

City of Fresno, California

Management Report

June 30, 2002

McGladrey & Pullen

Certified Public Accountants

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SECTION I
ACCOUNTANT'S LETTER

McGladrey & Pullen

Certified Public Accountants

To the Honorable Mayor and
Members of the City Council
City of Fresno, California

This report includes comments and suggestions with respect to matters that came to our attention during our audit of the basic financial statements of the City of Fresno, California (the City) for the year ended June 30, 2002. These items are offered as constructive suggestions to be considered as part of the ongoing process of modifying and improving the City's practices and procedures.

The following sections are included in this report:

Reportable Conditions—We noted certain matters involving internal control and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Included in this section is a description of these conditions and our recommendations for improvement.

Future Opportunities—Included in this section are general items offered as constructive management policy recommendations to be considered as part of the ongoing process of modifying and improving the City's procedures.

Information System Opportunities—The items in this section result from our review of the City's information systems performed in conjunction with our audit of the City's financial statements. These comments are offered as constructive recommendations to be considered in improving the City's existing Information Services Department procedures.

This letter is intended solely for the information and use of the Mayor, City Council and management of the City. However, this report is a matter of public record and its distribution is not limited.

We appreciate serving the City of Fresno and would be happy to assist you in addressing and implementing any of the recommendations in this report.

McGladrey & Pullen, LLP

Riverside, California
December 20, 2002

SECTION II
REPORTABLE CONDITIONS

In planning and performing our audit of the basic financial statements of the City of Fresno, California, (the City) for the year ended June 30, 2002, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. However, we noted certain matters involving internal control and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the City's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. We do not consider the reportable conditions listed below to be material weaknesses.

Year-end Closing Process

Condition: The City experienced significant difficulties in closing its year-end books, which resulted in several trial balance revisions and delayed the audit start date. These issues were due to numerous factors, including employee turnover in key financial management positions, ineffective communication between the Finance Department and other City departments regarding the information necessary for closing the books, numerous year-end closing and correcting entries and meager reviews and oversight over the year-end closing process. The year-end closing process completes the general ledger and enables the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America. Weak internal control over the financial reporting process may result in inaccurate financial reporting that may not be identified in a timely manner by management.

Recommendation: We recommend the City review its year-end closing process in order to improve timeliness and reduce the number of adjusting, reclassification and post-closing journal entries during the audit process. The review should include an analysis of the timing, methodology and personnel involved in the closing process with frequent status meetings held to update the year-end closing process. In addition, we recommend that the closing procedures include the preparation of account summaries for financial statement line items and account analyses for significant accounts. Also, entries prepared to allocate revenues and expenditures among funds should be performed when final account balances have been determined and by employees most involved in the daily administration of these transactions.

City response: Several years ago, the City of Fresno embraced a management style which decentralized much of the financial oversight away from the City controller and pushed it out to the various departments. At the time this was done, the City was maintaining its accounting information on a software system that was very basic, unsophisticated and did not require many of its departmental users to have a detailed understanding of accounting. The introduction of the PeopleSoft software package, the need for a more in-depth accounting background and a better understanding of the intricacies of financial reporting have resulted in the decentralized methodology hindering the timely closing of the City's books and records.

The sagging economy, the recent spate of corporate scandals and the implementation of GASB 34 all have placed more emphasis on detailed, real-time financial reporting and financial statements. In addition to the causes outlined above, the Finance Department did not fully anticipate or estimate the time and effort that the implementation of GASB 34 would entail or the learning curve that would be required as the City and its new auditing firm became familiar with one another, nor did the City have sufficient staff in place or the cooperation of field personnel to avoid some of the problems that were encountered. It is for these reasons that the City experienced a rough year-end closing for fiscal year 2002. As a result, several steps are being taken to ensure that the annual ritual of closing the books is more efficient, more timely and more accurate for the fiscal year ending June 30, 2003.

The Finance Department is taking a more hands-on approach to financial oversight and will be asking that each department designate a CAFR point person who will be given the responsibility to coordinate all responses back to the Finance Department with respect to financial statement issues, requests, questions, etc. These point persons will be included in year-end planning meetings and will be given training in how specific information should be submitted to the Finance Department so as to be in a format acceptable to the auditors, consistent with other departments and in a "review ready" format. Much of the information can be accumulated throughout the year and, as such, the CAFR process is being moved out of the "year end" mind set and identified more appropriately as a year-long effort.

Many of the newly developed plans will be implemented immediately as part of the fiscal year 2003 close. A broad overview of those plans is as follows:

- (1) The preparation of the CAFR function has been "carved" out of the Accounting Section of the Finance Department and established as its own year-round Financial Reporting Section. It is planned that not only will this section concentrate on the CAFR year round, but will work closely with the Budget, Internal Audit, Treasury and Accounting Sections to provide more real-time financial analysis throughout the year.
- (2) This new section is also taking on the function of grant administration. At the time the financial function was decentralized, grant oversight/administration was also decentralized. The result has been that no one particular department or individual in the City knows what grants are being applied for, what the status of those applications are, what matching amounts the City is going to be responsible for, whether or not grant requirements are being adhered to or what grants are actually in place.
- (3) The Finance Department is filling a vacant position with an individual who will not only coordinate grant administration, but will also assist with the year-end close and the CAFR preparation. As part of grant administration, policies and procedures will be established to develop controls and grant oversight procedures, and a database will be created that will centralize grant information. As part of the CAFR and year-end close assistance, this individual will aid in coordinating the efforts of the various departments with respect to documentation to be submitted, format to be used and training that may be necessary as it relates to understanding year-end cut-off procedures.

