COUNCIL AGENDA: 12/11/18
FILE: 18-1640
ITEM: 3.6

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Julia H. Cooper

SUBJECT: **SEE BELOW**

DATE: December 4, 2018

Approved D.DSyL Date 12/6/18

SUBJECT: EXTERNAL AUDITOR'S REPORT: REPORT TO THOSE CHARGED WITH GOVERNANCE FOR THE YEAR ENDED JUNE 30, 2018

RECOMMENDATION

Accept the Report to Those Charged with Governance for the year ended June 30, 2018 as issued by Macias Gini & O'Connell LLP, the City's external auditor.

OUTCOME

Provide overview of the recommendations from the external auditors on the City's internal control over financial reporting and compliance for the fiscal year 2017-18 to the City Council.

BACKGROUND

Historically, the Single Audit Report is presented to the City Council concurrently with the Comprehensive Annual Financial Report (CAFR) and the Report to Those Charged with Governance. The Single Audit is still being prepared and it is anticipated that the final report will be issued in January or February 2019. An informational memo will be prepared for the City Council at the completion of the Single Audit which will highlight any audit findings and will include a link to the final report.

ANALYSIS

Attached for the City Council's review is the Report to Those Charged with Governance for the year ended June 30, 2018.

Report to Those Charged with Governance

During the course of the audit, the Auditor conducted a limited examination of the City's internal controls and management practices. The Auditor looked for material weakness or reportable conditions that would require immediate disclosure to the City Council in accordance with generally accepted auditing standards. A deficiency 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.

- Material weakness is a deficiency 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
- Significant deficiency is less severe than a material weakness, yet important enough to merit attention by those charged with governance
- Control deficiency is the least severe deficiency in that potential misstatements are not material. Control deficiencies still warrant identification and remediation

As listed below, the Auditor's Report to Those Charged with Governance for fiscal year ended June 30, 2018 contains five significant deficiencies including three findings repeated from the prior fiscal year with the Auditor comment "In Progress". The finding 2018-002 in the Report (Completeness of the Schedule of Expenditures for Federal Awards) is not related to a program deficiency nor does it constitutes a violation of the federally-funded grant covenants. This finding is specifically to internal controls over financial reporting, and not a federal awards compliance finding.

Staff's responses to the Auditor's findings and other communications are included in the attached report. Finally, the Auditor's Report also reports a status of prior year findings for the Council's consideration.

Reference Number and Comments	Material Weakness	Significant Deficiencies	Control Deficiencies
2018-001 Risk Assessment of Internal Controls Over the Financial Reporting Process		X	
2018-002 Completeness of the Schedule of Expenditures for Federal Awards		X	
2018-003 Informational Technology: City-Wide Information Security Program*		X	
2018-004 Information Technology: Account Management, Password Configuration, Broad Privileged Access, Shared Accounts, and Audit Logging/Monitoring *		X	
2018-005 Information Technology: Change Management*		X	
* Repeat of Prior Year Findings			

EVALUATION & FOLLOW-UP

No additional follow-up actions with the City Council are expected at this time.

PUBLIC OUTREACH

This item will be posted to the City Council Agenda website for the December 11, 2018 meeting.

COORDINATION

The departments to which the comments in the Report to Management apply have reviewed the comments and their responses have been incorporated into the Report.

COMMISION RECOMMENDATION/INPUT

No commission recommendation or input is associated with this action.

CEQA

Not a Project, File No. PP17-009, Staff Reports, Assessments, Annual Reports, and Informational Memos that involve no approval of any City action.

/s/
JULIA H. COOPER
Director of Finance

For questions, please contact Lisa Taitano, Assistant Director of Finance, at (408) 535-7041.

Attachment

CITY OF SAN JOSE

Report to Those Charged With Governance

For the Year Ended June 30, 2018

Certified
Public
Accountants

CITY OF SAN JOSE

City Council
For the Year Ended June 30, 2018

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Honorable Mayor and City Council

City of San José, California

Ladies and Gentlemen:

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining information, which collectively comprise the City's basic financial statements ("financial statements"), of City of San José, California (City), as of and for the year ended June 30, 2018, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

In addition to the City's basic financial statements, we audit and separately report on the financial statements of the Successor Agency to the Redevelopment Agency of the City of San José ("SARA"), the Norman Y. Mineta San José International Airport, the San José –Santa Clara Clean Water Financing Authority, the Parks and Recreation Bond Projects Fund, the Library Parcel Tax Special Revenue Fund, the Library Parcel Tax Special Revenue Fund, the Pedestrian/Bicycle Facilities Grant, and the City of San José Deferred Compensation Plans as of and for the year ended June 30, 2018.

We did not audit the financial statements of the City of San José Federated City Employees' Retirement System and the City of San José Police and Fire Department Retirement Plan (collectively, "the Pension Trust Funds"). Those statements were separately reported on by other auditors and the required communications related to those audits were presented to the respective Boards of Retirement.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We did not identify any 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 consider item numbers 2018-001, 2018-002, 2018-003, 2018-004, and 2018-005 to be significant deficiencies. The City's written responses to the findings and recommendations identified are described in the Schedule of Comments and Responses section. The City's responses were not subjected to the auditing procedures applied in our audits of the financial statements. We did not audit the City's responses and, accordingly, we express no opinion on them. In addition, we would be pleased to discuss the recommendations in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing these recommendations.

Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, *Government Auditing Standards* and the Uniform Guidance, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our audit plan to the City dated July 18, 2018. Professional standards also require that we communicate to you the information related to our audits discussed on pages 3 through 6.

We would like to thank City management and staff for the courtesy and cooperation extended to us during the course of our engagement.

This communication is intended solely for the information and use of the Public Safety, Finance & Strategic Support Committee, City Council, City management, and others within the organization, and is not intended to be, and should not be, used by anyone other than these specified parties.

Macias Gini & O'Connell LLP

Walnut Creek, California
November 16, 2018

CITY OF SAN JOSE
City Council
For the Year Ended June 30, 2018

REQUIRED COMMUNICATIONS

I. Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 to the City's basic financial statements. As described in Note I.E. to the financial statements, the City changed accounting policies related to the following:

- **GASB Statement No. 75 - *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions (other postemployment benefits or OPEB)***
  This statement replaces the requirements of Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. As of July 1, 2017, the City restated the beginning net position to record the beginning net OPEB liability and OPEB related deferred outflows of resources, as follows:

	Governmental Activities	Business-Type Activities	Total
Net position - beginning, as previously reported	$ 3,437,781	$ 1,241,519	$ 4,679,300
Change in accounting principle	(467,608)	(65,233)	(532,841)
Net position - beginning, as restated	**$ 2,970,173**	**$ 1,176,286**	**$ 4,146,459**

- **GASB Statement No. 81 – *Irrevocable Split-Interest Agreements***
  This statement requires that a government that receives resources pursuant to an irrevocable split-interest agreement recognize assets, liabilities, and deferred inflows of resources at the inception of the agreement. This statement did not have any effect the City's financial statements.

- **GASB Statement No. 85 – *Omnibus 2017***
  This statement addresses a variety of topics including issues related to blending component units, goodwill, fair value measurement and application, and postemployment benefits (pensions and OPEB). This statement did not have any effect the City's financial statements.

