

CITY OF NEWTON, MASSACHUSETTS

MANAGEMENT LETTER

JUNE 30, 2010



Certified Public Accountants

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To the Honorable Board of Aldermen and Mayor
City of Newton, Massachusetts

In planning and performing our audit of the financial statements of the City of Newton, Massachusetts (City) as of and for the year ended June 30, 2010, 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, 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.

However, during our audit we became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and recommendations regarding those matters. This letter does not affect our report dated November 23, 2010, on the financial statements of the City.

The City's written responses to the matters identified in our audit 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, the Audit Committee, the Board of Aldermen, Mayor, and others within the organization and should not be used by anyone other than these specified parties.

A handwritten signature in black ink that reads "Sullivan, Rogers & Company, LLC". The signature is written in a cursive, flowing style.

November 23, 2010

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TABLE OF CONTENTS

	Page
Comments and Recommendations.....	1
Water and Sewer Billings.....	1
Bank Account Reconciliations.....	2
Water and Sewer Enterprise Fund Indirect Costs.....	3
Abandoned Property.....	4
Accounts Receivable Reconciliations.....	5
Risk Assessment and Monitoring.....	6
Student Activity Funds.....	7
Financial Policies and Procedures Manual.....	8
New Accounting and Financial Reporting Requirements for Fund Balances.....	9

Comments and Recommendations

Water and Sewer Billings

Comment

Consistent with the prior year, we identified the following deficiencies related to the City's water and sewer billing system:

1. Many water and sewer bills are based on estimates. We identified that some accounts had as many as 12 consecutive estimates and overall approximately 52% of users have multiple estimated bills.
2. Many water and sewer bills were based on "false reads", resulting from a faltering metering system.

During fiscal year 2010, the Water and Sewer Department continued to make a concerted effort to obtain actual readings on accounts that were based on estimates (beginning with accounts with the largest number of consecutive estimates) and accounts where readings appeared abnormal. As a result, the Water and Sewer Department issued approximately \$3,300,000 in abatements during fiscal year 2010, a decrease of approximately \$5,300,000 from fiscal year 2009. The cause of a substantial amount of these abatements is as follows:

1. Overestimates (approximately \$2,600,000)
2. False readings (approximately \$600,000)

It is important to note that the majority of these abatements were made prior to the taxpayer physically paying the bill. Actual cash outflows (i.e., refunds) totaled approximately \$522,000 during the fiscal year.

The installation of new meters and reading devices began in February 2010 and is expected to be completed by April 2012. As of June 30, 2010 approximately 5% of these new meters had been installed. As part of our subsequent audit work, we identified that abatements totaling approximately \$432,000 had been granted for July and August 2010 billings, which is less than the abated amount for the same period of the previous fiscal year by approximately \$87,000. It is imperative that accurate actual readings occur on all accounts at all times to properly bill customers for water and sewer use, which, under the current system, will require Water and Sewer personnel to manually obtain. The current billing system is ineffective and inefficient.

Recommendation

The City is currently in the process of replacing all of the City's meters and implementing a new metering process that will allow the City to remotely obtain a reading from City Hall at any point in time. The implementation of this new system should significantly reduce the need for substantial abatements (once the system is fully operational) since estimates will no longer be required and the ability to identify false readings will be enhanced. We recommend that the new metering system be implemented as soon as possible.

Management's Response

Management is in complete agreement with this recommendation.

Bank Account Reconciliations

Comment

Consistent with prior years, we identified many instances where reconciling items identified on *individual bank account reconciliations* were not investigated and/or resolved timely. Proper internal controls require the timely and appropriate resolution of reconciling items.

We also identified that monthly individual bank account reconciliations for the primary depository accounts and vendor and payroll checking accounts are not completed until 2 to 3 months after the end of the applicable month. Proper internal controls require the timely completion of individual bank account reconciliations.

Recommendation

We recommend that all reconciling items identified on individual bank account reconciliations be investigated and resolved by the subsequent month's bank account reconciliation.

We recommend individual bank account reconciliations be completed no later the 30 days subsequent to the prior month's end.

