



INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE
WITH *GOVERNMENT AUDITING STANDARDS*

To the Honorable Mayor and Members of the City Council
City of Pasadena, California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, 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 City of Pasadena, California, (the City) as of and for the year ended June 30, 2015, and the related notes to the financial statements, which collectively comprise the City's basic financial statements, and have issued our report thereon dated February 24, 2016.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the City's internal control over financial reporting (internal control) to determine the 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, we identified certain deficiencies in internal control that we consider to be material weaknesses and 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 City's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the following deficiencies to be material weaknesses:

Capital Assets

As a result of our audit procedures, we noted multiple items resulting in audit adjustments to capital assets that were recorded incorrectly or not recorded at all, that we consider to be material weaknesses:



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Capital Assets (Continued)

Condition:

Generally accepted accounting standards require that completed construction in progress assets be placed in service and properly depreciated according to the City's depreciation policy. During our audit, we noted that the City recognized completed construction in progress assets, however, failed to place those completed assets in service and properly recognize a corresponding depreciation expense to those assets. As a result, the City erroneously understated capital assets by approximately three million dollars (\$3 million); resulting in a restatement to the City's Net Position at June 30, 2015.

Management's Response:

The City staff identified this issue and agrees with this recommendation and has made the necessary corrections to the financial records.

Condition:

The City erroneously double capitalized six million dollars (\$6 Million) of business-type infrastructure assets in both the City's business-type activities and governmental-type activities; thus, overstating Governmental-Type activities and requiring a statement of net position by \$6 Million.

Management's Response:

The City agrees with this recommendation and has made the necessary corrections to the financial records. Additionally, the accounting of projects that cover both business-type and governmental-type activities will be separated to avoid this error in the future.

Condition:

Upon dissolution of the Former Pasadena Community Development Commission (PCDC), all assets, including property held for resale and capital assets owned by the Former PCDC were to be transferred to the Successor Agency of the Former PCDC. It was noted that the Successor Agency of the Former PCDC owns various properties and buildings that are not properly recorded in the Fiduciary Fund Statement of Net Position. These assets should be recorded at historical cost and, if capital assets, depreciated with the appropriate useful lives. This resulted in a restatement of fiduciary assets and opening net position.

Management's Response:

The City agrees with this recommendation and has made the necessary corrections to the financial records. As this was a one-time correction related to the dissolution of Redevelopment, this error will not occur again.

Condition:

In 2010, the City purchased land and building (YMCA) for \$8.3 Million with the intention of preserving its historic value to the City; and with no intentions of selling the asset. However, the City erroneously recorded the asset as property held for resale, in which under generally accepted accounting principles, requires the asset to be recorded on both the fund level balance sheet and the City's government-wide statement of net position. Due to the fact that the City did not have any intention on selling the asset, the asset should have been properly classified as a depreciable asset. In addition, by recording the asset at the fund level as property held for resale, the City overstated its fund level assets, thus, improperly calculating its major funds determination under GASB Statement No. 34.



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Capital Assets (Continued)

Management's Response:

The City disagrees to the extent that the property was initially acquired with the intention of resale at a future time; however, the City agrees that once the determination was made not to sell the asset, the classification of the asset should have been changed. The reclassification has been made. The major fund determination outcome was not changed by this correction.

Condition:

In the prior fiscal year, the City intended to reclassify land to land held for resale (2 Condos on Mar Vista and 1 Condo on N. Allen), in the amount of \$530,000. As aforementioned, generally accepted accounting principles require that land held for resale to be recorded on both the fund level balance sheet and the Governmental Statement of Net Position. The City properly reclassified land to land held for resale on the Government Statement of Net Position; however, failed to record the assets at the fund level. Thus, the general fund balance was understated, and the City improperly calculated its major fund determination.

Management's Response:

The City agrees with this recommendation and has made the necessary corrections to the financial records. The major fund determination outcome was not changed by this correction.

