

**CITY OF SAN RAFAEL
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

**FOR THE YEAR ENDED
JUNE 30, 2012**

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**CITY OF SAN RAFAEL
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

For the Year Ended June 30, 2012

Table of Contents

	<u>Page</u>
<i>Memorandum on Internal Control</i>.....	1
Schedule of Significant Deficiencies	3
Schedule of Other Matters.....	5
Status of Prior Year Other Matters.....	7
<i>Required Communications</i>.....	11
Financial Statement Audit Assurance	11
Other Information Included with the Audited Financial Statements	11
Accounting Policies	11
Unusual Transactions, Controversial or Emerging Areas	12
Estimates.....	12
Disagreements with Management	13
Retention Issues.....	13
Difficulties	13
Audit Adjustments.....	13
Uncorrected Misstatements	13

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MEMORANDUM ON INTERNAL CONTROL

October 26, 2012

To the City Council of
the City of San Rafael
San Rafael, California

In planning and performing our audit of the financial statements of the City of San Rafael as of and for the year ended June 30, 2012, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. Therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention to those charged with governance. We identified certain deficiencies in internal control that we considered to be significant deficiencies which are listed on the Schedule of Significant Deficiencies.

The City's written responses included in this report have not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, City Council, others within the organization, and agencies and pass-through entities requiring compliance with generally accepted government auditing standards, and is not intended to be and should not be used by anyone other than these specified parties.

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**CITY OF SAN RAFAEL
MEMORANDUM ON INTERNAL CONTROL**

SCHEDULE OF SIGNIFICANT DEFICIENCIES

2012-01: Controls Over Cash Receipts and Billing in Fire Department

Criteria: To strengthen internal control, employees who handle cash receipts collection should not also maintain the accounts receivable ledger, process billing, or have the authority to write off accounts receivable. In addition, reconciliations should be done on a regular basis to ensure that all revenue generated have been recorded in the City's general ledger.

Condition and Effect: As part of our internal control evaluation of the City's revenue cycle, we conducted an interview at the City's Fire Department cash collection site in May 2012. We noted the following:

1. There is no evidence of review of bills sent. The Battalion Chief initiates billing by providing documents to the Administrative Assistant II to generate bills. The Administrative Assistant II then prepares the invoices and the Battalion Chief reviews them for accuracy before mailing. However, there is no evidence that a review has been performed. Therefore, it will be difficult for the City to provide evidence that the review has taken place.
2. Receivables are not recorded on the City's general ledger at the time of billing. The Administrative Assistant II keeps copies of invoices sent in an "A/R" folder in the Fire Department. She checks periodically to make sure payments have been received. If a payment has not been received within one month, she informs the Battalion Chief to follow up on the payment. However, Finance is not notified about the amount of accounts receivable outstanding. By not recording the accounts receivable in the general ledger and relying on one employee to keep track of collectability, the City is exposed to the risk of cash receipts interception and/or the understatement of accounts receivable as well as revenue balances can result.
3. There is no cash register used in the Fire Department. Checks received by mail or over the counter are placed in a folder kept in the "Outgoing Mail" slot. However, these checks are not endorsed until they are delivered to the Finance Department. Cash received by mail or over the counter is kept in a locked drawer. By not immediately endorsing the checks and keeping them locked up during the hours of operation, the possibility of the interception of revenues increases.
4. The numeric sequence of cash receipts is not accounted for. If payment is received over the counter, the Administrative Assistant II fills out a receipt for the customer, but the receipts are not pre-numbered. Without accounting for the numeric sequence of the cash receipts, it is possible for an employee to intercept money collected.
5. Cash receipts batches are not reviewed by another employee in the Fire Department. In addition, the Fire Department does not reconcile revenue generated to cash receipts collected. The responsibility of reconciliation falls onto the Finance Department. Without the reconciliation between services provided by the Fire Department and revenue collected, the City is exposed to the risk of cash interception.

**CITY OF SAN RAFAEL
MEMORANDUM ON INTERNAL CONTROL**

SCHEDULE OF SIGNIFICANT DEFICIENCIES

Cause: Cash receipt and department billing processes throughout the City have not been reviewed since several departments reorganized their administrative processes over the past few years in response to staff reductions and attrition. One of the consequences of this is the weakening of some internal controls.