- **GASB Statement No. 86 – *Certain Debt Extinguishment Issues***
  This statement provides guidance for transactions in which cash and other monetary assets acquired with only existing resources, resources other than the proceeds of refunding debt, are placed in an irrevocable trust for the sole purpose of extinguishing debt. This statement did not have any effect the City's financial statements.

We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's 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 significantly from those expected.

The most sensitive estimates affecting the financial statements were:

- Measurement of investments at fair value
- Estimated allowance for losses on accounts receivable
- Estimated allowance for losses on loans receivable
- Estimated valuation of property held for resale
- Accrual and disclosure of self-insurance claims liabilities
- Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property
- Accrual of compensated absences
- Valuation of net pension liability, pension expense, and pension-relation deferred outflows and inflows of resources
- Valuation of net OPEB liability, OPEB expense, and OPEB-related deferred outflows and inflows of resources
- Accrual and disclosure of pollution remediation obligations

Management's estimates were based on the following:

- The City's investments are accounted for in accordance with the provisions of GASB Statement No. 72, *Fair Value Measurement and Application*, and accordingly, its fair value measurements are categorized within the fair value hierarchy established by the standard. The following levels indicate the hierarchy of inputs used to measure fair value and the primary valuation methodologies used for financial instruments measured at fair value on a recurring basis:
    - Level 1 – Investments whose values are based on quoted prices (unadjusted) for identical assets in active markets that a government can access at the measurement date.
    - Level 2 – Investments whose values are based on inputs – other than quoted prices included prices included within level 1 – that are observable for an asset, either directly or indirectly.
    - Level 3 – Investments whose values are based on unobservable inputs for an asset and may require a degree of professional judgment.
- Estimated allowance for losses on accounts receivable was based on historical experience.
- Estimated allowance for loans receivable is comprised of an allowance for risk and an allowance for present value discount. The allowance for risk was based on the consideration of the changes in the portfolio character, evaluation of current economic conditions and management's estimate regarding the likelihood of collectability based on loan provisions and collateral. The allowance for present value discount gives recognition to the economic cost of providing loans at interest rates below market and represents management's estimate of the present value of projected net cash flows to the City from the loan portfolio.
- Estimated valuation of property held for resale was based on the most recently available consultant analysis of estimated values performed at the request of a creditor and sales prices previously received from recent solicitations that resulted in purchase and sale agreements.
- Estimated liabilities for workers' compensation claims were based on management's estimate obtained from information derived from the City's claims database system adjusted for a discounted projection of unreported claims at 3.1%. Estimated liabilities for general liability and other claims were determined by the City Attorney's judgment about the ultimate outcome of the claims.

- Useful lives for depreciable property were determined by management based on the nature of the capital asset. Depreciation was calculated based on the straight-line method.
- Accrual of compensated absences was based on accrued eligible hours of vacation, sick leave and other compensatory time at current pay rates for eligible employees.
- Pension plans' employer and employee contributions requirements, net pension liability, and related deferred outflows and inflows or resources were based on actuarial valuations.
- OPEB plans' employer and employee contributions requirements, net OPEB liability, and related deferred outflows and inflows of resources were based on actuarial valuations.
- Accrual and disclosures of pollution remediation obligations were determined by the City's Environmental Compliance Officers and its environmental consultants' judgments about the ultimate outcome of the obligations.

Except for the fair value of the Pension Trust Funds investments and the pension and OPEB plans information based on actuarial valuations, we evaluated the key factors and assumptions used to develop these accounting estimates in determining that they are reasonable in relation to each opinion unit's financial statements taken as a whole. The fair value of the Pension Trust Funds investments and the pension and OPEB plans information based on actuarial valuations was agreed to the separately audited financial statements of the Pension Trust Funds, which were reported on by other auditors.

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were as follows:

- The City's Employee Defined Benefit Retirement Plans described in Note IV.A.
- The City's Postemployment Benefit Plans Other than Pension Plans in Note IV.A.4.
- Commitments and contingencies related to the Successor Agency to the Redevelopment Agency of the City of San José described in Note IV.C.

The financial statement disclosures are neutral, consistent and clear.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audits.

Corrected and 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. Management has corrected all such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole.

Disagreements with Management

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated November 16, 2018.

Management Consultation with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

II. Other Matters

We applied certain limited procedures to the management's discussion and analysis; the schedules of revenues, expenditures, and changes in fund balance – budget and actual for the General Fund, Housing Activities Fund, and Low and Moderate Income Housing Asset Fund; the schedule of employer contributions – defined benefit pension plans; the schedule of changes in the employer's net pension liability – defined benefit pension plans; the schedule of investment returns – defined benefit pension plans; the schedule of the City's proportionate share of the net pension liability and related ratios – CalPERS; the schedule of employer contributions - CalPERS; the schedule of changes in the employer's net OPEB liability and related ratios for the measurement periods ended June 30 – postemployment healthcare plans; the schedule of employer contributions – postemployment healthcare plans; and the schedule of investment returns – postemployment healthcare plans, which are required supplementary information (RSI) that supplement the basic financial statements. Our procedures and the other auditors procedures for the Pension Trust Funds consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, the separately audited financial statements of the Pension Trust Funds, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

We were engaged to report on combining and individual fund financial statements and schedules listed as supplemental information, which accompany the financial statements but are not RSI. With respect to this supplementary information, except for the supplementary information for the Pension Trust Funds, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves. The supplementary information for the Pension Trust Funds was agreed to the separately audited financial statements of the Pension Trust Funds, which were reported on by other auditors.

We were not engaged to report on the introductory and the statistical sections, which accompany the financial statements but are not RSI. We did not audit or perform other procedures on this other information and we do not express an opinion or provide any assurance on it.

SCHEDULE OF COMMENTS AND RESPONSES

Finding 2018-001 – Significant Deficiency
Risk Assessment of Internal Controls Over the Financial Reporting Process

Internal control is an integral process that is effected by the City's governing body, management and personnel and is designed to address risks and to provide reasonable assurance that in pursuit of the organization's goals, the following general objectives are being achieved:

- Executing orderly, ethical, economical, efficient and effective operations;
- Fulfilling accountability obligations;
- Complying with applicable laws, regulations, contracts and grant agreements; and
- Safeguarding resources against loss, misuse and damage.

Internal control is a dynamic integral process that should be continuously adapting to the changes the City is facing. Between 2006 and 2015, the City reduced its budgeted positions by 25 percent. This reduction and displacement of staff through the Civil Service Rules resulted in a significant disruption in the City's ability to maintain appropriate financial internal controls. Between 2015 and 2017, the City started to address its staffing challenges by filling vacant positions and adding three new personnel in the Finance Department. While the City has been successful in recruiting professionals to fill vacant positions over the past two years, it has been challenged with retaining these professionals. As such, the City has been continuously training and integrating new personnel into the City's complex accounting and financial reporting process. This rebuilding of staff has increased the workload of the remaining seasoned professionals.

