

CITY OF OAKLAND

Communications to City Council

For the Year Ended
June 30, 2019



Certified
Public
Accountants

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

Table of Contents

| | <i>Page</i> |
|---|-------------|
| Transmittal Letter..... | 1 |
| Required Communications..... | 2 |
| Current Year Recommendations..... | 6 |
| Status of Prior Recommendations..... | 9 |
| Summary of Uncorrected Financial Statement Adjustments..... | 10 |



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

In planning and performing our audit of the basic financial statements of the governmental activities, the business-type activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of the City of Oakland (City) as of and for the year ended June 30, 2019, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, we considered the City's internal control over financial reporting (internal control) as a basis for designing audit 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. In addition, the Port of Oakland (Port), a discretely presented component unit, is audited by us under a separate engagement and a separate letter of required communications is submitted to the Port's Board of Commissioners.

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 over financial reporting, 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 reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable as defined as follows:

- *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
- *Probable*. The future event or events are likely to occur.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses. Given these limitations, during our audit we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We have also included other comments and observations and a status of the prior year recommendations in this report.

We would like to thank City management and staff for the courtesy and cooperation extended to us during the course of our engagement.

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

Walnut Creek, California
December 13, 2019

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

REQUIRED COMMUNICATIONS

Professional standards require that we advise you of the following matters relating to our audit.

Our Responsibility in Relation to the Financial Statement Audit

As communicated in our Amendment No.1 to the Agreement dated January 31, 2019, our responsibility, as described by professional standards, is to form and express an opinion about whether the financial statements that have been prepared by management with your oversight are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America. Our audit of the financial statements does not relieve you or management of your respective responsibilities.

Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting. Accordingly, as part of our audit, we considered the internal control of the City solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

We are also responsible for communicating significant matters related to the audit that are, in our professional judgment, relevant to your responsibilities in overseeing the financial reporting process. However, we are not required to design procedures for the purpose of identifying other matters to communicate to you.

Planned Scope and Timing of the Audit

We conducted our audit consistent with the planned scope and timing we previously communicated to you.

Compliance with All Ethics Requirements Regarding Independence

The engagement team, others in our firm, as appropriate, our firm, and our network firms have complied with all relevant ethical requirements regarding independence.

Qualitative Aspects of the City's Significant Accounting Practices

Significant Accounting Policies

Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note I to the basic financial statements. There have been no initial selection of accounting policies and no changes in significant accounting policies or their application during 2019, except for the adoption of Governmental Accounting Standards (GASB) Statement No. 88, *Certain Disclosures Related to Debt* (Statement No. 88) as described in Note I Section E to the basic financial statements. The City included the additional disclosures related to debt default provisions in Note II Section G. No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus, except for the presentation of the Port of Oakland (Port) as discussed below.

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

The City presents the 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 City 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, and thus, is a unique presentation.

Significant Accounting 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 estimates affecting the City's financial statements were:

- *Fair value of investments.* The City's investments are generally carried at fair value, which is defined as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Fair value is a market-based measurement using observable market transactions or available market information. The fair value of the City's investments (including the Police and Fire Retirement System) is generally measured based on Level 1 inputs, which are quoted prices in active markets, or Level 2 inputs, which are inputs other than quoted prices in Level 1 that are observable for the asset, either directly or indirectly. To a lesser extent, the City has some investments measured based on Level 3 inputs, which are not observable.
- *Estimated unbilled sewer service revenue.* The estimates for unbilled sewer service revenue are based on an evaluation of the sewer service reports from the East Bay Municipal Utility District, cash flows, monthly billing cycles, and historical billings.
- *Estimated allowance for losses on accounts receivable.* The allowance for losses on accounts receivable represents aged receivables over 360 days.
- *Estimated allowance for losses on loans receivable.* The allowance for losses on loans receivable is based on the types of loans (e.g., forgivable, deferred, grant, or amortizing) and management's estimate regarding the likelihood of collectability based on loan provisions and collateral.
- *Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable properties.* The estimated useful lives of capital assets were determined based on the nature of the capital assets and management's estimate of the economic life of the assets.
- *Accrual of compensated absences.* Accrual of vacation, sick leave, and compensatory time is based on unused employee sick leave, vacation, and other compensatory time, and employees pay rates at year-end.
- *Estimated claims liabilities.* Estimated claims liabilities were based on actuarial evaluations using historical loss, other data, and attorney judgment about the ultimate outcome of the claims.
- *Estimated environmental costs.* Estimated environmental costs are based on valuation reports from the City's Public Works Department and external consultants.

