

City of Stockton

Stockton, California

Report on Internal Control Related Matters Identified in the Audit

For the Year Ended June 30, 2016

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Honorable Mayor and Members of the City Council
of the City of Stockton
Stockton, California

In planning and performing our audit of the financial statements of the City of Stockton, California (the "City") as of and for the year ended June 30, 2016, 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 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.

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 material weaknesses or significant deficiencies and therefore material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

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. 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 by those charged with governance.

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, audit committee, 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.

The Pun Group, LLP

Santa Ana, California
December 30, 2016

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Finding 2016-01 Internal Controls

Criteria:

Management is responsible for designing, implementing, and maintaining appropriate internal control over financial reporting and compliance.

Internal control is defined as a process implemented and monitored by the City Council, management, and other personnel. The Internal Control System should be designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Reliability of financial reporting;
- Effectiveness and efficiency of operations; and
- Compliance with applicable laws and regulations.

The Internal Control Framework would include establishing or enhancing guidance in the following areas:

- *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
- *Risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.
- *Control activities* are the policies and procedures that help ensure that management directives are carried out.
- *Information and communication* systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- *Monitoring* is a process that assesses the quality of internal control performance over time.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
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Finding 2016-01 Internal Controls (Continued)

Condition:

The City is in the process of upgrading its administrative and financial services by adding qualified personnel; hiring consultants with certain expertise; contracting with professional accountants to provide both internal and external auditing; and, making appropriate and informed decisions. As part of the upgrading process, the City has established a document titled "Auditing Findings Response Tracking Report" (the "Report").

The Report displays findings identified by City management, State Gas Tax Audit, State Controller's Office (SCO) Audits, prior external audit firm, County Grand Jury Report and the City's Internal Auditor. The findings in the latest Report totaled 323 items as of December 2016 organized in the following risk categories:

Risk Category		Total			Percentage	
Code	Description	Total	Open	Closed	Open	Closed
A	Processes	39	18	21	46%	54%
B	Capital Program	1	1	0	100%	0%
C	Operations/Service Delivery	1	1	0	100%	0%
D	Risk Management	3	2	1	67%	33%
E	Management	3	2	1	67%	33%
F	Organization and Staffing	14	6	8	43%	57%
G	Asset Management	8	5	3	63%	38%
H	Internal Controls	60	20	40	33%	67%
I	Funding and Economics	8	5	3	63%	38%
J	Human Resources	2	2	0	100%	0%
K	Governance	30	7	23	23%	77%
L	Technology	32	29	3	91%	9%
M	Compliance	15	6	9	40%	60%
N	Procurement	32	26	6	81%	19%
O	Accounting and Financial Reporting	73	26	47	36%	64%
P	Fraud	0	0	0	0%	0%
Q	Public Safety	2	0	2	0%	100%
Audit Findings, Total		323	156	167		
Percentage		100%	48%	52%		

Cause:

The City does not have detailed policies and procedures for its accounting systems that emphasize the need for proper review and approval for certain transactions that are susceptible to fraud.

Effect:

The City must establish an effective system of internal controls that would provide reasonable assurance regarding achievement of the City's objectives. An effective system of internal control reduces, to an acceptable level, the risk of not achieving the City's objective and may relate to all three objectives presented above.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
For the Year Ended June 30, 2016

Recommendation:

We recommend the City work closely with the Internal Auditors to design, implement and maintain its system of internal controls using the Internal Control Framework as outline above.

Management View and Corrective Action Plan:

The City is in agreement with this finding and recommendation. The City Manager's Office asked the City Auditor's Office to conduct a more robust and improved risk assessment process. It was identified by new management as one of the City's 37 Strategic Initiatives. The City has since contracted out the Internal Auditor role to Moss Adams LLP, a reputable CPA firm, to conduct a full risk assessment and several reviews of the City's internal controls.

The internal auditors began an internal audit plan in November 2013. This internal audit plan was originally to take place over a minimum 18-24 month period and is continuing to take place into the current fiscal year. The result will be an evaluation and documentation of the City's design of internal controls, further recommendations to change internal controls, evaluation of new or revised policies and procedures, and training for senior management, City Council and staff on internal controls. That body of work has been prioritized based on those business cycles that are of highest risk to the City for material misstatement to financial reporting. The final result of the work will be implementation of new internal controls, new standards of operations, new policies, and subsequent testing to ensure they are working as planned. These actions should remediate this finding. Administrative Services has categorized all findings and is prioritizing action items with the greatest effect on the City's internal control structure to mitigate those areas of highest risk. As indicated in the above table, the City made significant progress in implementing effective internal controls and closed some of the findings.