Recommendations: The City needs to review its entire cash collection procedure in the Fire Department in order to implement better internal control. Good internal control dictates that one employee should not have access to records used to maintain related assets. Good internal control further dictates that another employee should be involved in the records or assets so that they provide good checks and balances. At minimum, reconciliations should be done to ensure that all revenue generated by the fire officials is recorded in the general ledger. This includes reconciliation between the following:

- Services provided with amounts billed
- Amounts billed with accounts receivable on the general ledger
- Amounts collected with amounts sent to Finance
- Amounts sent to Finance with amount deposited to the bank account

Management Response: Management agrees that the controls over cash receipts and billing can be strengthened. The City has taken the following steps to address the issues raised:

1. Bill review: The Fire Chief or designee will review all bills prior to their issuance. This review is documented on the Outstanding Receivable Log, which was developed to track all Department-issued invoices.
2. Recording of receivables on the City's General Ledger: The Outstanding Receivable Log is accessible to the Finance Department, ensuring that all invoices initiated by Fire outside the centralized (Timeslips) system are reported to Finance. This information will enable Finance to properly record all receivables.
3. Security of cash and checks: All checks received by the Fire Department are now immediately stamped "for deposit only," and placed in a drawer that is locked at all times. The Fire Department directs cash payments to the 3rd Floor payment counter at City Hall.
4. Review of cash receipt batches and reconciliation of revenue and receipts: A review step has been added whereby receipt batches are reviewed prior to their submission to the Finance Department. This review is documented on the receipt batch transmittal form, used in the daily submission of checks to Finance. In addition, the Fire Department now reconciles all cash receipts to the general ledger each month.
5. In October 2012, the City engaged an independent consultant to perform a comprehensive review of cash collections, billing and other fiscal transaction processing in the Fire Department. The purpose of this review was to identify measures that would strengthen the City's internal controls with respect to these transactions. The measures addressing cash receipts and billings have been substantially implemented, and are reflected in this response.

Management intends to extend this review to include other departments in which such activity is conducted, and will review additional recommendations and solutions, evaluate the cost-benefit tradeoffs, and prioritize those identified for implementation during the remainder of fiscal year 2012-2013.

**CITY OF SAN RAFAEL
MEMORANDUM ON INTERNAL CONTROL**

SCHEDULE OF OTHER MATTERS

2012-02: Outdated Signature Cards

Signature cards for the bank and investment accounts should be updated immediately whenever there is a change in authorized signers. As of May 18, 2012, we found that the previous Finance Director was listed as an authorized signer for the City's Bank of New York trust account. In addition, the previous Interim Finance Director was listed as an authorized signer for the City's Local Agency Investment Fund (LAIF) accounts. Keeping ex-employees as authorized signers on the City's bank and investment accounts exposes the City to the risk of misappropriation of City assets. We were advised by the City that the City will update the signature cards of the accounts after the City fills the Finance Director position. We recommend that the City immediately remove the ex-employees from the authorized signer lists of all bank accounts. In the future, a step should be added to the employee departure checklist to ensure that outside parties (such as banks, investment advisors, and bond trustees) are informed that the departed employee no longer represents the City.

Management Response: Previously, the City waited until a replacement was ready to be added to the City's signature authority, before removing formerly authorized signers. In order to eliminate exposure associated with authority or access retained by terminated employees or contractors, the Finance Department will immediately remove their authority upon separation. The Finance Department has prepared an inventory of signature authorization to facilitate this process.

2012-03: Capital Asset Inventory

The Finance Department should perform a physical inventory of the City's capital assets on a rotational basis to ensure that capital assets records are complete and physical assets are safeguarded. Annually, Finance sends out capital asset listings to department heads for updates. Finance then adjusts its capital assets records based on these updates. Without a periodic inventory of the City's capital assets, the City may not be able to detect capital assets impairment, misplacement, or theft. We recommend that the City conduct a physical inventory once a year on a rotational basis to ensure that capital assets records are accurate.

Management Response: The Finance Department sends out capital asset listings (including vehicles, equipment, furniture and fixtures) annually to each department, and relies on departments to take inventory of their assets and report back if anything is out of order. Beginning in fiscal year 2012-13, Finance will continue to send out capital asset listing for to each department, but will require that each department perform an inventory of their equipment, sign the list and return to Finance.

