



CITY OF LONG BEACH

C-9

DEPARTMENT OF FINANCIAL MANAGEMENT

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August 19, 2008

HONORABLE MAYOR AND CITY COUNCIL
City of Long Beach
California

RECOMMENDATION:

Refer the Comprehensive Annual Financial Report (CAFR), Separately Issued Financial Statements and the Federal Single Audit for the Fiscal Year Ended September 30, 2007 to the Budget Oversight Committee. (Citywide)

DISCUSSION

Comprehensive Annual Financial Report

The Comprehensive Annual Financial Report (CAFR), prepared by the Financial Management Department, contains audited financial information on all City funds for the fiscal year ended September 30, 2007 (FY 07) in accordance with generally accepted accounting principles. In accordance with Section 302(e) of the City Charter, the CAFR is submitted annually to the City Council. The FY 07 CAFR uses reporting methods reflected in the Governmental Accounting Standards Board Statement No. 34 (GASB 34), the reporting model for all state and local governments. It is important to note that the CAFR is designed to report historical financial information only and is not designed to report financial projections or budgetary priorities.

We are pleased to report that the Independent Auditor's Report, found on page 1, concluded that the City's financial statements present fairly, in all material respects, the financial position of the City, and its related cash flow and budgetary information. The audit was conducted by KPMG LLP, a certified public accounting firm, under contract with the City Auditor.

The CAFR provides Basic Financial Statements that combine all of the City's assets and liabilities in one consolidated statement. Total City net assets, on an all funds basis, as shown on page 27, were \$3.7 billion as of September 30, 2007, which included \$3.0 billion for enterprise operations such as the Harbor Fund, Water Fund and

Tidelands Fund. Net assets increased by \$256.3 million from FY 06 and are in the form of buildings, real property, bond proceeds, funds reserved for capital projects, debt service and grants-funded programs. Most of these funds are restricted by federal or state law and are not available for discretionary use.

As of September 30, 2007, the unreserved fund balance for the General Fund reflects the Emergency Reserve of \$36.6 million, comprised of \$34.1 million designated by the City Council, plus \$2.5 million required by the City Charter, which reflects 10.0 percent of total General Fund expenditures, consistent with the City Council's Financial Policy.

A separately issued Management Letter accompanying the CAFR also provides certain recommendations from KPMG LLP, on how the City can improve its financial reporting and internal controls. City management has reviewed KPMG's recommendations and has responded to each issue in the attached letter (Attachment A).

Separately Issued Financial Reports and Statements

In addition to the CAFR, certain City funds, joint powers authorities, and other subsidiary entities are also required to submit audited annual financial statements under separate cover, including the Harbor Department, Water Department, Redevelopment Agency, Long Beach Housing Development Company, Southeast Resource Recovery Facility (SERRF) Joint Powers Authority, Aquarium of the Pacific and the Gas Enterprise Fund. These separate reports are enclosed and are issued annually to meet distinct legal and financial requirements. The financial statement for Long Beach Transit, a discretely presented component unit of the City, for which the City is the sole shareholder, is also included.

Federal Single Audit

Lastly, the Federal Single Audit required by the Federal Office of Management and Budget for municipalities receiving over \$500,000 annually in federal funds is also enclosed.

TIMING CONSIDERATIONS

Action on this item is not time critical.

FISCAL IMPACT

There is no fiscal impact associated with this action.

SUGGESTED ACTION:

Approve recommendation.

Respectfully Submitted,

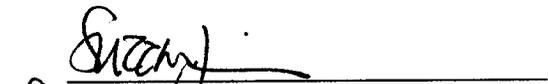


DAVID NAKAMOTO
ACTING CITY CONTROLLER



LORI ANN FARRELL
DIRECTOR OF FINANCIAL MANAGEMENT/CFO

APPROVED:


PATRICK H. WEST
CITY MANAGER

ATTACHMENTS:

- COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR) FOR THE CITY OF LONG BEACH, CALIFORNIA
- FEDERAL SINGLE AUDIT REPORT
- THE HARBOR DEPARTMENT FINANCIAL STATEMENT
- COMPREHENSIVE ANNUAL FINANCIAL REPORT OF THE LONG BEACH WATER DEPARTMENT
- REDEVELOPMENT AGENCY OF THE CITY OF LONG BEACH ANNUAL FINANCIAL REPORT
- THE LONG BEACH HOUSING DEVELOPMENT COMPANY ANNUAL FINANCIAL REPORT
- SOUTHEAST RESOURCE RECOVERY FACILITY (SERRF) JOINT POWERS AUTHORITY REPORT
- AQUARIUM OF THE PACIFIC CONSOLIDATING FINANCIAL STATEMENTS
- CITY OF LONG BEACH GAS ENTERPRISE FUND ANNUAL FINANCIAL REPORT
- LONG BEACH TRANSIT COMPREHENSIVE ANNUAL FINANCIAL REPORT
- AIR QUALITY MANAGEMENT DISTRICT FINANCIAL REPORT



GAS ENTERPRISE FUND OF THE CITY OF LONG BEACH

Schedule of Findings and Responses

September 30, 2007



KPMG LLP
Suite 2000
355 South Grand Avenue
Los Angeles, CA 90071-1568

**Report on Internal Control over Financial Reporting and on Compliance and
Other Matters Based on an Audit of Financial Statements
Performed in Accordance with *Government Auditing Standards***

The Honorable Mayor and City Council
of the City of Long Beach, California
The Citizens of the City of Long Beach, California:

We have audited the financial statements of the Gas Enterprise Fund of the City of Long Beach, California (the Gas Enterprise Fund), an enterprise fund of the City of Long Beach, California (the City), as of and for the year ended September 30, 2007, and have issued our report thereon dated May 8, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Gas Enterprise Fund's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Gas Enterprise Fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Gas Enterprise Fund's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with U.S. generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting. We consider the deficiencies described in the accompanying schedule of findings and responses as findings FS-07-01 to FS-07-03 to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be

material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Gas Enterprise Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The Gas Enterprise Fund's responses to the findings identified in our audit are described in the accompanying schedule of findings and responses. We did not audit Gas Enterprise Fund's responses and, accordingly, we express no opinion on them.

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

KPMG LLP

May 8, 2008

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Schedule of Findings and Responses

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I. Findings Related to the Financial Statements Reported in Accordance with *Government Auditing Standards*

FS 07-01: Financial Reporting

(a) Criteria

A significant deficiency in internal controls is the result of a deficiency in internal controls, or combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with U.S. generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. We believe the control deficiency described below represents a significant deficiency in internal controls.

(b) Condition

The Gas Enterprise Fund (Gas Enterprise Fund) of the City of Long Beach, California (the City) does not have an effective process or controls in place to determine that transactions are recorded and disclosed in accordance with U.S. generally accepted accounting principles (GAAP). The City's Information System (FAMIS) does not have the capability to generate GAAP financial statements. Due to this system limitation, the City is required to rely heavily on the use of excel spreadsheets. As such, the susceptibility of human error in the process exists.

During our audit and review of the financial statements of the Gas Enterprise Fund, we noted certain errors in the presentation of the financial statements. These included improper initial reporting of the following, which were subsequently corrected by management of the Gas Enterprise Fund, unless otherwise noted:

- Management has a policy to transfer construction in process to depreciable capital assets annually on September 30 of each year, rather than periodically during the fiscal year. This resulted in an understatement of depreciation expense by approximately \$120,000 for the year ended September 30, 2007, which management subsequently corrected.
- A \$148,000 entry and a \$156,000 entry were proposed to properly present other income and interest income, respectively. Management was incorrectly accounting for the Equipment Incentive Program entered into by the Gas Enterprise Fund and Community Development Fund. The adjustments were not made by the management; however, they are not material to the financial statements taken as a whole.

Furthermore, we identified certain non-GAAP policies currently in place. Management concluded that all non-GAAP policies are immaterial to the financial statements; however, the Gas Enterprise Fund does not perform a formal evaluation on a regular basis to ensure that all non-GAAP policies are identified and do not materially misstate the financial statements. During our review of non-GAAP policies not previously communicated by management, we noted the following misstatement, which was not recorded by management:

- A \$776,000 entry was proposed to properly present revenues earned for the fiscal year 2007. The Gas Enterprise Fund recognizes revenues earned from the sales of gas on a one-month lag

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as a result of the billing cycle. The Gas Enterprise Fund presents revenues earned from September 2006 through August 2007 for the fiscal year 2007 financial statements, rather than appropriately recognizing revenues earned from October 2006 through September 2007.

