

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

**FOR THE YEAR ENDED  
JUNE 30, 2011**

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

**For the Year Ended June 30, 2011**

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## MEMORANDUM ON INTERNAL CONTROL

December 20, 2011

To the City Council of  
the City of Napa, California

We have audited the financial statements of the City of Napa for the year ended June 30, 2011 and have issued our report thereon dated December 20, 2011. In planning and performing our audit of the financial statements of the City of Napa as of and for the year ended June 30, 2011 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.

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 significant deficiencies or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been identified. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls.

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 did not identify certain deficiencies in internal control that we consider to be material weaknesses.

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 identified certain deficiencies in internal control that we consider to be significant deficiencies that are included on the Schedule of Significant Deficiencies.

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 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, 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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**CITY OF NAPA  
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**SCHEDULE OF SIGNIFICANT DEFICIENCIES**

**2011-01: Internal Controls over Wire Transfers**

**Criteria:** Wire transfers should be initiated by one employee and authorized by another. Furthermore, employees who authorize wire transfers should not perform bank or investment account reconciliation.

**Condition:** During the interim phase of the audit, we noted that the City's bank only performed call-back confirmations on wire transactions over \$1,000,000. In addition, out of the six employees who could authorize wire transfers, one was a super-user to the City's financial system and three others performed bank or investment account reconciliations.

**Effect:** Allowing an employee to generate a wire transfer as well as to perform account reconciliations creates an opportunity for undetected fraud and error.

**Cause:** The City was in the process of setting up an online banking system that will not allow the same person to prepare and authorize/approve wire transactions.

**Recommendation:** During the interim phase of the audit, we recommended the City implement the online banking system as soon as possible.

**Management Response:** While there are 6 employees who can initiate wire transfers, the City's internal practice was to have a wire transfer initiated by one employee, and approved by a second employee who does not perform bank reconciliations. The bank performed call back verifications on wire transfers over \$1 million, but the wires were internally approved by a supervisor regardless of amount. The City has since implemented call back verifications for wire transfers of any amount, and is working toward completing the implementation of the online wire transfer system which requires one person to initiate a wire, and a second person to approve the wire before it is released by the bank.

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**CITY OF NAPA  
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**SCHEDULE OF OTHER MATTERS**

**2011-02: The Accounting and Audit Supervisor's access over Payroll**

**Criteria:** Employees who have access to electronic signatures should not also have access to blank check stock or payroll module.

**Condition:** The Accounting and Audit Supervisor who has full-access to the payroll module is responsible for reviewing payroll register. The Accounting and Audit Supervisor also has access to electronic signatures, blank check stock, and general ledger module.

**Effect:** Without proper review by another employee, one who has various accesses as mentioned above could create a fake employee or adjust one's pay without being detected.

**Cause:** The City feels that the Accounting and Audit Supervisor needs full access to the payroll module because she is the back-up person to run payroll, and because the City is still in process of implementing the remainder of the HR and Payroll modules, and the Accounting and Audit Supervisor is the project manager for that implementation. In addition, as a mitigating factor, the Accounting and Audit Supervisor needs the Finance Manager's approval to access the check stock.

**Recommendation:** The City should review the various duties assigned to the Accounting and Audit Supervisor. Her access to the module should be limited to inquiry only. If she needs full access to the payroll module, the function of payroll review should be done by another employee who cannot run payroll run, and do not have access to the blank check stock or electronic signatures.

**Management Response:** The electronic signatures access for payroll checks can be removed from the Accounting and Audit Supervisor. Currently the Accountants and the Finance Manager who have read only access to the Payroll module currently have access to the electronic signatures. The creation of all new employees, full time, part time, extra help and retired annuitants, is performed in the Human Resource department (HR). HR department creates the new record, assigns the job classification and step which is tied to the salary or pay rate range. The record is then sent to Finance Department where the benefits are assigned and any other special types of pay such as automobile allowance or telephone stipend. In addition the system has logging which is turn on for the Employee Master screen. Any and all changes are logged. The log includes what change was made, the user who made the change, and the date and time stamp for when the change was made. The check stock is locked in a cabinet and the payroll technician obtains the key from the Finance Manager.

**2011-03: Long-Term Debt Continuing Disclosure**

**Criteria:** Under the covenants of the City's Parkway Plaza Redevelopment Bond Series 2003 A and B, the 2004 Solid Waste Revenue Bonds, and the 2007 Water Revenue Bonds, the City must prepare an Annual Report no later than nine months after the end of the City's fiscal year. The Report should be filed by either the City or the bond trustee with the Municipal Securities Rule making Board (MSRB). These covenants have been made in order to comply with Securities Exchange Commission Rule 15c2-12(B)(5).

