TOWN OF LOS GATOS
TOWN COUNCIL FINANCE COMMITTEE
208 EAST MAIN STREET - NEIGHBORHOOD CENTER, ROOM 214
MONDAY, FEBRUARY 28, 2005 – 4:00 P.M.

VERBAL COMMUNICATIONS *(Three minute time limit)*

1. Discuss and accept Comprehensive Annual Financial Report for 2003/04 Fiscal Year ending June 30, 2004 (including independent auditor's report)
2. Discuss and accept Auditor Management Letter
3. Discuss Accounts Payable and Payroll Bi-Weekly Reports to Council (Verbal Report)

cc: Post
Los Gatos Weekly Times
San Jose Mercury News/The Guide
Los Gatos Daily

MEMORANDUM

OFFICE OF THE TOWN MANAGER

To: Council Finance Committee
Mike Wasserman
Steve Glickman

From: Stephen Conway, Director of Finance & Administrative Services

Subject: Review of 2004 Financial Statements and Memorandum on Internal Control Structure

Date: February 18, 2005

Attached is the Town's Comprehensive Annual Financial Reports (CAFR) for the 2003/04 fiscal year, including the independent auditor's report. We believe the report continues to meet the criteria necessary to receive both the Government Finance Officer's Association and the California Society of Municipal Finance Officers awards for Excellence in Financial Reporting. The Comprehensive Annual Financial Report (CAFR) is considered by the Governmental Accounting Standards Board (GASB) to be the "official annual report" of the Town. It is the Town's second CAFR prepared under the new reporting format required by the Governmental Accounting Standards Board (GASB) Statement #34.

The February 28th meeting is also intended to allow the Finance Committee members the opportunity to review the CAFR and the Management Letter with the Town management and recommend the report's acceptance by the Town Council on March 7, 2005. After review of these reports, including the attached Town responses to the auditor's recommendations in the Management Letter, Town staff will review with the Finance Committee the steps taken currently to address the recommendations made by the auditors. Staff will also provide the opportunity for the Committee to address any questions they have regarding the audited financial statements as presented in the CAFR.

The Comprehensive Annual Financial Report contains three basic sections. The first is the Introductory Section, which provides general information on the Town's structure, personnel, economic situation, major initiatives, and finances. A second Financial Section provides information on both fund types and individual funds and account groups. The final Statistical Section provides a broad range of trend data covering key financial indicators from the past ten fiscal years, it also includes demographic and miscellaneous data useful in assessing a Town's financial situation.

As mentioned, included in the CAFR is the independent auditor's report reflecting the examination of the Town's financial statements by C.G. Uhlenberg & Company, the Town's auditors. They have given the Town a "clean" opinion, finding the general purpose financial statements to be in conformance with generally accepted accounting principles (GAAP), presenting fairly, in all material respects, the financial position of the Town as of June 30, 2004, and the results of its operations and the cash flows of its proprietary fund types for the year then ended. If you have any questions before we meet on February 28th, please contact me at 408-354-6828.

Approved by Debra J. Figone, Town Manager

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TOWN OF LOS GATOS

MANAGEMENT LETTER FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Submitted by:

C. G. UHLENBERG LLP
Certified Public Accountants
333 Twin Dolphin Rd., Ste. 230
Redwood Town, CA 94065

Phone: (650) 802-8668
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Contact: Jeffrey J. Ira

February 2, 2005

C. G. UHLENBERG LLP

CERTIFIED PUBLIC ACCOUNTANTS

ROBERT E. BARSANTI (RETIRED) • PEGGY H. CHEN, C.P.A. • JEFFREY J. IRA, C.P.A. • KATHERINE CHAO, C.P.A. • JULIE LIN, C.P.A.

February 2, 2005

The Honorable Mayor
Town of Los Gatos, California

We have audited the basic financial statements of the Town of Los Gatos California (the Town), as of and for the year ended June 30, 2004, and have issued our reports thereon dated November 11, 2004.