In addition, late numerous and significant adjusting entries made by the City after the "close" of its financial records and preparation of final financial statements to be audited resulted in increased staff effort in re-performing reconciliations substantiating accounts and balances. Included in these adjusting entries:

- Insufficient review of closing entries resulting in numerous adjusting entries to correct errors after the "close" of its financial records.
- Insufficient review of complex government-wide reconciling journal entries resulting in post-closing adjusting entries. This includes decreasing capital assets for properties sold.
- Insufficient review of the complex SARA debt refunding impact to the City's financial statements. This resulted in not properly recognizing the pay off in the City's receivable from SARA, which had been incorrectly adjusted in the financing authority's records.
- Insufficient review of SARA's Redevelopment Property Tax Trust Fund revenues, resulting in an after the "close" adjusting entry of $18 million to report additional revenue and pass-through payments.
- Insufficient review of SARA's Land Held for Resale disposal of properties sold. This resulted in reporting property disposals and an adjustment to gain on properties sold, in the amount of $2.9 million.

The City has started to make investments in improving its financial reporting process over the past years; however, progress has been hampered by turnover of its recent hires. We recommend that the City evaluate the reasons for the increase in turnover and develop a plan to retain its personnel. In addition, the City should continue to incorporate the skills and experience of its new personnel assigned to key roles in the preparation of the annual financial statements to improve the efficiency of its financial reporting process, including cross-training to minimize the impacts of further turnover.

Management response

Management agrees with MGO's comment and acknowledges that staffing turnover resulting from resignations, retirements, and extended leave in the Specialized Accounting and Financial Reporting Sections of the Finance Department, Accounting Division negatively impacted timely and accurate reconciliation of general ledger accounts and completion of audit documents. Newly hired accounting staff assigned to complete these tasks had little or no institutional knowledge in the City's accounting processes and was further hampered by the lack of detailed desk procedures in some of the program areas. The review of staff work was challenging given the training level of supervisory staff who were also new to their roles and were experiencing an overwhelming workload created by key vacancies. Most impactful were the resignations of the Division's Deputy Director in June 2018 and Principal Accountant overseeing Specialized Accounting in August 2018. These departures created a loss of effective senior leadership and significant institutional knowledge needed for a successful fiscal close.

As the Governance Report mentioned, the City substantially reduced its staffing levels from 2006 to 2015 in order to address its budget shortfall, which also impacted staffing levels in the Financial Reporting/Special Accounting sections. In 2008, the total staffing in these two sections was 20 positions and in 2018 the staffing level is 17, a reduction of 15%. These Accounting sections are responsible for recording citywide accounting and budget transactions, maintaining the general ledger database, coordinating the City's annual external audit process, and preparing and producing the Comprehensive Annual Financial Report (CAFR), in addition to approximately 20 stand-alone financial reports. Additional work includes producing the City's annual cost allocation plans. Further complicating the governmental financial reporting this year was the introduction of a new accounting pronouncement from the Governmental Accounting Standards Board (GASB), specifically GASB 75, and an increase in the volume and complexity of accounting and reporting for federally-funded programs associated with the 2017 flood damage in the City.

Staff believes that the staffing challenges coupled with increased workload has led to the high staff turnover with several departures to other City departments and to outside public agencies with better compensation packages when compared to the City. The table below shows average years of tenure of the Accounting Division's professional accounting classifications in the Financial Reporting/Special Accounting sections. The statistics indicate that an average tenure of professional accounting staff is less than two years, which negatively impacts staff's technical growth and the quality of work product as mentioned in the Governance Report.

	Years in Classification	Years with City
Accountant I/II	2.34	5.15
Senior Accountant	1.57	1.88
Supervising Accountant	1.00	2.32
Principal Accountant	0.94	0.94

Despite these challenges, the Finance Department is undertaking various steps to address the issues raised in the Governance Report.

1. The Department has recently filled the Deputy Director of Finance, Accounting, positon, which has been vacant since June 2018. In addition, the Accounting Division has completed the recruitment for two vacant Accountant positions in the Specialized Accounting section and the Department is prioritizing the recruitment of the Principal Accountant vacancy for the Specialized Accounting section.

2. The Department anticipates during FY 2018-19, the Division will be able to institute and implement changes to address internal control issues including the following:

    - Ensure proper training and cross training of professional accounting staff in core job assignments, including developing and maintaining detailed desk procedures;
    - Reconcile and review of accounting transactions, including review and approval by Supervising and Principal Accountants in a timely manner;
    - Plan and execute citywide fiscal year-end close activities and recording of accounting transactions in a timely manner;
    - Prepare and review audit documents and draft financial reports for the external auditor's review; and
    - Prepare a citywide audit completion schedule in consultation with the external auditors and conduct weekly or bi-weekly status meetings to ensure that tasks are completed by the targeted dates.

3. As the City has decentralized accounting operations, proper coordination among department accounting staff and the Accounting Division staff is critical for the successful execution of the audit process and completion of the CAFR and other reports. The Accounting Division will coordinate and prepare a detailed work plan that will list fiscal year-end milestones to be completed by department accounting staff and delivered to the Accounting Division within the time lines prescribed in the work plan. The Finance Department will ensure that department senior management is aware of fiscal year-end close responsibilities and the related deliverables.

4. As budget resources permit, the Finance Department will participate in the training opportunities in the governmental accounting and financial reporting areas to professional accounting staff offered by the Government Finance Officers Association (GFOA), California Society of Municipal Finance Officers (CSMFO) and Association of Government Accountants (AGA). Finance Accounting staff will be encouraged to attend local CSMFO chapter meetings to maintain professional relationship with their counterparts and to facilitate exchange of professional knowledge.

5. As the Governance Report mentioned and as shown in the table above, the Finance Department continues to face recruitment and retention challenges for professional accounting staff. To address this issue, the Finance Department is working with the Human Resources Department, Office of Employee Relations, and Budget Office to explore creating Finance-specific accounting classifications for its management classifications (Senior Accountant, Supervising Accountant, and Principal Accountant). The new classifications would be intended to recognize the specialized skill sets needed to perform citywide complex accounting and financial reporting functions performed by these classifications in the Finance Department. If implemented, the Department believes these changes may help with attraction and retention issues but addressing workload and responsibilities of positions within the Finance Department will be an ongoing challenge.

Targeted Completion Date: June 30, 2019.

Finding 2018-002 – Significant Deficiency
Completeness of the Schedule of Expenditures of Federal Award

Criteria
Title 2 - Grants and Agreements, Subtitle A - Office of Management and Budget Guidance for Grants and Agreements, Chapter II - Office of Management and Budget Guidance, Part 200 - Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards - Subpart F - Audit Requirements Sec. 200.510 Financial Statements requires that the City prepare a schedule showing total expenditures for the year for each federal program.

Condition
During our audit, we noted the City's draft schedule of expenditures of federal awards (SEFA) included the Highway Planning and Construction Cluster expenditures that were overstated by $9,439,739 due to management oversight. Management included expenditures other than the federal portion in its grant inventory listing. The Highway Planning and Construction Cluster is managed by the City's Departments of Transportation, Planning, Building and Code Enforcement, and Parks, Recreation and Neighborhood Services.

These errors resulted in additional major programs for the fiscal year 2018 as the type A and type B threshold decreased. The City subsequently corrected the expenditures reported in its fiscal year 2018 SEFA.

Cause
The Departments of Transportation, Planning, Building and Code Enforcement, and Parks, Recreation and Neighborhood Services did not carefully review and submit all federal expenditures in the SEFA submitted to the City's Finance Department.

Effect or Potential Effect
The City's SEFA serves as the basis in determining the number of major programs required to be audited in a given fiscal year, and inaccuracies have the potential of affecting the programs selected for testing as major programs.

