CITY OF LOS ALTOS

MEMORANDUM ON INTERNAL CONTROL

FOR THE YEAR ENDED JUNE 30, 2023

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CITY OF LOS ALTOS
MEMORANDUM ON INTERNAL CONTROL
For The Year Ended June 30, 2023

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MEMORANDUM ON INTERNAL CONTROL

To the City Council of
the City of Los Altos, California

In planning and performing our audit of the basic financial statements of the City of Los Altos (City) as of and for the year ended June 30, 2023, 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 audit procedures that are appropriate in the circumstances 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.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore material weaknesses or significant deficiencies may exist that were not identified. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

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 City's financial statements will not be prevented, or detected and corrected on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

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. We consider the deficiencies in internal control included on the Schedule of Significant Deficiency to be significant deficiency.

Management'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.

Government Auditing Standards require the auditor to perform limited procedures on the City's response to the findings identified in our audit and described in the accompanying Schedule of Significant Deficiency. The City's response was not subjected to the other auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the response.

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 *Government Auditing Standards*, and is not intended to be and should not be used by anyone other than these specified parties.

Pleasant Hill, California
March 15, 2024

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MEMORANDUM ON INTERNAL CONTROLS

SCHEDULE OF SIGNIFICANT DEFICIENCY

2023-01 Timeliness of Year-End Close

Criteria: Effective organizations develops plans to ensure that adequate resources are available to analyze the City's general ledger to ensure that all accounts are accurate and timely for the reporting year. These resources need to be in place throughout the fiscal year to ensure proper accounting processes and procedures and allow time for the analysis of account balances and activities.

Condition: During the audit, City staff proposed numerous post-closing journal entries, which caused the audit team to reprocess and reanalyze the trial balance. City staff had difficulty completing closing entries prior to providing the trial balance for audit in various areas, which affected the year-end closing process and many of the City's funds. As a result, the year-end audit was adversely affected.

Cause: The tight labor market directly impacted the City's recruitment causing multiple vacancies in the finance department.

Potential Effect: The above condition delayed the completion of the year-end closing process, which increases the risk that errors or misstatements may go undetected and corrections may not be made in a timely manner.

Recommendation: The City should analyze staff resources to ensure the financial data is processed correctly and timely. In addition, the City should develop procedures to ensure that accounts are analyzed throughout the fiscal year to ensure a timely closing.

Management Response:

The City remains actively engaged in recruitment efforts. In January 2024, the Finance Department successfully hired one CIP/Finance manager, two accounting technicians, and one special project manager for ERP implementation. Additionally, it is projected that the Finance Manager position will be filled by May 2024..

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SCHEDULE OF OTHER MATTERS

NEW GASB PRONOUNCEMENTS OR PRONOUNCEMENTS NOT YET EFFECTIVE

The following comment represents new pronouncements taking effect in the next few years. We have cited them here to keep you abreast of developments:

EFFECTIVE FISCAL YEARS 2022, 2023 and 2024:

GASB 99 – Omnibus 2022

The objectives of this Statement are to enhance comparability in accounting and financial reporting and to improve the consistency of authoritative literature by addressing (1) practice issues that have been identified during implementation and application of certain GASB Statements and (2) accounting and financial reporting for financial guarantees. The practice issues addressed by this Statement are as follows:

- Classification and reporting of derivative instruments within the scope of Statement No. 53, Accounting and Financial Reporting for Derivative Instruments, that do not meet the definition of either an investment derivative instrument or a hedging derivative instrument.

- Clarification of provisions in Statement No. 87, Leases, as amended, related to the determination of the lease term, classification of a lease as a short term lease, recognition and measurement of a lease liability and a lease asset, and identification of lease incentives.

- Clarification of provisions in Statement No. 94, Public-Private and Public-Public Partnerships and Availability Payment Arrangements, related to (a) the determination of the public-private and public-public partnership (PPP) term and (b) recognition and measurement of installment payments and the transfer of the underlying PPP asset.

