



**TOWN OF LOS GATOS
TOWN COUNCIL FINANCE COMMITTEE
208 EAST MAIN STREET - NEIGHBORHOOD CENTER, ROOM 208
WEDNESDAY, MARCH 10, 2004
4:30 P.M.**

VERBAL COMMUNICATIONS *(Three minute time limit)*

1. Discuss and accept Comprehensive Annual Financial Report for 2002/2003 Fiscal Year ending June 30, 2003 (including independent auditor's report)
2. Discuss and accept Memorandum on Internal Control Structure
3. Discuss and provide feedback regarding recommendation to modify procedure for submittal of Town accounts payable and payroll check registers for Town Council approval

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

March 5, 2004



**Town of Los Gatos
Finance Committee
Highlights
Comprehensive Annual Financial Report (CAFR)
For the Year Ended June 30, 2003**

I. Finance Committee Meeting Background

The Town contracts with an independent certified public accountant to examine the books, records, inventories and reports of all officers and employees who receive, handle or disburse public funds each fiscal year. The FY 2002-03 audit was performed by Maze and Associates, an experienced firm specializing in audit services for California public agencies. Mr. Cory Biggs, a partner of the firm, is a certified public accountant as well as other members of his firm. Mr. Biggs will be attending today's meeting along with the audit manager for the Town of Los Gatos, Ms. Vicki Rodriguez. They will be providing comments to the Finance Committee on the Town's annual report and also on their Internal Control Memorandum's finding and the Town's response and will also be answering any audit related questions the Committee might wish to explore.

II. Review of Financial Report Dated June 30, 2003

Finance Staff will present to the Town's Finance Committee the Town's audited Comprehensive Annual Financial Report (CAFR) Dated June 30, 2003. Town staff will be discussing the audited financial results with the Committee focusing on the following:

- **Financial Section** - Auditors have given the Town's financial statements a "clean" audit opinion for the year ended June 30, 2003, (see third paragraph of the auditor's opinion on Page 1 of the Financial Section of the report) giving reasonable assurance that the financial statements are "free of material misstatement".
- **Governmental Accounting Standards Board (GASB) Statement # 34:** This is the first year the CAFR has been prepared using the new financial reporting requirements as prescribed by GASB 34. The first two basic financial statements on pages 14 & 15 (Statements of Net Assets and Statement of Activities) now present information on a Town-wide, full accrual accounting basis which reflect the overall financial position of the Town and its various funds, not just the amounts available for budgetary purposes. Fund information is also presented for major funds individually and non-major funds combined in a single column in the basic financial statement. Budgetary comparisons are presented as part of the basic financial statements for the major funds that have legally adopted budgets.
- **Management's Discussion and Analysis (MD&A).** Staff suggests attention be focused

on the MD&A and the notes to the basic financials statements. The MD&A found on pages 3 through 11. The MD&A is required as supplementary information to the basic financial statements. It provides a narrative introduction, overview and analysis of those statements. The notes to the basic financial statements found on pages 31 through 53 in the Financial section provide required detail disclosures and a description of the financial statements.

- **Statement of Net Assets.** The Statement of Net Assets (page 14) may serve as a useful indicator of a government's financial position. The Town had positive net assets of \$78.8 million at fiscal year end. The largest portion of the net assets, \$33.8 million, represents the Town's investment in its capital assets and infrastructure. Restricted assets of \$24.0 million are resources that are subject to external restrictions on how they may be used. The remaining \$20.9 million in net assets are unrestricted and may be used for to meet ongoing Town obligations. Again, this is an overall financial position indicator and is not the amount of current resources available for budgetary purposes.
- **Total Governmental Fund Balances.** Total governmental fund balances increased \$7.3 million from the prior year. The significant component of the increase resulted from the unspent proceeds (\$5.8 million) still available at June 30, 2003 from the \$10.7 million dollar Town COP issued in July 2002. While fund balances increased for the year, revenues overall were in decline. Revenues for governmental funds excluding Capital Projects declined by \$2.8 million from the peak of \$33.5 million received in FY 2000/01 due to declines in locally generated revenues like Sales Tax, Transient Occupancy Taxes, Business Licenses, and Interest Income and additional state revenue takes. On the positive side, revenues did grow very slightly (approximately \$100K) from FY 2001/02. Overall, General Fund balance closed at \$12.6 million dollars in designated reserves, including the Reserve for Economic Uncertainty which remains available at \$3,678,000.
- **Internal Service Fund Balances.** Internal Service Fund balances of \$9.9 million are adequately funded and sufficient to provide maintenance and replacement activities for the budget cycle. These funds are providing some limited opportunities for budget savings rebated to the Town's General Fund in FY 2003/04. Staff anticipates these rebates to continue over the next five fiscal years, gradually phasing them out once excess balances have been returned to the Town's General Fund.
- **General Fund-Statement of Revenues and Expenditures-Page 22.-**General Fund results reflect positive variances with revenues exceeding the adjusted budget and expenditures under the adjusted budget.