Recommendation
The City should continue to improve its process for reviewing expenditures reported in the SEFA by requiring department management to review and submit a detail listing of expenditures prior to being submitted to the Finance Department. In addition, the Finance Department should reconcile the detailed listing of expenditures to the SEFA for each significant federal program prior to the City submitting such detailed listing to its external auditors.

Management response

The Department of Transportation management agreed with the overstatement of the Highway Planning and Construction Cluster expenditures reported on the initial grant inventory listing due to a human error. This deficiency is not related to a program deficiency nor does it constitute a violation of the federally-funded grant covenants. This finding is specifically related to internal control over financial reporting, and not related to federal awards compliance funding. To ensure the accuracy of reporting the expenditures of Federal Awards, the City will update the federal grant guidance document and implement the following steps to address this issue:

1. Departments will perform analytical review procedures (i.e. current year vs. prior year expenditure changes) of their grant inventory listings on a quarterly and annual basis for accuracy.

2. Departments will reconcile the federal expenditures reported on the grant inventory listing to amounts recorded in the City's Financial Management System (FMS). The Accounting Division staff will perform a detail review of reconciliation for each significant federal programs prior to their submission to the Auditors.

3. The Accounting Division will also provide training to its professional accounting staff in reviewing the grant inventory listing for reasonableness and perform analytical and due diligence procedures.

   Target Completion Date: June 30, 2019

Finding 2018-003 – Significant Deficiency (Repeat of Prior Year Finding 2017-003)
Informational Technology: City-Wide Information Security Program

Criteria
Internal controls over financial reporting are reliant on information technology ("IT") controls which are designed effectively. In that regard, an effectively designed IT environment is one where an organization:

a) develops, documents, and disseminates to appropriate personnel, policies that addresses purpose, scope, roles, responsibilities, management commitment, coordination among organizational entities, and compliance; and procedures to facilitate the implementation of the policy and associated controls; and,

b) periodically reviews and updates the current policy and procedures.

Condition
Systems impacted: The specific information systems impacted by the below findings were provided separately to management. In addition, the previous audit team met with individual system owners and points of contact to discuss the nuances of these findings which varied slightly based on information system use, architecture, and other factors.

An entity-wide information security management program is the foundation of a security control structure and a reflection of senior management's commitment to addressing security risks. Overall policies and plans are developed at the entity-wide level. System and application-specific procedures implement the entity-wide policy. Ongoing monitoring of control design, implementation, and operating effectiveness should also be applied so that the program includes continuous monitoring processes.

Critical within a well-established information security program are documented policies, procedures, and guidance, security roles and responsibilities identified and appropriately delineated across the organization, and performing ongoing evaluations to ensure that policies and controls intended to reduce risk are effective. Without these aspects, security controls may be inadequate; responsibilities may be unclear, misunderstood, or improperly implemented; and controls may be inconsistently applied. Prior year auditor noted weaknesses within Management's information security program; specifically:

- Management had not assigned security responsibilities associated with its decentralized control environment. For example, there was no assignment of a centralized Chief Information Security Officer ("CISO") and/or Information Security Officer(s). Further decentralized information systems did not have a Component Security Officer ("CSO") or individual that was assigned to ensure the system/location met overarching security requirements.

- Management had not finalized, published, and communicated formal policies and procedures related to information technology ("IT") control processes. Examples of draft policies and IT controls not formally documented include:

Policies in draft	Not addressed in policy
Acceptable use	Baseline security configuration setting and monitoring
Access to network and systems	Auditable event and monitoring
Anti-virus	Application change & emergency change management
Business continuity and disaster recovery	Incident response
Data classification and handling	Vulnerability scanning
Encryption	Security training
Information security	Backup and data retention
Network security	
Password	
Secure system development	

- Management did not have processes implemented to perform continuous monitoring. Specifically, Management did not:

  - Perform periodic risk and vulnerability assessments, penetration testing, continuous monitoring through scanning or agent-based software tools, or perform other cybersecurity activities in order to identify, track and resolve security threats.

  - Perform security configuration management processes to establish and monitor platforms and software against best practices.

Cause

Due to budget constraints and significant reductions in ITD, Management has not developed or resourced an IT governance structure and processes that appropriately support the risks and threats associated with an organization of the City's size and with the added complexities of decentralization. Furthermore, while Management was in the process of finalizing and implementing City-wide policies and procedures over IT systems, they had not developed ongoing monitoring procedures to protect the integrity of financial data, nor were appropriate processes in place in order to monitor potential security threats.

Effect or Potential Effect

A lack of formal security responsibilities, as well as, policies and procedures related to security controls increases the risk that implementation of control activities may not be consistent throughout the divisions / components within the City.

Failure to perform network security vulnerabilities and penetration assessments increases the risk that the information system's security weaknesses are not identified and investigated in a timely fashion.

Failure to implement and monitor recommended security configuration and best practice settings increases the likelihood of misconfigurations that may be exploited.

Inadequate information security frameworks may lead to lapses in security requirements and consistent implementation across decentralized locations.

This could lead to errors, data loss, inappropriate access, and other risks with the potential to impair the confidentiality, integrity, and availability of systems and data. These issues may result in unauthorized access, use, disclosure, disruption, modification, or destruction of information and information systems, which may lead to misstatements on the financial statements.

Management Response:

Through June 2018, the Information Technology Department (ITD) made progress in the following Information Security Program areas related to governance and controls:

- Cybersecurity Office Inception
  - In the City budget process, resourced a new cybersecurity program overseeing information and systems security for the entire organization.
  - In April 2018, the City hired the organization's first Chief Information Security Officer.
- Governance
  - Drafted the City Information Security Standards Handbook, containing the instruction on controls prescribed to securely manage City systems. The first version was released in November 2018, and subsequent updates will take place at least annually.
  - Drafted a new security policy to replace old and irrelevant policies, the new policy based on the National Institute of Standards and Technology (NIST) Cybersecurity Framework (CSF). As of June 30, 2018, the policy remained in coordination and review for authorization.
- Risk Management
  - Completed vulnerability scans of the City's main assets and airport assets.
  - Initiated new periodic checks of vulnerabilities utilizing a vulnerability scanning tool, focusing on systems in the City's secure network perimeter ("Demilitarized Zone" or "DMZ") and newly implemented systems.
  - Initiated assessment of the technology infrastructure against the newly created set of baseline controls as defined in the Information Security Standards Handbook.

Finding 2018-004 - Significant Deficiency (Repeat of Prior Year Finding 2017-004)
Information Technology: Account Management, Password Configuration, Broad
Privileged Access, Password Configuration, Shared Accounts, and Audit Logging/Monitoring

Criteria
Internal controls over financial reporting are reliant on information IT controls which are designed effectively. In that regard, an effectively designed IT environment is one where an organization maintains the following:

Account Management includes the following criteria:

a. Identifies and selects the types of information system accounts needed to support organizational missions/business functions;
b. Assigns account managers for information system accounts;
c. Establishes conditions for group and role membership;
d. Specifies authorized users of the information system, group and role membership, and access authorizations (i.e., privileges) and other attributes (as required) for each account;
e. Requires approvals by appropriate personnel for requests to create information system accounts;
f. Creates, enables, modifies, disables, and removes information system accounts in accordance with organization-defined procedures or conditions;
g. Monitors the use of information system accounts;
h. Notifies account managers when accounts are no longer required, when users are terminated or transferred, and when individual information system usage or need-to-know changes;

i. Authorizes access to the information system based on a valid access authorization, intended system usage, and other attributes as required by the organization;
j. Reviews accounts for compliance with account management requirements periodically; and,
k. Establishes a process for reissuing shared/group account credentials (if deployed) when individuals are removed from the group.
l. Restrictions on the use of shared accounts such as defining the specific criteria that must be met in order to use a shared account and termination of the shared account credentials when members leave the group.