Condition:

In 1989, the City purchased land (Concord Senior Housing) in the amount of \$1.4 million; since this time, the City has failed to record the land as an asset on the Statement of Net Position as required under GASB Statement No. 34.

Management's Response:

The City agrees with this recommendation and has made the necessary corrections to the financial records.

Condition:

Generally accepted accounting standards requires that costs relating to projects be capitalized in the year in which they are incurred. During our audit procedures performed on capital assets it was noted that the City had expenditures incurred in previous years that were not capitalized until the current year. We also noted instances in which costs were capitalized in previous years, but reclassified as repairs and maintenance in the current year as it was determined they should not have been capitalized initially. This results in assets not being correctly valued or depreciated and causes misstatements in net position due to items being expensed as opposed to capitalized and vice versa.

Management's Response:

The City agrees with this recommendation and has made the necessary corrections to the financial records. The Finance Department will be working with the other departments to ensure they understand the importance of initially classifying assets correctly.



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Capital Assets (Continued)

Condition:

It became apparent during our audit that a large majority of the City's capital assets and infrastructure are tracked manually using an excel spreadsheet. This process results in more opportunity for errors to occur, many revisions to the spreadsheet during the audit process, and is not an adequate method to track the large number of assets owned by the City. We recommend that a capital asset tracking and management system be implemented to maintain the City's significant capital assets, and assist in tracking acquisition dates, relating useful lives, and depreciation.

Management's Response:

The City agrees with this recommendation and implemented a new Enterprise Resource Planning system, Tyler Munis, on July 1, 2015. A fixed asset module is part of this system and all assets are being transitioned from the excel spreadsheets to the Tyler Munis system.

Cash

As a result of our audit procedures, we noted one item relating to cash that we consider to be a material weakness:

Condition:

The City has a bank account that holds cash relating to parking revenues received. The account contains a cash balance but the City had recorded a receivable for the amount as opposed to recording the actual cash on hand. It is recommended that all cash accounts are properly reconciled to the GL at each year-end.

Management's Response:

The City agrees with this recommendation and has made the necessary corrections to the financial records.

Revenue/Receivables

As a result of our audit procedures, we noted multiple items and audit adjustments relating to revenue and receivables that we consider to be material weaknesses:

Condition:

The City had an advance recorded with the Successor Agency of the Former PCDC in the amount of \$39 Million representing an agreement between the City and the Former PCDC that was denied as an enforceable obligation by the Department of Finance (DOF) during fiscal year 2013, and has continued to be denied through fiscal year 2015. The advance should have been removed from the both the City and Successor Agency of the Former PCDC once it was denied. This resulted in a restatement of both governmental and fiduciary net position.

Management's Response:

The City previously recorded this amount after receiving direction from the City's prior external audit firm and in consultation with Legal Counsel. Ultimately, this is a management decision based on expectations and evaluation of the probability of a favorable outcome to the City. While we continue to rank this with a positive probability of a favorable outcome, we acknowledge the auditor's advice that in the face of regulatory denial different accounting is recommended. This amount is still under appeal pending a court decision. The City has made the necessary accounting adjustments to reflect this change.



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Revenue/Receivables (Continued)

Condition:

The City receives revenues for plan check fees relating to development projects ongoing. It was brought to our attention by management that these fees are paid for upfront prior to the projects commencing. A portion of these fees is considered refundable if the project is stopped or never completed. Under GAAP accounting rules, the refundable portion should be considered unearned revenue until requirements have been met to consider the revenue earned. This resulting in a restatement of opening governmental fund balance.

Management's Response:

As stated, the City's management discovered this error and has made the correction.

Long-Term Debt

As a result of our audit procedures, we noted multiple items and audit adjustments relating to long-term debt that we consider to be material weaknesses:

Condition:

During 2015, the City issued debt that resulted in an underwriters' discount of \$325K. The City included this amount with bond issue discount to be amortized over the life of the debt. Under Governmental Accounting, Auditing, and Financial Reporting Standards, an underwriters' discount is considered a use of current financial resources and thus recorded as an expenditure in the year it is incurred. This resulted in an increase of governmental expenditures.