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Finding 2016-02 Accounting Manual

Criteria:

An Accounting Manual would aid the Administrative Services Department and the City in providing training for accounting personnel, communicating and providing a source of reference to approved policies, and maintaining consistency of recording financial transactions.

Condition:

During the performance of our audit for the year ended June 30, 2016, we noted that the City does not have an updated policies and procedures manual (Accounting Manual) which would define personnel roles and responsibilities, described appropriate procedures for recording significant transactions in finance and accounting systems, define and set procedures for management oversight and review, establish key internal controls, and ensure accounting and reporting requirements established by GAAP are followed.

Cause:

The City has been in a two year long process of restructuring its management team and a significant amount of time and effort was required of the new team in preparing the Chapter 9 filings and catching up on the long overdue audits. Therefore, City management has not had sufficient time to focus on the development of a comprehensive accounting manual and it has not taken the highest priority.

Effect:

Without the Accounting Manual, personnel responsible for the daily work and transactions do not have a clear understanding of their role and responsibilities or the accounting standards applicable to their function. In addition, the absence of standardized procedures has and will create inefficient and inconsistent processing of transactions. Absent clear guidance, delays in financial reporting occur as staffs are unaware of where to find the answers.

Recommendation:

We recommend that the City develop a comprehensive Accounting Manual that would set the guidelines for recording significant transactions in the general ledger. In addition, Management should consider developing an Accounting Manual which includes at a minimum:

- Descriptions of functions each position performs
- Specific duties and responsibilities (desk procedures)
- Minimum required qualifications or standards
- Council/Management approved policies relating to specific transactions
- Procedures for processing of specific financial activities
- Appropriate monitoring and review controls

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
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Finding 2016-02 Accounting Manual (Continued)

Management View and Corrective Action Plan:

The City agrees with the finding and recommendation. The City also agrees that there has not been sufficient time or priority given developing the manual; although it was not due to the lack of understanding that the City needed to develop one. The City needed to focus on delivering accurate and timely financial reporting before it could focus on developing an accounting manual.

In some instances, the City has documented its accounting processes but has not finished due to work on the bankruptcy and the City's financial records and associated audits. With the largest burden on the Accounting Division for the implementation of the Plan of Adjustment and the new GASB Statements 68 and 71 on Pension Accounting, management and staff turned inward towards operational improvements, reviews of policies and procedures, and the establishment of better internal controls.

Now that the City has exited bankruptcy and is in the process of fully staffing the Accounting Division, the Accounting Division plans to begin drafting the Accounting Manual and work with the City's internal auditors to review and complete this project in 2017. The City will consider this recommendation in connection with the work it is currently performing as a result of the Risk Assessment and Internal Control Review by Moss Adams. The City will work on the first draft of the Accounting Manual in conjunction with work on improvements to the internal controls and revisions to policies and procedures which the City could then use for the development of a formal Comprehensive Accounting Manual.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
For the Year Ended June 30, 2016

Finding 2016-03 Accounting System

Criteria:

Reliable and updated financial systems are critical in producing accurate and timely financial statements.

Condition:

We evaluated the financial systems employed by the City in managing its overall fiscal operations, including processing of billings and payments, preparation of financial reports, budgets, and analysis of trends. These systems form the basis for all financial reporting that is critical to the decision making process, and ultimately, the basis for the financial stability of the City. We found that the systems employed by the City are outdated and are not adequate nor are appropriate for a City of this size and complexity. Specific deficiencies of the system employed include, but are not limited to:

1. Inability to automatically post activity from outsourced operations such as banking, loan servicer, parking, parking tickets, library and other auxiliary systems.
2. There is a sufficiently high volume of manually posted transactions to record daily financial activities due to the lack of integration. Manual entries are time consuming, subject to significant risk of error, and cause delays in monthly and year end close process.
3. Complex processes for the retrieval of data that is needed on a day-to-day basis. In addition, certain key reports used for budgeting and limited financial reporting contain unresolved errors in the data.
4. The library's accounting billing and AR system is not integrated into the City's GL. The City is only able to reconcile the two systems on an annual basis due to the time it consumes.

