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CITY OF OAKLAND
Agenda Report

2004 MAY 13 PM 6:25

TO: Office of the City Administrator
ATTN: Deborah A. Edgerly
FROM: Finance and Management Agency
DATE: May 25, 2004

RE: INDEPENDENT AUDITOR'S MANAGEMENT LETTER AND REQUIRED COMMUNICATIONS FOR THE YEAR ENDED JUNE 30, 2003

SUMMARY
The Independent Auditor's Management Letter and Required Communications for the recently completed audit of fiscal year 2002-03 are now complete and are being presented to the Finance & Management Committee. This report contains recommendations that staff has already started to implement since they will strengthen operating efficiency and further enhance internal controls. The Management Letter contains no reportable conditions.

FISCAL IMPACT
This is an informational report only; there is no fiscal impact.

DISCUSSION
The Independent Auditor's Management Letter contains the following:

The **Required Communications**, which are required by professional auditing standards, includes the auditor's responsibility, significant accounting policies and unusual transactions, accounting estimates, audit adjustments and difficulties in performing the audit. There are no reportable conditions.

The **Current Year Recommendations & Responses** are for areas that could improve on operational efficiencies and further strengthen internal controls. City staff has begun to implement these recommendations.

- *Subsidiary Ledgers are not properly communicated to the Accounting Division:*
  The effected departments have already implemented a process for communicating all transactions to the Accounting Division. They will also reconcile their records on a monthly basis.

- *"Allowance for Doubtful Accounts" needs to be reviewed and updated, when necessary:*
  The City uses an "Allowance for Doubtful Accounts" of 49 percent, which is consistent with other Cities and municipalities. Although, the independent auditor

agrees that this rate is reasonable and consistent, it recommends that the City conduct a periodic analysis of the loans and receivables to determine the collectibility of these items.

- *Notes and loans origination and servicing functions should be segregated:*
  The Community & Economic Agency (CEDA) is responsible for managing the City's notes and loans. Since the independent auditor feels that CEDA does not have the expertise required to properly account for and monitor the notes and loans, they recommend that these functions be assigned to Finance & Management Agency. Staff will conduct a cost-benefit analysis of this recommendation to ensure that costs do not outweigh the benefits.

- *Fund Reservation for projects:*
  The City reserves fund balance for projects authorized by the City Council. The independent auditor opines that for reporting purposes, the project balances should be reported as designations, instead of reserves. Staff will implement this accounting treatment in future reporting.

- *Logical Security procedure needs to be developed:*
  The City has in place a procedure that disables employee's access to the financial modules. Staff is now more vigilant in implementing this procedure.

- *Computer Operations area needs a halon suppression system:*
  The City is in the process of relocating the server and other sensitive hardware to the Emergency Operations Center. In addition, a back-up server will be installed in the Lionel Wilson building.

The **Passed Journal Entries** are accounting entries recommended by the independent auditor. However, since these entries have no significant impact on the City's financial report, the Comprehensive Annual Financial Report (CAFR) and due to the fact that they were received from the independent auditor after the completion of the CAFR, they were not booked.

ACTION REQUESTED OF THE FINANCE COMMITTEE
Staff recommends that the Committee accept this informational report.

Respectfully submitted,

WILLIAM E. NOLAND
Director, Finance & Management Agency

Prepared by:
Gregoria M. Torres
Acting Controller

APPROVED FOR FORWARDINGTO
THE FINANCE AND MANAGEMENT COMMITTEE:

Office of the City Administrator

CITY OF OAKLAND,
CALIFORNIA

Report to City Council

For the Year Ended
June 30, 2003

CITY OF OAKLAND
Report to City Council
For the Year Ended June 30, 2003

Table of Contents

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To the City Council of the
City of Oakland

In planning and performing our audit of the basic financial statements of the City of Oakland (City) for the year ended June 30, 2003, we considered the City's internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the basic financial statements and not to provide assurance on internal control.

However, during our audit we evaluated the City's general control environment and became aware of certain matters that should be improved and that we consider an opportunity for strengthening operating efficiency. The memorandum that accompanies this letter summarizes our comments and recommendations. The information contained herein does not affect our report dated February 27, 2004, on the basic financial statements of the City.

We have already discussed our recommendations with various City personnel and would be pleased to discuss them further, to perform any additional study of these matters, or to assist you in implementation upon request.

We have included in this letter a report to communicate certain matters to the audit committee (or equivalent), as required by auditing standards generally accepted in the United States of America.

The accompanying required communications are intended solely for the information and use of the City Council and the Finance Committee and are not intended to be and should not be used by anyone other than these specified parties.

Macias, Gini & Company LLP

Certified Public Accountants

Walnut Creek, California
February 27, 2004

CITY OF OAKLAND
Report to City Council
For the Year Ended June 30, 2003

REQUIRED COMMUNICATIONS

Professional auditing standards require auditors to communicate with the Audit Committee (or equivalent) on a number of subjects. The following information satisfies these requirements, and is solely for use of the City Council and the Finance Committee.

