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To the Audit Committee and
Management of the
City of Fresno, California

We have audited, in accordance with the 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, the 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 Fresno, California (City), as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the City's basic financial statements and have issued our report thereon dated March 27, 2014. Our report includes a reference to other auditors who audited the financial statements of the City of Fresno Cultural Arts Properties, the City of Fresno Employees Retirement System and the City of Fresno Fire and Police Retirement System, as described in our report on the City's financial statements. This letter does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

In planning and performing our audit of the financial statements, 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.

However, during our audit we became aware of deficiencies in internal control other than significant deficiencies and material weaknesses and matters that are opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and suggestions regarding those matters. A separate report dated March 27, 2014, contains our report on significant deficiencies in the City's internal control. This letter does not affect our report dated March 27, 2014, on the financial statements of the City. We have also included in this letter a status of the prior year recommendations.

We will review the status of these comments during our next audit engagement. We have already discussed these comments and suggestions with City personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

The City's written responses to these other control deficiencies identified in our audit have not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the responses.

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

Maciar Jini & O'Connell LLP

Newport Beach, California

March 27, 2014

CITY OF FRESNO, CALIFORNIA
Current Year Recommendations
June 30, 2013

2013-A: COMPREHENSIVE RISK ASSESSMENT

Criteria

In 1992 the Committee on Sponsoring Organizations of the Treadway Commission (COSO) established a nationally recognized framework for internal control in its *Internal Control – Integrated Framework and its related Guidance for Smaller Public Companies: Reporting on Internal Controls over Financial Reporting*. The COSO framework establishes five elements of internal control: (1) Control Environment; (2) Risk Assessment; (3) Control Activities; (4) Information and Communication; and (5) Monitoring. These elements provide a common framework against which internal control systems can be assessed and improved. Risk Assessment is an integral part of internal control and management should periodically evaluate the risks and monitor the changes facing the City. This process involves evaluating both previously identified risks and potential new risks and providing assurance that (1) controls are designed properly to address significant risks and (2) controls are operating effectively.

Condition

During our audit of the City and discussion with the City's Internal Auditor, we noted the City has not performed a formal update to its risk assessment conducted in fiscal year 2011. Through the economic downturn, and layoffs, various other factors have caused potential changes in the areas of risk.

Cause

The City has had reduction in staff, which included a reduction in the Internal Audit Department. The Internal Audit Department performs various compliance audits, however not a comprehensive City-wide risk assessment.

Effect

With the various changes to the City, which include staff reduction, the City may be exposed to risks not identified during the last comprehensive risk assessment as conditions have changed.

Recommendation

We recommend that the City evaluate and perform a City-wide risk assessment, either through the utilization of the Internal Audit Department, or through a third party.

Views of Responsible Officials

The City's Principal Internal Auditor will attempt to complete a comprehensive citywide risk assessment during fiscal year 2015; however, this type of comprehensive and time consuming citywide risk assessment project by one person will take place as time is available so that the Principal Internal Auditor can continue to conduct limited scope audits as directed by the City Manager's Office, and/or as requested by City Management as they arise throughout the City organization.

CITY OF FRESNO, CALIFORNIA
Status of Prior Year Recommendations
June 30, 2013

2012-1 COMPENSATED ABSENCES

Observation

During our audit of compensated absences, we performed procedures to test the accuracy of accrued leave obligation at June 30, 2012. We noted that the query used by management to generate the report supporting the obligation at June 30, 2012 was not correct and employees who retired between June 30, 2012, and the date the report was run, were excluded. This resulted in an understatement of the compensated absence balance of \$592,107 for the City as a whole as of June 30, 2012.

Recommendation

We recommend the City ensure reports used to prepare year end financial statement balances be reviewed for completeness and accuracy to properly determine the compensated absences balance at year end.

Status

Implemented.

2011-1: FUND BALANCE RESERVES

Observation (revised)

Effective July 1, 2010, the City adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. The provisions of this statement revised the classifications of fund balances for governmental funds. As a result, the City Council established the Unappropriated Reserve Fund by adopting Resolution No. 2004-27, creating the General Fund Emergency Reserve Fund (Reserve Fund) at 5% of General Fund annual expenditures. This is reported as committed fund balance in the General Fund.

