CITY OF ALAMEDA
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS

FOR THE YEAR ENDED
JUNE 30, 2011

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CITY OF ALAMEDA
MEMORANDUM ON INTERNAL CONTROL
AND
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For the Year Ended June 30, 2011

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MEMORANDUM ON INTERNAL CONTROL

November 29, 2011

Honorable Mayor, City Council, and City Auditor
of the City of Alameda
Alameda, California

We have audited the financial statements of the City of Alameda for the year ended June 30, 2011, and have issued our report thereon dated November 29, 2011. Our opinions on the financial statements and this report, insofar as they relate to the Community Improvement Commission of the City of Alameda, Alameda Reuse and Redevelopment Authority, Alameda Municipal Power, and the Housing Authority of the City of Alameda, are based solely on the report of other auditors. In planning and performing our audit of the financial statements of the City of Alameda as of and for the year ended June 30, 2011, 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 our auditing procedures 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.

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.

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.

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 significant deficiencies or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been identified. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to errors or fraud may occur and not be detected by such controls. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

Included in the Schedule of Other Matters are recommendations not meeting the above definitions that we believe to be of potential benefit to the City.

The City's written responses included in this report have not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, City Council, others within the organization, and agencies and pass-through entities requiring compliance with generally accepted government auditing standards, and is not intended to be and should not be used by anyone other than these specified parties.

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SCHEDULE OF OTHER MATTERS

2011-01 -- Loan Receivable Collectability

On December 16, 2003, the City loaned $2,200,000 to Alameda Power and Telecom, currently Alameda Municipal Power, for the purpose of constructing a hybrid fiber-optic/coaxial telecom network. As of June 30, 2011, the loan receivable was still outstanding with no set repayment date. The City should assess the collectability of this loan. If the collectability is deemed unlikely, the City should write off the loan from its books.

Management Response: The City will evaluate the repayment status of this loan as part of the preparation of the budget for Fiscal Year 2012-13.

2011-02 – Review of Check Registers

To ensure that sufficient internal controls are in place, check register that details all payments processed should be reviewed by an employee who cannot access the disbursements module of the City's financial system.

During the audit, we noted that the Controller reviews an Edit Batch List generated from the City's financial system prior to each check run. The Edit Batch List details each check that will be printed for that check run. Checks are printed upon the Controller's approval of the List. However, the final check register and the Edit Batch List are not compared after the check run.

The City's current practice allows for the possibility that a payment be added to the check run after the Edit Batch List is approved by the Controller because the review is done prior to the checks being printed.

We recommend that a review of the final check register to be done to ensure that all disbursements were properly approved.

Management Response: This recommendation was implemented in July 2011.

2011-03 -- Authorized Signer of City's Investment Account

Signature cards of bank and investment accounts should be updated immediately when there is a change in authorized signers.

As of June 30, 2011, a City employee who retired in August 2008 was still listed as an authorized signer in the City's LAIF account.

We recommend that the City review all its signature cards of cash and bank accounts immediately to ensure that all accounts signers are current and authorized by the Council. In addition, procedures should be established to ensure that outside parties (such as banks, investment safekeepers, investment advisors, and bond trustees) are aware of key employee turnover in a timely manner in order to prevent misrepresentation of the City.

Management Response: This recommendation has been implemented.

CITY OF ALAMEDA
MEMORANDUM ON INTERNAL CONTROL

SCHEDULE OF OTHER MATTERS

2011-04 -- Capitalization Policy Update

The City has a capitalization threshold of $50,000 for its infrastructures currently. While it is essential to capitalize capital expenditures, a lower threshold means that more items are capitalized. Hence, resources are spent in keeping track of these items. To improve efficiency of the City's closing of its books at year end, we recommend that the City consider raising its threshold to a higher amount.

Management Response: The City will increase its infrastructure capitalization minimum for each capital project to $100,000 beginning in Fiscal Year 2011-12.

CITY OF ALAMEDA
MEMORANDUM ON INTERNAL CONTROL

SCHEDULE OF CURRENT STATUS OF
PRIOR YEAR SIGNIFICANT DEFICIENCY

2010-01 – Information Technology Best Practices Recommendations

Criteria:

In reviewing controls over the information systems, we expect to find a verifiable computer vulnerability management/patch management process, such that critical patches are applied in a timely manner, typically within thirty to sixty days. This patching process can be verified by regular vulnerability scanning. In addition, we expect to find audit logs on critical systems such that any material changes to that system are logged and reviewed for unauthorized activity. This is especially true for financial applications where by data integrity is crucial.

