



BROWN ARMSTRONG

Certified Public Accountants

To the Honorable City Council
City of Pasadena
Pasadena, California

MAIN OFFICE

4200 TRUXTUN AVENUE

SUITE 300
BAKERSFIELD, CA 93309
TEL 661.324.4971
FAX 661.324.4997
EMAIL info@bacpas.com

7673 N. INGRAM AVENUE

SUITE 101
FRESNO, CALIFORNIA 93711
TEL 559.476.3592
FAX 559.476.3593

221 E. WALNUT STREET

SUITE 260
PASADENA, CALIFORNIA 91101
TEL 626.204.6542
FAX 626.204.6547

5250 CLAREMONT AVENUE

SUITE 237
STOCKTON, CA 95207
TEL 209.451.4833

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Pasadena (the City) as of and for the year ended June 30, 2014, 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.

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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section 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. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control that we consider to be significant deficiencies. These significant deficiencies are presented in the significant deficiencies and other matters attachment.

As a service to the City, we also identified during our audit certain matters that provide you an opportunity to enhance your existing internal controls. These matters are provided as recommendations for your consideration and are not considered to be material weaknesses or significant deficiencies in internal control. The other matters are presented in the "Significant Deficiencies and Other Matters" attachment.

The written responses and comments provided by the City 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 City, and federal awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than these specified parties.

BROWN ARMSTRONG
ACCOUNTANCY CORPORATION

*Brown Armstrong
Accountancy Corporation*

Bakersfield, California
November 14, 2014

SIGNIFICANT DEFICIENCIES AND OTHER MATTERS

CURRENT YEAR SIGNIFICANT DEFICIENCIES

14-01 Disbursements and Accounts Payable

During our walkthrough of the City's disbursements and accounts payable cycle, we noted that controls can be made more robust by including the below mentioned recommendations. These will help to identify and detect the commonly used fraud schemes like:

- A. Kickbacks
- B. False or Inflated Vendor Invoices and Altering Checks
- C. Excess Purchasing Schemes
- D. Duplicate Payment Schemes
- E. Stealing Checks
- F. Stealing Cash by Using a Wire Transfer

Recommendations

- Enforce mandatory vacations for employees in purchasing, accounts payable processing, disbursement, and related recordkeeping functions. The vacations should be at least two weeks long and occur at the end of an accounting cycle. Cross train employees so that someone else does the job during the vacation.

Management's Comments Regarding Corrective Actions Planned

The City is in the process of negotiating reduced vacation caps which require employees to take vacation time rather than defer it and accumulate more vacation time on the books. The City will need to further evaluate its ability to implement the recommendation both from a position coverage standpoint as well as a labor relations issue.

- Notify vendors that you are using a fraud hotline.

Management's Comments Regarding Corrective Actions Planned

The City agrees with this recommendation and will add fraud hotline information on Purchase Orders, City bid documents, as well as on the City's Purchasing website.

- Examine contracts with the same vendor for similar items. If there are similar items in two separate contracts, determine that performance has occurred under both contracts.

Management's Comments Regarding Corrective Actions Planned

The City believes this warrants further evaluation and possible consideration of a citywide contract management function. The recommendation will be implemented as part of the Enterprise Resource Planning (ERP) system.

- Review recent purchases to see whether the same vendor is winning all the bids led by a specific purchasing agent or for a specific commodity.

Management's Comments Regarding Corrective Actions Planned

This suggestion is not fully applicable to the City as we do not have purchasing agents. The City has bid procedures in place with contracts coming to City Council for final approval. This process is currently being reviewed to address any weaknesses.

- Compare the petty cash reimbursements to the regular reimbursement process to ensure employees are not asking for reimbursement from both.

Management's Comments Regarding Corrective Actions Planned

The City agrees to test periodically as part of internal audit of petty cash.

- Reconcile the cash disbursement records to the accounts payable open invoice file.

Management's Comments Regarding Corrective Actions Planned

This suggestion is not applicable to the City as the City utilizes an Enterprise Resource Planning system and this is automated.

- Severely restrict the use of manual checks.

Management's Comments Regarding Corrective Actions Planned

The only manual checks are petty cash checks and Accounts Payable manual checks which are held and used only for emergencies. The City has not used an Accounts Payable manual check for over three years. Both Payroll and Accounts Payable enter all check information into the PeopleSoft ERP and special checks are issued by the system. Special Handling or special one-time checks are highly discouraged and Department Head approval is required. Additional restrictions will be enacted to further limit the use of special handling requests.

- Ensure new ERP system rejects duplicate entry of an invoice from a vendor.

Management's Comments Regarding Corrective Actions Planned

This is a built in feature of the new Tyler Munis ERP system.

- After each period end, management should create a log of all invoices received above the limit dictated by the City's policy and check to ensure that they were recorded in the proper period.

Management's Comments Regarding Corrective Actions Planned

This suggestion will be further evaluated in conjunction with the roll out of the Tyler Munis ERP core financial modules.

- Passwords to be established in the new ERP system and to be used for individuals authorized to make wire transfers, and bank callback verifications procedures be put in place for telephone transfers exceeding a predetermined dollar amount.