**Condition:** As of June 8, 2011, the City had not filed the Annual Reports, due March 31, 2011, for the Parkway Plaza Redevelopment Bond Series 2003 A and B, the and the 2007 Water revenue bonds.

**Effect:** The City was not in compliance with the Bond covenant.

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**SCHEDULE OF OTHER MATTERS**

**Cause:** The trustee is responsible for filing the Annual Report for the City's Parkway Plaza Redevelopment Bonds Series 2003 A and B, and the 2007 Water Revenue Bonds. The City is responsible for filing the Annual Disclosure for the 2004 Solid Waste Revenue Bonds. The Annual Report for the 2004 Solid Waste Revenue Bonds was filed on March 29, 2011. Due to significant changes in staffing, the City did not have a mechanism in place to ensure that the trustee filed the Annual Reports for the Parkway Plaza Redevelopment Bond Series 2003 A and B or the 2007 Water Revenue Bonds.

**Recommendation:** The City should ensure that the Annual Report is filed timely with MSRB. If the Trustee is responsible for the filing, the City should follow up to make sure that the filing is being completed by the deadline.

**Management Response:** The City has set up automatic reminders with both the trustee and internal staff to be sure the Annual Reports are filed timely in the future.

**2011-04: Capital Asset Physical Inventory**

**Criteria:** The City should conduct a physical inventory of their capital assets periodically to ensure that its capital assets records are complete and physical assets are safeguarded. In addition, the City should tag its capital assets for tracking purposes.

**Condition:** The City has not performed a physical inventory of its capital assets since May 2009. In addition, the City's capital assets are not tagged.

**Effect:** Movable capital assets are subject to the risk of misplacement or theft.

**Cause:** The City capitalizes assets over \$5,000. The City feels that most of these assets are fixtures such as roads and bridges that are deemed as unnecessary to inventory.

**Recommendation:** We recommend that the City annually performs a physical inventory on capital assets a rotational basis to verify the existence of capital assets recorded in the City's books. We also recommend that the City tags its movable capital assets to prevent theft.

**Management Response:** The City is considering the option of increasing the capitalization threshold to \$25,000. Fleet assets are tracked within the FleetFocus module and are on a maintenance schedule by which the vehicles are serviced every year. The inventory is thus completed over the duration of the year when the vehicles are brought in for service. The City is currently developing a Capital Asset Policy and Procedure manual, which will include an annual inventory of all assets.

**2011-05: Evidence of Review of Check Register's**

**Criteria:** To ensure proper review of the check register has taken place, there should be documentation indicating the employee who reviewed the check registers and the date that review occurred.

**Condition:** During the interim phase of the audit, we were informed that the Accounting and Audit Supervisor reviewed the City's check registers. However, there was no indication on the current year check registers that reviews have taken place.

**Effect:** The lack of physical evidence of review made it hard for the City to ensure that the procedure was in place.

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**SCHEDULE OF OTHER MATTERS**

**Cause:** It was the City's procedure to review the check register electronically. At the time of the interim audit, there was no report developed within set up in the system to indicate a review had been performed.

**Recommendation:** During the interim phase of the audit, we recommended that the City implement a log to indicate who reviewed the check register and when the review takes place.

**Management Response:** The City has developed a report within the financial system to show the review and electronic approval of each invoice prior to the printing of the checks.

**2011-06 -- Information System Review**

We conducted an Information Systems Review with our audit which encompassed the financial information system and the network environment that houses it. Currently, there are no Information Technology standards to which local governments are required to conform. Indeed there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments can use to implement appropriate controls to ensure adequate security over information technology. Our Information Technology staff has 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<sup>1</sup>. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. NIST recommends these for state and 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
- Information systems risk management

While the results of our work did not indicate material weaknesses, we noted the following which could be improved.

***Payment Card Industry Compliance***

The City is not in compliance with the Payment Card Industry Data Security Standard (PCI-DSS). Any organization that processes credit cards is required to comply with PCI-DSS, even if the processing is outsourced. Failure to meet compliance requirements results in higher transaction fees and liability if a security breach is found. Since the City accepts credit cards as a form of payment, the City must be compliant with the applicable controls.