In planning and performing our audit of the basic financial statements of the Town, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance of internal control. As part of our audit, we made a study and evaluation of internal controls, including applicable internal administrative controls used in administering federal award programs, to the extent we considered necessary to evaluate such controls as required by auditing standards generally accepted in the United States of America; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Circular A-133, *Audits of States, Local Governments* and *Non-Profit Organizations*.

A description of the responsibility of the management for establishing and maintaining the internal control structure, and of the objective of inherent limitations in such a structure, is set forth in the attached Appendix 1, and should be read in conjunction with this report.

We did ***not*** note any matters involving the internal control and its operation that we consider to be reportable conditions. *Reportable conditions* involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting and compliance that, in our judgment, could adversely affect the Town's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material, in relation to the basic financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We did ***not*** note any matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above. The following comments present our findings with suggested solutions for your consideration and possible implementation. These comments and recommendations, all of which have been discussed with the appropriate

members of management, are intended to improve internal control or result in other operation efficiencies.

Our comments contained herein are based solely on observations made during our audit of the Town's 2003-2004 basic financial statements and, accordingly, are not based on the results of any special studies designed to report on these matters. Accordingly, additional information and study may be required before acting on our suggestions.

This letter is intended solely for the information and use of management, the Mayor, and Town Council and should not be used for any other purpose. However, this restriction is not intended to limit the distribution of this letter, which is a matter of public record.

We would be pleased to discuss these matters in greater detail at your convenience.

Very truly yours,

C. G. UHLENBERG LLP

C. G. Uhlenberg LLP

CURRENT YEAR FINDINGS AND RECOMMENDATIONS

CREDIT CARD CONTROL AND POLICY

Finding 04-1 - From a sample of twenty employees with assigned credit cards we noted the following areas of control over credit card handling that the Town may want to consider for further review:

1. Supervisor signatures on credit card requests forms. We noted inconsistencies in the approval of the request forms when transferring between departments and when issuing new cards.

2. The list of cardholders by position in the credit card handbook. We noted two cardholder positions were not included in the list kept in the handbook.

3. The list of employees with credit cards. We noted four terminated employees that were still on list of current cardholders.

Recommendations - We recommend the following for each of the above points:

1. We recommend that the Town adhere more diligently to the policy of having the director of finance **and** the department managers approve the credit card request forms before they are sent to the town manager for approval. This should include the approval of new credit card requests and transfers between departments.

   Town Response - The Town agrees with this recommendation. Town staff will be reminded that all required signatures or substitute authorized signatures must be obtained before new credit cards are issued or inter-departmentally transferred to Town staff.

2. We recommend that the Town review the list of cardholders by position annually to ensure the list is current.

   Town Response - The Town agrees with this recommendation. The Finance Department will initiate a procedure this fiscal year to include a Town-wide review of the list of current cardholders to ensure the list is current and valid.

3. We recommend the Town adhere more diligently to their policy requiring cardholders to return the cards when their employment ends and that the list of cardholders be reviewed more routinely for terminated employees still on the list.

   Town Response - The Town agrees with this recommendation. The Town Manager's office will coordinate with its Human Resources function to ensure termination procedures include the return of all Town property, including credit cards. It should be emphasized that current procedures do provide for canceling the card upon termination, whether or not the card is actually returned to the Town for destruction or not.

PRIOR YEAR FINDINGS AND RECOMMENDATIONS

TOWN OF LOS GATOS

PRIOR YEAR FINDINGS AND RECOMMENDATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

CASH AND INVESTMENTS

Treasurer's Report - The California Government Code §53646 requires that the Town Treasurer submit a quarterly investment report to the Town Council within 30 days following the end of the quarter covered by the report. The Town Treasurer has elected to submit these reports on a monthly basis, which is allowed by the California Government Code. We have noted, however, that the December 31, 2002, March 31, 2003, and June 30, 2003 reports were not submitted within the required timeframe.