The Public Works Department recently completed a comprehensive inventory of City-owned vehicles. This information will be used to reconcile with capital assets and ensure appropriate resources for replacement.

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**CITY OF SAN RAFAEL
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR OTHER MATTERS

2011-01 -- Enforceable Obligations Payment Schedule

California Health and Safety Code Section 34169(g)(1) requires the Redevelopment Agency to:

“.....adopt an Enforceable Obligation Payment Schedule that lists all of the obligations that are enforceable within the meaning of subdivision (d) of Section 34167 which includes the following information about each obligation:

(A) The project name associated with the obligation.

(B) The payee.

(C) A short description of the nature of the work, product, service, facility, or other thing of value for which payment is to be made.

(D) The amount of payments obligated to be made, by month, through December 2011.”

The Enforceable Obligation Payment Schedule (EOPS) adopted by the Agency on September 6, 2011, listed two obligations which show “various” as payees. These obligations amounted to \$23,470 for maintenance of RDA offices and \$44,130 for legal services.

We recommend that the Agency amend the EOPS to include payee information on the Schedule.

Management Response: Agency staff will update the EOPS to reflect the payee information.

Current Year Status: Completed. Agency staff updated the EOPS to reflect payee information.

2011-02 -- Year-End Adjustment Assistance

On July 1, 2010, the City issued the 2010 Taxable Pension Obligation Bonds in the amount of \$4,490,000 to prefund a portion of the obligations of the City to the Marin County Employees’ Retirement Association (MCERA). The bond proceeds were deposited in a separate account with MCERA. Every pay period, MCERA drew down the City’s actuarial required contributions to MCERA from this account. During the year, while the activities in this account were monitored by the City, its corresponding balance in the City’s general ledger was not adjusted to reflect the activities. During the year-end audit, City staff brought this item to our attention and requested our assistance in recording the appropriate entries. The balance in this account as of June 30, 2011 was \$229,170.

Management Response: The department’s practice in accounting for funds held by a fiscal agent is to monitor funds during the fiscal year and to post a final general ledger reconciliation at year end. Due to unique aspects of this bond, staff delayed the year-end general ledger reconciliation in order to confirm the appropriate entries with the auditors.

Current Year Status: Completed. Staff now completes year-end journal entries, prior to arrival of auditors.

**CITY OF SAN RAFAEL
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR OTHER MATTERS

2011-03 -- Information System Review

We conducted an Information Systems Review with our audit which encompassed the financial information system and the network environment that houses it.

Currently, there are no Information Technology standards to which local governments are required to conform. Indeed there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments can use to implement appropriate controls to ensure adequate security over information technology. Our Information Technology staff have reviewed these informal guidelines and concluded that the certification and accreditation framework developed by the National Institute of Standards and Technology (NIST) for the Federal Information Security Management Act (FISMA) are the most appropriate for local government¹. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. NIST recommends these for state and local governments. Our procedures included performing an external network scan based on NIST criteria and in determining that internal control provides for:

- Internet access defenses including hacker prevention, detection and deterrent systems
- Security of data from physical or network access
- Adequately protecting data from unauthorized internal access
- Reasonable measures to ensure continuation of service
- Information systems risk management

We noted a few areas during our Information System Review that could be improved. A summary of these recommendations which we believe are “best practices” are as follows:

Payment Card Industry Compliance

The City is not in compliance with the Payment Card Industry Data Security Standard (PCI-DSS). Any organization that processes credit cards is required to comply with PCI-DSS, even if the processing is outsourced. Failure to meet compliance requirements results in higher transaction fees and liability if a security breach is found. Because the City accepts credit cards as a form of payment, the City must be compliant with the applicable controls.

Management Response: Our IT Department along with our consultant from MarinIT continues to work diligently installing all the updates needed to make our network PCI-DSS compliant.

Current Year Status: The technical changes required for PCI compliance are now complete. The only remaining item for the City to complete is to publish a formal computer security policy. This draft is now complete and has been distributed to the City's Technology Team. After obtaining input from all departments, the City will finalize the policy and present it to the Management Team for concurrence and the City Manager for approval (planned for December 2012 or January 2013). At that point, the City will re-submit to auditing services for PCI compliance.