- Clarification of provisions in Statement No. 96, Subscription-Based Information Technology Arrangements, related to the subscription-based information technology arrangement (SBITA) term, classification of a SBITA as a short term SBITA, and recognition and measurement of a subscription liability.

- Extension of the period during which the London Interbank Offered Rate (LIBOR) is considered an appropriate benchmark interest rate for the qualitative evaluation of the effectiveness of an interest rate swap that hedges the interest rate risk of taxable debt.

- Accounting for the distribution of benefits as part of the Supplemental Nutrition Assistance Program (SNAP).

- Disclosures related to nonmonetary transactions.

- Pledges of future revenues when resources are not received by the pledging government.

- Clarification of provisions in Statement No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments, as amended, related to the focus of the government-wide financial statements.

GASB 99 – Omnibus 2022 (Continued)

- Terminology updates related to certain provisions of Statement No. 63, Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position.

- Terminology used in Statement 53 to refer to resource flows statements.

The Requirements of this Statement are Effective as Follows:

The requirements in paragraphs 26–32 related to extension of the use of LIBOR, accounting for SNAP distributions, disclosures of nonmonetary transactions, pledges of future revenues by pledging governments, clarification of certain provisions in Statement 34, as amended, and terminology updates related to Statement 53 and Statement 63 are effective upon issuance.

The requirements in paragraphs 11–25 related to leases, PPPs, and SBITAs are effective for fiscal years beginning after June 15, 2022, and all reporting periods thereafter.

The requirements in paragraphs 4–10 related to financial guarantees and the classification and reporting of derivative instruments within the scope of Statement 53 are effective for fiscal years beginning after June 15, 2023, and all reporting periods thereafter.

Earlier application is encouraged and is permitted by individual topic.

How the Changes in This Statement Will Improve Financial Reporting

The requirements of this Statement will enhance comparability in the application of accounting and financial reporting requirements and will improve the consistency of authoritative literature. Consistent authoritative literature enables governments and other stakeholders to more easily locate and apply the correct accounting and financial reporting provisions, which improves the consistency with which such provisions are applied. The comparability of financial statements also will improve as a result of this Statement. Better consistency and comparability improve the usefulness of information for users of state and local government financial statements.

EFFECTIVE FISCAL YEAR 2023/24:

GASB 100 – Accounting for Changes and Error Corrections

The primary objective of this Statement is to enhance accounting and financial reporting requirements for accounting changes and error corrections to provide more understandable, reliable, relevant, consistent, and comparable information for making decisions or assessing accountability

This Statement defines accounting changes as changes in accounting principles, changes in accounting estimates, and changes to or within the financial reporting entity and describes the transactions or other events that constitute those changes. As part of those descriptions, for (1) certain changes in accounting principles and (2) certain changes in accounting estimates that result from a change in measurement methodology, a new principle or methodology should be justified on the basis that it is preferable to the principle or methodology used before the change. That preferability should be based on the qualitative characteristics of financial reporting—understandability, reliability, relevance, timeliness, consistency, and comparability. This Statement also addresses corrections of errors in previously issued financial statements. This Statement prescribes the accounting and financial reporting for (1) each type of accounting change and (2) error corrections. This Statement requires that (a) changes in accounting principles and error corrections be reported retroactively by restating prior periods, (b) changes to or within the financial reporting entity be reported by adjusting beginning balances of the current period, and (c) changes in accounting estimates be reported prospectively by recognizing the change in the current period. The requirements of this Statement for changes in accounting principles apply to the implementation of a new pronouncement in absence of specific transition provisions in the new pronouncement. This Statement also requires that the aggregate amount of adjustments to and restatements of beginning net position, fund balance, or fund net position, as applicable, be displayed by reporting unit in the financial statements.

