9811X	ADA/TRAFFIC (ISTEA)-MEDIA	20.205	(149,464)
			$ (1,509,748)

Recommendation:

The departments with programs and grants that have matching requirements should use a separate account or project code to record the local match at the time of the transaction, rather than recording the matching during the closing of the projects.

Management Response:

The management of these grants has been transferred from the Public Works Agency to the Community and Economic Development Agency (CEDA) as a result of an organizational restructuring approved by City Council in the FY 2007-09 policy budget. CEDA plans to allocate the grant expenditures between grant funds and local matching funds as well as grant revenues on a monthly basis to prevent these negative balances.

Finding No. 4 – Oakland Redevelopment Agency – Significant Deficiency

Duplicate Notes Receivable

During the testing of notes receivable, we obtained a supporting schedule that details the beginning balances, current year activity, and ending balances for outstanding notes. During our testing of additions to notes receivable, we discovered a new note that was already recorded as an addition in the previous year. This duplicate entry caused an overstatement of assets in the amount of $1,732,171.

We recommend the supporting schedule for notes receivable be analyzed for accuracy during the Agency's closing process to reduce the risk of financial statement misstatements.

Management Response:

Management acknowledges the finding and the correction was made accordingly. The Community and Economic Development Agency staff and the Accounting Division staff of the Finance and Management Agency will closely monitor the tracking of Agency loans and notes receivables in the future.

Finding No. 5 – Oakland Redevelopment Agency – Compliance

Loan, Property and Blight Report Not Submitted to City Council

Under California Health & Safety Code Section 33080.1, every redevelopment agency shall present an annual report to its legislative body within six months of the end of the Agency's fiscal year. The annual report shall contain all of the following:

- **a.** An independent auditor's report on financial statements;
- **b.** An independent auditor's report on legal compliance;
- **c.** An annual Report of Financial Transactions of Community Redevelopment Agencies (fiscal statement), Health & Safety Code Section 33080.5;
- **d.** A housing activities report, Health & Safety Code Sections 33080.4 and 33080.7;
- **e.** A blight progress report (specifies actions and expenditures made in the previous fiscal year to alleviate blight), Health & Safety Code Section 33080.4;
- **f.** A loan report (identifies loans (receivable) which equal or exceed $50,000 and that were found by the Agency during the previous fiscal year to have either defaulted or not complied with the terms of the agreements approved by the Agency), Health & Safety Code Section 33080.4; and
- **g.** A property report (describes properties owned by the Agency and those acquired in the previous fiscal year); Health & Safety Code Section 33080.4.

During our compliance testing, we noted that all seven reports were submitted to the State Controller on December 28, 2007; however, the reports were submitted to the Agency's Board of Directors on March 6, 2007, which is after the six months requirement. In addition, the Agency only submitted four of these reports, omitting the blight progress, loan and property reports.

We recommend the Agency implement a procedure to ensure the timely and complete submission of reports, as required by the Health & Safety Code.

Management Response:

Management acknowledges the finding by the auditors and the mandated timeline established by law. For practical reporting purposes, however, future compliance is a challenge because of the staff report review process involved including the Brown Act public notification requirement before the item is subject to review by the Agency's Board of Directors. Management's first priority is to meet the State Controller's December 31st deadline because of the significant monetary penalty imposed by law. Its second priority is to assess how compliance with the 180-day deadline for the above reports can be accomplished given the logistics involved with the City's year-end audits.

CITY OF OAKLAND

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STATUS OF PRIOR YEARS RECOMMENDATIONS

2006 Comment:	***Internal Service Funds***
Condition/Effect/ Recommendation:	The internal service funds have a fund balance deficit that has been increasing over time. We recommend the City review its current budget repayment plan and revise it to cure the deficit over a reasonable period of time, such as three to five years.
Status:	Not addressed. See Finding #2.
2006 Comment:	***General Claims Liabilities***
Condition/Effect/ Recommendation:	We recommend that the City Attorney's Office implement procedures to check for updated claim status once the loss run report has been sent to the actuary. Any significant changes to the loss run report that affects the status of general liability claims should be promptly communicated to the actuary.
Status:	Implemented.