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

- *Net pension liability, net OPEB liability, and deferred outflows and inflows of resources related to pension and OPEB.* The City is required to contribute to its pension and OPEB plans at an actuarially determined rate. The actuarial pension and OPEB data, including the liabilities, deferred outflows of resources, and deferred inflows of resources, are based on actuarial calculations performed in accordance with the parameters set forth for the pension plans under GASB Statement No. 68, *Accounting and Financial Reporting for Pensions* and GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, which incorporate actuarial methods and assumptions adopted by the City.

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 opinion units that collectively comprise its basic financial statements.

Financial Statement Disclosures

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements are the disclosures related to investments, long-term obligations, litigation, and pension and other postemployment benefits. The disclosures about investments, long-term obligations, and pension and other postemployment benefits are described in Note II Section A, Note II Section G, Note II Section H, and Note III Sections A and B, respectively, to the financial statements.

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

I. Significant Difficulties Encountered during the Audit

We encountered no significant difficulties in dealing with management relating to the performance of the audit.

II. Corrected and Uncorrected Misstatements

For purposes of this communication, professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that we believe are trivial, and communicate them to the appropriate level of management. Further, professional standards require us to also communicate the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole and each applicable opinion unit. The attached schedule summarizes uncorrected financial statement misstatements whose effects in the current and prior periods, as determined by management, are immaterial, both individually and in the aggregate, to the financial statements taken as a whole and each applicable opinion unit.

III. 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, which could be significant to the City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

IV. Representations Requested from Management

We have requested certain representations from management, which are included in the City's management representation letter dated December 13, 2019.

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

V. Management Consultations with Other Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters. Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

VI. Other Significant Matters, Findings or Issues

In the normal course of our professional association with the City, we generally discuss a variety of matters, including the application of accounting principles and auditing standards, operating and regulatory conditions affecting the entity, and operational plans and strategies that may affect the risks of material misstatement. None of the matters discussed resulted in a condition to our retention as the City's auditors.

VII. Required Supplementary Information

We applied certain limited procedures to the management's discussion and analysis, the pension and other postemployment benefits schedules, and the budgetary comparison schedules for the General Fund and the Other Special Revenue Fund, which are required supplementary information (RSI) that supplement the basic financial statements. Our procedures consisted of inquiries of management regarding 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 audit the RSI and do not express an opinion or provide any assurance on the RSI.

VIII. Supplementary Information and Other Sections

We were engaged to report on the combining financial statements and schedules, which accompany the financial statements but are not RSI. With respect to this supplementary information, 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.

We were not engaged to report on the introductory and statistical sections of the comprehensive annual financial report, which accompany the basic financial statements but are not RSI or supplementary information. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

CURRENT YEAR RECOMMENDATIONS

**2019-001 Other Control Deficiency
Adequate Personnel Levels in the Finance Department**

The City’s personnel in the Finance Department is responsible for maintaining the City’s financial records in accordance with accounting principles generally accepted in the United States of America (GAAP) as promulgated by the Governmental Accounting Standards Board (GASB). In addition to its routine activities, over the upcoming years, the City will be required to determine the potential impact on complex and constantly evolving accounting and financial reporting issues, such as the new accounting standards on fiduciary activities, leases, and the new financial reporting model.

Condition:

During the course of the 2019 audit and over the past several years, the City’s Finance Department has been dependent on a handful of individuals in the Controller’s Bureau to obtain data, create back-up documentation, prepare financial analysis, and draft the financial statements. This reliance on a small pool of staff has left the City vulnerable to employee absences and turnover, including the extended, unplanned absences of several key staff members during the production of the 2019 financial statements, which exposed the City to delays in the completion of critical year-end functions and draft financial statements.

