

**CITY OF SAUSALITO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

**FOR THE YEAR ENDED
JUNE 30, 2009**

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**CITY OF SAUSALITO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

For the Year Ended June 30, 2009

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MEMORANDUM ON INTERNAL CONTROL

September 30, 2009

To the City Council of
the City of Sausalito, California

In planning and performing our audit of the financial statements of the City of Sausalito as of and for the year ended June 30, 2009, 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 opinion 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.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We noted no matters that we consider to be material weaknesses.

Included in the Schedule of Other Matters are recommendations not meeting the above definitions that we believe to be of potential benefit to the City.

The City's written responses included in this report have not been subjected to the auditing 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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SCHEDULE OF OTHER MATTERS

2009-01: Year-end Closing

Criteria: Year-end closing procedures should be designed and carried out effectively to ensure that all significant year-end journal entries are recorded timely.

Condition: In the current year, finance department had two changes in key personnel. As part of the year-end closing process, City staff expended a significant amount of time to close the books and provided us the year-end financial data for our analysis. We received the financial data from the City and performed our analytical review, variance analysis and other applicable audit work. As a result, we inquired with staff on whether certain post-closing journal entries were required. Staff determined that additional post-closing journal entries were required and proposed 44 post-closing journal entries for our review. They were all accurate and correctly prepared by staff. These journal entries included payable accruals, receivable accruals, long-term debt transactions, capital assets transactions, capital outlay transactions, compensated absences, and claims payable.

Cause: The City had a year end closing process and staff had spent a significant amount of time to close the books. In the current year, there were changes in certain key finance personnel. As a result, a number of year-end closing entries were overlooked. However, as noted above, after the auditors had inquired about whether additional journal entries were required, staff had prepared and proposed all the necessary journal entries which were found to be accurate by the auditors.

Effect: The number and amount of significant post-closing adjustments indicates that if the City's year end closing procedures is not enhanced in the future, it would raise the potential that a significant error or errors could occur and not be timely detected and corrected by existing staff.

Recommendation: As part of the year end closing, the general ledger should be subjected to additional analysis and review to ensure that ending balances are supported and appropriate. Current year-end account balances should be compared with prior year's balances to determine whether the amounts are reported accurately. Capital assets records should be reviewed to make sure that they are reconciled to general ledger balances. City Council minutes should be reviewed regularly to make sure that significant financial transactions are appropriately recorded in the general ledger.

Management Response: City concurs with the recommendation and will work diligently to limit post-closing adjusting entries for fiscal year 2009-2010.

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SCHEDULE OF OTHER MATTERS

New Pronouncements:

The following comments represent new pronouncements taking affect in the next few years. We cite them here to keep you abreast of developments:

2009-02 - Statement No. 53 - Accounting and Financial Reporting for Derivative Instruments (Effective for fiscal 09/10)

This Statement is intended to improve how state and local governments report information about derivative instruments in their financial statements. Specifically, GASB 53 requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting (proprietary and entity-wide financial statements). Governments enter into derivative instruments as investments; as hedges of identified financial risks associated with assets or liabilities, or expected transactions (that is, hedgeable items); or to lower the costs of borrowings. Governments often enter into derivative instruments with the intention of effectively fixing cash flows or synthetically fixing prices. Common types of derivative instruments used by governments include interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts. In addition, this standard addresses hedge accounting requirements.

Management Response: City concurs with the recommendation and will comply with the requirements in fiscal year 2009-2010.

2009-05 Statement No. 54 Fund Balance Reporting and Governmental Fund Type Definitions (Effective for fiscal 10/11)

This Statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds.

The initial distinction that is made in reporting fund balance information is identifying amounts that are considered **nonspendable**, such as fund balance associated with inventories. This Statement also provides for additional classification as **restricted, committed, assigned, and unassigned** based on the relative strength of the constraints that control how specific amounts can be spent.