One hindrance that resulted in the City not being able to close its books in a timely manner and begin the process of preparing the CAFR, is that the books and records of the City are not all maintained on one software system. The financial information is scattered over several off-line sets of books. Some accounting data is maintained on the HTE system, some on Hansen, others on separate DOS-based programs (e.g., the Transit and Sewer funds), some on BRASS and still other information on PeopleSoft. In order to even begin the process of closing the books, all of these other systems must be closed. None of these off-line systems integrate with PeopleSoft, which has necessitated that another system, GOFUND, be used, to consolidate all of this information into one working trial balance. An even further complication is that the City maintains its budget on the cash basis and its books on a combination of the cash basis and the modified cash basis, whereas the CAFR must be prepared on the full accrual basis. As a result, all year-end accruals must be booked manually and reversed manually in the following year.

Several steps are being taken to reduce some of the manual processes that are necessary as a result of the software and cash vs. accrual issues.

- (1) Investigation is being made into either moving the Transit and Sewer fund books to another software that integrates with PeopleSoft or moving them to PeopleSoft directly.
- (2) PeopleSoft is being researched to see if the books can be structured such that a cash basis set of books and an accrual set of books can be maintained on the same system, thereby eliminating the need to utilize GOFUND.
- (3) At the end of the current year's budget season, the Budget Section will be looking into what other software packages might be available to aid in the budget preparation process that would also integrate into PeopleSoft.

The goal of these and other investigations is to develop procedures that will aid in the closing of the books and records on a more timely basis, and make conversion from the cash basis to the full accrual basis easier, less time consuming and less susceptible to error.

The Financial Reporting Section is also looking into standardizing workpapers, creating workpaper templates that can be given to the field to make workpapers more comprehensive, standardized and easier to prepare. PeopleSoft reports that are available to support various account balances are also being reviewed to determine adequacy of detailed information and, as necessary, additional reports will be designed to aid in the year-end close.

While year-end closing status meetings were held frequently in the past, they did not include representatives from other departments. With the establishment of key CAFR personnel in each department, these CAFR contact people will also be included in all year-end status meetings.

In addition, rather than assigning responsibility for all CAFR to the limited number of CAFR specialists now in the Financial Reporting Section, others within the Finance Department will be involved. Those working in specific areas on a daily basis will be preparing schedules, adjustments, footnote disclosures and other items that may be needed. For example, the Treasury Section specializes in cash, debt, notes and accounts receivable; the Payroll Section has expertise in salaries and wages, benefits and payroll accruals; and the Accounting Section has hands-on knowledge of accounts payable, fixed assets and other account balances. Rather than preparing the CAFR and all backup, journal entries, footnotes and schedules themselves, the financial reporting team in the Financial Reporting Section will oversee and coordinate the CAFR function, with many of the items being prepared by those who work with the information on a daily basis.

Closing procedures related to accounts payable cutoff, fixed assets, observation of various physical inventories at year end, and the reconciliation of book to physical balances, along with the appropriate adjustments, and reconciliation of petty cash accounts are all being reviewed.

The CAFR must be thought of as a year-long process and emphasis must be on good monthly closes by all departments, with analysis being performed on an as-you-go basis. Corrections and cleanup cannot be done only at year end as part of the close. This, too, is an education process and will require training of field personnel and a better understanding of the impact failure to do so has on the City as a whole.

As a result of a worsening economy, the City must work toward not only reporting budget and actual differences in the CAFR, but to do so on a more proactive basis. This is necessary in order to be able to react more quickly to unanticipated economic changes, and also so as to provide management with the tools necessary to make better and more informed decisions. By no means is it possible to implement all of the corrective measures that are necessary and desired within the next few months. However an action plan is being developed, the team is being put together and the goals are being established.

Administration of Federal and State Grants

Condition: The Finance Department is responsible for preparing the Schedule of Expenditures of Federal and State Awards for reporting purposes and for ensuring the accuracy of requests for reimbursement and other financial reports submitted to the granting agencies. During our audit, we noted that the Finance Department experienced difficulty in administering the grant reporting process, including not knowing what federal and state awards the City has, distinguishing federal awards from state awards, determining the amount of expenditures of federal and state awards to be included in the Schedule of Expenditures of Federal and State Awards, and grantor-imposed submission deadlines for reporting on the Schedule of Expenditures of Federal and State Awards. This was due to the lack of communication between the Finance Department and the respective City departments applying, receiving and administering the federal and state assistance. The U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, states that the City is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. The lack of effective communication among the various City departments may result in the City preparing an erroneous Schedule of Expenditures of Federal and State Awards and missing required reporting deadlines. With the City receiving large federal and state awards from numerous funding sources, effective internal communication is crucial to an effective monitoring and reporting process.

Recommendation: We recommend the City's Finance Department create a grants coordinator position to serve as a liaison among all the City departments. This position could help eliminate the errors in the grant reporting process by working closely with all respective departments in obtaining all the information necessary in preparing the Schedule of Expenditures of Federal and State Awards, including maintaining copies of all grant and award agreements. This position could also serve to keep all respective departments informed of changes to the grant recording and reporting process and any reporting submission deadlines.

City response: The Finance Department is very much in support of the establishment of a centralized grant management function within the Finance Department. Prior to the arrival of a new controller and a new assistant controller, both within the last year to year and a half, the City had decentralized this function and given the responsibility of grant management to each individual department. With the active pursuit of more and more grants, this decentralization has become inefficient and problematic. The Finance Department, with the support of the City Manager's Office, is in the early stages of establishing a new section within the Finance Department to be known as the Financial Reporting Section that will take on, as one of its responsibilities, the monitoring of grant funds. This unit will develop and implement citywide policies on grant management, tracking of all grant applications and awards for consistency and propriety, monitoring ongoing status of existing awards, sources of funding and achievement of corrective action plans (if applicable). This unit will identify programs with greater inherent risks in order to identify training needs and assist departments in maintaining compliance.