Management's Comments Regarding Corrective Actions Planned

This suggestion will be further evaluated and implemented in conjunction with the roll out of the Tyler Munis ERP core financial modules. Workflow methodology, password security, and audit trail of approvals are a robust component of the new Tyler Munis ERP system. Additional procedures will be put into place in regards to wires and bank callback verifications. The current wire security is in place utilizing Bank of America's cash management system which requires two independent approvals for wires.

- Changes to the vendor master file to be periodically reviewed for reasonableness.

Management's Comments Regarding Corrective Actions Planned

The City agrees with this recommendation and further evaluation is being conducted to determine procedures to be followed and who will perform them. Additionally, the vendor master file has been reviewed as part of ERP preparations. The new procedures will require a full review annually or more frequently.

CURRENT YEAR OTHER MATTERS

14-02 Payroll, human resources, and employee reimbursement

During our walkthrough of the City's payroll, human resources, and employee reimbursement cycle, we noted that adequate controls are in place and no fraud instance was noted, however, controls can be made more robust by including the below mentioned recommendations. These will help to identify and detect the commonly used fraud schemes like:

- A. Ghost Employees
- B. Overpayment Schemes
- C. Diverting Wages or Payroll Taxes
- D. Stealing Paychecks
- E. Employees Writing Extra Checks to Themselves
- F. Embezzling Withholding (Other Than Taxes)
- G. Keeping Former Employees on the Payroll
- H. Company Credit Card Fraud
- I. Expense Report Fraud

Recommendations

- Require mandatory vacations of employees in the personnel and payroll functions. Vacations should be at least two weeks long and occur during a payroll cycle. Cross train employees so that someone else does the job during the vacation.

Management's Comments Regarding Corrective Actions Planned

The City is in the process of negotiating reduced vacation caps which require employees to take vacation time rather than defer it and accumulate more vacation time on the books. The City is currently in the process of hiring an Accountant to provide additional coverage in the Payroll unit.

- Require time cards for all employees. Subject these time cards to review and approval by supervisors.

Management's Comments Regarding Corrective Actions Planned

The City already utilizes timecards for all employees with mandatory review by supervisors.

- Use time clocks for hourly employees.

Management's Comments Regarding Corrective Actions Planned

The implementation of electronic time clocks for all employees is currently being considered by Executive Management staff. The City previously reviewed this issue upon the implementation of its current electronic time card system (VTI).

- Place time cards in a location where a supervisor can watch employees clock in and out (to ensure that they use only their own time cards).

Management's Comments Regarding Corrective Actions Planned

Under the current system only the Police Department still uses paper time cards. Electronic time cards are only accessible by the employee and appropriate supervisory staff or department Payroll Clerks by use of their secure password.

- Severely restrict the use of manual checks.

Management's Comments Regarding Corrective Actions Planned

Neither Payroll nor Accounts Payable uses manual checks. Both groups use their automated systems to generate checks insuring that data is captured for all checks issued.

- On a surprise basis, and where applicable, use the accounting department or internal auditors to deliver checks directly to employees. Obtain identification from employees as needed.

Management's Comments Regarding Corrective Actions Planned

The City agrees with this recommendation. Currently 98.6 percent of employees utilize direct deposit and do not receive an actual paycheck. The Finance Department, Human Resources, and Internal Audit Manager will develop and implement a process for identifying any ghost employees and validating position controls.

- Require that cash advances be closed out at least monthly.

Management's Comments Regarding Corrective Actions Planned

The City does not issue cash advances other than travel advances when requested. The current procedure requires that unspent travel advances be returned to the City no later than the third day after return.

- Compare mileage reimbursements to the previous year requests.

Management's Comments Regarding Corrective Actions Planned

The City has a fleet of City vehicles and does not have a large volume of mileage reimbursements. Most of the existing reimbursements are of one time reimbursements related to travel to a conference or training opportunity and do not lend themselves to trend comparisons.

14-03 IT walkthrough

During our walkthrough of the City's information technology (IT) controls, we noted that:

1. IT risk assessment processes is not documented.
2. Programmers and Data Base Administrator have access to the key financial production server. There is no segregation of duties.
3. No formal Disaster Recovery plan is in place.

Recommendation

We recommend that:

- The City develop and maintain adequate documentation of formal IT risk assessment processes.

Management's Comments Regarding Corrective Actions Planned

The City is currently developing a more formal IT Risk Assessment Process. It is expected to be completed by December 31, 2015.

- Proper segregation of duties should be created between Programmers and Data Base Administrator who have access to the key financial production server. The City should put a proper monitoring process in place. One way could be to have a "Segregation of Duties" (SOD) report to be generated from the new system for review. The new ERP system should have this capability and the report to be used for management's review

Management's Comments Regarding Corrective Actions Planned

The current PeopleSoft Financial application has not been under vendor support for more than 5 years. As issues in the production environment developed it was necessary for programmers to make corrections in this environment for business continuity. The Segregation of Duties under the new ERP application is now fully supported by the vendor. Issues encountered will be addressed by the vendor, eliminating the need for programming support in the production environment. Segregation of Duties will be strictly adhered to. Access level reports can be run in accordance

with best practices. This is not only the rule for ERP but for all DoIT managed systems across the City.