***Management Response:***

A policy delineating the steps for the City to comply with the PCI standards is nearing final approval. Following adoption of this policy, the City will conduct training regarding data security for staff who handling credit card data and conduct the tests called for in the policy and the PCI-DSS.

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<sup>1</sup> "State, local, and tribal governments, as well as private sector organizations are encouraged to consider using these guidelines, as appropriate." NIST SP 800-37 Rev 1 pg 11

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## MEMORANDUM ON INTERNAL CONTROL

### CURRENT STATUS OF PRIOR YEAR MATERIAL WEAKNESSES

#### 2010 - 1: Fiscal Year End Close

**Criteria:** Management is responsible for the accuracy of the financial statements and the maintenance of the general ledger system and other records used to prepare the financial statements. Timeliness of the financial statements is key to a best practices approach in providing policy makers the year end financial results soon enough to be useful and to meet filing deadlines.

**Condition:** The year end audit was delayed and timing adversely affected as a result of the systems conversion and continuing staffing shortages. These conditions are not new and were discussed in our prior year Memorandum (See 2009-01, Timeliness of the Close of the Books.)

Staff has been working diligently to improve conditions and made major progress by converting to the new IFAS system and by weaning off some consultants that were used in prior years to support staff during the preparation of the system conversion.

While these change are expected to contribute to efficiency improvements and ease the year end closing pressures in future years, this first year under the new system proved problematic. Despite providing two rounds of closings prior to starting our work, staff was unable to complete their analysis and closing entries before audit commencement which was scheduled to meet the Redevelopment and Transportation Development Act filing deadlines.

During the audit, staff proposed twenty-one post closing entries, an increase over prior years. Staff had difficulty completing the closing for capital assets, capital projects fund grant revenues and transfers, allocations of investment income and various revenue accruals. These areas significantly affected the year end close and most of the City's funds.

**Effect:** Conditions delayed the completion of the close which increases the risk that errors may go undetected by staff and corrections may not be made in a timely manner. Audit effort was increased in response to these increased risks.

**Cause:** System conversion, and staffing shortages and changes.

**Recommendation:** The City's fiscal year end closing process and journal entries associated with the close should be completed and posted prior to the commencement of fieldwork. Staff should ensure that a complete close of the books is performed prior to scheduling auditors to perform fieldwork.

**Management Response 2009-2010:** The year end closing process for the 2009-10 fiscal year was extended as a result of the recent implementation of the IFAS financial reporting system and the associated change in account codes. Management concurs with the audit recommendation. Processes have been implemented to ensure that the year end closing process and journal entries will be completed prior to the commencement of the next fiscal audit.

**Current Year Status:** The year end audit for fiscal year 2010-11 was scheduled for a time when the auditors and the City had the availability. The IFAS financial system is substantially implemented, and the Finance Department is operating at full staff. There is one remaining accounting services consultant, for which the budget has been converted to budget for a full time Accountant in the fiscal year 2012-13 budget, at which time the Finance Department will be relying on internal staff to complete the daily operations, closing of the books and preparing for audit. The Finance Department was ready for the audit as scheduled. The opinion date of the auditors was a full 40 days earlier than the prior fiscal year, and the material weaknesses were eliminated. There were also fewer audit adjustments. For fiscal year 2011-12, final audit has been moved up by 3.5 weeks.

## MEMORANDUM ON INTERNAL CONTROL

### CURRENT STATUS OF PRIOR YEAR MATERIAL WEAKNESSES

#### 2010 - 2: Journal Entry Reviews and Approvals

**Criteria:** Journal entries are an important transaction cycle that affects all aspects of accounting and financial reporting. Prudent internal control concepts dictate that no single employee should process a transaction without the involvement of another employee. For journal entries, this typically takes the form of a second employee performing a review and approving the proposed entry prior to posting. The review and approval should be documented by a reviewers signing and dating that their review has been completed and the entry is approved.

**Condition:** We selected forty journal entries for testing and noted four did not have written evidence of approval. Although the four which did not have evidence of approval appeared appropriate, the lack of review represents a material weakness and a potential that other untested journal entries may not be appropriate. Because of this error rate, staff subsequently re-reviewed all journal entries posted during fiscal 2009-10. During our final phase, we re-sampled another forty journal entries and verified all had been properly reviewed and approved.

**Effect:** Without proper approval of journal entries the likelihood of error, improper accounting treatments, and potential fraud increase.

**Cause:** System conversion, and staffing shortages and changes.

**Recommendation:** We recommend that the City implement a park and place function that allows someone to create entries and then alerts and allows the proper authorized employees to review and approve the entry prior to posting.