(c) Cause

Although management has certain controls in place relating to the review and approval of the financial statements, management had not identified the specific issues noted above internally before the audit took place.

(d) Effect or Potential Effect

The lack of effective controls in place over the preparation of financial statements and related disclosures may lead to the Gas Enterprise Fund producing financial information that does not adhere to GAAP.

(e) Recommendation

We recommend that management enforce their internal controls to ensure the preparation of year-end financial statements are in accordance with GAAP. Furthermore, we recommend that management implement formal policies and procedures to document their consideration of all non-GAAP policies at least annually to ensure that the non-GAAP policies do not materially misstate their financial statements.

(f) Views of Responsible Officials

Projects are monitored and are capitalized when the majority of expenses have been paid and asset is in use. Assets are entered in to the Fixed Asset Accounting System (FAACS) with an acquisition date and estimated life. FAACS calculates depreciation to the date of acquisition regardless of the date entered into the system. A misstatement may occur only if the acquisition date is incorrectly entered thus misstating annual depreciation expense, or if the asset is capitalized in a year subsequent to the actual service year thus understating depreciation in one year and overstating depreciation in the following year. Financial Management will add verbiage in the year-end inventory memo regarding the capitalization of capital improvement projects and strengthen the wording related to the accuracy of the acquisition date.

In 1996, the Gas Enterprise Fund purchased equipment on behalf of the Community Development Department. The purchase was recorded as an expense on the Gas Enterprise Fund's financials. This should have been recorded as an interest bearing long-term advance between funds. In 2007, Community Development repaid the advance, including accrued interest. This appears as miscellaneous revenue in the Gas Enterprise Fund's 2007 financials. The City determined that the amount was not material and would not mislead financial statement readers. It is a policy of the City to record immaterial prior period entries in the year they are discovered. To restate equity is neither prudent nor desirable.

The Gas Enterprise Fund's revenue recognition has always lagged one month since meters reads by nature are for past service. The bill dates on these accounts reflect the end of the service period. The Gas Enterprise Fund has consistently recognized revenue for the same periods in their financial

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statements. Realigning the City's revenue months in fiscal year 2007 could mislead financial statement readers. In addition, the difference between 12 months of revenue from September 2006 through August 2007 compared to October 2006 through September 2007 is immaterial.

The City and Gas Enterprise fund (within the City) are aware that the effective interest method is GAAP compliant but historically has used the straight-line method due to transparency of computation and lack of materiality. In addition, the City has several stand-alone financial statements (the Harbor Fund, the Water and Sewer Funds), which also use the straight-line method. The City consistently uses these methods across funds. Starting in fiscal year 2008, both the City and Gas Enterprise Fund will use the effective interest rate method on all new bonds issues. The Gas Enterprise Fund is also aware that fair market value of pooled cash and investments is required under GAAP. Annually the City compares fair market from historical cost. The variance had been determined to be immaterial.

Financial sections throughout the City encourage continuous education of accounting personnel. Management employees are members of the Governmental Financial Officer Association (GFOA) and California Society of Municipal Financial Officers (CSFMO). Management always attends the GFOA update on current and upcoming GASB pronouncements.

FS-07-02: Lack of Information Technology Policies and Procedures

(a) Criteria

A significant deficiency in internal controls is the result of a deficiency in internal controls, or combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. We believe the control deficiency described below represents a significant deficiency in internal controls.

(b) Condition

The City does not have formal Information Technology (IT) security and safeguarding policies and procedures. During our audit, we noted that the City has implemented procedures to address the issues surrounding information security, such as signing a confidentiality agreement upon commencing of employment. However, policies and procedures are not formally documented.

Additionally, the City does not have formally documented policies and procedures related to systems and application change control. Based on our audit of the Human Resources System (Tesseract), we note that the system changes do follow an informal process and programming changes are documented into the program itself; however, formal documentation of appropriate approval, testing, and user acceptance is not always obtained. Based on our audit of FAMIS, the Fixed Asset Accounting System (FAACS), and the Advanced Purchasing and Inventory Control System (ADPICS), we note that system patches and bug fixes performed by the Financial Systems Officer in the Department of Financial Management do follow a formal process and programming changes are documented. However, changes made by the Technology Services programmers for other changes,

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such as modifying custom reports, follow an informal documentation process and appropriate approval, testing, and user acceptance are not always obtained.