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

As stated in our contract with the City, dated August 11, 2003, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement and are fairly presented in accordance with accounting principles generally accepted in the United States of America. 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 control over compliance in accordance with 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 *U.S. Office of Management and Budget (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. The federal compliance portion of the audit is scheduled for completion by the statutory deadline of March 31, 2004 and we will inform you of any reportable matters at the conclusion of that portion of the audit.

II. Significant Accounting Policies and Unusual Transactions

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our contract, 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 financial statements. As discussed in Note 12 the City is participating in an interest rate swap, to lower its borrowing costs. The City was required to enhance the disclosures for this transaction due to the implementation of Technical Bulletin 2003-01 *Disclosure Requirements for Derivatives Not Presented at Fair Value on the Statement of Net*

REQUIRED COMMUNICATIONS (Continued)

Assets. As discussed in Note 20 the City was required to restate the Net Assets of the Governmental Activities to record the net pension assets for the Police and Fire Retirement System and to account for the accreted interest that was related to the Central District Refunding Bonds, Series 1989A.

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 other transactions entered into by the City during the fiscal year that were both significant and unusual that should be brought to your attention, nor were there transactions for which there is a lack of authoritative guidance or consensus.

III. 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:

- Estimated claims liabilities
- Estimated allowance for losses on accounts and loans receivable
- Useful life estimates for capital assets
- Net pension assets

We evaluated the key factors and assumptions used to develop the above estimates in determining that they are reasonable in relation to the financial statements taken as a whole.

REQUIRED COMMUNICATIONS (Continued)

IV. Audit Adjustments

For 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). The audit adjustments regarding accounts receivable, notes and loans receivable, interfund receivables/payables, net pension asset, accounts payable and deferred revenue, in our judgment, indicate matters that could have a significant effect on the City's financial reporting process.

We are also required to inform you about uncorrected misstatements aggregated by us during the current engagement that were determined by management to be immaterial, both individually and in the aggregate, to the basic financial statements taken as a whole. In our judgment, none of the "passed journal entries", as attached, whether individually or in the aggregate, indicate matters that could have a significant effect on the City's financial reporting process.

V. 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.

VI. Consultations with Other 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 governmental unit'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.

VII. Major 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, since this is the first year of our audit, no such discussion occurred prior to our retention as auditors for the current year.

VIII. Difficulties in Performing the Audit

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

CURRENT YEAR RECOMMENDATIONS AND MANAGEMENT RESPONSES

Subsidiary Ledgers

The Revenue Division of the Finance and Management Agency and the Community & Economic Development Agency (CEDA), maintain subsidiary ledgers that are not properly communicated to the general ledger staff of the Finance and Management Agency. For instance, we noted that the Revenue Division did not communicate certain information regarding business tax revenue, which caused an incorrect amount to be recorded in the general ledger, and we noted that CEDA did not communicate lien receivables accurately to the general ledger staff or with the Revenue Division, which caused differing receivable amounts to be reported between the various ledgers. These variances cause difficulty in the monitoring of the financial reporting process because the general ledger amounts may be different than what the department has recorded. We recommend that the Finance and Management Agency emphasize to the Revenue Division and CEDA to communicate all relevant accounting data and to reconcile all subsidiary ledgers on a timely basis.

Management Response

The Revenue Division and CEDA have already implemented a process for communicating all transactions and any subsequent adjustments to the general ledger staff of the Finance and Management Agency and to reconcile their records with the general ledger staff on a monthly basis.

Allowance For Doubtful Accounts

The City has established a policy of recording an allowance for doubtful accounts of 49% of the outstanding loans and notes receivable balances. In other words, the City believes it will collect 51% of the actual notes and loans made to others. The City is basing this practice on past experience with notes and loans collections and has asserted that the amounts are fairly stated. While the allowances recorded appear to be reasonable and consistently applied from year to year, a detailed analysis created by the City's staff showing how the allowance corresponds with past experience would aid in auditing the reasonableness. By performing an analysis of the outstanding loans, to determine the collectibility of the loans and notes, City management will be able to monitor how the City is performing in the area of collections. We recommend that the City conduct a periodic analysis of the historical collectibility of outstanding notes and loans to determine whether the allowance being used is appropriate or whether it needs to be updated from time to time.

Management Response

Management agrees that a periodic review and analysis of the outstanding loans should be conducted by the Community and Economic Development Agency (CEDA) staff in coordination with the Finance and Management Agency staff. Management plans on implementing this process in the near future.

Notes and Loans

The Community & Economic Development Agency (CEDA) is currently responsible for managing the portfolio of notes and loans receivable. In some cases, CEDA does not have the required expertise to perform the necessary accounting and monitoring of the notes and loans receivable balances to ensure they are reported in accordance with U.S. generally accepted accounting principles (GAAP.) For example we noted the following:

- We found several instances of individual notes and loans being recorded in the accounting records in periods subsequent to the notes and loans being made.
- We noted several notes and loans that should have been written-off as not collectible during the year, however, these notes and loans remained in the financial records.