¹ "State, local, and tribal governments, as well as private sector organizations are encouraged to consider using these guidelines, as appropriate." NIST SP 800-37 Rev 1 pg 11

**CITY OF SAN RAFAEL
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR OTHER MATTERS

Audit/Event Logging

The City does not appear to have audit logs on the financial application server, such that any change, addition or deletion of user accounts within the application are tracked and monitored. The City should have audit/event logs of any addition, deletion or change in financial application user accounts and that log should be monitored by someone without the rights to effect such changes. In addition, any administrative access such as upgrades or application modifications by IT personnel, outside consultants or vendors should also be logged and reviewed.²

Management Response: The City's Eden Financial System has an audit history for each application.

Current Year Status: Standard reports are available in the current version of Tyler Eden for monitoring user security settings and vendor activation. Finance may decide to implement internal auditing procedures for these areas, depending on resource availability.

Password Management and Session Locks

Password Management on the Financial Application

The City does not enforce regular password changes or require the use of complex passwords for users on the financial application. There should be a written policy for the regular changing of financial system account passwords and the use of complex passwords for users. An automatic enforcement of this policy would be optimum. There should be enforced password complexity for the financial system to reduce the risks of easy guessing and brute force attacks against the passwords. Required use of unique alpha numeric and special character combinations along with a password length of at least 8 characters is optimum. There should be a policy that requires a limit on repeating financial system account passwords. This will stop users from circumventing password change controls. An automatic enforcement of this policy would be optimum. Users should not share passwords with other users nor use password easily guessed by other users.

Password Management for Operating Systems

The City does not enforce regular password changes or require the use of complex passwords for users. There should be a written policy for the regular changing of operating system account passwords and the use of complex passwords for users. An automatic enforcement of this policy would be optimum. There should be enforced password complexity for the operating system to reduce the risks of easy guessing and brute force attacks against the passwords. Required use of unique alpha numeric and special character combinations along with a password length of at least 8 characters is optimum. There should be a policy that requires a limit on repeating operating system account passwords. This will stop users from circumventing password change controls. An automatic enforcement of this policy would be optimum. Users should not share passwords with other users nor use password easily guessed by other users.

² For more information on Audit/Event log management see NIST SP 800-92 Guide to Computer Security Log Management.

**CITY OF SAN RAFAEL
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR OTHER MATTERS

Session Locks

The City does not have session locks turned on for the financial application or the workstation operating systems. A session lock is a temporary lockout of the operating system or financial application when a user stops work and typically moves away from the immediate physical vicinity of the computer. Generally, employees may leave their workstation for lunch or break and not log off or log out of the application. This leaves the operating system or financial application open and available to any passerby. Any person with physical access would be able to perform any tasks the absent user has privileges or rights to do. At the very least workstations should be set to lock out the workstation after a period of inactivity. Best practice would be to have both the operating system and financial application have lockouts after a period of inactivity.

Management Response: The IT Division has begun implementing various technical changes to the City's computer network in order to bolster security. We are currently in the process of implementing changes to address issues identified in previous audit reports as high risk, especially as they pertain to PCI compliance. We will then continue to address other, lower priority, potential security issues. Additionally, IT has begun addressing physical security of our communications and computer equipment by initiating inventory control of all City owned devices. Our next plan is to work on addressing access control and user management issues.

Current Year Status: The draft security policy includes a section on passwords and other authentication controls. Implementation of network passwords will include complex password requirements such as a length of at least 8 characters with letter, number, and special character combinations as well as minimum password expiration and aging. Access to the Eden Tyler system will be handled by pass-through of Windows network authentication. Guidelines will be established for automatic as well as manual session locks.

REQUIRED COMMUNICATIONS

October 26, 2012

To the City Council of
the City of San Rafael
San Rafael, California

We have audited the financial statements of the City of San Rafael as of and for the year ended June 30, 2012, and have issued our report thereon dated October 26, 2012. Professional standards require that we advise you of the following matters relating to our audit.

Financial Statement Audit Assurance: Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit in accordance with generally accepted auditing standards does not provide absolute assurance about, or guarantee the accuracy of, the financial statements. Because of the concept of reasonable assurance and because we did not perform a detailed examination of all transactions, there is an inherent risk that material errors, fraud, or illegal acts may exist and not be detected by us.

