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CITY OF SACRAMENTO

Report to Management

For the Fiscal Year Ended June 30, 2002

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
FOR THE FISCAL YEAR ENDED**

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Macias, Gini & Company LLP
Certified Public Accountants and
Management Consultants

3927 Lennane Drive
Suite 200
Sacramento, CA 95834-1922
916.928.4600
916.928.2755 FAX
www.maciasgini.com

Honorable Mayor, Members
of the City Council and
Management
Sacramento, California

In planning and performing our audit of the basic financial statements of the City of Sacramento (City) for the year ended June 30, 2002, we considered the City's internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the basic financial statements. As part of our audit, we evaluated the City's system of internal accounting control, to the extent we considered necessary to evaluate the system as required by auditing standards generally accepted in the United States of America. Although our audit was not designed to provide assurance on internal controls, we noted certain matters involving internal controls and their operations, and are submitting for your consideration related recommendations designed to help the City make improvements and achieve operational efficiencies. Our comments reflect our desire to be of continuing assistance to the City. This letter does not affect our report dated December 6, 2002, on the basic financial statements of the City.

We will review the status of these comments during our next audit engagement. We have already discussed these comments and recommendations with various City personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Additionally, we have included in this letter a statement on communications with the Honorable Mayor and City Council as required by professional auditing standards.

The accompanying comments and recommendations are intended solely for the information and use of the Honorable Mayor, City Council, management and others within the organization.

Macias, Gini & Company LLP
Certified Public Accountants

Sacramento, California
December 6, 2002

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
REQUIRED COMMUNICATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2002**

REQUIRED COMMUNICATIONS

Professional auditing standards require auditors to communicate with the audit committee (or in the absence, the governing body) on a number of subjects. The following information satisfies these requirements, and is solely intended for the use of the Honorable Mayor, City Council and management.

I. The Auditor's Responsibility Under Generally Accepted Auditing Standards

The audit of the City of Sacramento's (the City) basic financial statements as of and for the year ended June 30, 2002 was conducted in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards. The objective of an audit is the expression of opinions concerning whether the financial statements present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, the aggregate remaining fund information and the discretely presented component units of the City of Sacramento, as of June 30, 2002, and the respective changes in financial position and cash flows, where applicable, thereof and the respective budgetary comparison for the general fund for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As part of our audit, we considered the City's internal controls, as required by auditing standards generally accepted in the United States of America, for the purpose of establishing a basis for determining the nature, timing, and extent of auditing procedures necessary for expressing our opinion concerning the financial statements.

Audits are based on the concept of selective testing of data and are not designed to detect all potential errors, fraud or illegal acts. Audits are also conducted with a view of the materiality of transactions, and are not intended to comment or identify all matters which might impact the financial statements or the operations of the City, and do not provide an opinion on the adequacy of internal controls.

II. Significant Accounting Policies and Unusual Transactions

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the City are described in Note 1 to the financial statements. We noted no transactions entered into by the City during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
REQUIRED COMMUNICATIONS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2002**

III. Management Judgments and Accounting Estimates

Management judgments and accounting estimates are an integral part of the financial statements. Those judgments are based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The more significant financial statement components requiring management judgment are as follows:

- Accrual and disclosure of self insured claims liabilities
- Accrual and disclosure of compensated absences
- Depreciation estimates for capital assets

During our audit, we performed procedures necessary to evaluate amounts and disclosures requiring management judgment and determined them to be reasonable in the circumstances.

IV. Audit Adjustments

For the purposes of this report, professional standards define an audit adjustment as a proposed correction of the basic financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the City's financial reporting process (that is, cause future financial statements to be materially misstated). In our judgment, none of the adjustments we posed, whether recorded or unrecorded by the City, either individually or in aggregate, indicate matters that could have a significant effect on the City's financial reporting process.

We are also required to inform you about uncorrected misstatements aggregated by us during the current engagement that were determined by management to be immaterial, both individually and in the aggregate, to the basic financial statements taken as a whole. Therefore, we have attached the Schedule of Uncorrected Misstatements, which summarizes those uncorrected misstatements.

V. Other Information in Documents Containing Audited Financial Statements

Management's Discussion and Analysis (MD&A) - The MD&A and the required supplementary information other than MD&A, are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standard Board (GASB). We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
REQUIRED COMMUNICATIONS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2002**

VI. Disagreement with Management

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

VII. Consultations with Other 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 governmental unit'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.