Management's Response:

The City agrees with this recommendation and has made the necessary corrections to the financial records.

Condition:

Under generally accepted accounting principles, governments frequently incur interest cost in connection with the acquisition, construction, and improvement of capital assets. As such, related interest expense should be capitalized as a part of the cost of that asset. The calculation of the amount of interest to be capitalized considers the amount of capital outlay incurred on qualifying assets. During our review, we noted that the City was using a simplistic calculation to determine the amount of interest to capitalize. The City capitalized interest based on a percentage of bond proceeds drawn down, net of interest revenue. This is an incomplete method in determining the proper amount of interest to capitalize in accordance with GASB Statement No. 62. Therefore, interest expense and Construction in progress, was improperly stated for prior years.

Management's Response:

The City agrees with this recommendation and has made the necessary corrections to the financial records.



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Long-Term Debt (Continued)

Condition:

Under generally accepted accounting principles, the original issue premium or discount relating to the issuance of debt, is required to be amortized over the life of the debt. It was discovered that the City had written off all premiums relating to business-type debt in 2013, thus improperly stating their business-type activities net position by roughly \$12 Million. This required an adjustment in the current year to restate their business-type net position by that same amount. We recommend that the City ensure all premiums and discounts relating to long-term debt are being properly amortized over the life of the related debt.

Management's Response:

The City agrees with this recommendation and has made the necessary corrections to the financial records.

Purchasing

As part of our audit procedures, we reviewed the City internal controls over the purchasing process and noted multiple weaknesses in the processes and controls surrounding the purchasing function.

Condition:

When items are purchased, there is no verification that goods have been received or services have been performed prior to submitting invoices for payments. Also, the vendor master file is not being updated timely with new vendors and information relating to those vendors such as addresses, bank information, etc. These weaknesses could result in payments being made for services never performed, or payments not being received by vendors because the incorrect information is on file.

Management's Response:

The City agrees with this recommendation and made corrections to this process before the end of the 2014-2015 Fiscal Year. The vendor master file was reviewed as part of the implementation of the new Enterprise Resource Planning system, Tyler Munis, and will be reviewed at least annually as part of the 1099 issuance process.

Condition:

There were multiple instances during testing in which the purchase order date was after the invoice date. The City changed ERP systems at the close of the fiscal year, and noted that there were numerous invoices received which required processing of payment that had no applicable purchase order in the system. In order to process payment, a purchase order had to be created after the services had already been performed and invoice had already been received.

Management's Response:

The City agrees with this recommendation and is working to correct this practice.



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Disbursements & Accounts Payable

As a result of our audit procedures, we noted multiple items relating to the recording of disbursements and accounts payable that we consider to be material weaknesses:

Condition:

There were a number of transactions that related to the fiscal year 2014, but were recorded as expenditures during fiscal year 2015 due to the City's year-end close and reconciliation process not being adequate.

Management's Response:

The City agrees with this recommendation and is working to correct this practice.

Condition:

During our test work, we noted approximately \$600,000 in disbursements relating to services performed in FY 2015, which were not properly accrued for as of June 30, 2015. We recommend the City implement a better review process for invoices received after the close of the fiscal year to ensure that all items are properly accrued for.

Management's Response:

The City agrees with this recommendation and is working to correct this practice.

Condition:

There were a number of transactions in which the supporting documentation to justify the transaction and its amount was inadequate. This included items that did not have invoices but just check requests or internal invoices prepared by the City but not third party invoices provided by the vendors. This also included support that appeared to be hand altered with numbers being crossed out and changed. We were unable to determine when the change was made or what it was made for. We recommend that the City ensure each transaction has adequate documentation to support it, including mainly third party documentation, and ensure that if a change is needed to an invoice, the City utilize a change form or process to better track who is making the change and why it is being made.