The Finance Department is evaluating the need for and establishment of a full-time staff position to be responsible for citywide grant management activities. In addition, the Finance Department is looking into the creation of a Grants Management Steering Group and the creation of a citywide grants management database.

The Grants Management Steering Group would have, as one of its responsibilities, the task of reviewing grant proposals. In addition, this group could act as the clearinghouse for all grant applications. Critical to this group would be the participation of a Budget Section representative to assist in the coordination of grant application activities among City departments and to determine the citywide financial consequences of accepting funds.

The Grants Management Steering Group would initially be charged with the task of formalizing the responsibilities for the centralized grants management function as well as the duties of each specific department. Specific written authorizations for grant management will be established. The group will seek the help and contribution of grant experts within the City as well as external sources. Some of those duties and responsibilities to be part of the initial focus of the group will be to provide training for City personnel on grant regulations, ensuring timely draw-downs of grant funds, working with agencies to resolve any grant issues, and setting up and translating grants into the PeopleSoft system.

A key function of the Grants Management Steering Group will be to establish a comprehensive citywide grant database for the purpose of tracking, reporting and monitoring the City's grants. In addition, the group should establish a timetable for meeting on a regular basis in order to produce a citywide policy and procedures manual for grant management, suggesting training topics and identifying grant concerns.

In order for the Grants Management Steering Group to accomplish the goals of a centralized function, Budget Section involvement is critical in order to assist in the development of a work plan that will assist in providing the necessary resources, both monetary and personnel as necessary, to start and complete intended projects of the group. Also of critical importance is the involvement of personnel from the Accounting Section of the Finance Department. This involvement would help to coordinate consistent overall closing processes and procedures among all departments.

The Finance Department has hired a new management analyst who will start in mid-May. It is the intent of the Finance Department to have this individual head up this effort under the direction of the City controller and assistant City controller.

Cost Allocation Plan

Condition: The City's Cost Allocation Plan (CAP) was last approved by its cognizant agency in 1984. The methodology employed in preparing the CAP has changed considerably over the last 18 years (i.e., from 1984 to 2002). In addition to being approved by the City's federal cognizant agency, the City's CAP must be approved by the State of California Department of Transportation (CALTRANS), the City's pass-through grantor for the Highway Research, Planning and Construction Program for indirect costs charged to that program to be eligible for reimbursement. CALTRANS has not yet received the City's CAP. The CAP has historically been prepared to only capture costs of certain departments, and federal grants were never considered as a user or beneficiary of these departments when allocating these costs among users. We noted numerous indirect costs charged to federal awards that were not included in the City's CAP. OMB Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, states that all central service costs that a local government intends to claim for reimbursement under a federal award must be included in its CAP. Indirect costs omitted from the City's CAP and not approved by the City's federal cognizant agency and respective pass-through grantor agencies will not be reimbursed to the City. The City may also be liable to reimburse its grantors for indirect costs already requested and received. This could amount to significant costs the City would have to fund through different means.

Recommendation: We recommend the City reevaluate its methodology in preparing the CAP to include all departments and cost centers that the City intends to allocate costs to based on current updated allocation methods. In addition, we recommend that the City submit this comprehensive CAP to its respective federal cognizant agency and pass-through agencies for approval at least six months prior to the beginning of the City's fiscal year in which it intends to claim these indirect costs for reimbursement.

City response: As you noted during the course of your audit procedures, the City has been using a much outdated software program for the preparation of its CAP. The program is a DOS-based program that does not allow for a great deal of flexibility. As a result, the CAP, as currently prepared by the City, does not include many of the reimbursable, allowable indirect costs. The Budget Section is currently in the process of evaluating software programs that will accomplish the much needed documentation and flexibility required by the City. Upon the selection of a software package, the CAP will be analyzed in detail, with changes made as necessary.

The City will, upon evaluation of its methodology, and upon updating its allocation methods, submit the new CAP to the various respective federal cognizant agencies and pass-through agencies for approval of the CAP. It must be noted, however, that an outside, third-party consultant, Mr. Richard Pearl of Maximus, was engaged to review the current CAP for compliance with OMB Circular A-87. Mr. Pearl found the CAP to be in compliance. It must also be noted that the City's policy is to direct bill many of its indirect costs through interdepartmental billings. This results in fewer indirect costs to be allocated under the CAP and provides a better matching of actual project costs. When the City has undergone past governmental reviews by agency oversight, there have been no challenges to the CAP.

SECTION III
FUTURE OPPORTUNITIES

Open Purchase Requisitions

Condition: While documenting our understanding of the purchase and disbursement cycle, we noted that open purchase requisitions originated in prior years, that can no longer be drawn from, exist in the City's PeopleSoft system. This caused the pre-encumbrance amounts to be overstated; thereby not allowing for additional spending in those areas and preventing the transfer of funds to other needed areas. Through discussions with the City's purchasing manager, the majority of the open purchase requisitions will not be used and should be canceled.

Recommendation: We understand that a consultant was previously engaged to write a query to identify all open purchase orders. We recommend that this query be run each month, as a part of the City's month-end closing process, and that the City cancel open purchase requisitions that will not be used.

City response: Management agrees with the assertion that there are a number of open purchase requisitions in the system that have not been closed. The system would require that a modification be made to it since under the current version, requisitions cannot be closed until the purchase order (PO) itself has been closed.

Management disagrees that the requisition ties up funds that can be used for other purposes. Only after a requisition becomes approved and converted to or applied against a PO do the funds become encumbered. In PeopleSoft, a pre-encumbrance does not reduce the available appropriation, a PO does.