Condition:

We were informed by City staff that the current audit logs on the Financial Application Server, are not reviewed on a regular basis and when they are reviewed do not provide enough information to determine who changed what. Based upon an internal vulnerability scan run on May 6, 2010, we discovered three critical vulnerabilities on the Financial Application Server. These three vulnerabilities were the same vulnerabilities found by our internal scan run on March 11, 2009. The details of the vulnerabilities have been communicated to City staff.

Effect:

We believe it is reasonably possible that an attack on and unauthorized access to the City financial application systems could occur and not be detected during the normal course of operation. Individually, neither the financial application server vulnerability nor the lack of review of audit/event logging constitutes a significant deficiency. However, we believe that together these deficiencies raise the risk that changes to the financial application and/or data could go undetected.

Cause:

Due to a weakness in the City's flaw remediation (vulnerability/patch management) process, a critical vulnerability was not patched or by some other means mitigated in a timely manner. In addition, due to a lack of audit and accountability policy and procedures, financial application audit logs are not reviewed regularly and do not produce actionable information. As such, an adverse change to the data within the application would not be caught in the normal course of business. Together the breakdown of control can lead to an unauthorized change to the financial application that could lead to a financial misstatement.

SCHEDULE OF CURRENT STATUS OF PRIOR YEAR SIGNIFICANT DEFICIENCY

Recommendation:

Currently, there are no Information Technology standards to which local governments are required to conform. Indeed, there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments can use to implement appropriate controls to ensure adequate security over information technology. However, according to the National Institute of Standards and Technology (NIST) "State, local, and tribal governments, as well as private sector organizations, are encouraged to use the guidelines, as appropriate" NIST SP 800-100. In addition, the State of California singled the NIST standards out for adoption for State agencies in the California Information Security Strategic Plan (OCT 2009), "...by adopting the National Institute of Standards and Technology (NIST) 800-37 guidelines for certification and accreditation of information systems. Applying NIST guidelines to state government systems will demonstrate California's leadership in building a resilient, secure, and trustworthy digital infrastructure." We therefore recommend the adoption of NIST standards for information systems controls.

The following specific recommendations are found in the NIST control catalog and relate specifically to our findings:

- *Financial Application Server Vulnerabilities* - These vulnerabilities should be mitigated as soon as possible. The City should also implement a verifiable vulnerability/patch management process. The City should also evaluate and monitor the effectiveness of its information systems control procedures, including periodic vulnerability scans. If the vulnerabilities cannot be corrected, other mitigating controls such as host-based firewalls should be employed.

- *Audit/Event Logging* - We believe this is another important standard of NIST. Audit/event logs provide an effective detective control by automatically creating a record of every change made to the financial application and the server on which it runs on. The logs would include authorized changes and unauthorized changes made, to the server, application or data, by employees or would be hackers. In order for the City to effectively respond to potential unauthorized changes the City will need to have a process to review the audit logs for unauthorized changes on a regular basis. Given the financial system is at greater risk because of vulnerabilities, the systems logging and reviews of those logs are critical in detecting and responding to unauthorized changes in a timely manner. Without review of audit logs the City will not be able to detect material changes to the financial application or financial data during the normal course of business. NIST provides guidelines on audit/event log policies and processes (NIST SP 800-53 rev 3 § AU and NIST SP 800-92 Guide to Computer Security Log Management).

Current Year Status:

The City is planning for the outsourcing to a third party vendor of the computer platform used to host its accounting system in Fiscal Year 2011-12, which will provide for increased security, regular updates to system and accounting software, and daily backups of its data.

CITY OF ALAMEDA
MEMORANDUM ON INTERNAL CONTROL

SCHEDULE OF CURRENT STATUS OF
PRIOR YEAR OTHER MATTERS

2010-02 -- Bank and Investment Accounts Signature Cards

Signature cards for the bank and investment accounts should be updated immediately when there is a change in authorized signers. During our examination of the City's signature cards, we found that two departed employees were still listed as authorized signers in two bank accounts and one investment account.

We were informed by the City that due to the continuous staff turnover in Finance in recent months, the signature cards of the above accounts were not updated.

We recommend that the City review all of its signature cards immediately to ensure that all authorized signers are current. In addition, a step should be added to the employee departure checklist to ensure that outside parties (such as banks, investment advisors, bond trustees) are informed that the departed employee no longer represents the City.

Current Year Status:

See Other Matter 2011-03.

2010-03 -- Payroll Database

Significant changes to the payroll database, such as employee additions and changes in pay rates, should be verified by another employee. Currently, the Administrative Technicians, who process payroll, have the ability to change data and add employees to the payroll database without an independent review by an employee who does not have access to the database.