Based on our audit of the Utility Billing System, we note that the system changes are required to have Remedy tickets; however, we could not obtain evidence in all cases that changes moved into production had tickets as some could not be identified. The group supporting this system does follow an informal process; however, formal documentation of appropriate approval, testing, and user acceptance is not always obtained. There is no additional review by IT management prior to the change moving into production.

(c) Cause

The City has policies and procedures over its information technology security, systems, and application change management. These policies and procedures were in full practice, however, were not consolidated into a formal written manual until fiscal year 2008.

(d) Effect or Potential Effect

Lack of documented information security policies and procedures weaken the IT general control environment. With regards to change management, once a system is operational, further changes to the system are usually required to meet the business developing needs. Such changes should be subjected to controls as stringent as those used in the development or implementation of a new system. If there is little or no control over system changes, the benefits originally gained by controlling the system's implementation are lost as subsequent changes are made.

(e) Recommendation

We recommend that management formalize the current procedures into policies and develop standard IT security and safeguarding policies, such as:

- Information security infrastructure requirements
- Password-based access control
- Password protection
- Virus protection
- Internet Web site controls
- Standard network system configuration
- Network system administration
- Application security administration
- Firewall and router security
- Transmission of data/encryption
- Physical/perimeter security and data center protection

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Additionally, we recommend that management develop and implement formal IT change management policies, standards, and related procedures associated with system (e.g., infrastructure and configuration change) and application change control. Management should ensure that the new developments are understood and communicated to all IT and supporting the City's personnel. Adequate formal change management procedures should be designed and implemented to ensure that changes to the key financial systems are made in a controlled manner. Specifically, we recommend that the following controls be implemented and enforced:

- All change requests should be formally authorized and documented by appropriate management and business owner;
- Appropriate change management software should be utilized for the Tesseract application to support the migration of programming changes to the live environment;
- Changes that are made to the IT systems are tested, validated, and approved prior to implementation into the production environment. Test criteria should be documented and applied for all testing. This is to ensure that the changes will meet the user requirements and that the changes will not have a negative impact on any of the existing;
- User acceptance sign-off should be obtained and maintained before changes are migrated to the production environment;
- Changes made to IT systems should be validated after promotion to production to confirm that the change did not impact the system functionality or data integrity and that unauthorized changes were not inadvertently or intentionally promoted;
- Access to migrate changes into production should be segregated from the responsibilities of program development. Only a limited number of personnel should have access to migrate changes to the production environment to ensure that this process is well controlled and only tested, authorized, and properly approved changes are migrated into production;
- Change procedures also be applied to both system and application configuration settings (e.g., tolerance setting such as check authorization limits; three-way match; work flow flags to escalate for approval; and system configuration on hardware). Configuration settings are a key component of many information systems. Configuration settings frequently can impact the design and/or operating effectiveness of internal control over financial reporting;
- Emergency change provisions and controls are outlined to ensure that changes requiring immediate implementation are properly handled, allowing for timely change and no impact to systems and applications related to the financial reporting process; and
- Finally, we recommend that documentation of the activities above be maintained to strengthen the overall IT general control environment.

We recommend that these policies be formally communicated throughout the organization to users supporting and maintaining information systems and technology and are accessible and understandable to all persons. This ensures that management sets a clear direction and demonstrates support and commitment to information security through the issuance and maintenance of an

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information security policy. We recommend an annual review and update of the IT policies and procedures occur to integrate any new system, technology, and process improvements.

(f) Views of Responsible Officials

In fiscal year 2008, the City's Technology Services Department formalized its various security procedures in a comprehensive information technology security policy to guide those supporting and maintaining information systems, as well as those using the systems. This security policy was approved by the City Manager on April 22, 2008. Also in fiscal year 2008, the City's Technology Services department finalized its various change management policies in a comprehensive information technology change management policy to guide those supporting and maintaining the City's software applications.