Password Strength the organization employs the principle of strong passwords, requiring credentials of reasonable complexity and inactivity-based log-out.

Separation of Duties the organization documents separation of duties of individuals and defines information system access authorizations to support separation of duties. Separation of duties addresses the potential for abuse of authorized privileges and helps to reduce the risk of malevolent activity without collusion. Separation of duties includes, for example: (i) dividing mission functions and information system support functions among different individuals and/or roles; (ii) conducting information system support functions with different individuals (e.g., system management, programming, configuration management, quality assurance and testing, and network security); and (iii) ensuring security personnel administering access control functions do not also administer audit functions.

Least Privilege the organization employs the principle of least privilege, allowing only authorized accesses for users (or processes acting on behalf of users) which are necessary to accomplish assigned tasks in accordance with organizational missions and business functions.

Access Restrictions for Change the organization defines, documents, approves, and enforces physical and logical access restrictions associated with changes to the information system. Organizations should maintain records of access to ensure that configuration change control is implemented and to support after-the-fact actions should organizations discover any unauthorized changes.

Audit Events the organization:

a. Determines that the information system is capable of auditing organization-defined auditable events;
b. Coordinates the security audit function with other organizational entities requiring audit-related information to enhance mutual support and to help guide the selection of auditable events;
c. Provides a rationale for why the auditable events are deemed to be adequate to support after-the-fact investigations of security incidents; and,
d. Determines that the organization-defined audited events are to be audited within the information system along with the frequency of (or situation requiring) auditing for each identified event.
e. *Audit Review, Analysis, and Reporting* the organization reviews and analyzes information system audit records periodically for indications of inappropriate or unusual activity and reports findings to the appropriate personnel or role within the organization. Information security-related auditing performed by organizations can include, for example, auditing that results from monitoring of account usage, remote access, wireless connectivity, mobile device connection, configuration settings, system component inventory, use of maintenance tools and nonlocal maintenance, physical access, temperature and humidity, equipment delivery and removal, communications at the information system boundaries, use of mobile code, and use of VoIP.

Condition

Systems impacted: The specific information systems impacted by the below findings were provided separately to management. In addition, the Grant Thornton team met with individual system owners and points of contact to discuss the nuances of these findings which varied slightly based on information system use, architecture, and other factors.

System authorization, access, and account management controls must be used to limit system activities to ensure legitimate use, least privilege, and segregation of duties. Access controls provide assurance that critical systems assets are safeguarded and that logical access to sensitive applications, system utilities, and data is provided only when authorized and appropriate. Further, broad or special (privileged) access privileges, such as those associated with operating /database system software, administrative accounts, and /or superusers, may allow normal controls to be overridden or otherwise circumvented. Additionally, a lack of logging and monitoring broad or privileged access may result in unusual or suspicious activity going unidentified. Grant Thornton noted the following. Grant Thornton noted Management should address the following:

Account Management

- Management did not have a process to consistently document and retain approvals related to initial authorization and ongoing changes to user's access for seven systems tested.
- Management did not perform periodic access recertification for users (including privileged users) and system accounts for 11 systems tested.
- Management did not define the timeframe in which a separated employee or contractor's access from the Network must be disabled after separation and the timeframe in which a reassigned employee's access must be reviewed and updated after reassignment.

Password Configuration

Grant Thornton noted that there was no consistent password policy City-wide for the systems identified above. As a result we noted that password security configuration settings were not consistently aligned with best practices across the network, platforms, and devices. Specifically, we noted information systems did not meet some or all of the following:

- Minimum length requirements
- Enforce the use of alpha numeric characters
- Restrict the use of common words; and,
- Apply password expiration

In addition, we noted that information systems did not log users out after a period of inactivity or lock users out after a set number of failed password attempts.

Broad / Privileged User Accounts

- For one system tested we noted the IT team had access to the operating system and the database.
- Management did not consistently segregate system management functions such as user and system administration from functional responsibilities for seven systems tested. Further system users had IT administrative responsibilities.
- We noted that a system / tool was utilized to make direct changes to production data for a system tested. This tool enables users to bypass transactions made via the applications in the normal course of business, circumvent manual controls in place and update data directly in the database. Per discussion with Management, users require approvals before making changes to data via this tool; however; there were no systematic restrictions that required approvals prior to the updates being made.

Shared Accounts

- We noted instances where systems utilized shared accounts which negate accountability of use. Specifically a shared account was used to make direct data changes via the tool described above and to transfer information into systems.

Audit Logging and Monitoring

- Management did not log and/or monitor activities associated with privileged user accounts (e.g. system administrators, user administrators, network administrators, operators, and developers) for four systems tested. Further one system had limitations which did not allow it to log activities.
- We noted a lack of formally defined auditable events (such as privileged use, invalid password attempts, key configuration changes, or changes made directly to financial data), investigation and analysis processes.

Cause

- Management had not implemented a policy and procedures that appropriately documents account management requirements as part of their internal control framework.
- Management had not defined City-wide password security configurations. Additionally, some information systems did not have the technical capability to enforce password configuration best practices.
- Management had not defined requirements for privileged user accounts, shared accounts, logging/ monitoring, and segregation of duties in policy and procedures.

Effect or Potential Effect

<u>Account Management</u>

- Without formally completing or approving access requests, changes or timely terminations of access, there is an increased risk of inappropriate or unauthorized access to information systems and financial data.
- Without a periodic review of user and system accounts, there is a greater probability that an access change made in error would not be identified in a timely manner.
- Without defining the requirements around logical and physical access removal for separated or reassigned employees and contractors, there is an increased risk that access will not be removed or will not be removed in a timely manner. This access may allow inappropriate access to execute system functions. This could also lead to a license violation issue.

<u>Password Configuration</u>

Failure to implement recommended security settings and best practices for passwords increases the likelihood of account compromise by malicious users

<u>Broad / Privileged User Accounts</u>

- Failure to effectively restrict access to applications based on job function and employ adequate segregation of duties increases the risk for abuse of system privileges, fraud, and inappropriate activity without collusion.
- Direct data changes bypass system transactions and controls and therefore increase the risk of inappropriate updates to data. This may impact the organization's ability to rely on the completeness, accuracy, and validity of financial data. Further, the use of shared user accounts on a production system reduces the audit and accountability of users within the system and password security. In other words, there is no traceability of user's activity to perform these changes to production data.

<u>Shared Accounts</u>

Shared accounts negate accountability of use in that Management is not able to identify the user that made changes.

<u>Audit Logging and Monitoring</u>

Failure to maintain adequate logging and monitoring of higher risk application events and privileged access increases the risk that suspicious activities may not be identified and investigated.

This could lead to errors, data loss, inappropriate access, and other risks with the potential to impair the confidentiality, integrity, and availability of systems and data. These issues may result in unauthorized access, use, disclosure, disruption, modification, or destruction of information and information systems, which may lead to misstatements on the financial statements.