Management is developing a policy that will require City staff to review their open POs quarterly and to look for those that can be cancelled or otherwise liquidated. The cancellation process will eliminate the associated open requisitions. Management will also inquire about whether or not a modification has been made to the new system upgrade for PeopleSoft (which the City has yet to acquire) which would allow for the cancellation of purchase requisitions independent from closing POs.

Payroll

Condition: While documenting our understanding of the payroll function, we noted that certain payroll personnel have the ability to process payroll (authorization function) and post transactions to the general ledger (recording function). A strong system of internal control includes a proper segregation of duties that separates the functions of authorization, recording, review and custody.

Recommendation: We suggest that personnel with access to the payroll module be restricted from posting related payroll transactions to the general ledger. This restriction may help guard against misappropriation of assets and/or improper recording of payroll transactions to the general ledger.

City response: Management considers no corrective action necessary. While payroll staff do indeed process payroll and post to the general ledger, they do not "authorize" payroll. Only department management staff have the ability to authorize payroll transactions. Payroll staff merely process that information which has been provided to them by the various City departments. Within the Payroll Section, the processing duties are segregated among several individuals. Dangers from payroll irregularities are lessened due to this division of responsibilities, and the likelihood of detection of irregularities is greatly increased.

The Time and Labor Module lead, or his backup, loads the transactions and runs the processes necessary to create the final payroll product—checks. Any changes made to payroll data are generated in the respective departments and submitted to payroll, with all documentation kept on file as support for the changes. New employees can only be added by the Personnel Department, and each department enters its own hours. Furthermore, the PeopleSoft HR system does not allow payroll staff to access their own payroll entry screens, which prevents them from improperly changing their own payroll data.

After the payroll run is completed, the senior accountant in the Payroll Section takes the finalized payroll data, audits the data and then posts it to the general ledger. Payroll is balanced by general ledger account, fund/org, project and task adjustments, and must tie exactly to the Payroll Summary Report. All documentation relating to this process is retained. In addition, a payroll accountant runs a report that reflects all net checks over \$3,000 and all gross checks over \$5,000. These are reviewed for reasonableness and proper authorization.

Vendor Listings

Condition: We noted that a listing of approved and/or prohibited vendors is not maintained by anyone in the City's Purchasing or Accounts Payable Departments. The City's procurement policy requires that, when a PO is issued, the vendor is screened to ensure it is in good standing with the City, and that it does not have a poor service history. In addition, OMB Circular A-102, *Grants and Cooperative Agreements with State and Local Governments*, prohibits federal agencies from reimbursing local governments for incurring expenditures to vendors that are debarred, suspended or otherwise excluded from participation in Federal assistance programs.

Recommendation: We recommend that the City's Purchasing Department maintain and update a list of approved and prohibited vendors and refer to those lists when issuing POs. This will ensure compliance with the City's procurement policy and help to prevent the disallowance of expenditures related to federal and state grants.

City response: Management agrees that the City does not maintain a list of prohibited vendors and, furthermore, that there is no control in place that would prevent payments to vendors that might result in a violation of expenditures under certain grant programs.

The nearest control in place is that accounts payable personnel do maintain regular contact with the departments and are routinely notified to "hold" payments if there is a breach or nonperformance issue pending. In addition, the computer system does allow for inactivating vendors to prohibit further transactions. However, this feature is rarely used and is normally restricted to those vendors that are no longer in business.

Due to the size of the vendor database for the City, (currently 16,869 vendors), it would be virtually impossible for the accounts payable staff to monitor which vendors are approved/not approved with respect to various grants. Grant contracts are normally administered by the benefiting departments and the Finance Department will and must continue to rely on those departments in order to be informed about vendors that can or cannot be used. Under the current computer system, the Finance Department is not able to activate a vendor for certain transactions and inactivate it for others.

Management disagrees that the City does not keep a list of approved vendors. The City has a listing of 16,869 vendors in its computer database. As long as a vendor is not in "inactive" status, the database represents our approved vendor list. Accordingly, the City does, by virtue of the system, possess an Approved Vendor List.

Condition: There is no formal procedure to ensure that new vendors created in the PeopleSoft system actually exist. It is possible that fictitious vendors could be created in the system and, if certain conditions exist, payments could be made to these vendors without detection.

Recommendation: We recommend that the City require proof of existence when a vendor is created in the system. This could be accomplished by sighting business licenses or permits.

City response: Management agrees that there is no specific control in place designed to prevent the creation of a nonexistent vendor and, if certain conditions exist, payments could be made to these vendors without detection; however, there are limited controls in place.

Under the current structure, the creation of a vendor in the system is restricted to staff with accounts payable security access. Currently, 25 employees in the Purchasing, Finance and Information Systems Departments have this access. When a vendor is created, it is routine to obtain the vendor's TIN for 1099 reporting, but it does not preclude a vendor from being set up if the number is not available at the time. However, only management personnel can approve, by signature, payments to vendors. Finance management provides a third level of review and approval for those vouchers in which the requestor and the approval signatory are the same (i.e., credit card payments).

Management recognizes it is possible that nonexistent vendors could be created and payments made to them, although cooperation/collusion of personnel would be involved. The City will investigate and then prepare a policy and procedure that, at a minimum, would require that, prior to payment, a new vendor must have on file with the City its vendor's license number and/or taxpayer number.

