

CITY OF EAST PALO ALTO
EAST PALO ALTO, CALIFORNIA
REPORT TO MANAGEMENT
FOR THE FISCAL YEARS ENDED
JUNE 30, 1987 AND JUNE 30, 1986

MORRIS, DAVIS & COMPANY
Certified Public Accountants

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MORRIS·DAVIS & COMPANY

Certified Public Accountants

City Council Members
City of East Palo Alto, California

We have examined the general purpose financial statements of the City of East Palo Alto, California (the City) as of and for the years ended June 30, 1987 and June 30, 1986, and have issued our report thereon dated July 29, 1988. As part of our examination, we made a study and evaluation of the City's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the City's general purpose financial statements. Our study and examination was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole.

The management of the City of East Palo Alto is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of the City of East Palo Alto taken as a whole. However, our study and evaluation disclosed the following conditions that we

believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to general purpose financial statements of the City of East Palo Alto may occur and not be detected within a timely period.

- Records maintained by the City did not provide sufficient current financial information to serve as a basis in preparing required fiscal reports and guide the City's administration in formulating management decisions. Also, the accounting method used did not adhere in all cases to generally accepted accounting principles. Furthermore, the City did not maintain an updated and complete general ledger that contain complete records/information on financial activities and year end account balances.
- The City did not maintain a complete listing of equipment purchased during the year. In addition, equipment purchased was not properly tagged for identification/control and complete records were not maintained to show the person or persons accountable for the equipment.
- Inadequacy of internal control system over the use of credit cards issued to City officials.
- The City had no written investment policy and procedures to serve as an authorized basis for investment decisions.
- The cash management system and budgetary process was inadequate.

These conditions were considered in determining the nature, timing and extent of the audit tests to be applied in our examination of the 1987 and 1986 general purpose financial statements, and this report does not affect our report on these financial statements dated July 29, 1988.

This report is intended solely for the use of management and City Council Members and should not be used for any other purpose.

Morris, Davis & Company
July 29, 1988

FINDINGS AND RECOMMENDATIONS

CITY OF EAST PALO ALTO
SUMMARY OF FINDINGS AND RECOMMENDATIONS
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In general during the periods ending June 30, 1987 and June 30, 1986 we found that the City's policies, procedures and records maintained are inadequate and do not provide sufficient information to ensure proper management control over the City's operations and financial activities.

Currently however, the City has adopted various measures and systems that management believed would improve control over the City's fiscal and operational activities.

FINDING I - ACCOUNTING AND RECORDS MANAGEMENT SYSTEM

The records maintained by the City did not provide sufficient current reliable financial information to serve as a basis in preparing the required financial reports and guide the City's administration in formulating management decisions. Also, the method of accounting used did not adhere in all cases to generally accepted accounting principles and the requirement of the National Council of Governmental Accountants Statement 1. Further, the City did not maintain a general ledger that contain complete records/information on year end account balances and financial activities for fiscal years ended June 30, 1987 and 1986.

Governmental Accounting and Financial Reporting Principles - Statement 1, issued by the National Council of Governmental Accounting states:

a. "Accounting and Reporting capabilities;

A governmental accounting system must make it possible both (a) to present fairly and with full disclosure the financial position and results of financial operations of the funds and account groups of the governmental unit in conformity with generally accepted accounting principles; and (b) to determine and demonstrate compliance with finance-related legal and contractual provisions.

b. Generally Accepted Accounting Principles;

Generally accepted accounting principles (GAAP) are uniform minimum standards of and guidelines to financial accounting and reporting. Adherence to GAAP is essential to assuring a reasonable degree of comparability among the financial reports of state, provincial, and local governmental units. Governmental accounting systems thus must provide data that permit reporting on the financial status and operations of a government in conformity with GAAP. This Statement sets forth the application of GAAP to state and local

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governmental units. It establishes standards for both comprehensive annual financial reports and separately issued general purpose financial statements.

An important aspect of GAAP as applied to governments is the recognition of the variety of legal and contractual considerations typical of the government environment.

These considerations underlie and are reflected in the fund structure, basis of accounting, and other principles and methods set forth in the statement and are a major factor distinguishing Governmental accounting from commercial accounting. Governmental accounting systems designed in conformity with these principles can readily satisfy most management control and accountability information needs with respect to both GAAP and legal compliance reporting.

c. Fund Accounting Systems;

Governmental accounting systems should be organized and operated on a fund basis. A fund is defined as a federal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations."