In November 2010, in accordance with Resolution No. 2004-27, the Mayor declared a fiscal emergency which was unanimously approved by the City Council in Resolution No. 2010-260, thereby reducing the Reserve Fund balance from \$10.6M at July 1, 2010, to \$1.4M at June 30, 2011. At June 30, 2013, the Reserve Fund balance was \$1.9M, and was reported as committed fund balance in the General Fund.

Based upon the City's interpretation of the reserve policy, 5% of the 2013 Adopted General Fund Appropriation of \$236.2M is \$11.8M. According to the reserve policy, the Reserve Fund was underfunded by \$9.9M at June 30, 2013, after considering the existing balance at fiscal year-end.

Recommendation

We recommend that the City review its current Reserve Fund policy and current financial position and develop and document a plan to be approved by City Council on how the Reserve Fund will be replenished to comply with the policy. In addition, the City Council should consider amending section 1212 of the Municipal Code to address how the Reserve Fund should be replenished.

Status

The City's ongoing fiscal situation has been caused by a variety of factors, including the economic downturn, unsuccessful local investment decisions, and an increase in indebtedness burdening the General Fund related to underperforming assets. In addition, the adoption of unaffordable future commitments to labor groups and others has exasperated the situation.

Beginning in February 2009, the City working with its employees and the public, has undertaken numerous rounds of budget reductions to address what has been well over a cumulative \$100 million in operating revenue shortfalls since that time. City-wide the workforce has been reduced by attrition and lay-offs from 4,171 employees in January 2009 down to 2,909 (30.3%) as of June 30, 2013. Non-essential City services have been

CITY OF FRESNO, CALIFORNIA
Status of Prior Year Recommendations
June 30, 2013

2011-1: FUND BALANCE RESERVES (Continued)

eliminated or severely curtailed, maintenance has been deferred, community centers are now operated by volunteer community-based organizations or staffing and hours have significantly reduced. Public Works and Parks have been particularly hard hit in the area of service impacts as have Police services. Various bargaining units have agreed to wage concessions or compensation deferrals and anticipated deficit fund recovery plans were required to be deferred as the ongoing economic depression persisted.

The City of Fresno, like other California cities, is limited in its ability to enhance existing revenue resources or its ability to create new ones. The City's top three revenue generators, Property Tax, Sales Tax and Charges for Services were pummeled and are just beginning to show small signs of recovery. All the while the revenues were declining, labor costs were and continue to increase. Long-term employment contracts or Memoranda's of Understanding (MOUs), entered into when the economy was growing, have prevented a full realignment of expenditures with available resources. Personnel costs, which include salaries and fringe, retirement contributions and the pension obligation bonds, encompassed 73% of the General Fund in Fiscal Year 2012. It is estimated that these costs will continue to increase in the near term until such time as MOUs can be renegotiated. At this time it is estimated that in 2014 these costs will take up 78% of the General Fund.

The City also sought opportunities on the revenue side, including adoption of Commercial Solid Waste and Commercial Recycling franchises which aided the General Fund. The City also negotiated an increase in the PG&E gas service franchise fee, increased the Building Permit fee, and engaged in an aggressive Business License Tax audit program.

In March 2012, the Mayor and City Manager presented a Fiscal Sustainability Policy (FSP) to the City Council which clearly established a policy framework to enable the City to accomplish four outcomes: 1) to set a course to restore the City's overall financial health and credit rating; 2) to achieve spending and minimum financial reserve targets; 3) to adopt employee compensation policy changes to be negotiated as employee contracts are opened for negotiations, and 4) to direct immediate actions seeking to match expenditures to revenues and to identify options for savings in employee compensation and other operating costs. The City Council unanimously adopted the Policy which set forth a ten-year path for the City to regain fiscal health.

Under the Policy, budgets are being built to not only balance the annual budget but to also allocate funding to eliminate negative funds and to also restore at least minimum reserve levels. Analysis was performed which acknowledged that the City needed a minimum of \$10 to \$12 million per year in additional cost cuts or revenue increases, continued over a ten-year period, to structurally balance the City's operations and fiscal health, even while operating at lower service levels.

