CITY OF NAPA
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS

FOR THE YEAR ENDED
JUNE 30, 2010

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CITY OF NAPA
MEMORANDUM ON INTERNAL CONTROL
AND REQUIRED COMMUNICATIONS

For the Year Ended June 30, 2010

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MEMORANDUM ON INTERNAL CONTROL

February 1, 2011

To the City Council of
the City of City of Napa, California

We have audited the financial statements of the City of Napa for the year ended June 30, 2010 and have issued our report thereon dated February 1, 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, 2010 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 identified certain deficiencies in internal control that we consider to be material weaknesses that are included on the Schedule of 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
MEMORANDUM ON INTERNAL CONTROL

SCHEDULE OF 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: *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.*

SCHEDULE OF 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: *Management concurs with this audit recommendation. All journal entries are approved prior to posting.*

SCHEDULE OF 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: *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.*

SCHEDULE OF OTHER MATTERS

2010 - 4: Statement No. 54 Fund Balance Reporting and Governmental Fund Type Definitions (Effective for fiscal 10/11)

This Statement establishes 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 initial distinction that is made in reporting fund balance information is identifying amounts that are considered **nonspendable**, such as fund balance associated with inventories. This Statement also provides for additional classification as **restricted, committed, assigned, and unassigned** based on the relative strength of the constraints that control how specific amounts can be spent.

The **restricted** fund balance category includes amounts that can be spent only for the specific purposes stipulated by constitution, external resource providers, or through enabling legislation.

The **committed** fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of the government's highest level of decision-making authority. Amounts in the **assigned** fund balance classification are intended to be used by the government for specific purposes but do not meet the criteria to be classified as restricted or committed. In governmental funds ***other than the general fund***, assigned fund balance represents the remaining amount that is not restricted or committed.

Unassigned fund balance is the residual classification for the government's general fund and includes all spendable amounts not contained in the other classifications. ***In other funds***, the unassigned classification should be ***used only to report a deficit balance*** resulting from overspending for specific purposes for which amounts had been restricted, committed, or assigned. Governments are required to disclose information about the processes through which constraints are imposed on amounts in the committed and assigned classifications.

Disclosure of the policies in the notes to the financial statements is required.

This Statement also provides guidance for classifying stabilization amounts on the face of the balance sheet and requires disclosure of certain information about stabilization arrangements in the notes to the financial statements.

The definitions of the general fund, special revenue fund type, capital projects fund type, debt service fund type, and permanent fund type are clarified by the provisions in this Statement. Interpretations of certain terms within the definition of the special revenue fund type have been provided and, for some governments, those interpretations may affect the activities they choose to report in those funds. The capital projects fund type definition also was clarified for better alignment with the needs of preparers and users. Definitions of other governmental fund types also have been modified for clarity and consistency.

Management Response: *The City staff will evaluate and implement as appropriate.*

MEMORANDUM ON INTERNAL CONTROL

CURRENT STATUS OF PRIOR YEAR SIGNIFICANT DEFICIENCIES

2009-01 **Timeliness of the Close of the Books**

We noted in the prior three years' Memorandums on Internal Control that a shortage of experienced accounting staff caused difficulty and delays in the timely completion of the close of the City's books. Conditions during the year end audit work conducted after June, 30 2009 were exacerbated by the financial system implementation, the absence of the Finance Director from the closing process who had been assigned to oversee that system implementation and the departure of the Finance Manager. The system implementation was given top priority during the first six months of the fiscal 2009-2010. Because of these issues, management hired an Interim Finance Director and assigned an existing Finance Department consultant to act as Interim Finance Manager to ensure adequate skills were in place to keep the Department functioning. In total, the City is using four consultants to shore up its finance staff on a temporary basis to maintain processes and procedures.

During our audit, we performed sufficient tests to satisfy ourselves that processes and procedures were in place to produce accurate financial data for inclusion in the financial statements and we satisfied ourselves that there were no material errors in the financial statements. We noted post closing adjustments decreased to 18 from the 23 which occurred in the prior year and once data was received from staff, it was in generally accurate and reliable. Our work was delayed a number of times due to competing demands on staff which was unable to provide us with certain data required for the audit until March 2010. These delays are compounded by the need of the Housing Authority to file its financial data online by March 31 which is also the Single Audit filing deadline.

The City has made substantial progress in the system implementation and the effects felt this year are not expected to be a major problem in future years. However, the Finance Department in its current state cannot adequately function without either the continuation of the consultants or permanent replacements. We understand that all of the consultants' contracts end in June 2010.

The City should address its staffing needs as soon as possible to ensure resources are available as needed for operations and to provide continuity during the next fiscal close which will be the first close on the new system. In addition, continued refinement of the system should be ongoing to ensure that the timeliness of critical closing procedures improves to ensure required reporting can be completed in a timely fashion.

Current status: See additional information in item **2010-01 Close of Books**.

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REQUIRED COMMUNICATIONS

February 1, 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, 2010 and have issued our report thereon dated February 1, 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 2010. The following two pronouncements became effective, but did not have a material effect on the financial statements:

- **GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets***

  A summary of GASB 51 follows:

  Governments have different types of intangible assets, such as easements, water rights, patents, trademarks, and computer software. Easements are referred to in the GASB 34 description of capital assets which has raised questions about whether and when intangible assets should be considered capital assets for financial reporting purposes.

  The absence of specific authoritative guidance has resulted in inconsistencies in the recognition, initial measurement, and amortization of intangible assets among governments. The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets to reduce inconsistencies and enhance comparability.

- **GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments***

  This Statement is intended to improve how state and local governments report information about derivative instruments in their financial statements. Specifically, GASB 53 requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting (proprietary and entity-wide financial statements). Governments enter into derivative instruments as investments; as hedges of identified financial risks associated with assets or liabilities, or expected transactions (that is, hedgeable items); or to lower the costs of borrowings. Governments often enter into derivative instruments with the intention of effectively fixing cash flows or synthetically fixing prices. Common types of derivative instruments used by governments include interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts. In addition, this standard addresses hedge accounting requirements.

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 2010.

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, 2010, the City held approximately $121 million of cash and investments as measured by fair value. Fair value is essentially market pricing in effect as of June 30, 2010. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2010.

- *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, 2010, management had established an allowance for collectability of approximately $7.1 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.

Moss Adams

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