- **Notes-Cash & Investments (pages 36-39)** Town investments are presented at fair market value at June 30, 2003. Approximately \$15.4 million is invested in the State of California's Local Agency Investment Fund (LAIF), the remaining balances in US Treasuries or agencies (\$36.7 million), money market mutual funds (923K), and certificates of deposit (\$2.4 million) or cash (\$2.4 million). Investment balances totaling approximately \$57.8 million provide the Town with strong financial underpinnings to navigate the continuing economic downturn.

III. Review of Auditor's Memorandum of Internal Control Structure.

As part of the Town's annual audit process, the Town receives an annual Memorandum on Internal Control Structure from its external auditors, Maze and Associates, CPA's. The Memorandum addresses certain internal control improvements suggested by the auditors during the course of their financial audit. It is important to note that the report indicates that none of the four items mentioned by the auditors in the Memorandum constitute "material weaknesses" in the Town's financial reporting system. The items listed are more of an financial/operational housekeeping nature that are normally addressed by Town staff in the year following the audit. The Finance Committee will review the Memorandum with the Town staff and be informed of the Town's response to each finding in the auditor's Memorandum.

IV. Recommendation on Town Council Reports-Accounts Payable and Payroll.

Staff will discuss the policy and internal control aspects of the current Town practice of submitting all Town accounts payable check listing and payroll reports to the Town Council for approval post-issuance. Town staff has received inquiries from Town Council members about the history of this practice and should it be examined for the potential to modify this procedure or eliminate the practice. Currently, only three cities of our County survey who responded, the Cities of Saratoga, Sunnyvale and Campbell expenditure listings to the Town Council post-issuance on the Consent Calendar of their council meetings. The cities of San Jose, Mountain View, Morgan Hill, Los Altos, and Gilroy do not. Staff believes there is no legal requirement either by Town ordinance or General Law requirement to submit these reports. However, the auditors will provide to the Committee their comments as to the value of review by Town Council.

One suggestion for possible recommendation to Town Council is to include a monthly certification from the independently elected Town Treasurer as part of the Treasurer's Monthly Investment Report that she has reviewed the check runs and they appear to be in conformance with the Town's budgetary limits and Town financial policies.

November 7, 2003

To the Town Council of
the Town of Los Gatos

Under generally accepted auditing standards in the United States of America, auditors are encouraged to report various matters concerning an entity's internal control structure noted during an audit, and are required to report certain of those matters. Matters that are required to be reported are significant deficiencies in the design or the operation of the internal control structure that, in the auditor's judgment, could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

As part of our audit of the financial statements of the Town of Los Gatos for the year ended June 30, 2003, we considered the Town's internal control structure in determining the scope of our audit procedures for the purpose of rendering an opinion on the financial statements. While our purpose was not to provide assurances on the internal control structure, certain matters came to our attention that we want to report to you. These matters, along with our recommendations, are described in the accompanying memorandum.

A material weakness is a significant deficiency in which the design or operation of one or more of the 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 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.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses as defined above. However, none of the significant deficiencies described in the accompanying memorandum is believed to be a material weakness.

The accompanying memorandum on internal control structure is intended solely for the use of management and the Town Council. This restriction is not intended to limit the distribution of this letter and the accompanying memorandum which, upon acceptance by the Town Council, are a matter of public record. To the extent that the Town Council intends to rely upon this letter and the accompanying memorandum, such reliance should take into account the limited basis on which our recommendations were developed, as described above, and the limitations inherent in the internal control structure. In addition, the Town Council should understand that the criteria used by us in considering the internal control structure could differ significantly from the criteria the Town Council may be using for its purpose.

We wish to express our appreciation for the courtesies and cooperation extended to our representatives during the course of their work. We would be pleased to discuss these recommendations in greater detail or otherwise assist in their implementation.

Very truly yours,

TOWN OF LOS GATOS
Memorandum on Internal Control Structure

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.

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.

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.

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 OF LOS GATOS
Memorandum on Internal Control Structure

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 our total (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.

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.

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.