**Management Response 2009-2010:** Management concurs with this audit recommendation. All journal entries are approved prior to posting.

**Current Year Status:** The City has implemented a park and place function in current year. However, we sampled forty journal entries in current year and noted that one was prepared and posted by the same employee.

**Management Response to Current Year Status:** The City has implemented additional controls to ensure that all journal entries prepared and/or entered by one employee are approved by a separate employee.

## MEMORANDUM ON INTERNAL CONTROL

### CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

#### 2010 - 3: Investigating and Implementing System Efficiencies

**Criteria:** The City expended significant amounts of staff time and money developing and implementing the new IFAS System, a modern, very powerful and flexible system. Staff has been very busy with the implementation of this system in fiscal 2009-10 and has not fully realized all system capabilities and efficiencies. Some efficiency will occur due to the learning curve. Other efficiencies require an active pursuit of system functionality and desire to look for new ways of completing work better and faster.

**Condition:** The new system has only been in use for a year.

**Effect:** Closing pressures and complexities can be mitigated with additional efficiencies.

**Cause:** System conversion, and staffing shortages and changes.

**Recommendation:** Staff should continue with the remaining system implementation issues and then pursue additional system capabilities with the goal of improved efficiencies. For example, staff continue to use manually prepared spreadsheets for the following areas which could be setup in system ledgers:

- Loans receivable

- Capital assets

- Governmental activity long term liabilities

- Report writer reports such as

  - REAC Reports

  - Financial statement formats that match the annual financial statements

There may be other functionality such as journal entry park and post, purchase order e-processing and e-commerce integration staff will find useful.

**Management Response 2009-2010:** Management concurs with this audit recommendation. Finance Department staff have been working diligently to identify additional opportunities to utilize the functionality of the new financial reporting system. These efforts will continue into the next fiscal year.

**Current Year Status:** The City is in process of implementing the Capital Assets and Contract Management modules of IFAS and has developed reports and account set up to assist with the preparation of the REAC report. The City is currently working toward setting up accounts and developing reports to allow for financial statements to be generated directly from IFAS.

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## REQUIRED COMMUNICATIONS

December 20, 2011

To the City Council of the  
City of Napa, California

We have audited the financial statements of the City of Napa as of and for the year ended June 30, 2011 and have issued our report thereon dated December 20, 2011. 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 2011. The following two pronouncements became effective, but did not have a material effect on the financial statements:

- **GASB Statement No. 54 – Fund Balance Reporting and Governmental Fund Type Definitions** -- This Statement established 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 City's financial statements, as well as Note 8 to the financial statements, were modified to include required disclosures.
- **GASB Statement 59 -- Financial Instruments Omnibus** -- The objective of this Statement is to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. This is a technical clean up pronouncement that had no material impact to the financial statements.

**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 2011.

As discussed in Note 18 to the financial statements, the State of California adopted ABx1 26 on June 28, 2011, which suspends all new redevelopment activities except for limited specified activities as of that date and dissolves redevelopment agencies effective October 1, 2011. The State simultaneously adopted ABx1 27 which allows redevelopment agencies to avoid dissolution by opting into an “alternative voluntary redevelopment program” requiring specified substantial annual contributions to local schools and special districts. These conditions raise substantial doubt about the ability of the Napa Community Redevelopment Agency, a component unit of the City, to continue as a going concern. However, on August 11, 2011, the California Supreme Court issued a partial stay of ABx1 26 and a full stay of ABx1 27, but the partial stay did not include the section of ABx1 26 that suspends all new redevelopment activities. As of December 20, 2011, the Supreme Court has not ruled on the case and the Agency is subject to suspension provisions.

**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 discussed below:

- *Estimated Fair Value of Investments* (Note 3 to the financial statements) - As of June 30, 2011, the City held approximately \$113 million of cash and investments as measured by fair value. Fair value is essentially market pricing in effect as of June 30, 2011. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2011.
- *Allowance for Doubtful Account – Notes Receivable* (Note 5 to the financial statements): The City has loaned approximately \$21 million to other parties to promote its low and moderate income housing programs. As of June 30, 2011, management had established an allowance for collectability of approximately \$2.5 million based on its estimate of the ultimate likelihood of collection.

**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. However, the completion of our work was delayed several times due to the system implementation issues discussed in our comment.

**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 not propose any audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the city's financial reporting process.

**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.

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

Maze & Associates

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