Deposits

Condition: Certain accounts in PeopleSoft entitled "Deposits from Others" are often used as "Miscellaneous" expenditure accounts so that expenditures may be made for an account that is at or has exceeded its budget limit. For example, if a department needs to write a check for an expenditure category that has reached its budgeted limit, the employee preparing the purchase order will code the expenditure to the deposit account. This type of transaction, when performed frequently, may result in a debit balance to a liability account. More importantly, the expenditure is excluded from the statement of activities and results in inaccurate reporting of expenditures and liabilities. Further, it allows for expenditures in excess of budgeted amounts. There are no controls in place to restrict the debit for the expenditure from posting to the deposit account.

Recommendation: We recommend that the City review the transactions posted to these liability accounts and perform any necessary adjustments to ensure these accounts only reflect additions or refunds of customer deposits.

City response: Management agrees. The account, Deposits from Others, is intended to be a liability account in which monies are receipted until such time as they are subsequently refunded. During the audit, it became apparent that, in many funds, this account had a debit balance. The conclusion was that monies had been refunded or expended out of this account, without a corresponding (preceding) deposit. Further, because there is no software system budgetary control for this account, the system would not prevent expenditures or other debit entries from being posted to this account.

Management will establish that each fund manager maintain a subsidiary ledger of this account, so that any expenditure entry can be supported by a prior cash receipt, also recorded and posted into that account. Management will also allocate resources necessary to reconcile or otherwise clear out this account for any historical transaction(s) that cannot be matched to corresponding receipts.

Condition: The City Departmental Agency fund owes approximately \$37,000 to numerous City employees, which is recorded in a general ledger account entitled "Deposit Held for Others". These amounts owed were accumulated through amounts withheld from employees' paychecks. We noted that the City does not have readily supporting documentation as to which employees are owed these funds, or what amounts each employee is owed.

Recommendation: We recommend the City perform a detailed analysis of this account to determine who is owed these funds and provide for timely repayment.

City response: The \$37,000 relates to a refund that was received from a life insurance provider for supplemental life insurance premiums paid by various employees over numerous years. While this amount is to be refunded to the respective employees, the Risk Management Department is of the opinion that the refund should be allocated back to the inception of the life insurance program. The Finance Department, however, believes that the more reasonable, cost-effective and time-efficient method is to allocate the refund to those participating in the plan at the time the

refund was generated. The check itself had no specific identification as to what years the refund related to. The allocation rate could consist of a blending of the ratio of face value of the policies purchased by the employees and the additional premiums paid by the employees. The date at which this blended rate would be determined would be as of December 1997, the date that the event occurred that caused the refund—divestiture of the insurance company. The methodology suggested by the Risk Management Department does not appear to be cost effective in this instance. The Payroll Section is in the process of generating this analysis and, upon approval by the controller, refund checks will be generated to those participants who were in the plan in December 1997.

Enterprise Fund General Ledgers

Condition: The Sewer and Transit Enterprise Funds are maintained on separate accounting systems independent of the PeopleSoft financial accounting system, which is used by all other funds. These Sewer and Transit funds are maintained by specific employees who are knowledgeable of the intricacies of maintaining these accounting systems and access to these systems is limited to those specific employees only. Employing separate general ledgers creates unnecessary additional closing procedures in reconciling these funds and combining them with the other funds of the City.

Recommendation: We recommend that the City utilize the PeopleSoft financial accounting system to record the daily operations for all funds, including the Sewer and Transit funds. A universal accounting system helps minimize the monthly and year-end closing processes and provides easier access to all applicable employees to retrieve and utilize information to make informed financial accounting decisions.

City response: Management agrees. The Sewer and Transit funds have their own operating systems. The detail in PeopleSoft for these funds is restricted to vouchers paid and deposits received for these funds—basically, only cash transactions. All other transactions, including most noncash transactions, are reflected in the sub-operating systems only. Accordingly, complete financial information is restricted to these subsystems. This creates a dependency on these operating systems and hinders outside party access and monitoring. This also delays the closing of the books as these sub-systems must be closed and all balances posted to GOFUND.

Management is currently carving out a time frame to convert these systems to PeopleSoft. The senior accountant in charge of the Enterprise Funds and the principal accountant over the Accounting Section will oversee this effort. It is expected this effort will take 6–12 months to complete.

The goal is to reduce manual effort, make data more available to management and minimize the monthly and year-end closing processes. Other cities utilizing PeopleSoft for Enterprise Fund accounting are being contacted in order to assist in the conversion over to PeopleSoft so as to hopefully expedite the process.

Employee Training

Condition: The City does not provide its finance and accounting personnel with adequate resources to obtain the training and education necessary in performing their duties as efficiently and effectively as possible. While we understand the City's current budget constraints, necessitated by current economic conditions, hinders the City's efforts in the training area, we believe that it is imperative that the City provide its employees with the training resources necessary to ensure that the City is adhering to current accounting, performance and operating standards and guidelines required by its various state and federal funding sources.

Recommendation: We recommend that the City provide its employees with the necessary resources (i.e., education, training and experience) required to remain capable and knowledgeable in performing their assigned job responsibilities.

City response: The Finance Department does not dispute this finding. For quite a few years there has not been a major emphasis on training. As a result of prior budget crises, training tends to be one of the first areas cut from the budget. The perception is that training can be handled primarily in house and, as a result, costs and funding can be kept to a minimum. Training, however, involves an expert working with learners to transfer to them certain areas of knowledge or skills necessary to improve their current jobs and performance levels. While the City does have a number of individuals with the multifaceted set of skills that makes them good teachers, it is not an easy prospect for everyone to attain this same skill level that enables them to be a good teacher. While some staff are self-starters and excel at teaching themselves or actively seeking independent ways of expanding their knowledge, others need a more structured classroom environment.

It is the intent of the Finance Department to begin to develop, over the next year, a formal training plan that will encompass not only the training that is currently available, but also personal development and succession planning topics. Currently classes in computer skills, safety issues and sexual harassment awareness are available, but the Finance Department would also like to investigate and develop programs that would also include courses on communications, customer service, diversity, ethics, human relations and quality initiatives such as benchmarking.