The condition resulted in a long and tedious reconstruction process of the City's books of accounts, delays in audit timing and additional costs to the City. It also created problems which are discussed further in this section.

We recommend that the City implement necessary measures to adopt formal fiscal policies, establish a formal accounting system and prepare a fiscal policies and procedures manual with the required forms and books of accounts to properly record and account for the City's financial transactions in accordance with generally accepted accounting principles as required by the National Council of Governmental Accounting and to strengthen the internal accounting control.

As a measure, the City acquired computer equipment. However, the automated accounting process was started in October, 1986. During the reconstruction process, the equipment was used by the City to assist in accounting and recording fiscal activities for fiscal years 1986/87 and 1985/86.

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FINDING II - CASH MANAGEMENT SYSTEM AND BUDGETARY PROCESS

During the periods under review, we noted the City's inability to adequately manage its cash flow. In addition, the deficient budgetary process and lack of effective planning and instructions contributed to the City's inability to develop a viable cash management system.

The City's obstacles to a sound cash management system were:

- 1) Grossly overstated revenue projections.
- 2) Insufficient detail information in departmental personnel budgets to assure that budgeted personnel costs are adequate to cover authorized positions.
- 3) Lack of control over purchasing of goods and services.

The following is a summary of actual and budgeted revenues and expenditures for the last two years ending June 30, 1987 which shows that actual and budgeted expenditures were greater than the actual and budgeted revenues making it necessary for the City to utilize beginning accumulated fund balances.

<u>REVENUE</u>	<u>Actual</u>	<u>Budgeted</u>	Variance Favorable (Unfavorable)
1985-86	\$5,310,925	\$5,279,871	\$ 31,054
1986-87	4,334,698	4,890,500	(555,802)
 <u>EXPENDITURES</u>			
1985-86	6,182,751	5,737,189	(445,562)
1986-87	5,359,054	5,649,273	290,219

In addition, there were unfunded expenditures incurred under the capital project funds which were ultimately covered by the City's general fund. These conditions contributed to a \$239,642 fund deficit under the general fund as of June 30, 1987, computed as follows:

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FINDING II - CASH MANAGEMENT SYSTEM AND BUDGETARY PROCESS -
CONTINUED

General Fund

<u>1985-86</u>	<u>Actual</u>	<u>Budgeted</u>	<u>Variance Favorable (Unfavorable)</u>
Revenue	\$2,817,273	\$2,691,211	\$126,062
Expenditures	<u>3,293,842</u>	<u>3,018,386</u>	<u>(275,456)</u>
Revenue Over (Under) Expenditures	(476,569)	(327,175)	(149,394)
Transfer out to cover unfunded expenses	(18,341)	-	(18,341)
Fund Balance, Beginning of Year	<u>1,387,999</u>	<u>1,229,231</u>	<u>158,768</u>
Fund Balance, End of Year - June 30, 1986	<u>\$ 893,089</u>	<u>\$ 902,056</u>	<u>(\$ 8,967)</u>
 <u>1986-87</u>			
Revenue	\$2,998,109	\$3,160,000	(\$161,891)
Expenditures	<u>3,861,033</u>	<u>3,762,000</u>	<u>(99,033)</u>
Revenue Over (Under) Expenditures	(862,924)	(602,000)	(260,924)
Transfer out to cover unfunded expenses	(269,807)	-	(269,807)
Fund Balance, Beginning of Year	<u>893,089</u>	<u>902,056</u>	<u>(8,967)</u>
Fund Balance (Deficit) End of Year - June 30, 1987	<u>(\$ 239,642)</u>	<u>\$ 300,056</u>	<u>(\$539,698)</u>

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FINDING II - CASH MANAGEMENT SYSTEM AND BUDGETARY PROCESS -
CONTINUED

We recommend the City take necessary steps toward eliminating fund deficits and development and implementation of a viable cash management system and budgetary process. Improvement of records and policies should be effected to ensure that sufficient information and procedures are available to effect the development and implementation of improvements in the area of cash management and budget systems.

FINDING III - WRITTEN INVESTMENT POLICY

The City did not have written investment policies and procedures to serve as an authorized basis and to assist management on investment decisions.

City management indicated that only short term investments are maintained, however they agree that written policies and procedures should be developed. Management stated that a formal investment policies and procedure will be developed.