Management's Response

With the addition to the staff of a new Accounts Receivable Processor position in August, 2010 the primary deposit accounts are now being reconciled daily. As a result, outstanding items on individual bank accounts are being cleared in a timelier manner, usually by the end of the subsequent month, as recommended. It should be noted that some items, while not cleared, have been identified and are awaiting anticipated resolution. Also, the vendor and payroll accounts incurred delays in the last quarter of the fiscal year associated with the withdrawal of Bank of New York Mellon from the municipal government market, necessitating a change of banks to Eastern Bank. This resulted in transitional reconciliation issues which are presently being addressed.

Water and Sewer Enterprise Fund Indirect Costs

Comment

The water and sewer enterprise funds are charged for various indirect costs for interdepartmental services. Based on our audit, we believe the City's indirect cost allocations appear reasonable and appropriate.

The Massachusetts Department of Revenue (DOR) has issued an "Informational Guideline Release" (IGR 08-101) in which the DOR recommends every community with an enterprise fund establish a written, internal policy regarding indirect cost allocations, which are to be reviewed annually. We identified that the City does not have a written policy related to the water and sewer enterprise funds' indirect cost allocations.

Recommendation

We recommend the City implement the recommendations of the DOR as identified in IGR 08-101 by establishing a written internal policy regarding indirect cost allocation, which should be reviewed annually. In addition (and as stated in IGR 08-101), as part of the annual budgeting process, City officials should understand and agree on what indirect costs are appropriated as part of the general fund operating budget and what percentage of these costs should be allocated to the water and sewer enterprise funds.

Management's Response

The Comptroller and Public Works Department Chief of Budget and Finance will document the interdepartmental services cost allocation plan prior to the spring 2011 rate setting review process.

Abandoned Property

Comment

At June 30, 2010, the City's general ledger reports a liability for unclaimed checks totaling approximately \$581,000. However, there are currently no procedures in place to investigate and resolve the status of these unclaimed checks. In addition, a current list of check numbers, check dates, payee names and amounts that support the amount reported on the general ledger is not maintained, which inhibits the facilitation of the resolution of the unclaimed amounts.

In addition, the City has not placed any old outstanding checks into tailings for the past two fiscal years.

Recommendation

We recommend that the Comptroller and Treasurer/Collector's office work together to investigate and identify the check numbers, check dates, payee names and amounts that reconcile to the balance reported on the general ledger.

We recommend that the Treasurer/Collector's office implement procedures to investigate and resolve the unclaimed check amounts.

We recommend that the Treasurer/Collector implement procedures to place old outstanding checks into tailings annually, at a minimum.

Management's Response

Letters, postings, and published notices were issued in fiscal year 2010 for \$97,975.91 of vendor checks deemed abandoned property. Actual designation as such to the Comptroller has been delayed while awaiting a final listing of outstanding checks for both the vendor and payroll accounts from Bank of New York Mellon in conjunction with the transition of these accounts to Eastern Bank during last quarter of fiscal year 2010 and first quarter of fiscal year 2011. Further tailings have also been delayed by the non-maintenance of a name and address database for outstanding checks. Treasury will work with IT and the Comptroller to reestablish and maintain this database for use in the periodic clearing of Eastern Bank checks, annually at a minimum.

Accounts Receivable Reconciliations

Comment

Through the date of this report, improvements were made regarding the timely reconciliation of non-utility accounts receivable balances between the Collector's detailed balances and the general ledger.

However, procedures are not in place to reconcile the Collector's detailed water and sewer accounts receivable balances to the general ledger timely. Effective internal controls require the timely reconciliation of detailed accounts receivable balances to the general ledger. Failure to perform these tasks timely inhibits the safeguarding of assets and does not provide for accurate and timely financial reporting.

Recommendation

We recommend that the City reconcile the Collector's detailed water and sewer accounts receivable balances to the general ledger no later than 30 days after the end of the previous month. We also recommend that the Treasurer/Collector and Comptroller approve (e.g., sign off) each accounts receivable reconciliation.

Management's Response

Monthly reconciliations between the general ledger control totals and MUNIS detail are performed monthly by the Comptroller and Deputy Treasurer for all major receivables, with the exception of the water and sewer receivables. A summary document identifying specific reconciling items is prepared as documentation for the monthly process. Not later than February, 2011 the Comptroller and Deputy Treasurer will extend the monthly process to include water and sewer rate receivables.