This Statement requires disclosure in notes to financial statements of descriptive information about accounting changes and error corrections, such as their nature. In addition, information about the quantitative effects on beginning balances of each accounting change and error correction should be disclosed by reporting unit in a tabular format to reconcile beginning balances as previously reported to beginning balances as restated.

Furthermore, this Statement addresses how information that is affected by a change in accounting principle or error correction should be presented in required supplementary information (RSI) and supplementary information (SI). For periods that are earlier than those included in the basic financial statements, information presented in RSI or SI should be restated for error corrections, if practicable, but not for changes in accounting principles.

EFFECTIVE FISCAL YEAR 2024/25:

GASB 101 – Compensated Absences

The objective of this Statement is to better meet the information needs of financial statement users by updating the recognition and measurement guidance for compensated absences. That objective is achieved by aligning the recognition and measurement guidance under a unified model and by amending certain previously required disclosures.

Recognition And Measurement

This Statement requires that liabilities for compensated absences be recognized for (1) leave that has not been used and (2) leave that has been used but not yet paid in cash or settled through noncash means. A liability should be recognized for leave that has not been used if (a) the leave is attributable to services already rendered, (b) the leave accumulates, and (c) the leave is more likely than not to be used for time off or otherwise paid in cash or settled through noncash means. Leave is attributable to services already rendered when an employee has performed the services required to earn the leave. Leave that accumulates is carried forward from the reporting period in which it is earned to a future reporting period during which it may be used for time off or otherwise paid or settled. In estimating the leave that is more likely than not to be used or otherwise paid or settled, a government should consider relevant factors such as employment policies related to compensated absences and historical information about the use or payment of compensated absences. However, leave that is more likely than not to be settled through conversion to defined benefit postemployment benefits should not be included in a liability for compensated absences.

This Statement requires that a liability for certain types of compensated absences—including parental leave, military leave, and jury duty leave—not be recognized until the leave commences. This Statement also requires that a liability for specific types of compensated absences not be recognized until the leave is used.

This Statement also establishes guidance for measuring a liability for leave that has not been used, generally using an employee’s pay rate as of the date of the financial statements. A liability for leave that has been used but not yet paid or settled should be measured at the amount of the cash payment or noncash settlement to be made. Certain salary-related payments that are directly and incrementally associated with payments for leave also should be included in the measurement of the liabilities.

With respect to financial statements prepared using the current financial resources measurement focus, this Statement requires that expenditures be recognized for the amount that normally would be liquidated with expendable available financial resources.

GASB 101 – Compensated Absences (Continued)

Notes to Financial Statements

This Statement amends the existing requirement to disclose the gross increases and decreases in a liability for compensated absences to allow governments to disclose only the net change in the liability (as long as they identify it as a net change). In addition, governments are no longer required to disclose which governmental funds typically have been used to liquidate the liability for compensated absences.

How the Changes in this Statement Will Improve Financial Reporting

The unified recognition and measurement model in this Statement will result in a liability for compensated absences that more appropriately reflects when a government incurs an obligation. In addition, the model can be applied consistently to any type of compensated absence and will eliminate potential comparability issues between governments that offer different types of leave.

The model also will result in a more robust estimate of the amount of compensated absences that a government will pay or settle, which will enhance the relevance and reliability of information about the liability for compensated absences.

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STATUS OF PRIOR YEARS SCHEDULE OF SIGNIFICANT DEFICIENCY

2020-01: Timely Preparation of Bank Reconciliations and Investment Reconciliations

Bank and investment reconciliations are an important element of the City's internal control and bank reconciliations and related adjustments should be completed after month end, generally within 30-45 days.

During our testing of internal controls over bank and investment reconciliations, we selected bank and investments reconciliations for the months of January and February 2021 to test, however, these reconciliations were not ready as of August 2021. The June 2021 bank reconciliations were not completed until late December 2021, six months later.

According to the Finance staff, the delay was due to the staff shortage and turnover.