Management's Response:

The City agrees with this recommendation and began implementing changes prior to the close of the 2014-2015 Fiscal Year.

Purchasing Cards

As a result of our audit procedures we noted multiple items relating to the purchasing cards (p-cards) and related processes that we consider to be material weaknesses:

Condition:

The City purchasing manual states that purchases under \$3,000 can use a p-card without additional authorization, given that the purchase does not qualify as a prohibited p-card transaction. We noted that in early fiscal year 2015, proof of authorization for transactions over the authorized amounts were not being properly tracked by the City, and minimal to no review of these transactions were being performed. We recommend a thorough review is performed of transactions in excess of authorized amounts, and the proper approvals are obtained and recorded.



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Purchasing Cards (Continued)

Management's Response:

The City agrees with this recommendation. The entire purchasing card program was evaluated and re-implemented at the beginning of Fiscal Year 2016. As such, limits were reduced, the number of cards issued was reduced and user training with every card holder was conducted to ensure compliance with the policy.

Condition:

The City purchasing manual states that all p-card holders are required to have a signed p-card agreement on file, which typically occurs after the employee goes through the required p-card orientation in order to receive their card. We noted multiple instances in which no signed p-card agreement was on file for p-card holders actively using their cards. We recommend that the City ensure all p-card holders go through the proper orientation and sign the required agreement prior to continued use of their p-cards.

Management's Response:

The City agrees with this recommendation. The entire purchasing card program was evaluated and re-implemented at the beginning of Fiscal Year 2016. As such, limits were reduced, the number of cards issued was reduced and user training with every card holder was conducted to ensure compliance with the policy. During each user training the user was required to sign the p-card agreement before taking possession of their new card.

Condition:

During 2015, the City had items called "Ghost Cards" that were considered p-cards. These did not represent actual p-cards but rather agreements with excessive spending limits, often in excess of \$750,000, with frequently used vendors to expedite the process of getting invoices paid. These transactions had minimal controls or review surrounding them. While these transactions did have supporting invoices, there were no purchase order's or contracts stipulating what was being purchased, for what quantity, and for what amount. We recommend that the City cease use of these "Ghost Cards" and following the purchasing policies put in place to acquire goods and services and to process payments.

Management's Response:

The City agrees with this recommendation. All "Ghost Cards" have been eliminated and individual contracts and/or purchase orders have been issued with the respective vendors.

Condition:

During 2015, the City had multiple "Emergency Cards" issued that had no spending limits and were to be used in case of emergencies, most specifically relating to IT. A card with no spending limits opens the City up to additional risks in the event it is used improperly. We recommend that the City either put a limit on these cards, or cease the use of these and update the proper procedures to follow in the case of an IT emergency, and also specify in the purchasing manual what specifically is considered an IT emergency.

Management's Response:

The City agrees with this recommendation. As of Fiscal Year 2016 the City Manager, Assistant City Managers and the Finance Director hold the only emergency cards. Instead of allowing cards with no limits, the respective cards have regular spending limits in line with other card holders on a day-to-day basis, and the emergency spending limits may only be activated during an emergency by contacting the card issuer and answering security questions.

Inventory

Condition:

As a result of our audit procedures relating to inventory, it was noted that the City failed to capitalize the costs of purchased fuel, prior to the actual usage of the fuel.

Management's Response:

The City has corrected the item. As the City tanks are replenished frequently, the City chooses to expense the costs of purchased fuel during the fiscal year. In order to correctly record fuel inventory at year end, the City will measure the fuel inventory at the fiscal year end and make a year-end fuel inventory adjustment accordingly.