The programs to be developed will include in-house training, but it is the intent of the Finance Department to also investigate on-line training options, off-site training and bringing training consultants into the City for group training. A plan will be developed that assesses each Finance Department employee's job specifications and then establishes a training program necessary to assist him or her in developing the skills to optimize their potential. More emphasis will be placed on accounting and performance standards and guidelines necessary to allow the City to remain in compliance with federal and state funding sources.

In addition to increased efficiencies in processes being performed and better adherence to program specific requirements, it is the goal of the Finance Department to increase job satisfaction and morale among employees, increase employee motivation, increase capacity to adopt new technologies and methods, increase innovation in resolving issues, reduce departmental conflict and enhance the City's image.

Annual Appropriations Limit

Condition: In preparing the annual Appropriations Limit calculation, the City has two options to consider for each annual adjustment factor used in determining the Limit. Effective with the 1990/1991 fiscal year, cities have the option of using either the growth in the California Per Capita Income (CPI) or the growth in the nonresidential assessed valuation due to new construction within the City for the inflation adjustment factor. This is an annual election. The City also has the option of using the City population growth or the County population growth for the population adjustments factor. This is also an annual election. The City has historically only considered the growth in the California CPI and the City population growth factors in determining its annual Limit. These elections were made as a result of the City keeping two separate annual Limit calculation schedules based on different adjustment factor criteria. By not exploring all available options to determine the annual Appropriations Limit calculation, the City may not be maximizing its Limit to the fullest extent.

Recommendation: We recommend that the City consider all available options each year in determining its annual Limit, including the nonresidential assessed valuation due to new construction that can be attained from the County of Fresno Assessor's Office. After a careful examination of each option, the City should adopt those option factors that would provide the best total annual adjustment factor. The decision as to which of the options to select must be done by a recorded vote of the City Council. This would maximize the City's Appropriations Limit.

City response: The calculation of the annual Appropriations Limit has been transferred from the Budget Section to the Accounting Section. In addition, information has been obtained from McGladrey & Pullen, LLP, as well as the California Legislative Analyst's Office, to assist with future calculations.

Condition: The City maintains two separate Appropriations Limit calculation schedules when determining the annual adjustment factor. One schedule calculates the annual Appropriations Limit using the City population growth factor and the CPI factor, and the other schedule calculates the annual Appropriations Limit using the County of Fresno population growth factor and the CPI factor. In determining which annual factors to consider, the City bases its decision on the effect of each total adjustment factor to the prior year's annual Appropriations Limit. By not considering each year's total adjustment factor to the prior year-end City Council approved Appropriations Limit, the City may have understated its annual Appropriations Limit through FY 2001/2002.

Recommendation: We recommend the City revise its methodology in calculating its annual Appropriations Limit to consider each annual total adjustment factor in relation to the prior year-end City Council approved Appropriations Limit. We also recommended that the City reevaluate its prior years Appropriations Limit calculations to correctly apply the total adjustment factors back to FY 1990/1991. It should be noted that, if the City revises the Limits of prior years, adequate notice must be given and the City may be challenged on the entire methodology used to compute the revised Appropriations Limit.

City response: During the calculation of the upcoming Appropriations Limit, prior calculations will be reviewed and recalculated if, after analysis, it is determined that a benefit can be derived.

Condition: The City does not publish the annual Appropriations Limit and the total Appropriations Subject to Limitation in its Annual Adopted Budget. California Government Code, Section 37200, requires the annual Appropriations Limit and the total Appropriations Subject to Limitation be published in the Annual Adopted Budget.

Recommendation: We recommend the City publish the annual Appropriations Limit and the total Appropriations Subject to Limitation in its Annual Adopted Budget.

City response: The annual Appropriations Limit calculation had at one point in time been published in the City's Annual Adopted Budget. It is not clear when or why this procedure was discontinued. The Calculation will once again be published in the Annual Adopted Budget beginning with the 2003–2004 Budget.

Disposal of Assets

Condition: There are inadequate controls over the disposal of City assets. Currently, department heads are able to request retirements of assets with little or no oversight for those assets with costs less than \$5,000. This may lead to misappropriation of assets if not monitored closely. In addition, subsidiary fixed asset ledgers may not be properly or timely updated to reflect the assets currently in service.

Recommendation: We recommend the City implement greater control over the disposal of assets less than \$5,000. In addition, the appropriate documentation should be forwarded to the Finance Department immediately to ensure that these assets are properly accounted for, and any gain or loss on disposal of these assets is properly recorded.

City response: Management partially disagrees. There is a lack of control over the disposal of assets in that it is once again decentralized to a certain extent. The form to record asset disposals is Form F/A-91. Assets with a historical cost of \$5,000 or less require only the department head to approve and the Finance Department to acknowledge. Assets with a historical cost of more than \$5,000 require approval by the City manager. The lack of control lies in confirming that a Form F/A-91 was completed for all or any asset disposed of. Total reliance is on control at the department level. Accordingly, it is possible for an asset to be physically disposed of without a corresponding Form F/A-91 completed. The Finance Department has no control in place to ensure this is not occurring.

Management is looking into establishing a policy that includes departments having regular cycle counts of assets or sample counts to verify the existence of assets. Department property monitors should become more active in the

administration of control for fixed assets, including locations, custodianship, disposals and other safeguarding features. The City will be investigating whether it should consider incurring the cost for citywide physical inventories at least once every five years.