The result of these overall system deficiencies is a significant degradation in efficiency of staff, who must utilize manual processes or other software products for the recording and reporting of routine financial activity, such as billings, personnel and payroll data, inventories, capital asset, depreciation, budgeting, etc.

Cause:

The City has a twenty plus year old outdated accounting system that needs to be updated.

Effect:

Accounting records and useful data cannot be easily accessed by management and others needed in analysis of current and historical financial conditions of the City. The lack of integration of the City's subledger can cause the general ledger to be misstated.

Recommendation:

The City is strongly urged to begin the process of review of other software applications that are specifically designed for municipal entities and have the full functionality needed for a City of this size and complexity. These other software applications should be evaluated in light of their general acceptance in cities of this nature and size, the level of internal user support required to operate the software, the training required for users and the cost.

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Management View and Corrective Action Plan:

Management concurs that we need to replace our accounting system and review other software platforms and applications that can support the City based on its size and complexity. The City also agrees that it is problematic to retrieve data from the system in a variety of formats due to the age and limited capabilities of the current financial system.

The City Council approved an RFP on January 12, 2016, to obtain the services of an Enterprise Resource Planning (“ERP”) Consultant for the needs analysis. On January 24, 2017, Council approved moving forward with a different ERP consultant to assist the City in selection and implementation of a new financial system and also approved 11 new City positions to serve as the core project team. A software vendor contract is anticipated to be awarded by December 2017.

In the meantime, the City upgraded the HTE system to version 9.3 in August 2016 and began the process of evaluating potential improvements to processes and procedures made possible by this upgrade.

With an outdated financial system, it is neither cost effective nor technologically and operationally feasible at this time to achieve full automation within the subsidiary systems or sub-ledgers for library services and loans receivable and parking tickets. The City’s current financial system does not provide the capability to automatically post every single transaction carried on in the subsidiary ledgers or from other nonintegrated subsystems as it works in a batch environment. However, the City’s utility billing, accounts receivable and cash receipts subsidiary ledger modules are integrated with the City’s general ledger through automated system interfaces. These subsidiary ledgers account for the largest share of City revenues.

We agree reconciling the various systems is difficult and time-consuming, and that more efficient operations could be achieved with a new or fully upgraded financial system. Moss Adams also identified the interface of key data in its Report on General Computer Controls dated June 2014.

Management also concurs that regular reconciliation is an industry best practice that the City will continue to pursue and implement as an operational standard. Until the City operationalizes a new financial system, it will continue to operate in a partially manual mode without needed modern business analytics, processes or tools.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
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Finding 2016-04 Ability to Retain Qualified Accounting Personnel

Criteria:

In order to have effective accounting systems and internal controls, the City should retain qualified accounting personnel who can initiate, record and process the various transactional flows of the City. Having qualified accounting personnel are a key element to running a successful Accounting Department.

Condition:

During the fiscal year ended June 30, 2016, the City has lost significant accounting personnel within the department. The City's accounting personnel decreased more than 50% compared to the same year ended June 30, 2015, and the City has not been able to fill qualified personnel to desire positions.

Cause:

The City experienced high turnover and understaffing during and subsequent to the year ended June 30, 2016.

Effect:

Ineffective internal control to the financial statements can be caused by poor segregation of duties and lack of accounting personnel. The lack of the functional accounting department for the City can cause material weakness to the financial statements in the future.

Recommendation:

We recommend that the City hire qualified personnel for the Accounting Department, and also take necessary actions to retain its personnel.

Management View and Corrective Action Plan:

Management agrees that qualified accounting personnel are essential to maintaining effective internal controls and accurate financial statements. The City completed a full evaluation and revision of the Accountant job description that incorporates more stringent minimum requirements for accounting educational coursework to attract a more focused and experienced professional workforce. The City also revised the test for the Accountant job classification with the same financial and analytical focus. A recent recruitment resulted in the hiring of five entry-level accountants who will begin employment mid-fiscal year. One vacancy remains with the recruitment expected to be completed in spring 2017.