VIII. Major Issues Discussed with Management Prior to Our Retention

No discussion occurred in connection with our retention regarding accounting principles or scope of work.

IX. Difficulties in Performing the Audit

We encountered no significant difficulties in dealing with management in performing our audit.

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
COMMENTS AND RECOMMENDATIONS
JUNE 30, 2002**

INVESTMENT POLICY

Management Comment:

Government Auditing Standards require that we perform tests of the City of Sacramento's (City's) compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on financial statement amounts. Accordingly, our audit procedures included determining whether investments made and held by the City were authorized by law and the City's investment policy.

The City Treasurer is responsible for managing the investments in accordance with Section 73 of the City Charter and City Council ordinances and resolutions. The Treasurer maintains a City-sponsored investment pool, which includes the City's financial resources plus certain financial resources of external parties. The Treasurer also manages separate investment accounts for external parties. An investment policy adopted by the City Council pursuant to the City Charter governs the Treasurer's investment of these resources. The adopted City investment policy permits certain investments that are not specifically authorized under California Government Code Section 53601.

Section 53601 sets forth statutory guidelines regarding investments made by local agencies and includes qualitative and quantitative restrictions for certain types of investments. Section 53601 restricts local agency investments in corporate notes to those with a maximum maturity of five years at the date of purchase. Section 53601 also limits local agency investments in money market mutual funds to a maximum of 20% of the local agency's portfolio. Section 53600, which sets forth the applicability of Section 53601, expressly includes chartered cities in the definition of a "local agency."

Although the City's investments complied with the investment authority granted by City Council, certain investments held during the year were not specifically permitted by Section 53601. As disclosed in the City's financial statements for the fiscal year ended June 30, 2002, the City held \$67.2 million of corporate notes with maturities beyond five years as of the date of purchase. As of June 30, 2002, \$20 million of these corporate notes had remaining maturities beyond five years, which represented 3.4 percent of the amortized cost of the City-sponsored investment pool. Investments separately managed by the City included \$4.2 million of corporate notes with maturities beyond five years as of the date of purchase. The separately managed corporate notes represented 5.4 percent of the amortized cost of the separately managed investment portfolio. In addition, the City's investment in money market mutual funds exceeded 20 percent of total pooled investments by \$32.7 million.

Recommendation:

We understand that it is management's belief that the City, as a chartered city, is free to adopt an investment policy that is not consistent with California Government Code Section 53601. However, we believe that the City Council should periodically revisit the City's investment policy to determine whether the Council's objectives regarding safety, liquidity and yield are properly reflected. We believe that the City Council should consider adopting an investment policy that is consistent with California Government Code Section 53601.

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
COMMENTS AND RECOMMENDATIONS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2002**

INVESTMENT POLICY (Continued)

Management Response:

In 1978, when the current City Treasurer joined the City, there was no "formal" or "informal" Investment Policy in place. The City Treasurer Investment Authority was defined in the City Charter and implemented through City Council Resolution # 446, dated December 17, 1964. Both the City Charter and Resolution provided the City Treasurer the authority to invest, as he/she deemed prudent.

In 1978, the current City Treasurer undertook a review both internally and externally to determine what the Treasurer's Investment Authority was, and what other Public Fund Investment Policies existed in the State of California. The Sacramento City Attorneys Office indicated that general "Law City" authority did not restrict the Charter Authority of the City. Further, the City Treasurer could find no other City or County in the State of California that had an Investment Policy.

With the assistance of the Sacramento City Attorneys Office and numerous other senior staff at the City and Agency, the City Treasurer developed an Investment Policy for the Sacramento City Council to consider and approve. This policy was approved by the City Council in 1979. This Investment Policy has been amended by the City Council on seven occasions since its adoption, and reaffirmed on at least 35 separate occasions since its adoption. (The amendments to the policy have generally been minor) In addition to these actions there have been several reviews of impacts of local government mismanagement of public funds. There were extensive discussions of City Investment practices and policies following the debacles in the cities of San Jose, Montebello and Camarillo as well as Orange County. Following these discussions, City Council reaffirmed the City's Investment Policy and adopted new City Council resolutions. Specifically, City Council Resolutions # 89-167 and # 95-108 provided the Treasurer with prudent guidelines to conduct the City's investment activities. To this date, all investment decisions and activities have been within the authority granted by City Council as described in the City Charter and City Council Resolutions.