The **restricted** fund balance category includes amounts that can be spent only for the specific purposes stipulated by constitution, external resource providers, or through enabling legislation.

The **committed** fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of the government's highest level of decision-making authority. Amounts in the **assigned** fund balance classification are intended to be used by the government for specific purposes but do not meet the criteria to be classified as restricted or committed. In governmental funds *other than the general fund*, assigned fund balance represents the remaining amount that is not restricted or committed.

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Unassigned fund balance is the residual classification for the government's general fund and includes all spendable amounts not contained in the other classifications. *In other funds*, the unassigned classification should be *used only to report a deficit balance* resulting from overspending for specific purposes for which amounts had been restricted, committed, or assigned. Governments are required to disclose information about the processes through which constraints are imposed on amounts in the committed and assigned classifications.

Disclosure of the policies in the notes to the financial statements is required.

This Statement also provides guidance for classifying stabilization amounts on the face of the balance sheet and requires disclosure of certain information about stabilization arrangements in the notes to the financial statements.

The definitions of the general fund, special revenue fund type, capital projects fund type, debt service fund type, and permanent fund type are clarified by the provisions in this Statement. Interpretations of certain terms within the definition of the special revenue fund type have been provided and, for some governments, those interpretations may affect the activities they choose to report in those funds. The capital projects fund type definition also was clarified for better alignment with the needs of preparers and users. Definitions of other governmental fund types also have been modified for clarity and consistency.

Management Response:

The City is aware of the financial reporting Fund Balance and will comply with applicable requirements in the required fiscal year ending June 30, 2011.

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STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2008-01: Deposits Payable

We inquired about the City's deposits payable and noted the following:

- Deposits payable included many old debit balances which have not been reconciled. These debit balances are mostly from Community Development Department. The City is aware of these debit balances. The City should reconcile and resolve all old outstanding debit balances as soon as possible.
- The City was unable to provide us a current detail listing of deposits payable. To make sure that the City's deposit payables are recorded accurately, and to prevent potential over-payment or under-collection of deposits, the City should keep an up-to-date detail listing of deposits payable.

Current Status:

Management Response:

The City agrees that deposits payable should be reconciled monthly and that an up-to-date detail listing of deposits payable be maintained. Accordingly, the City has reconciled the old debit balances and has established a procedure for maintaining an up-to-date listing of deposits payable.

2008-02: Information Technology Best Practices

We conducted an Information Systems Review with our audit which encompassed the financial information system and the network environment that houses it. We significantly expanded our work from previous years beyond looking solely at financial information systems as a result of greater risks of unauthorized access caused by overall industry growth of web-based commerce and internet based financial systems. Internal controls that are present in the overall network environment have become more important and relevant to understanding the internal controls over financial systems. We believe Information System controls must be continuously improved and enhanced to stay ahead of the ever increasing sophistication of hackers and criminals.

Currently, there are no Information Technology standards which local governments are required to conform to. Indeed there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments may 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 government. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. We understand the U.S. Department of Justice recommends these for 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

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STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

A summary of our results and “best practices” recommendations are as follows:

- *Payment Card Industry Compliance* - Any organization that processes credit cards is required to comply with the Payment Card Industry Data Security Standard (PCI-DSS), even if the processing is outsourced. The standard was developed to minimize the risk of loss due to security breaches in processing credit card transactions. Merchants which conform to the Standard pay lower transaction fees than those that do not comply and they minimize their liabilities which may result from security breaches. The Standard requires varying levels of controls depending on transaction levels. In general, merchants must:
 1. Fill out a self-assessment questionnaire (SAQ).
 2. Submit the SAQ to acquiring banks.
 3. Perform quarterly external network scans and submit the results to acquiring banks.
 4. Have a full independent PCI audit performed by a Qualified Security Assessor (QSA) and submit it to acquiring banks. (Required for level 1 merchants only).