Management Response

The Information Security Standards Handbook, issued in November 2018, directs City functions on controls to securely manage and operate information systems in the City, including Account Management. Activities completed by June 30, 2018:

- Reviewed and refreshed separation of duties across IT applications, infrastructure, and cybersecurity functions. Procedures for the mentioned divisions will be reviewed to ensure checks and balances are maintained into the future. Reviewed and applied account management procedures and approvals allow the City to apply and enforce Least Privilege Principles, Need to Know, and Access Restrictions as stated in the Information Security Standards Handbook. This step is in preparation for an IT Security Assessment slated for FY 2019.
- Reviewed and reapplied group policy controls for password complexity and change frequency. Planned additional action for review and updates to staff access to software applications, network shares, and documents for completion by the end of December 2018.

The Information Security Standards Handbook has a section that specifies the basic events that each system must log. These events are in alignment with the National Institute Standards and Technology measures and are deemed new minimums.

The Cybersecurity Office initiated periodic reviews or firewall logs for anomalous perimeter security activity. Long-term, the City aims to implement a form of Security Operations Center to monitor and analyze all logs for critical risk alerting and fast response.

Finding 2018-005 – Significant Deficiency (Repeat of Prior Year Finding 2017-005)
Information Technology: Change Management

Criteria
Internal controls over financial reporting are reliant on IT controls which are designed effectively. In that regard, an effectively designed IT environment is one where an organization:

a. Determines the types of changes to the information system that are configuration-controlled;
b. Reviews proposed configuration-controlled changes to the information system and approves or disapproves such changes with explicit consideration for security impact analyses;
c. Documents configuration change decisions associated with the information system;
d. Implements approved configuration-controlled changes to the information system;
e. Retains records of configuration-controlled changes to the information system for an organization-defined time period;
f. Audits and reviews activities associated with configuration-controlled changes to the information system; and,
g. Coordinates and provides oversight for configuration change control activities through an organization defined configuration change control element (e.g., committee, board).

Condition
Systems impacted: The specific information systems impacted by the below findings were provided separately to management. In addition, the Grant Thornton team met with individual system owners and points of contact to discuss the nuances of these findings which varied slightly based on information system use, architecture, and other factors.

Change management processes provide assurance that software, data, and other changes associated with information systems are approved and tested so they do not introduce functional or security risks. A disciplined process for testing, approving, and migrating changes between environments, including into production, is essential to ensure that systems operate as intended and that no unauthorized changes are implemented.

Grant Thornton noted that Management did not have a process to consistently document and retain evidence related to change management activities including change request and approval, scheduling, initiation, testing, implementation approvals and post-implementation review for eight systems tested. In addition, we noted that City personnel do not have access to source code for one system tested, which is handled by the vendor, but were responsible for user acceptance testing and certain approvals, which were not consistently documented and retained.

Cause
As part of the internal controls framework, management has not incorporated a policy and procedure to periodically monitor and review the configuration items that are migrated to production. Additionally, IT personnel did not consistently document and retain evidence related to change management activities (e.g. change request and approval, scheduling, initiation, testing, implementation approvals and post-implementation review).

Effect or Potential Effect
Without formally completing or approving change management activities for system changes, patches and modifications, there is an increased risk that change management controls will not be completed. Without effective control over changes that are migrated to the production environment, there is an increased risk that an inappropriate code change could be introduced into the production environment, potentially impacting the financial statement and related processes (i.e. cash accountability, financial reporting, etc.). Inappropriate code change could have a negative impact on system functionality, availability, or ability to produce complete and accurate financial data. These issues may result in unauthorized access, use, disclosure, disruption, modification, or destruction of information and information systems, which may lead to misstatements on the financial statements.

Management Response:

The Information Technology Department (ITD) began a five-month process of improving change control processes in June 2018. In addition to review of configuration changes by the City's Change Advisory Board (CAB), a new organization-wide Change Control Board (CCB) was formed and maintains enterprise level visibility and communications channels for all major information and systems moves/adds/changes. Departments have new visibility into what is impacting their operations, communicate needs, and approve/reject changes. The CCB has been in operation since August 2018. Logs of all changes requests are available in a tracking system implemented in August 2018.

The basic financial statements of the City of San José as of and for the year ended June 30, 2017 were audited by other auditors. The following Prior Year's Findings were written by those auditors and we are required to document the status of Prior Year's Findings.

STATUS OF PRIOR YEAR'S FINDINGS

Finding 2017-001 Controls over estimating loan loss reserves

Criteria
Management is responsible for the preparation and fair presentation of the financial statements in accordance with US GAAP. This includes the design, implementation, and maintenance of internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Internal controls over financial statement estimates are particularly important given the important judgements inherent in making those estimates.

Condition
The City maintains a Housing Activities Fund and Low and Moderate Income Housing Asset Fund with total loans to borrowers of $135 million and $509 million, respectively, at June 30, 2017. Of those loan balances, management recorded an allowance for uncollectible loans for 47% and 55%, respectively, of the gross loan balances in these two governmental funds which are maintained on the modified accrual basis of accounting. In addition to these reserves on loan principal, management also reserved 100% or $128 million of accrued interest on these loans as uncollectable at the government-wide level which is presented on the a full accrual basis of accounting. Management's estimates for the governmental funds were made using a methodology combining an allowance for collectability risk and an allowance for present value discount at 1%. Management's methodology is documented and has been consistently applied for several years but the assumptions were not supported by evidence of incurred losses on loans such as historical results, industry data, and actual performance of individual loans or current credit quality of the borrower. Many of these traditional measures of loan losses were not tracked by the City and, therefore, were not factored into the loan loss calculation.

US GAAP outlines use of an incurred loss model when estimating loan losses. Inherent in that model is that a loss has occurred as of the financial statement date for a loan loss reserve to be accrued. In other words, expected future losses are not accrued, no matter how likely. GASB Statement 34, in particular, notes that liabilities and losses should be recognized when transactions take place. In context, this is the equivalent of the notion of "incurred" – that is, the occurrence of the transaction is the triggering event for recognition of the transaction itself. The occurrence of the transaction (the loan) would give rise to the recognition of the asset –and then the other elements of the transaction (such as losses incurred) would be recognized as they are incurred over the asset's life. GASB Statement 62 outlines the accounting for loss contingencies including impairment of receivables and underscores the notion of incurred losses for events which occur as of the financial statement date that indicate a receivable has been impaired and for which an estimate of impairment is measurable. This incurred loss notion is made explicit in GASB 62.102 (emphasis added):

> An estimated loss from a loss contingency (as defined in paragraph 96) should be accrued if both of the following conditions are met:
>
> a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it should be probable that one or more future events will occur confirming the fact of the loss.
>
> b. The amount of the loss can be reasonably estimated.

Management was asked to provide evidence supporting the reasonableness of assumptions applied in the estimate of uncollectible loans. For example, we inquired about the policy to record a 40% reserve on certain categories of loans. While management was able to share an 11-year old point system which has evolved to a blanket 40% reserve, neither that evolved point system nor the resulting 40% had any relationship to incurred loan losses on these loan portfolios. Therefore, management was not ultimately able to adequately support the assumptions applied even though they were able to demonstrate they had complied with their policy.