FINDING IV - PAYROLL AND EMPLOYEE FRINGE BENEFITS

During the fiscal years 1985 and 1986 the City did not maintain a system to properly record payroll expenses and employee fringe benefits. The condition resulted in unrecorded payroll costs and improperly classified employee fringe benefits.

The City maintained the services of an outside agency to prepare it's payroll until November, 1986 when the City adopted it's own automated payroll system. The system corrected the problem which automatically distributes payroll costs among the City's funds and projects into the general ledger reports including that of fringe benefit expenses.

FINDING V - PROPERTY AND EQUIPMENT ACCOUNTING

The City did not maintain a complete listing of equipment purchased during the year. In addition, equipment purchased were not properly tagged for identification/ control and complete records were not maintained to show equipment location and persons accountable for the equipment. This was apparently due to the lack of an accountant/fiscal officer to account for and record these transactions.

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FINDING V - PROPERTY AND EQUIPMENT ACCOUNTING - CONTINUED

Sound management practices requires that there be proper control and accountability of the City's fixed assets. The manual on Accounting for General Fixed Assets issued by the California Committee on Municipal Accounting states the following for purposes and accountability of fixed assets and equipment.

"The purpose of recording general fixed assets are primarily stewardship needs to provide for physical and dollar value control and secondarily for an accountability for general government capital expenditures over the years. Thus, fixed asset accounting is recommended for the following reasons.

1. To safeguard a sizable investment.
2. To fix responsibility for the custody of equipment.
3. To assist in the formulation of acquisition and retirement policies through accumulation of data regarding prices, sources of supply, and useful life.
4. To provide record support for reimbursement of depreciation under grants and intragovernmental service program.
5. To provide data for financial reporting.
6. To account for depreciation in enterprise funds.
7. To provide information for insurance purposes."

City management indicated that they plan to conduct a comprehensive inventory of all property and equipment, however, because of staff reductions such plan was not immediately carried out. Management, however indicated that they intend to carry out the plan in the immediate future.

We recommend that the City take necessary steps to adopt a system for complete recording and accounting of property and equipment in accordance with the aforementioned manual.

FINDING VI - INTERFUND ACCOUNTS

The City did not maintain a system to properly record and reconcile interfund transactions between the various funds the City maintained during the fiscal years ending June 30, 1986 and 1987. This resulted in unrecorded interfund accounts.

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FINDING VI - INTERFUND ACCOUNTS - CONTINUED

The National Council for Governmental Accounting Statement I requires that interfund accounts be properly recorded in accordance with the nature of the interfund transactions. The system of proper recordation of interfund transactions is essential throughout the budgeting, accounting and reporting processes. The system would also ensure proper charging of expenditures and revenues to the appropriate fund accounts.

The City should adopt a system to properly record interfund transactions in accordance with the requirement of the National Council of Governmental Accounting.

FINDING VII - CREDIT CARDS

The City's system was inadequate to control the use of credit cards issued to City officials beginning October 1, 1986. The condition might result in uncontrolled and abusive use of these cards.

During July, 1987, the City recalled, cancelled, and discontinued the use and issuance of credit cards to it's officials.

FINDING VII - ANNUAL REPORT OF FINANCIAL TRANSACTIONS

The Annual Report of Financial Transactions submitted by the City to the State did not agree with available records maintained by the City as of June 30, 1987 and June 30, 1986. This was mainly due to inadequate accounting and records management system maintained by the City during the year.

National Council for Governmental Accounting, Statement I, on Governmental Accounting and Financial Reporting Principles states:

"A governmental accounting system must make it possible both: (a) to present fairly and with full disclosure the financial position and results of financial operations of the funds and account groups of the governmental unit in conformity with generally accepted principles . . . "

Accordingly, sound fiscal management system dictates that financial reports should be current, accurate and are linkable to records or worksheets maintained by the reporting entity.

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FINDING VII - ANNUAL REPORT OF FINANCIAL TRANSACTIONS -
CONTINUED

We recommend that the City establish and implement systems to ensure that reported financial statements are accurate, current and linked to their records or worksheet maintained by the City. This will involve establishment of sound accounting and record keeping systems.

In October, 1986, the City had started to maintain a formal book of accounts to record its financial activities through a combination of computerized and manual process. The implementation of this accounting should correct the records keeping problem and cost distribution system.