We believe the City qualifies as a Level 3 or 4 merchant due to activity levels of less than 1 million transactions and currently it need only complete and maintain the SAQ in-house. However, we understand SAQ submissions will become mandatory for Level 3 and 4 merchants in the near future. Staff has not completed the SAQ, but should do so and prepare for the submission requirement.

- *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.
- *General Information Systems Controls* - We compared the City’s information systems controls with the various NIST standards and believe improvements should be considered for implementation such as formalizing business continuity plans including alternate processing site locations, contingency planning and training. We provided a detailed report to the City’s IT and Finance Staff which describes the relevant standards and the control status for their consideration.

As noted above, the City is not required to conform to NIST standards and could use another set of guidelines to ensure the adequacy of controls. However, we recommend the City select an appropriate industry standard such as NIST to plan, organize and monitor information security proactively.

Current Status:

Management Response:

The City appreciates the comprehensive Information Systems Review performed by the auditor as the City believes that continuous internal control reviews will lead to appropriate business process improvements that optimizes risk against IT application and systems performance. The following management responses reply to the auditor’s observations and comments:

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Payment Card Industry (PCI) Compliance – The City has downloaded and reviewed the Payment Card Industry Data Security Standards (PCI-DSS) and agrees that the City should complete and have on file a self-assessment questionnaire (SAQ). The City will monitor PCI-DSS and should SAQ submissions become mandatory for Level 3 and 4 merchants. The City will submit as applicable.

Audit Event logs – The City agrees that changes, additions or deletions of user accounts within the financial application should be tracked and monitored within its financial application software. The City also agrees that optimum IT internal controls suggest that its financial applications logs should be monitored by someone without the rights to effect such changes. In addition, the City accepts that any administrative access such as upgrades or application modifications by IT personnel, outside consultants or vendors should also be logged and reviewed.

Although the City's current version of Springbrook Software (financial application) does not have internal audit/event log functionality, the available updated version of Springbrook Software does have enhanced Audit/Event Log functionality. The city's Strategic Plan anticipates purchasing the upgraded version of Springbrook Software in the future. However, the City has implemented other internal controls to provide for integrity of its data and data access:

1. The City has a Help Desk application that logs and reports all requests for changes, additions or deletions of user accounts within the financial application.
2. The City has a Help Desk application that logs and reports any administrative access requests to upgrade or modify financial applications.
3. The City's has internal control procedures that limit the authority to make changes, additions or deletions of user accounts to employees that do not have rights to effect such changes.
4. The City has internal control document and system review mechanisms that are specifically designed to detect unauthorized changes to critical data.

General Information Systems Controls (GISC) – The City agrees that although there is not an obligation to comply and conform to standards promulgated by the National Institute of Standards and Technology (NIST), continuous business process improvements should always be considered for implementation such as formalizing business continuity plans including alternate processing site locations, contingency planning and training. The City will review the detailed report provided by the auditors that describe the relevant standards and the control status for consideration where applicable.

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STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2008-03 - Upcoming GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets* (Effective for fiscal 09/10) - Retroactive Application Required

Governments have different types of intangible assets, such as easements, water rights, patents, trademarks, and computer software. Easements are referred to in the GASB 34 description of capital assets, which has raised questions about whether and when intangible assets should be considered capital assets for financial reporting purposes.

The absence of specific authoritative guidance has resulted in inconsistencies in the recognition, initial measurement, and amortization of intangible assets among governments. The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets to reduce inconsistencies and enhance comparability.