Recommendation:

The City should re-evaluate its current structure and level of effort to ensure that all of the functions of the City’s Finance Department are adequately staffed. As part of this evaluation, the City should ensure that an adequate level of personnel is proficient in governmental accounting standards, federal compliance requirements, and *Government Auditing Standards* to ensure timely completion of account reconciliations; technical evaluation of upcoming changes in accounting standards on the City’s financial position; and financial and compliance reporting requirements.

Management’s Response:

The City concurs with this recommendation and has taken actions to accelerate hiring for key finance vacancies. In addition, the City will broaden the role of existing staff to expand the team engaged in the annual production of the financial statements and provide backup for unplanned absences. The City has increased staff access to Government Finance Officers Association training opportunities in support of these goals and will consider the need for additional finance staff in the upcoming mid-cycle budget deliberations.

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

CURRENT YEAR RECOMMENDATIONS (Continued)

**2019-002 Other Control Deficiency
Information Technology: City-Wide Information Security Program**

Criteria:

Internal controls over financial reporting are reliant on effectively designed information technology (IT) controls. In that regard, an effectively designed IT control environment is one where an organization:

- (a) develops, documents, and disseminates to appropriate personnel, policies that addresses purpose, scope, roles and responsibilities, management commitment, coordination among organizational departments, and compliance; and procedures to facilitate the implementation of the policy and associated controls;
- (b) periodically reviews and updates the current policies and procedures; and
- (c) systematically monitors and tests its environment to ensure that policies and procedures are operating as designed.

Condition:

An entity-wide information security management program is the foundation of a security control structure and a reflection of senior management’s commitment to addressing security risks. Overall policies and plans are developed at the entity-wide level. System and application-specific procedures implement the entity-wide policy. Ongoing monitoring of control design, implementation, and operating effectiveness should also be applied so that the program includes continuous monitoring processes.

Critical within a well-established information security program are updated documented policies, procedures, and guidance; security roles and responsibilities identified and appropriately delineated across the organization; and ongoing evaluations to ensure that policies and controls intended to reduce risk are effective. Without these aspects, security controls may be inadequate; responsibilities may be unclear, misunderstood, or improperly implemented; and controls may be inconsistently applied. In addition, continuous monitoring of the City’s systems is necessary to mitigate threats from cyberattacks, which have increasingly impacted other local governmental entities ability to issue payments, assist with client services, receive remittances, and perform basic governmental functions.

During our audit, we noted weaknesses within the City’s information security program. Specifically, the City does not have updated policies and procedures along with continuous risk assessment and testing programs in place to actively mitigate threats to the City’s IT infrastructure from ransomware attacks, cyberattacks, and other unauthorized data breaches. In addition, we noted of a risk induced from lack of control in physical access to one of the City’s server rooms. Due to the legacy design of the City’s administrative office building, the ventilation system is not sufficient for the server rooms located in that building during this year’s heat waves. As a result, during this summer we observed that the City’s server room had unlocked opened doors to provide circulation in order to prevent the servers from overheating.

Recommendation:

We recommend the City evaluate its allocation of resources dedicated to cyber security threats and ensure resources are dedicated to update policies and procedures and to continuously perform periodic risk and vulnerability assessments, penetration testing, monitoring through scanning or agent-based software tools, or perform other cybersecurity activities in order to identify, track and resolve security threats. In addition, the City should continue its migration of its IT equipment to a co-location site that would provide the City with adequate cooling, power, bandwidth, and physical security for its IT equipment.

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

CURRENT YEAR RECOMMENDATIONS (Continued)

Management's Response:

The City concurs with this recommendation concerning the need to improve the City-Wide Information Security Program in general, and the specific recommendations to:

1. accelerate the migration of servers from the legacy onsite data centers either to the Cloud or to our certified co-location facility at Digital Realty, and
2. increase the allocation of resources dedicated to cybersecurity detection and incident response.