Town Response - The Town Treasurer agrees to the finding. The Treasurer believes she can meet the submitted requirement date of 30 days after month end by considering the date the report is submitted to the Town's Agenda review process as the "date submitted". Workload and timely receipt of bank statements, have occasionally led to delays in the Treasurer meeting this deadline, but she informs staff that she has taken steps to meet the deadline submission dates.

Status - Implemented

Timely Reconciliations of Bank Accounts - We noted that the December 2001 and March 2002 bank statements were not reconciled in a timely manner. As we recommended to the Town Treasurer last year, bank reconciliations must be completed within 30 days of receipt of the bank statements. After 30 days, the financial institutions have the discretion of holding the Town responsible for any bank errors.

Town Response - The Town agrees with this recommendation. The Treasurer and staff will work to develop a calendaring memorandum or other automated system where positive confirmation that the Treasurer reconciliation has taken place will be confirmed by a designated Finance staff person.

Status - Implemented

Check Stock Safety Features and Positive Pay - Currently, the only safety feature on the Town's check stock is a watermark. First, and foremost, we once again recommend that the Town consider utilizing the Positive Pay system offered by most commercial banks, whereby the bank can only cash checks that are listed on the Town's check register. Until the Town is ready to do this, we recommend that the next time checks are ordered, other safety features are added, such as a "void clause," laser ink printing, etc.

Town Response - The Town agrees that fraud prevention is very important. The Town has contacted a vendor who we will put in touch with our financial system vendor (Pentamation) to see if positive pay has a potential for being implemented in the Town's system.

Status - Because of certain limitations of the Town's current financial system and compatible technologies, positive pay has yet to be implemented. Implementation may wait to be scheduled as part of a finance system upgrade.

Petty Cash Funds – Surprise Counts - We understand a surprise petty cash fund count has not been performed since December of 2001. We recommend these be done at least quarterly.

Town Response - The Town agrees that surprise counts of petty cash were delayed due to workload issues. This is an important internal control procedure. We are pleased to announce that a surprise count was performed in September 2003 and is now scheduled for quarterly preparation by the Town Accountant. We do believe because of the relatively small size of our total petty cash (8 petty cash accounts totaling $2,400 for all accounts), a quarterly surprise count may be too frequent to support a cost vs. benefit analysis. We believe perhaps three surprise counts a year should be considered as an alternative.

Status - Implemented. The Town has performed two comprehensive surprise petty cash counts in FY 2004/05 and additional counts are expected to be performed before year end.

FORMAL PURCHASING POLICY

The purchasing policy that the Town currently follows was issued in 1997. We recommend it be reviewed and updated to provide strict guidelines on current day issues such as petty cash, travel reimbursements, credit card purchases and the amount for which a formal purchase order is required. It should also designate those individuals that are authorized to have a Town credit card and who can approve purchases. Once these policies are established, the rules and guidelines must be enforced.

Town Response - The Town agrees. An update to the Town's purchasing policies is listed as item #3 in the Finance divisions Work Plan approved for FY 2004/05.

Status - In progress.

CAPITAL ASSETS

Although the Town maintains a detailed listing of capital assets, a physical inventory of these fixed assets has not been completed in several years. We recommend that the Town complete a physical inventory and update its listing of capital assets and related accumulated depreciation.

Town Response - The comment is correct as of the period ending June 30, 2003. However, the Town is pleased to report that a Town-wide inventory of capital assets was completed by staff in September 2003.

Status - Implemented.

TOWN OF LOS GATOS

MANAGEMENT'S RESPONSIBILITY FOR, AND THE OBJECTIVES AND LIMITATIONS OF, THE INTERNAL CONTROL STRUCTURE FOR THE FISCAL YEAR ENDED JUNE 30, 2004

The following comments concerning management's responsibility for the internal control structure and the objectives of, and the inherent limitations in, the internal control structure are adapted from the Statements on Auditing Standards of the American Institute of Certified Public Accountants.

Management's Responsibility

Management is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefit and related costs of the internal control structure policies and procedures.

Objectives

The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of basic financial statements in accordance with accounting principles generally accepted in the United States of America.

Limitation

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projection of an evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.