Inactive Funds

Condition: Certain funds within the Billing and Collection fund group are no longer being utilized, even though these inactive funds still show cash and related liabilities on the City's financial statements. Although we attempted to obtain from the City the detail of the funds to which this cash and related liabilities are owed, the City could not produce this detail. As of June 30, 2002, there was approximately \$1,500,000 recorded in these funds. Proper treatment of this cash would be to distribute it to the funds to which it is owed. Incomplete recording of assets held in a fiduciary fund and the untimely distribution of these assets to the appropriate funds may result in a breach of the fiduciary responsibility imposed on a fiduciary fund. This practice results in incorrectly reported cash and net assets, as well as revenue, and can have an effect on a certain fund's decision with respect to expenditure of its cash.

Recommendation: We recommend that the City implement controls that will allow for the proper monitoring of cash collected by the Billing and Collection funds. This will help ensure the proper recording of assets and revenue within the recipient funds and the timeliness of cash distributions to these funds.

City response: The fund that is being referred to is the Utility Service Deposits (52503) fund. During the years that the FAMIS software package was used (FY 1991–1999), cash receipts from customers for earned income went into a Utility Billing and Collection (UB&C) Clearing fund. An accountant would then transfer to the appropriate utility fund its respective portion/allocation of the cash receipts based on an HTE report that was provided from UB&C. Deposits from customers went into a Utility Services Deposit fund in order to separate the earned income from the cash receipts that were not yet considered to be earned but rather were deferred and considered a liability to the City.

Utility Service deposits are collected and reimbursed according to Fresno Municipal Code, Section 2-1105, Establishment of Credit for Municipal Utility Services:

- (a) **Commercial or Industrial Accounts.** "An applicant for any utility service for a commercial or industrial establishment or for any measured or metered water service shall establish his credit to the satisfaction of the Controller. An applicant's credit will be deemed to be established if the applicant: (1) makes a cash deposit with the city or makes an assignment to the city of a savings and loan investment certificate or passbook, or a commercial bank savings or time deposit certificate, or furnishes a two-party guaranty or corporate surety bond satisfactory to the Controller, to secure the payment of charges for municipal utility services;"
- (b) **Return of Security and Prepaid Charges.** "If a customer's account has not been delinquent in twelve consecutive months, any service deposit or other security for said account shall be returned to the depositor upon application for refund of said security. Upon the closing of any account, the balance of the security or prepaid charges, remaining after the closing bill for service has been paid, and less any city offsets, shall be returned to the customer upon application for refund, provided such application is made within one year after discontinuance of service. No interest shall be paid by the city on any such balance. In the event no such application is received in one year, said balance shall be forfeited."

Once PeopleSoft was implemented, UB&C began applying all cash receipts into the Utility Clearing fund vs. the Utility Service Deposit fund. Furthermore all deposit refunds are also being taken out of the Utility Clearing fund vs. the Utility Service Deposit fund making the Utility Service Deposit fund appear to be dormant. Because the utility deposits represent a liability for the City vs. earned income, the City needs to separate the utility deposits from the cash receipts that represent earned income. The Finance Department's Accounting Section met with UB&C and have requested that future deposits be recorded directly into the Utility Service Deposit fund vs. the Utility Clearing fund.

Also, the Accounting Section is examining the detail in the Utility Clearing account in order to determine the account balance that needs to be transferred from the Utility Clearing fund to the Utility Service Deposits fund in order to have a correct deposit balance on the books and records. All other excess amounts would need to be cleared out to income or to beginning net assets as a prior period adjustment.

Health and Welfare Trust Fund

Condition: The City utilizes two different outstanding check lists for reconciling outstanding items for the Health and Welfare Trust Fund. The City pays Bank of America for citywide account reconciliation services, which includes an outstanding check list for the Health and Welfare Trust Fund. This outstanding check list is more up to date versus the outstanding check list provided by the Trust's Third Party Administrator (TPA), HealthComp, which is what the Health and Welfare Trust fund was utilizing.

Recommendation: To be consistent with the citywide bank reconciliation, we recommend that the Health and Welfare Trust fund utilize Bank of America's outstanding check listing.

City Response: The Finance Department is unclear as to what this comment is referring to. The account used by the Health and Welfare Trust is a zero balance account. Checks are written by HealthComp and then, upon presentation to the bank for payment, funds are transferred from the City's operating account to cover the Health and Welfare Trust checks being presented for payment. The account is immediately swept back to zero. HealthComp presents to the City and the City forwards to the bank the checks that they have written. The bank then compares that list against the checks that have cleared and generates an outstanding check list. It is this outstanding check list that Treasury is utilizing when it reconciles the operating account. Finance is unclear what other "outstanding" check list the auditor is referring to.

Condition: The City's Health and Welfare Trust fund employs a TPA as noted in the comment above to administer the Health and Welfare Trust Plan. The TPA currently does not provide for an independent annual financial statement audit nor does it provide the City with an audit report on its internal control over operations. By providing the City with these audit opinions, the City can have more reliance that funds are being disbursed for allowable Trust purposes and that the TPA has adequate internal control over the administration of the Trust Plan.

Recommendation: We recommend that the City amend its contract with its Health and Welfare Trust TPA prior to renewal to include a clause requiring the receipt of an annual independent financial audit and report on internal control.

City response: In prior years this was not an audit finding. In prior years the City's previous auditors, upon finding that the TPA had not had an independent financial audit conducted or had a report on internal control prepared, proceeded to perform alternative testing. The City will request, however, that HealthComp have an independent audit performed along with the preparation of a SAS 70 report for the period ended June 30, 2003.

Utility Billing and Collections

Condition: Per our observation of the City's utility billing and collection process, we noted only one employee in the mailroom opening and sorting utility payments. City policy requires a minimum of two employees in the mailroom at all times when mail is opened and sorted. This reduces the risk of potential misappropriation of City assets.