As it relates to the general recommendation, the Information Technology Department (ITD) continues to implement the projects initiated last year to strengthen the City's overall technology infrastructure and automate processes, monitor systems, and analyze operational and operational and security issues as they are identified. The City will consider the need for additional staff to support these initiatives in the upcoming mid-cycle budget deliberations.

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

STATUS OF PRIOR RECOMMENDATIONS

**2018-001 Material Weakness in Internal Control Over Financial Reporting
Financial Reporting Process**

Recommendation:

During the fiscal year 2018 audit, we noted that the City’s financial reporting process continues to rely on numerous manual spreadsheets to support computations to prepare its financial statements. This manual process is prone to errors such as the audit adjustment identified related to the City’s pension expense and related pension activities if not carefully analyzed. We recommend the City evaluate its financial reporting process and its preparation of the financial report and consider investing in other tools and trainings to automate its year-end financial reporting process in order to increase efficiency and decrease errors.

Status of Corrective Action:

Resolved.

**2018-002 Other Control Deficiency
Information Technology: City-Wide Information Security Program**

Recommendation:

During the prior years’ audits, we recommend the City evaluate its allocation of resources dedicated to cyber security threats and ensure resources are dedicated to update policies and procedures and to continuously perform periodic risk and vulnerability assessments, penetration testing, monitoring through scanning or agent-based software tools, or perform other cybersecurity activities in order to identify, track and resolve security threats.

Status of Corrective Action:

In process – see current year finding 2019-002.

CITY OF OAKLAND

Communications to City Council
For the Year Ended June 30, 2019

SUMMARY OF UNCORRECTED FINANCIAL STATEMENT ADJUSTMENTS
(Dollars in thousands)

| No. | Fund | Account Name | Debit | Credit |
|------------|---|------------------------------------|--------------|---------------|
| #1 | <i>To reclassify outstanding checks dated prior to June 30, 2019 from accounts payable.</i> | | | |
| | General Fund | Cash held in Treasury: City Pool | | \$16,489 |
| | General Fund | JP Morgan Payables | \$16,489 | |
| #2 | <i>To true up deferred outflow of resources and pension expense.</i> | | | |
| | Governmental Activities | Pension Expense | | 767 |
| | Governmental Activities | Deferred Outflows of Resource | 767 | |
| | Sewer EF ¹ | Deferred Outflows of Resource | 762 | |
| | Sewer EF | Pension Expense | | 762 |
| | Parks & Rec EF | Deferred Outflows of Resource | 5 | |
| | Parks & Rec EF | Pension Expense | | 5 |
| | Equipment ISF ² | Deferred Outflows of Resource | 263 | |
| | Equipment ISF | Pension Expense | | 263 |
| | Radio ISF | Deferred Outflows of Resource | 79 | |
| | Radio ISF | Pension Expense | | 79 |
| | Reproduction ISF | Deferred Outflows of Resource | 21 | |
| | Reproduction ISF | Pension Expense | | 21 |
| | Facilities ISF | Deferred Outflows of Resource | 82 | |
| | Facilities ISF | Pension Expense | | 82 |
| | Central Stores ISF | Deferred Outflows of Resource | 21 | |
| | Central Stores ISF | Pension Expense | | 21 |
| | Purchasing ISF | Deferred Outflows of Resource | 41 | |
| | Purchasing ISF | Pension Expense | | 41 |
| #3 | <i>To true up net pension liability and pension expense.</i> | | | |
| | Radio ISF | Net Pension Liability | 467 | |
| | Radio ISF | Pension Expense | | 467 |
| | Governmental Activities | Pension Expense | 467 | |
| | Governmental Activities | Net Pension Liability | | 467 |
| #4 | <i>To record pass-through expenditures pursuant to FEMA's cooperative agreement.</i> | | | |
| | Federal and State Grant Fund | Public Safety Expenditure | 2,175 | |
| | Federal and State Grant Fund | Due to other governmental agencies | | 2,175 |

¹ EF – Enterprise Fund

² ISF – Internal Service Fund