Not only have the City's Investment Policies been extensively reviewed internally by the Sacramento City Council, staff and the public through hearings and coverage, but also by external agencies and entities working with the city. Some of those who have reviewed the investment policies are: the Municipal Rating Agencies who rate the City's credit (Moody—Standard & Poor's), municipal bond insurers insuring some of the cities outstanding bond issues and the numerous Financial Consultants working with the city.

Further, the City Treasurer regularly has presented the policy to other Professional organizations, i.e., California Municipal Treasurer's Association, California Treasurer's Association, Municipal Finance Officers Association, as well as the San Francisco Bond Club and the Bond Buyers Annual Seminar. As an "expert witness" in the Orange County legal proceedings, the current City Treasurer provided the City of Sacramento's Investment Policy as an exhibit. Following all of the external presentations there has not been an issue or question raised as to the "prudent nature" or "authority" for the policy. Finally, the City Treasurer has convened an Investment Committee and detailed reports of activity are provided.

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
COMMENTS AND RECOMMENDATIONS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2002**

INVESTMENT POLICY (Continued)

Management Response (Continued):

The City Treasurer believes it is prudent to review investment results and receive direction from City Council on the matter of public fund investment. Further, the City Treasurer believes in public reports, discussions and interaction with other senior City Staff knowledgeable in financial matters to develop policy positions. The City Treasurer has committed substantial time and effort to this matter and is both grateful and appreciative for the time City Council and City Staff have devoted to this matter.

The Treasurer will continue to provide full disclosure to City Council on investment matters and will continue to strive to continue management of the City's Investment Program in a prudent fashion.

AUDIT COMMITTEE

Management Comment:

The City of Sacramento (City) has not established an audit committee or its equivalent, which is essential in assisting the City Council in fulfilling its oversight responsibilities. An audit committee appointed by the City Council is an important tool in monitoring 1) the integrity of the City's financial statements, 2) the City's compliance with legal and regulatory compliance and 3) both the real and perceived independence of external auditors. An audit committee would facilitate direct communication between the independent auditors, management and the City Council, and would be particularly important in advising the City Council on technical matters and the financial audit process. In addition, *Government Auditing Standards*, Amendment No. 2, *Auditor Communication*, issued by the Comptroller General of the United States, requires specific communication between auditors and audit committees regarding the auditor's responsibilities for the audit, including the nature and extent of tests of compliance with laws and regulations and internal controls.

Recommendation:

We recommend that the City Council formally establish an audit committee to enhance the credibility of the financial reporting process. Members of the audit committee should possess expertise in financial accounting and reporting, auditing and public administration sufficient to effectively resolve issues raised during the audit and to communicate the results of the audit with the City Council.

Management Response:

Management does not concur with this recommendation. Staff presents the independent audits and management letter to the City Council at a public hearing. The recommendation to establish an audit committee is contrary to the City Council directive to staff to reduce the number of boards and commissions that advise the City Council. The City has a long history of receiving unqualified audit opinions and relatively minor management comment recommendations.

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
COMMENTS AND RECOMMENDATIONS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2002**

INTERNAL AUDIT FUNCTION

Management Comment:

At present, the City of Sacramento does not have an internal audit function. An internal audit function could assist the City Council in monitoring management and departmental performance, the existence of effective internal controls, compliance with established policies and procedures, and the accuracy of financial reporting. An internal audit function could result in substantial benefits to the City through strengthened internal controls and increased operating efficiency.

Recommendation:

We recommend that the City formally establish an internal audit function. The internal auditors should be completely independent of the finance department and should report directly to the City Council or to an audit committee. In order to realize the maximum benefits of an internal audit function, we recommend the following:

- Internal auditors should possess relevant experience and an appropriate educational background such as a bachelors or masters degree in accounting, finance, information technology or similar area.
- The City Council should annually adopt an internal audit work plan, and the scope of the internal audit work should consider all areas of the City's operations.
- The internal audit function should include appropriate quality control measures and follow appropriate professional standards such as those issued by the American Institute of Certified Public Accountants, the Institute of Internal Auditors and the United States General Accounting Office.
- The results of work performed by the internal auditors should be documented, and the reports should be submitted directly to the City Council or to the audit committee.

Management Response:

City Council authorized the City Manager to establish and recruit for a City Internal Auditor with resolution 2002-094 on February 19, 2002. The recruiting efforts are in process.