With respect to the 1% discount factor, a factor which represents 27% of the recorded reserves, management has characterized this as an opportunity cost discount in its loan loss policy (lost earnings by virtue of the monies being invested in loans instead of an investment portfolio). This same 1% was characterized differently in the footnotes to the financial statements as an adjustment for below-market interest rates. Management was unable to explain how their 1% discount aligned with US GAAP but did relay on several occasions that they "make the market" on their loans and their actual interest rates of 0-6% and loan terms were market; not below market. In management's response below, however, management indicates "When this type of loan is made to developers and low income residents, the fair value of the loan receivable becomes less than its face value. In other words, this type of affordable housing loan receivable cannot be sold at its face value in the market."

In this regard, we find the City's documentation and explanations about market vs. below-market interest rates and loan terms to conflict with one another and the concept of opportunity cost appears to have no support in US GAAP.

Most recently, management provided a memorandum dated November 1, 2017, which suggested the loan portfolio actually had no impaired loans but the reserve was intended to reflect the potential that as loans become due, they may be renegotiated to allow borrowers to further the housing program's objective of affordability. While we appreciate that renegotiations in future years may result in loan due date extensions or forgiveness of loans, we don't see how US GAAP would support the current accounting of future decisions and how those future decisions have any relationship to the 47% and 55% uncollectibility reserves which have evolved from the 11-year old point system.

Finally, management has shared with us discussions they've had with several other cities in California who have housing loans along with a State housing department. These other agencies have different loan loss reserve levels ranging from 0-100% of the loan balance. Management has interpreted this variety to be evidence of a widely recognized and prevalent industry standard in setting loan reserves. We view the dissimilar reserve results to indicate other agencies simply have different results after applying their policies. No evidence of a recognized and prevalent industry standard in establishing loan reserves was provided. Further, management has not articulated how the methodologies of each of these other agencies are used or their applicability to the City's particular loan portfolio. The City's assertion has, essentially, been that they can set the reserve by policy which is inconsistent with US GAAP.

We recommend management (1) clarify what they are trying to measure with the loan reserves, (2) align what they are trying to measure with US GAAP and (3) look to actual evidence of loan impairment for reserve analyses instead of old models which have no relationship to actual impairment in the portfolio.

We were able to independently develop an estimate within an acceptable range of the recorded balance to satisfy your audit objective.

Cause
The assumptions used in developing the loan loss reserve are based on an internal policy and have not been supported by evidence of incurred losses consistent with the requirements of US GAAP.

Effect or Potential Effect
Financial statements may be misstated if key assumptions in accounting estimates are not supported by quality evidence.

Management response (unaudited)

Summary of Management's Response
Management had multiple discussions with Grant Thornton explaining and clarifying the affordable housing loan program and what the City is trying to measure with respect to the loan reserves. Management had explained to Grant Thornton why the current methodology for loan loss reserve is acceptable under GASB rules. The City has used this methodology for twenty-eight years and while this methodology may be "old model" it has withstood internal and regular audits. In addition, City staff had inquired with other cities in California and verified that there is a wide range of reserve rates used by other local governments, and the practice of estimating reserves based on each entity's analysis of their unique affordable housing loan programs in their communities is widely recognized and prevalent within local governments. Accordingly, to conclude that the City's loan reserve measurement does not align with US GAAP, would conclude that many governments are not in compliance with US GAAP.

Management disagrees with Grant Thornton that an incurred loss model (described in second paragraph under "Condition") must be used when estimating loan loss reserves. The incurred loss model is not specified in GASB Statements 34 or 62. The incurred loss model is a topic in FASB ASC 450, Contingencies. GASB 34 states "revenues, expenses, gains, losses, assets, and liabilities resulting from exchange and exchange-like transactions should be recognized when the exchange takes place". Grant Thornton is interpreting this as equivalent to the incurred loss model described in FASB ASC topic 450. We disagree. GASB 62 states "an estimated loss from a loss contingency should be accrued if information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired at the date of the financial statements, and the amount of loss can be reasonably estimated". From an accounting perspective, an asset is impaired when its fair value is less than its book value. Unlike traditional mortgage loans, most of the City's affordable housing loans do not have fixed repayment schedules, requires payments due only in years when the projects report earning positive cash flow, and can be renegotiated to extend loan terms for continuing affordable housing purposes. When this type of loan is made to developers and low income residents, the fair value of the loan receivable becomes less than its face value. In other words, this type of affordable housing loan receivable cannot be sold at its face value in the market. Therefore, a loan loss reserve is established when an affordable housing loan is made.

As GASB does not have any statement addressing the method for estimating affordable housing loan loss reserves, GASB 76 allows a government to use practices that are widely recognized and prevalent in state and local government. The City's point system provides a fair and consistent way of estimating loan loss reserves. Reserves are based on loan type (e.g. construction, permanent), project type (e.g. multi-family, shelter, special needs), City's loan position (first, second, third, fourth), other lender/regulatory requirements, loan performance, strength of developer, and other unique issues to the project. Loan risks are reviewed annually for relevance. The City tracks actual loan loss event and accounts for it promptly: when an actual loss event occurs, the City writes off the loan receivable and related loan loss reserve. The City's disagreement with Grant Thornton on this issue does not warrant a material weakness comment from Grant Thornton on the City's internal control as the City views its methodology to be consistent with GASB 76. The City has worked diligently to provide the documentation and reasoning behind its methodology; demonstrated its relevance; and inquired with its peer agencies, and the Government Finance Officers Association (GFOA), and Government Accounting Standards Board (GASB) regarding the appropriateness of its estimates. Furthermore, for the second year in a row, Grant Thornton was able to independently develop an estimate within an acceptable range of the recorded balance to satisfy its audit objective. This indicates that the risk of a material misstatement is remote.

Management's Response
The City's loan loss reserve is conservatively estimated to address the essence of the housing loan program –affordability and the loan loss reserve allowance is management's estimate of potential credit losses in the affordable housing loan portfolio. The City's loan loss reserve ensures that the City recognizes in its financial statements that these loans were made to ensure affordability for our extremely low, very low, low, and moderate income residents. Loan repayments depend on the negotiated structure of the deal. The City's developer loans are not typically structured like traditional mortgages with fixed payment terms. Instead, many of the loans are structured to have payments due only in years when the projects report earning positive cash flow, or "residual receipts". Some are focused so heavily on extremely low income and/or special need populations that they expect no positive cash flow during the entire affordability restriction period. As such, the City's loan loss reserve recognizes the possibility that some of these loans likely will not be fully repaid and/or may be renegotiated to extend affordability for our lowest income residents.

The City believes that the methodology for loan loss reserve is acceptable under GASB rules. The City has used this methodology for twenty-eight years and this methodology has withstood internal and regular external audits. The City's methodology includes a risk evaluation model and assigns points to various loan criteria: loan type, project type, City's loan position, other lender/regulatory requirements. Under the current methodology, project loans and individual borrower loans that make scheduled payments during a fiscal year are evaluated for both discount and risk factors. Other project loans and individual borrower loans are grouped together by loan type, payment type or other common factors for the purpose of calculating a global discount and risk factor on the aggregate total of the group. Loans are secured by first, second, third or lower in lien-property deeds of trust except for first time homebuyer loans, which are all secured by second deeds of trust. Interest and principal are typically due in installments, except for first time homebuyer loans, which do not require payments until their maturity dates.