A summary of the statement:

- Intangible assets should be classified, accounted for and reported as capital assets, unless excluded from the scope. Guidance in this statement is in addition to existing capital asset guidance.
- GASB 51 specifically addresses the nature of intangible assets.
 - *Lack of physical substance.* An asset may be contained in or on an item with physical substance, for example, a compact disc in the case of computer software. An asset also may be closely associated with another item that has physical substance, for example, the underlying land in the case of a right-of-way easement. These modes of containment and associated items should not be considered when determining whether or not an asset lacks physical substance.
 - *Nonfinancial nature.* In the context of this Statement, an asset with a nonfinancial nature is one that is not in a monetary form similar to cash and investment securities, and it represents neither a claim or right to assets in a monetary form similar to receivables, nor a prepayment for goods or services.
 - *Initial useful life greater than one year.*
- GASB 51 excludes:
 - Assets acquired or created primarily for the purpose of directly obtaining income or profit.
 - Assets resulting from capital lease transactions reported by lessees.
 - Goodwill created through the combination of a government and another entity.
- Recognition of an intangible asset occurs only if it is considered identifiable. That is when either of the following apply:
 - The asset is separable from the government. That is it can be sold, transferred, licensed, rented, or exchanged.
 - The asset arises from contractual or other legal rights, regardless of whether transferable or separable.

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- Specific conditions must be present to recognize internally generated intangibles. Capitalization of costs begins after all of the following criteria are met:
 - Determination of specific objectives of the project and the nature of the service capacity expected upon the completion.
 - Demonstration of the feasibility that the completed project will provide its expected service capacity
 - Demonstration of the current intention, ability, and effort to complete or continue development of the intangible asset.
 - Internally generated computer software is used as an example in applying the specific conditions approach.
- Amortization lives are addressed:
 - Limited by contractual or legal provisions.
 - Renewal periods for rights may be considered if there is evidence that the government will seek and be able to achieve renewal and that any anticipated outlays to be incurred as part of achieving the renewal are nominal. Such evidence should consider the required consent of a third party and the satisfaction of any conditions required to achieve renewal.
 - An indefinite life (no amortization) is permitted so long as there are:
 - No limiting legal, contractual, regulatory, technological, or other factors, and
 - No subsequent change in circumstances.
 - A permanent right-of-way easement is an example.

Retroactive Application. For GASB 34 Phase I & II governments, retroactive reporting is required for intangible assets acquired in fiscal years ending after June 30, 1980. Retroactive reporting is not required for intangible assets with indefinite useful lives or internally generated intangibles, as of the effective date of this Statement.

Current Status:

Management Response:

The City is aware of all the financial reporting and implementation requirements of GASB 51 and will comply with applicable requirements in the required fiscal year ending June 30, 2010.

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REQUIRED COMMUNICATIONS

September 30, 2009

To the City Council of
the City of Sausalito, California

We have audited the financial statements of the City of Sausalito as of and for the year ended June 30, 2009 and have issued our report thereon dated September 30, 2009. 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 is 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. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2009. As described in notes to the financial statements, during the year, the City implemented the following new standards:

- Statement No. 49 - Accounting and Financial Reporting for Pollution Remediation Obligations

This Statement establishes financial reporting of obligations for pollution remediation. There was no material effect on the financial statements from the implementation of this statement.

- Statement No. 45 - Accounting And Financial Reporting By Employers For Postemployment Benefits Other Than Pensions

GASB 45 uses Pension Accounting (GASB 27) to change the accounting for Other Post Employment Benefits (OPEB) to full accrual at the Entity-wide and proprietary funds financial statement levels. Under the concepts in GASB 45 an actuarial study or simplified measurement method calculation is performed to determine an Annual Required Contribution (ARC). So long as employers contribute this amount every year, no accrual adjustment is needed in the financial statements. A summary of the impacts of this statement are presented below.

As discussed in Note 9 to the financial statements, during the year ended June 30, 2009, the City contributed less than the ARC for fiscal 2008-09 by paying retiree health care premiums in the amount of \$128,891. As of June 30, 2009, the City had a net OPEB obligation in the amount of \$442,746. There was no cumulative effect of the accounting change as of the beginning of the year.

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. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2009.

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 and compensated absences.

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 7. 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 is 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.

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 proposed audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the City's financial reporting process related to the recording of capital assets, depreciation and revenue accrual.

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 audit committee.

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