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
COMMENTS AND RECOMMENDATIONS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2002**

CASH DISBURSEMENTS

Management Comment:

During our testing of internal controls over the City's cash disbursements transaction cycle, we noted one instance out of a sample of 60 procurement transactions in which written justification for a sole-source purchase of approximately \$27,700 was not prepared. For sole-source purchases, section 3.4.2 of the City's Administrative Policy Instructions states "*a completed Requisition should be sent to Purchasing, accompanied by complete specifications for the product or service requested, and the name of the vendor and/or product being requested. In addition, a written justification must be provided with the Requisition if the purchase will total more than \$3,000.*"

The City's established procurement policies are intended to ensure that competent vendors are selected and that costs are minimized. Compliance with these administrative policies is essential to fulfilling public policy objectives and maintaining the public's trust. Without the required written justification for sole-source purchase, the City is unable to demonstrate compliance with its administrative policies.

Recommendation:

We recommend that the Procurement Services Manager, or other authorized personnel, verify and approve all sole-source purchases to ensure that the required documentation has been prepared in accordance with the City's Administrative Policy Instructions.

Management Response:

Management initiated a complete review of the City procurement policies and procedures in fiscal year 2002. A comprehensive revision of City procurement policy, that includes sole source policy and procedures, will be implemented in March 2003.

**CITY OF SACRAMENTO
REPORT TO MANAGEMENT
COMMENTS AND RECOMMENDATIONS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2002**

ACCOUNTS RECEIVABLE - ADVANCED LIFE SUPPORT ENTERPRISE FUND

Management Comment:

The City of Sacramento (City) accounts for its ambulance services in the Advanced Life Support (ALS) Enterprise Fund. During our testing of accounts receivable in the ALS fund, we noted that the City does not have a written policy for valuing year-end accounts receivable, which represent outstanding charges for services provided through the end of the fiscal year. These accounts receivable are unique in that the amounts that the City will ultimately collect are based on contractual agreements with third-party payers, such as Medicare, health maintenance organizations and insurance providers. Generally accepted accounting principles (GAAP) require that healthcare and related service providers adjust patient service revenue and accounts receivable for contractual allowances in order to properly reflect the amount for which patients, or third-party payers, have an obligation to pay. GAAP further require that patient accounts receivable be recorded net of allowances for bad debts, which should be reported as expenses rather than adjustments to revenue. The City's current approach is to analyze cash receipts after year-end and to record accounts receivable and revenue based on actual payments received. This approach does not provide an appropriate evaluation of contractual allowances and bad debt.

Recommendation:

We recommend that the City develop a written policy to ensure that accounts receivable in the ALS fund are valued based on the amounts that the payers are obligated to pay rather than actual payments received. The policy should utilize the patient and billing information provided by Allied Information Services (AIS), its third-party billing administrator, in determining these amounts.

Management Response:

Management agrees. Recommended policy will be developed in fiscal year 2002-2003.

City of Sacramento
Schedule of Uncorrected Misstatements
For the Year Ended June 30, 2002
(Dollars in thousands)

Entry	Account Description	Fund		Debits (Credits)				Expenditure /Expense
		Name	No.	Assets	Liabilities	Equity	Revenue	
1	Fund balance - beginning of year	SHRA				\$ 2,312		
	Advances from other city funds	SHRA			\$ (2,312)			
	Advances from other city funds	SHRA			103			
	Debt service principle expenditure	SHRA						\$ (103)
	To adjust SHRA's financial statements to reflect interfund advances from other City funds and to reclassify the current year repayment.							
2	Advances to other SHRA funds	Other City Debt	326	\$ 1,201				
	Advances to other SHRA funds	91 Marks-Roos	332	1,008				
	Due from other governments	Other City Debt	326	(1,201)				
	Due from other governments	91 Marks-Roos	332	(1,008)				
	Deferred revenue	Other City Debt	326		1,201			
	Deferred revenue	91 Marks-Roos	332		1,008			
	Revenue (payment rec'd in fy 01/02)	Other City Debt	326				\$ 103	
	Fund balance - beginning of year	Other City Debt	326				(1,304)	
	Fund balance - beginning of year	91 Marks-Roos	332				(1,008)	
	To adjust the City's financial statements to reflect interfund advances to SHRA funds.							
3	Revenue	Transportation and Development Special	790				404	
	Deferred revenue	Revenue Fund	790		(404)			
	To defer accounts receivable which were not collected within the availability period.							
				\$ -	\$ (404)	\$ 2,312	\$ (1,805)	\$ (103)