The City's formal policies and procedures ensure the proper safeguarding of:

- Information Security Infrastructure Requirements
- Password-Based Access Control
- Password Protection
- Virus Protection
- Internet Web Site Controls
- Standard Network System Configuration
- Network System Administration
- Application Security Administration
- Firewall and Router Security
- Transmission of Data/Encryption
- Physical/Perimeter Security and Data Center Protection.

FS-07-03: Administrative Access – Inappropriate Administrative Access and Lack of Review over Appropriateness of User Access and Segregation of Duties within Certain Applications

(a) Criteria

A significant deficiency in internal controls is the result of a deficiency in internal controls, or combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. We believe the control deficiency described below represents a significant deficiency in internal controls.

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(b) Condition

We noted two users with excessive administrative access: a Technical Support Officer and a System Support Specialist. In addition, management does not have a control in place to ensure proper segregation of duties within Software Configuration and Library Manager (SCLM). We noted several programmers have SCLM access to promote changes to production causing a segregation of duties conflict. Access to SCLM should be limited to two to three individuals independent of any programming responsibilities. Furthermore, management does not currently have controls in place to periodically review and document the appropriateness of user access to the financially significant applications, administrative access to Active Directory, Resource Access Control Facility (RACF), and SCLM.

(c) Cause

Access Review: For more than ten years, the Technology Services Department has provided utility billing staff with system access to assist them in reviewing users' access to the Utility Billing System. However, over time, the reports have become more cumbersome, and have not been updated to reflect programming changes that impact on system access. As a result, the reports do not provide sufficient information for Utility Billing staff to properly verify and update access levels in the system

Access Control: Technology Services' current level of application support staff has precluded segregation of duties between the test and production environments for the SCLM application. Since SCLM is a tool that was not utilized for the City's primary financial systems (FAMIS, ADPICS, BPREP, FAACS), the lack of segregation of duties within SCLM does not pose a significant risk.

(d) Effect of Potential Effect

Weaknesses in user access control may lead to situations where an employee has the ability to perpetrate an error or irregularity and to conceal the error or irregularity. Additionally, a lack of adequate security over user access in the business systems and improper segregation of duties can potentially expose the City to a variety of risks resulting from unauthorized manipulation of financial data as well as an unauthorized exercise of system functions.

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(e) **Recommendation**

We recommend that Administrative Access be restricted to users within the IT department with a specific job need. Users with Administrator Access making programming changes and promoting those changes into production should be segregated. Periodic review of users with access to financially significant applications helps prevent unauthorized access and potential financial misstatement due to unauthorized access. We recommend that the City implement a formal review, similar to the established procedures performed on the FAMIS system, of users with access to significant financial applications and Administrative Access to supporting applications, including Active Directory, SCLM, and RACF. Additionally, management should include the Data Center as part of the annual review or review data center access more frequently based on the rate of turnover. This review should be performed at least annually to ensure that inappropriate system access is detected and remediated. Similar to the FAMIS procedures, this review should be performed in conjunction with the IT department and business owners. Evidence of review by business owners and the IT department should be documented, signed, and dated and maintained for audit purposes.

(f) **Views of Responsible Officials**

Access Review: For Utility Billing, the Technology Services Department will develop new, improved access control reports that Utility Billing staff can more readily use to verify and adjust user access. Only individuals whose job requires system administrator access will be allowed to have such access. Additionally, a yearly review of access levels to the system will be conducted, documented and signed off by the Utility Billing and the Technology Services Department support person.

Access to Active Directory, SCLM and RACF will also be reviewed and verified in a similar fashion and documented.

Access Control: The Technology Services Department applications support programming staff that have administrative access to systems use the access so they can move programming changes into the production environment. A policy change has been made to this process to require the Technology Services Operation's staff to make all moves into Production. New procedures for the operations organization have been developed. This is part of a larger change management control process that is being developed that at a high level, will include the following:

- Procedures that define the type of documentation needed for system changes;
- Approval required to process system changes;
- Appropriate testing (QA and User), and proof of testing;
- Appropriate signoff for each change prior to putting into production;
- Requirements for an internal TSD system that will track all change requests;
- Communication plan to business partners within the City notifying them of the internal change management system; and
- Deployment of the Process to all systems maintained by TSD.