We were told by Finance that the City's financial system cannot produce a report that tracks changes made to the payroll database for review purposes.

Changes to the personnel database should be reviewed by an employee who does not have access to the database. Also, employees who process payroll should not have the ability to change payroll database.

Current Year Status:

The City is in progress in implementing this recommendation.

SCHEDULE OF CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

2010-04 – Advance Collectability

The City's Golf Course Enterprise Fund advanced the ARRA General Fund Leasing Activity Subfund $300,000 in fiscal year 2001 to fund predevelopment activities in connection with the Golf Course at Alameda Point. In fiscal year 2009, the City had planned to repay this advance in full in fiscal year 2010. However, during the current year, the City has not come to a conclusion with ARRA as to how this advance should be repaid.

As of June 30, 2010, this advance amounted to 6% of the total assets of the Golf Course Enterprise Fund. The City should determine if the advance is collectible for this Fund. If the advance is determined to be uncollectible, an operating transfer should be recorded and the advance written off.

Current Year Status:

This advance was repaid prior to the end of Fiscal Year 2010-11.

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REQUIRED COMMUNICATIONS

November 29, 2011

Honorable Mayor, City Council, and City Auditor
of the City of Alameda
Alameda, California

We have audited the financial statements of the City of Alameda as of and for the year ended June 30, 2011, and have issued our report thereon dated November 29, 2011. Professional standards require that we advise you of the following matters relating to our audit.

Financial Statement Audit Assurance: Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit in accordance with generally accepted auditing standards does not provide absolute assurance about, or guarantee the accuracy of, the financial statements. Because of the concept of reasonable assurance and because we did not perform a detailed examination of all transactions, there is an inherent risk that material errors, fraud, or illegal acts may exist and not be detected by us.

Other Information Included with the Audited Financial Statements: Pursuant to professional standards, our responsibility as auditors for other information in documents containing the City's audited financial statements does not extend beyond the financial information identified in the audit report, and we are not required to perform any procedures to corroborate such other information. Our responsibility also includes communicating to you any information that we believe is a material misstatement of fact. Nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements. This other information and the extent of our procedures is explained in our audit report.

Accounting Policies: Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note 1 to the financial statements. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2011. The City adopted the provisions of the following GASB Statements during 2011:

- **GASB Statement No. 54 – *Fund Balance Reporting and Governmental Fund Type Definitions*** -- This Statement established fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds. The City's financial statements, as well as Note 8 to the financial statements, were modified to include required disclosures.

- **GASB Statement 59 -- *Financial Instruments Omnibus*** -- The objective of this Statement is to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. This is a technical clean up pronouncement that had no material impact to the financial statements.

Unusual Transactions, Controversial or Emerging Areas: No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2011.

As disclosed in Note 15 to the financial statements the State of California adopted ABx1 26 in June 2011, which suspends all new redevelopment activities except for limited specified activities as of that date and dissolves redevelopment agencies effective October 1, 2011. The State simultaneously adopted ABx1 27 which allows redevelopment agencies to avoid dissolution by opting into an "alternative voluntary redevelopment program" requiring specified substantial annual contributions to local schools and special districts. However, on August 11, 2011, the California Supreme Court issued a partial stay of ABx1 26 and a full stay of ABx1 27, but the partial stay did not include the section of ABx1 26 that suspends all new redevelopment activities.

Estimates: Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally 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 markedly from management's current judgments. The most sensitive accounting estimates affecting the financial statements are fair values of Investments and depreciation of capital assets.

As of June 30, 2011, the City, held approximately $214 million of cash and investments as measured by fair value. Fair value is essentially market pricing in effect as of June 30, 2011. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2011.

Management's estimate of depreciation is based on useful lives determined by management. These lives have been determined by management based on the expected useful life of assets as disclosed in Note 5 to the financial statements. We evaluated the key factors and assumptions used to develop the depreciation estimate and determined that it is reasonable in relation to the basic financial statements taken as a whole.

Disagreements 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 City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

Retention Issues: We did not discuss any major issues with management regarding the application of accounting principles and auditing standards that resulted in a condition to our retention as the City's auditor.

Difficulties: We encountered no serious difficulties in dealing with management relating to the performance of the audit.

Audit Adjustments: For purposes of this communication, professional standards define an audit adjustment, whether or not recorded by the City, as a proposed correction of the financial statements that, in our judgment, may not have been detected except through the audit procedures performed. These adjustments may include those proposed by us, but not recorded by the City, that could potentially cause future financial statements to be materially misstated, even though we have concluded that the adjustments are not material to the current financial statements.

We did not propose any audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the City's financial reporting process.

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. We have no such misstatements to report to the audit committee.

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

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