Recommendation: We recommend the City enforce its billing and collection procedures to minimize the risk of asset misappropriation.

City response: Management concurs, and this procedure will be enforced.

SECTION IV
INFORMATION SYSTEMS OPPORTUNITIES

Organizational and Operational Controls

A thorough and up-to-date organization structure is important in providing a well-defined and orderly business environment, including formalized organization charts, job descriptions for each position in the organization and operating policies and procedures. Additionally, proper levels of responsibility should be clearly defined for adequate segregation of duties. This structure should not permit the perpetration and concealment of material errors or irregularities. Functions unique to processing should be divided within the organization to prevent or detect errors or irregularities in the normal course of business.

Program Change Control

Condition: We noted that the systems application developer has the functional capacity within the HTE system to retrieve a program, make a change to that program, compile it and place it back into the production environment without ever being detected. This could have a direct effect on the accuracy and integrity of the data on the system. The risk also exists that rogue code could be embedded into a program and never be detected.

Recommendation: We recommend the City implement a formal program change control process whereby adequate review and approval of all program changes be obtained and monitored.

City response: See City response at the end of this section.

PeopleSoft User Access Changes

Condition: We noted that the information services supervisor has the authority to add, delete and change users and functional parameters within the PeopleSoft application. We also noted that there is no formal process to authorize the addition, removal or change to a particular user's functional access. This process lacks accountability and presents an opportunity for unauthorized and undetected changes to user access that could affect the accuracy, confidentiality and integrity of data within the system.

Recommendation: We recommend the City implement a formal authorization process to add, delete and change users and functional parameters within the PeopleSoft system. This will help to maintain the accuracy, confidentiality and integrity of data within the system.

City response: See City response at the end of this section.

Information Systems Policies and Procedures

Condition: The City has developed a number of minor information systems security policies. While reviewing these policies we observed a number of areas that should be enhanced or added to the existing documentation. Properly designed security policies and procedures will establish defined roles and responsibilities for the information security officer, security administrators and users.

Recommendation: We recommend that management further develop the information systems security policies and procedures to provide a framework for the overall direction and implementation of information security. Specific roles and responsibilities should be identified along with specific procedures for the following security issues:

- Intrusion detection notification and suspicious activity reporting.
- Incident response procedures to potential intrusions.

- Firewall implementation, configuration and monitoring.
- Remote access authorization, authentication and monitoring.
- Encryption methods required to protect transmitted information.
- Monitoring compliance with all security policies and procedures.
- Monitoring financial condition, performance and security audits of vendors.

Properly designed security policies and procedures provide the framework for controlling access to critical computer resources and processing.

City response: See City response at the end of this section.

Logical Security Controls

Inadequate logical access security controls increases the potential for losses resulting from technical and business exposure. These exposures can result in minor inconveniences or total shutdown of the computer functions.

Computer files should be protected from unnecessary or unauthorized access by controls that reduce the risk of intentional or unintentional misuse, theft, alteration or destruction. Access controls apply to computer department personnel, users, management and hardware and software vendors.

PeopleSoft Security

Conditions: We noted the following with regard to the PeopleSoft application:

- There is no minimum password length established for authentication to the application.
- There is no password change requirement established to ensure adequate password controls within the application.
- The application does not lock users out after a minimum number of invalid access attempts.
- There is no audit reporting control within the application to help monitor changes to user access levels.

Recommendations: We recommend Information Technology management consider implementing the following with regard to the PeopleSoft application:

- A minimum password length (six to eight characters) should be established for authentication to the application.
- A password change requirement (every 30 to 60 days) should be established to ensure adequate password controls within the application.
- The application should lock users out after a minimum number (three) of invalid access attempts to maintain the integrity of data within the system.

- The application should maintain a control to enable security administrators to monitor changes to user access levels within the system.

City response: See City response at the end of this section.

Backup and Recovery

A major area of consideration for computer systems is backup and recovery. The possibilities for disasters are numerous and they can happen without warning. A workable and tested business continuity plan can help ensure critical resources will be available in the event of a disaster.

It is crucial to have backup files in the event information contained within the system is destroyed or inadvertently modified. Without proper backup and recovery procedures, the City could incur significant disruption and expense. Recovery procedures can provide records replacement and ensure operational continuity following an event that renders existing software and hardware unusable.

Business Continuity Program

Condition: During our review of the Business Continuity Program, we noted the following:

A disaster recovery plan is currently in the process of being developed; however, it does not contain the appropriate detail or procedures to assist with an information systems recovery. Additionally, the plan does not address backup voice, data communications or Internet banking recovery strategies.

Business recovery plan testing, training and awareness activities have not been completed. Periodic department training and awareness should be completed and documented so that employees maintain an understanding of what their role is in the business recovery process.

Recommendation: We recommend the following related to the Business Continuity Program:

Recovery agreements and recovery strategies should be developed for all critical systems. This includes voice/data communications and Internet banking. As the popularity and functionality of Internet banking grows, the criticality of the application and the recovery requirements will increase. Once completed, all business continuity planning documentation should be reviewed and approved by the Board.

Departmental structured walk-through testing should be completed to increase the awareness and understanding of the role each employee has in the recovery of the banks critical processes. Periodic department training and awareness should be also completed and documented so that employees maintain an understanding of what their role is in the business recovery process.

Overall City response: The City has engaged the services of Pacific Technologies, Inc. (PTI), Bellevue, Washington, to perform an Information Services needs assessment. Based upon the findings of PTI, the Information Services Department will be making a formal presentation to City management in the near future that will address the findings of the needs assessment as well as the conditions noted during the audit for the fiscal year ended June 30, 2002.