Financial Statement Close Process

Condition:

As a result of our audit procedures, it became apparent that the overall financial statement close process for the City is inadequate in order to close the records in a timely fashion. The following items are instances of those inadequacies:

- Bank reconciliations not being completed with six months of year-end
- Closing journal entries still being prepared six months after year-end
- Client proposed restatements due to improper reconciliations during the year and in the past
- The CAFR not being ready before December 31

Management's Response:

The City agrees with this recommendation. This is the first year that the City has not produced its CAFR and related financial reports prior to December 31. The delay has been due to the implementation of the new Enterprise Resource Planning system and staff vacancies. The City will complete its reconciliations, journal entries and financial reports in a timely manner for Fiscal Year 2016.

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. We consider the following deficiencies to be significant deficiencies:

Outstanding Checks

Condition:

As a result of our audit procedures, we noted that the City had checks on their outstanding checklist that were, in certain instances, in excess of 3 years old. We recommend that the City replenish their cash balance for these stale dated checks and submit them to the State of California in accordance with state escheatment laws for unclaimed property.

Management's Response:

The City agrees with this recommendation and will establish an annual escheatment process for outstanding checks.



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Petty Cash

Condition:

As a result of our audit procedures, it was noted that the City does not reconcile all petty cash accounts to the GL at year-end, and also that there is an excessive amount of petty cash on hand, in excess of \$100,000. We recommend that all petty cash balances properly to the GL and that the City reduce the amount of petty cash on hand to a reasonable amount.

Management's Response:

The City agrees with this recommendation and will reconcile all petty cash accounts at year-end. Additionally, the City will reduce or eliminate petty cash counts for departments to reduce the overall exposure.

Purchasing

Condition:

As a result of our audit procedures, it was noted that no independent review of the vendor Masterfile or edit listing is being performed, and no review of annual purchase volume is being performed. We recommend that the Finance Department periodically review the vendor listing, include any changes made to that listing, as well as review annual purchase amounts to vendors to ensure vendors are being paid proper amounts, and no unauthorized changes to the vendor listing are made that would result in fraudulent or inaccurate payments being made during the year.

Management's Response:

The City agrees with this recommendation. The Vendor Master File and related purchase volume will be reviewed at least annually as part of the 1099 process. Additionally, the maintenance of the Vendor Master File has been transferred out of Accounts Payable to Purchasing. This transfer ensures that those individuals with the ability to issue a payment do not have access to modify vendor records.

Timecards

Condition:

As a result of our audit procedures, it was noted that there were certain instances in which employees at comparable levels were able to approve each other's time cards for specific pay periods. We recommend that employees have specific approvers in positions above their level to ensure all time input is accurate and properly completed.

Management's Response:

The City agrees with this recommendation and the change has been implemented.

Acting Pay Employees

Condition:

As a result of our audit procedures, it was noted that for acting pay employees (grade-scale increases) Human Resources does not possess an efficient way to ensure that employees are returned to their original rate of pay. We recommend a procedure be developed to ensure that these employees are returned to their original rate of pay timely and efficiently.

Management's Response:

The City agrees with this recommendation and is taking steps to ensure that employees are returned to their original rate of pay timely and efficiently. We anticipate a tracking system will be available in Tyler Munis that will assist with this effort.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the City's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed the following instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*:

Other Matters

During the fiscal year under audit, we noted that the City's fraud hotline was directly handled by the City Controller. The City Controller had the direct and sole discretion to communicate issues, concerns or fraudulent activity directly to Council. In addition, the City Controller was charged with following up and also communicating issues to the City Attorney directly. The Fraud Hotline should be handled by an individual independent of the Finance Department and any other Departments outside of the City Manager or City Attorney offices.

During our audit, we noted that employees had not been trained on how to communicate fraud or on the City's policies concerning fraud, ethics and conflicts of interest. To have a complete internal control structure, employees should be periodically and consistently trained on these City policies.

The City failed to meet Debt Covenant Reporting requirements for the fiscal year ended June 30, 2015.



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City's Response to Findings

The City's response to the findings identified in our audit was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the City's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the City's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Lance, Solt & Lughard, LLP

Brea, California
February 24, 2016