While there is no effect to fund balance, as the notes and loans examined were offset with a deferred revenue liability, there is an effect to the net assets reported in the government-wide financial statements. The effect proved to be immaterial and did not significantly affect the financial statements, however, by improving the controls over notes and loans the City will have more confidence in the balances due. Accurate notes and loans receivable also improve cash flow projections to the City and help to mitigate the potential for material misstatements of the notes and loan balances. Therefore, we recommend that the City consider assigning the servicing procedures to staff of the Finance and Management Agency in order to work with CEDA to ensure that notes and loans are properly reported in accordance with GAAP.

Management Response

Management believes that the notes and loans in question are fully reserved and agrees with the statement above that these have no significant effect on the City's financial statements. CEDA will conduct periodic reviews in coordination with the Finance and Management Agency to identify those notes and loans, if any, that require submission to the City Council for review and approval to be written off. Additionally, management will review the recommendation with respect to strengthening internal controls between loan origination and loan servicing to ensure that the implementation costs would not exceed the effectiveness and benefits to be derived.

Fund Reservation

The City currently reserves fund balance for projects authorized by City Council resolution. In accordance with GAAP, the function of "reserved fund balance" is to isolate the portion of fund balance that is not available for the following period's budget, so that unreserved fund balance can serve as a measure of current available financial resources. Examples of reservations are resources not available for spending, such as inventory or prepaid balances, and legal restrictions on spending, such as encumbrances owed to third parties or trustee cash balances restricted by debt covenants. Since projects authorized by City Council do not meet these criteria, these balances should be recorded as unreserved fund balance. However, the City may still report these authorized projects separately as "designations", a component of unreserved fund balance. Designations represent a government's self-imposed limitations on the use of otherwise available current financial resources. Therefore, we recommend the City use these definitions to more appropriately classify its fund balances in future financial statements.

Management Response

Management agrees with the recommendation and will implement it in future reporting.

Logical Security

Significant delays occur when Finance employees are terminated and when the IT Division disables the employee's access to the Oracle Financial Modules. We tested the application access for 5 former Finance employees, which showed that for 2 employees, the application access was disabled up to 6 and 7 months after their termination date. The City's Human Resources Division provides a termination list of employees to the IT department, but the list does not identify their departmental affiliation. As a result, it takes considerable time for IT to identify Finance staff that have left the City. By not disabling the employees' access from Oracle Financial Modules, the terminated employee or someone else with the terminated employees information could access the application and change the data. The IT Division and the Finance and Management Agency should develop internal procedures to immediately notify the IT Division of when Finance employees leave the City or transfer to another department.

Management Response

There is an existing procedure which authorizes an assigned IT staff to disable access to Oracle Financial Modules for employees where no activities show in the employees' Oracle accounts for 150 calendar days. In addition, the IT Division receives a list of terminated employees from the Personnel Division on a regular basis. This list serves as a basis for disabling former employees' access to the Oracle System. In addition, the Accounting Division of the Finance and Management Agency will ensure that the IT Division receives a list of the terminated employees on a regular basis.

Computer Operations

The City maintains a water fire suppression system for the computer equipment, rather than a recommended halon suppression system. The City opted against halon suppression because of environmental concerns. However, should a fire occur and appropriate high temperatures are reached, the water suppression system will activate causing significant damage to the City's IT hardware. We recommend that the City's IT Division consider installing a halon suppression system.

Management Response

The City plans to relocate its sensitive hardware to a secure facility within the next few months.

CITY OF OAKLAND

Passed Journal Entries
June 30,2003
(In Thousands)

Account	Debit	Credit	Reason for Entry
GENERAL FUND			
Cash	518		To record unrealized gains on investments
Investment income		518	in accordance with GASB 31.
Fund Balance - Reserve for projects	13,032		To reclassify Council authorized projects as
Fund Balance - Designated for projects		13,032	designations.
SRF - FEDERAL AND STATE GRANT FUNDS			
Notes & Loans Receivable	99		Oakland Business Development Corporation
Deferred Revenue		99	loans were understated based on audited analysis.
Investment income	173		To record unrealized loss on investments
Cash		173	in accordance with GASB 31.
Notes/Loans Receivable		2,590	To write-off notes/loans receivable. Per the
Allowance for doubtful accounts	1,269		client, the notes cannot be written off until
Deferred Revenue	1,321		the City Council authorizes the action.
REMAINING AGGREGATE FUNDS			
Various Funds:			
Cash	257		To record unrealized gains on investments
Investment income		257	in accordance with GASB 31.
Municipal Capital Improvement Fund:			
Allowance For Doubtful Acct	3,603		To write off receivables related to the
Miscellaneous Receivables		3,603	Montgomery Wards transaction.
Parks and Recreation:			
Charges for services	6,082		To reclassify revenue from charges for
Nonoperating revenues - other		6,082	services to nonoperating revenues - other.
GOVERNMENT ACTIVITIES			
Unearned Revenue	80		To amortize the current year portion of the
Investment Income		80	funds received as a result of refinancing the Interest Rate Swaps.
Interest Expense	17,431		To reclassify the accreted interest as
Expense - CEDA		17,431	interest expense.
Property Tax	292		To reflect property tax collected in excess
Beginning Net Assets		292	of the estimate made in the prior year as an adjustment to beginning net assets.

8

FINANCE & MANAGEMENT CMTE.
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