- The City develop an IT strategic plan and have a Disaster Recovery plan in place.

Management's Comments Regarding Corrective Actions Planned

DoIT is still working under the existing IT Strategic Plan that is in effect for the next two years. While it is referenced as an initiative in the Strategic Plan, a schedule for its completion was not developed. The development of a Disaster Recovery Plan is now a component of the ERP Project.

14-04 Possible Expenditure Irregularities

During the audit, possible irregularities with certain invoices and payments associated with a specific City program were identified by Management. These possible irregularities are reflected in the City's financial statements. As a result, there is no material impact on the fair presentation of the City's financial statements. City Management has retained the services of consultants to review these possible irregularities.

Recommendation

Management should evaluate the results of the consultants' review and determine what changes, if any, to internal control policies and procedures are necessary.

Management's Comments Regarding Corrective Actions Planned

The City agrees with this recommendation and is in the process of preparing specific action steps to address the recommendations of the consultant's report. These identified irregularities are significant and the City has taken immediate action in a number of areas and has and will be making a number of process changes and structural changes to prevent a repeat of these types of irregularities. The consultant's report identified forty-three specific recommendations. A detailed action plan has been developed and will be presented to the Audit Committee and City Council, which will provide a response to each of the recommendations.

PRIOR YEAR SIGNIFICANT DEFICIENCIES

None

PRIOR YEAR OTHER MATTERS

13-01 Cash Disbursements

To test the City's controls over accounts payable and cash disbursements, we selected a sample of fifty one (51) cash disbursements that occurred during the year and reviewed the supports and approvals to ensure that they were booked in accordance with accounting requirements. One (1) of the fifty one (51) cash disbursements was not approved by the authorized signatory.

Recommendation

We recommend that the City's Accounts Payable Division take steps to ensure that all invoices processed have been approved by an individual authorized to approve the invoice submitted.

Management's Comments Regarding Corrective Actions Planned

It should be noted that this involved a \$133.00 transaction. The current system requires manual intervention to determine authorization for permitted transactions. This requires Accounts Payable (AP) staff to verify each signature against the signature authorization form to determine if the signature is valid and appropriate for each invoice. In this particular case, the individual that signed for the disbursement is an authorized signatory for some items but not for this type of disbursement. Considering that there are fourteen different approval codes that are listed on the signature authorization, and the fact that each City staff member can have multiple approval code combinations, this process can be cumbersome, especially during peak times. Management will review the current signature authorization form for improvement.

AP staff works diligently to verify that all invoices meet the requirements of the City's approval policies. AP will continue to closely monitor all invoices that are submitted to ensure proper approval authorization has been obtained prior to processing invoices for payment. Going forward, the City is finalizing plans to award a contract for a new Enterprise Resource Planning (ERP) system citywide. The City's ERP solution will provide for validation of authority for approval through the work-flow process for approvals as a built in automatic feature and represents the best solution to this issue.

An internal audit of AP process and procedures has been added to the items contemplated for inclusion in the City's annual internal audit plan.

Current Year Status

Item completed except for internal audit of Account Payable process which is part of the City Manager sponsored internal audit.

13-02 Cash Handling

To test the City's controls over cash handling and to ensure that cash handling procedures are being properly followed, we visited three (3) departments, namely Park and Recreation, Library Services, and Human Services. We noted:

- Cash at the Central Library and Jackie Robinson Center was short and did not match with their records during our surprise cash count.
- Cash registers were being shared by multiple people at the Central Library and Jackie Robinson Center.
- At the Central Library, the register did not have tape to record cash transactions.
- Transactions were not entered into the Active Net system at the time cash was received.

Recommendation

We recommend:

- The City's cash handling policies be made available to all persons handling cash and an acknowledgement should be obtained from employees noting that they have read and understand the policies.
- Cash to be handled in dual custody.
- Daily reconciliations to be completed by a person not handling cash, or by a supervisor.
- Proper training to be provided to those handling cash.

Management's Comments Regarding Corrective Actions Planned

The City agrees with this recommendation and has implemented the recommendation in almost all situations. As reported in the October 28, 2013, memo to the Audit/Finance Committee, Human Services and Recreation have implemented the changes recommended here. The Library has implemented some but not all of the recommendations due to the nature of its operations. The Finance Department will conduct an analysis by November 28, 2013, to determine what steps and mitigating controls can be applied to address the two recommendations made but not fully implemented by the Library. It should also be noted that the audit tests that resulted in these findings were conducted prior to numerous actions taken by the City in response to the City's Cash Handling internal audits, including cash handling trainings (both conducted and scheduled) for all cash handlers. The amount of the shortage found at the Library was \$6.80.

Current Year Status

Item completed. The recommendations made above have been implemented. Internal audits of petty cash and cash handling are being conducted along with quarterly cash handling training.