The focus and reality of obtaining structural balance for the City is to address structural changes in employee compensation particularly in the areas of unsustainable employee health care costs, unsustainable paid leave balances, establishing rational and reasonable compensation plans consistent with community standards and local labor markets, simplification of MOUs, limitations on "premium pay", to negotiate with active employees and not retirees and to avoid long-term agreements and unpredictable salary formulas. The ten year plan has been developed to "leave no stone unturned" as the City works to restructure its operations to match expenditures to available revenues; to restore not only General Fund reserves but reserves in other funds and to eliminate negative fund balances. Solutions developed must be structural and long-term as opposed to merely deferring costs or debt. The ten year plan continues to be adhered to and progress has been made toward eliminating or reducing negative funds and paying down the interfund loans made by Water and Commercial Solid Waste Funds to the General Fund. The City has every intention of developing citywide reserves over the course of the ten year plan. It is simply going to take time and ongoing improvement in the economy as well as continued reductions in costs.

CITY OF FRESNO, CALIFORNIA
Status of Prior Year Recommendations
June 30, 2013

2011-2: UTILITY BILLING RECEIPTS

Observation

During our consideration of internal controls over the utility billing system, we noted that the HTE (SunGard), the City's utility billing subsidiary ledger, does not interface with PeopleSoft, the City's general ledger system. The Finance Department until January 2012 (transferred to the Utilities Department subsequent to January 2012) prepares a manual entry as a result of a cumbersome reconciliation process.

Recommendation

We recommend that the City consider developing an automatic interface between the HTE and PeopleSoft systems to ensure utility revenue is accurately captured and reported in the financial statements reducing the risk of a misstatement occurring during the manual reconciliation process.

Status

The City continues to agree with this recommendation and ultimately intends to make this a reality.

It is true that a manual journal entry is still required to record the Utility receipts on the PeopleSoft books. Part of the contract with the outside consultant assisting the City in its conversion over to water meters was to build the interface necessary for the HTE system to post daily into PeopleSoft. The plan for the interface had always been that it would be built toward the end of the project as the City first had to complete the conversion of the HTE system from bimonthly billing to monthly billing – which it did; fully capture all reads from the newly installed water meters and complete the presentment of bills reflecting charges based upon actual usage rather than a flat rate, which it has done as well. Installation of the residential meters was completed by the end of December 2012 and transition to charges based upon actual usage was also completed prior to the end of Fiscal Year 2013. Initial discussion meetings were held to begin the process of revisiting just what remained to be done with respect to completing the interface between the HTE system and PeopleSoft. The consultant who was engaged in the conversion was also requested to provide an overview of what remained to be done in order to complete the HTE to PeopleSoft interface.

Just as the City was reestablishing the timing and plan to build the interface, two events occurred which impeded progress; Utilities, Billing and Collection (UB&C) experienced a devastating loss due to the death of a valued staff member who had expended hundreds of hours becoming familiar with the HTE System and the data that would need to be transmitted electronically to the PeopleSoft System through the interface. Shortly thereafter, the City also lost the Information Services HTE lead who was heading up the team to build the bridge as she returned home to Canada. The UB&C position has only recently been filled within the last month and this individual must begin the process of becoming familiar with the HTE System which, will take some time. The HTE lead position has yet to be filled but recruitment is underway. This bridge program, upon completion, will enable the direct posting of utility payments into the PeopleSoft system on a daily basis, however, at this time, it is not expected that the interface will be completed by June 30, 2014. It is hoped that the project will be completed in calendar year 2015. Until that time, the manual posting will continue along with the reconciliation procedures necessary to ensure that the amounts journaled into PeopleSoft from HTE reports are accurate.

CITY OF FRESNO, CALIFORNIA
Status of Prior Year Recommendations
June 30, 2013

2011-4 INFORMATION TECHNOLOGY: User Account Management

Observation

During our audit we considered the general controls over information systems, including user rights to the network and applications. We tested the City's controls over employee terminations and noted the user accounts were still active subsequent to the termination dates for 2 of 25 terminated employees selected for testing. During our audit for fiscal year 2010, we noted a similar finding where 5 of 25 terminated employees still had active user accounts subsequent to the termination dates.

Recommendation

Though the condition has slightly improved, we recommend the City evaluate and revise its current procedures related to employee terminations. Procedures should include a method of communication between the Human Resources Department and the Information Services Department, to ensure user access is terminated timely to safeguard the City's data.

Status

Implemented.