The City has also invested in multi-family rental housing projects serving extremely low to moderate income individuals through subordinate loans with terms of up to 55 years. Generally, these loans are to be repaid through fixed payments or net cash flow payments from project operations and the term and potential risk of each loan varies. Because of the net cash flow feature of these subordinate loans, there is greater risk of variability in the timing of payments and, potentially, a lower probability of eventual repayment on these subordinate loans than on other loan types.

The City maintains a valuation allowance against loans receivable comprised of an allowance for risk and an allowance for present value discount. The allowance for risk is maintained to provide for losses that can be reasonably anticipated. The allowance is based upon continuing consideration of changes in the character of the portfolio, evaluation of current economic conditions, and such other factors that, in the City's judgment, deserve recognition in estimating potential loan losses. The allowance for risk takes into consideration maturity dates, interest rates, and other relevant factors.

In accordance with City policy, loans are funded at below market rates of interest and include amortized net cash flow deferred repayment terms. This policy exists to enhance the well-being of the recipients or beneficiaries of the financial assistance, who, as described above, are very low, low, or moderate-income individuals or families, or developers of housing for such individuals or families.

Accordingly, for financial statement purposes, the City has established an allowance account against the loans receivable balance containing a present value discount. The present value discount gives recognition to the economic cost of providing loans at interest rates below market, and represents an estimate of the present value of projected net cash flows to the City from the loan portfolio. The present value discount attributable to the loans will be recognized as interest income only as such loans are repaid in full because of the deferred nature of the loan portfolio and the high level of uncertainty relating to the likelihood that cash flows will occur as projected. The difference between the individual outstanding loan balances and the calculated net present value of the loans results in the allowance for present value discount. Losses are recognized as an addition to the allowance and any subsequent recoveries are deducted from the allowance.

Grant Thornton reported the same comment last year as significant deficiency because the City was unable to provide evidence to support the assumptions for estimating the loan loss reserve. The City, including the Housing Department, has experienced high personnel turnover in the last five years resulting in misplaced documentation. In August 2017, the City located the evidence supporting the assumptions applied in the estimate under the City's current methodology. In addition to providing the evidence, the City performed and provided additional analyses to demonstrate the relevance of the current methodology to the Housing loan portfolio. The City also inquired with peer agencies and had reached out to GFOA and GASB, both organizations stated that if the City has compelling evidence that the methodology is prevalent in the government industry and the City has applied that methodology on a consistent basis, the City does follow the requirements of US GAAP.

Management disagrees with Grant Thornton in its comment that the City's current methodology for estimating loan loss reserve is not consistent with the requirements of US GAAP. The City as governmental agency, is required to follow GASB Standards for accounting and financial reporting practices. The incurred loss model recommended by Grant Thornton, which is described in FASB ASC topic 450, Contingencies, is not specified in GASB statements. Pursuant to GASB Statement 76, if the accounting treatment for a transaction is not specified in GASB Statements, GASB Technical Bulletins, GASB Implementation Guides, and literature of the AICPA cleared by the GASB, a government entity can apply sources of nonauthoritative accounting literatures, such as FASB statements or practices that are widely recognized and prevalent in state and local government or others. No other government agency that the City inquired with uses incurred loss model in estimating their housing loan loss reserves and Grant Thornton was unable to provide a city or government agency that they audited that uses the incurred loss model that they recommend. Thus the City is hesitant to depart from GASB guidelines and move to incurred loss model for estimating loan loss reserves.

Status
Corrected. Management formalized its loan loss reserve policies and procedures for loans made by the City's Housing Department. The Department's loan portfolio is comprised of several types of loans. The loan loss reserve represents the potential loss of value in the loan assets' value. The methodology for determining the loan loss reserve for the Department's loan portfolio has, therefore, been broken down into individual categories of loan types. Each category was analyzed and a formula was applied to determine the loan loss reserve by category. The policy is consistent with GAAP, as promulgated by GASB.

Finding 2017-002 Untimely identification of errors and lack of or inaccuracies in account reconciliations

Criteria
Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America ("US GAAP"). This includes the design, implementation, and maintenance of internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Condition
The City's preparation of its Comprehensive Annual Financial Report ("CAFR") is a responsibility centralized within the Finance Department who compiles and verifies financial data, accounting estimates and US GAAP application decisions maintained by that department along with those generated by the various departments within the City's decentralized structure.

The process of preparing an accurate CAFR is complicated by the variation in levels of supervisory review, reconciliation and processing flows within the finance and other departments along with the inconsistencies in accounting background among the departments.

We noticed several areas where this challenge was apparent:

- In the City's Municipal Water Fund and Integrated Waste Management Fund, a reconciliation between the CIS subsystem and general ledger balances were not completed as a normal procedure in the yearend close. In addition, a detailed supervisory review was not performed of the reconciliation prior to being provided for audit and we discovered additional errors which led to additional adjustments in accounts receivable and revenue. For the Municipal Water Fund, correcting adjustments with a net impact of $2,034,000 were posted and an additional $423,000 was identified but not corrected to decrease accounts receivable and revenues as a result of this reconciliation. An additional $338,000 of credits were identified within the receivable subledgers that were not reclassified to liabilities, therefore we proposed an adjustment to reclassify these amounts. For the Integrated Waste Management Fund, correcting adjustments with a net impact of $610,000 were posted to increase accounts receivable and revenues as a result of this reconciliation. An additional $1,680,000 of credits were identified within the receivable subledger that were not reclassified to liabilities, therefore we proposed an adjustment to reclassify these amounts.
- Within the Special Assessments Fund and Housing Activities Fund, we identified two instances where revenue was recorded in the incorrect period and this error was not identified in a timely manner by the City. The impact of these errors was to overstate revenue in fiscal 2017 that really belong in fiscal 2016 in the amounts of $1,171,000 and $1,539,000, respectively.
- In the City's Low and Moderate Housing Fund we identified a loan which had a forgiveness clause embedded in the agreement that was not fully reserved for when it should have been in accordance with the City's policy. As such, we proposed an adjustment to increase the reserve for this loan of $1,150,000.

We recommend that Management require at least annual reconciliations of all accounts between the subsystem and the general ledger ending balances. Furthermore we recommend increased training for preparers and reviewers of journal entries and reconciliations to assist in the timely identification of errors.

Cause
Account reconciliations are not always being performed or being performed accurately. Additionally, supervisory review had not identified the lack of reconciliations or errors in those reconciliations.

Effect or Potential Effect
Deficiencies in the design or operation of reconciliation controls can lead to errors in the financial statements.

Status
While the City has corrected the three examples cited above, the financial reporting process continues to have certain deficiencies, as discussed in finding 2018-001.

Finding 2017-003 Informational Technology: City-Wide Information Security Program

Status
In process of implementation. The City hired Chief Information Security Officer (CISO) during the fiscal year 2018. This finding was repeated in its entirety, and presented as current year finding 2018-003.

Finding 2017-004 Information Technology: Account Management, Password Configuration, Broad Privileged Access, Password Configuration, Shared Accounts, and Audit Logging/Monitoring

Status
In progress of implementation. This finding was repeated in its entirety, and presented as current year finding 2018-004.

Finding 2017-005 Information Technology: Change Management

Status
In progress of implementation. This finding was repeated in its entirety, and presented as current year finding 2018-005.