Other Information Included with the Audited Financial Statements: Pursuant to professional standards, our responsibility as auditors for other information in documents containing the City's audited financial statements does not extend beyond the financial information identified in the audit report, and we are not required to perform any procedures to corroborate such other information. Our responsibility also includes communicating to you any information that we believe is a material misstatement of fact. Nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements. This other information and the extent of our procedures are explained in our audit report.

Accounting Policies: Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note 1 to the financial statements. During fiscal year 2011-12, there have been no initial selections of accounting policies and no changes in significant accounting policies. However, the City adopted the provisions of the following GASB Statement during the year:

GASB 64 - *Derivative Instruments: Application of Hedge Accounting Termination Provisions, an amendment of GASB Statement No. 53*

Some governments have entered into interest rate swap agreements and commodity swap agreements in which a swap counterparty, or the swap counterparty's credit support provider, commits or experiences either an act of default or a termination event as both are described in the swap agreement. Many of those governments have replaced their swap counterparty, or swap counterparty's credit support providers, either by amending existing swap agreements or by entering into new swap agreements. When these swap agreements have been reported as hedging instruments, questions have arisen regarding the application of the termination of hedge accounting provisions in Statement No. 53, Accounting and Financial Reporting for Derivative Instruments. Those provisions require a government to cease hedge accounting upon the termination of the hedging derivative instrument, resulting in the immediate recognition of the deferred outflows of resources or deferred inflows of resources as a component of investment income.

The objective of this Statement is to clarify whether an effective hedging relationship continues after the replacement of a swap counterparty or a swap counterparty's credit support provider. This Statement sets forth criteria that establish when the effective hedging relationship continues and hedge accounting should continue to be applied.

This Statement did not have any impact on the City's financial statements.

Unusual Transactions, Controversial or Emerging Areas: No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

As discussed in Note 1N to the financial statements, the City restated the July 1, 2011 balances of fund balance or net assets of several funds of the City.

As discussed in Note 16 to the financial statements, the State enacted laws which dissolved Redevelopment Agencies effective January 31, 2012. The City elected to become a Housing Successor to the Redevelopment Agency and pursuant to the laws it is recipient to the encumbered housing assets of the former Redevelopment Agency. All other assets were distributed to and all of the Redevelopment Agencies debts were assumed by a Successor Agency governed by an Oversight Board. This Successor Agency is reported as a private purpose trust fund.

Estimates: Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The most sensitive accounting estimates affecting the financial statements are depreciation, compensated absences and fair values of Investments.

- *Management's estimate of the depreciation:* is based on useful lives determined by management. These lives have been determined by management based on the expected useful life of assets as disclosed in Note 1. We evaluated the key factors and assumptions used to develop the depreciation estimate and determined that it is reasonable in relation to the basic financial statements taken as a whole.

- *Accrued compensated absences:* are estimated using accumulated unpaid leave hours and hourly pay rates in effect at the end of the fiscal year. We evaluated the key factors and assumptions used to develop the accrued compensated absences and determined that it is reasonable in relation to the basic financial statements taken as a whole.
- *Estimated Fair Value of Investments:* As of June 30, 2012, the primary government of the City, held approximately \$75 million of cash and investments, as measured by fair value. Fair value is essentially market pricing in effect as of June 30, 2012. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2012.

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 City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

Retention Issues: We did not discuss any major issues with management regarding the application of accounting principles and auditing standards that resulted in a condition to our retention as the City's auditors.

Difficulties: We encountered no serious difficulties in dealing with management relating to the performance of the audit.

Audit Adjustments: For purposes of this communication, professional standards define an audit adjustment, whether or not recorded by the City, as a proposed correction of the financial statements that, in our judgment, may not have been detected except through the audit procedures performed. These adjustments may include those proposed by us but not recorded by the City that could potentially cause future financial statements to be materially misstated, even though we have concluded that the adjustments are not material to the current financial statements.

We did not propose any audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the City's financial reporting process.

Uncorrected Misstatements: Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. We have no such misstatements to report to the City Council.

This report is intended solely for the information and use of the City Council, its committees, and management and is not intended to be and should not be used by anyone other than these specified parties.

Mage & Associates

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