Without the timely completion of bank and investment reconciliations, errors or unauthorized transactions in these accounts might not be detected and remedied in a timely manner.

We recommend that the City ensure that the bank and investment reconciliations are prepared and reviewed timely within 30 to 45 days of the end of the reporting period.

Current Status:
The City completed the bank reconciliations for June 30, 2023 timely. However, the cash clearing accounts the Finance utilized to keep track of the details of the cash and investments was not reconciled with the general ledger until January 2024.

Management Response on Current Status:

> In October 2023, the City conducted an update to its ERP software system, resulting in a discrepancy between the cash clearing accounts and the detailed general ledger accounts. Finance staff resolved the discrepancy and rectified the ERP software error in January 2024.

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STATUS OF PRIOR YEARS SCHEDULE OF OTHER MATTERS

2022-01: Fund Type

GAAP provide that enterprise funds may be used to report any activity for which a fee is charged to external users for goods or services.

It appears Storm Drain Enterprise Fund has not charged fees to external users since FY2018.

This Fund might not longer qualify as a enterprise fund type.

We recommend the City evaluate the Storm Drain Fund and consider merging it into General Fund if it no longer qualifies as an enterprise fund, as applicable in the future years.

Current Status:
The City merged the Storm Drain into the General Fund in the fiscal year 2023.

2021-01: Timely Invoice payments

The City should pay vendor invoices in a timely manner, within 30-45 days of receiving the invoices.

During our interim audit sampling testing, we noted that the City did not pay three invoices sampled in a timely manner. According to the Finance staff, the delay was due to the delayed approval by the Department.

Accounting records may not be properly reflected in the correct reporting periods if the invoices were not processed in a timely manner. Expenditures may be under stated and cash available may be overstated due to the delay.

We recommend the City should communicate with the other departments in the City and establish corresponding standard procedures to ensure timely submission of invoices to Finance.

Current Status:
No exceptions were noted during the fiscal year 2023 audit.

Management Response:

The City has introduced internal controls for the year-end closing process. Departments submitted their invoices in a timely manner during fiscal year 2023.

STATUS OF PRIOR YEARS SCHEDULE OF OTHER MATTERS

2021-03: Information System Risk Management Policy

Risk management policy is to provide guidance regarding the management of risk to support the achievement of the City's objectives, protect staff and business assets and ensure financial sustainability.

During the information system review with the City, we noted that the IT department has no written risk management policy.

Without specific Risk Management Policy, the City is leaving the determination of how to deal with cyberattacks to individual employees, which could impede financial statement reporting.

We recommend that the City to set up a formal written Information System Risk Management Policy to ensure the security of the financial system and be well prepared for unexpected cyberattacks.

Current Status:
Implemented

Management Response:

The City staff has finalized the policy and conducted the risk management audit in fiscal year 2023.

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STATUS OF PRIOR YEARS SCHEDULE OF OTHER MATTERS

2020-03: Journal Entries Preparation and Posting

Segregation of duties is an integral part in maintaining adequate effectiveness in an entity's internal control environment. Journal entries are an important transaction cycle that affects all aspects of accounting and financial reporting. Prudent internal control concepts dictate that no single employee should have the ability to process a transaction without the involvement of another employee.

During our testing of journal entries, we noted that both the Financial Services Manager and Administrative Services Director can prepare and post the journal entries to the finance system directly.

It appeared that the Finance System was set up to allow both staff to prepare and post the journal entries.

Allowing the preparer to post their own journal entries, even after review by a 2nd staff, could subject the City to the potential risk of the journal entries being manipulated or altered with further verification.

We recommend that the City establish proper procedures to ensure the segregation of duties to mitigate the potential risk of journal entries being altered without verification.

Current Status:
No exceptions were noted during the fiscal year 2023 audit.

Management Response on Current Status:

The City has employed temporary staff to fill vacancies, ensuring timely posting in fiscal year 2023.

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