Risk Assessment and Monitoring

Comment

When internal controls are *initially* implemented, they are usually designed to adequately safeguard assets. However, over time, these controls can become ineffective due to changes in technology, operations, etc. In addition, changes in personnel and structure, as well as the addition of new programs and services, can add risks that previously did not exist. As a result, all municipalities must periodically perform a risk assessment to anticipate, identify, analyze and manage the risk of asset misappropriation. Risk assessment (which includes fraud risk assessment), is one element of internal control.

The risk assessment should be performed by management-level employees who have extensive knowledge of the City's operations. Ordinarily, the management-level employees would conduct interviews or lead group discussions with personnel who have knowledge of the City's operations, its environment, and its processes. The risk assessment process should consider the City's vulnerability to misappropriation of assets. It should also address operations that involve heightened levels of risk. When conducting the assessment, the following questions should be considered:

- What assets are susceptible to misappropriation?
- What departments receive cash receipts?
- What departments have movable inventory?
- What operations are the most complex?
- How could assets be stolen?
- Are there any known internal control weaknesses that would allow misappropriation of assets to occur and remain undetected?
- How could potential misappropriation of assets be concealed?
- What prior internal control issues could still continue to be problematic?

Once the areas vulnerable to risks have been identified, a review of the City's systems, procedures, and existing controls related to these areas should be conducted. The City should consider what additional controls (if any) need to be implemented to reduce risk.

After risk has been assessed, periodic monitoring of the identified risk areas must be performed in order to evaluate the controls that have been implemented to mitigate the risks. Since control-related policies and procedures tend to deteriorate over time, the monitoring process ensures that controls are fully operational and effective.

Recommendation

We recommend that management develop and implement a risk assessment program to periodically anticipate, identify, analyze, and manage the risk of asset misappropriation. The risk assessment program should be formally documented and become part of the City's financial policies and procedures manual.

We recommend that management develop and implement a monitoring program to periodically evaluate the operational effectiveness of internal controls. The monitoring process should be documented in order to facilitate the evaluation of controls and to identify improvements that need to be made.

Management's Response

Management will explore this recommendation further with the City's auditors and the new Financial Audit Advisory Committee.

Student Activity Funds

Comment

The City maintains student activity funds for several of its schools. Massachusetts General Laws (MGL) Chapter 71, Section 47, which establishes various guidelines related to student activity funds, states the following:

“There shall be an annual audit of the student activity funds which shall be conducted in accordance with procedures as agreed upon between the school committee and the auditor based upon guidelines issued by the department of education.”

An annual audit or agreed upon procedures is not being performed on the City’s student activity funds. Based upon the MGL requirement and the inherent risks associated with student activity funds, we believe that the performance of an audit or agreed-upon procedures on the City’s student activity funds would be prudent.

It should be noted that the City’s general fund does not necessarily have to bear the cost of the audit or agreed-upon procedures engagement, as these activities could be funded from student activity fund resources.

Recommendation

We recommend the City comply with the requirements of MGL Chapter 71, Section 47 by having an audit or agreed-upon procedures performed on their student activity funds.

Management’s Response

The school administration works closely with each school's accounting for student activity funds each year including a year end balance and review. The school administration will continue to work with the Comptroller to comply with all management requirements including internal audits of the student activity accounts.

Financial Policies and Procedures Manual

Comment

Although the City adopted top level financial policies during fiscal year 2008, we believe that preparation of a formal policy and procedures manual would improve and standardize the City's financial policies and procedures. Without formalized written policies and procedures, the City is inherently subject to everyday inconsistencies in its operations. It is also difficult to measure performance and efficiencies without a baseline. The number of such inconsistencies can be minimized by the written codification of policies and procedures and insistence on adherence to them.

Such a manual should include policies and procedures relative to all financial functions and processes, including, but not limited to, the following:

- Cash receipts
- Purchase orders
- Cash disbursements
 - Payroll
 - Vendor
- Administration of grants
- Administration of student activity funds
- Personnel (i.e., hiring, payroll and related changes, etc.)
- Month-end and year-end closing procedures

The manual should also clearly define the objectives, responsibilities and authorizations for all employees/job positions.

The use of written policies, procedures, and job descriptions in conjunction with specific assignment of responsibilities would increase supervisory personnel's effectiveness. Such written documents would decrease the time spent on supervision of clerical personnel and in attempts to define job responsibilities on each occasion of employee turnover.

Recommendation

We recommend that the City develop and implement a financial policies and procedures manual.

Management's Response

Management is in complete agreement with this recommendation. The Finance/Administration working group of department heads will develop a plan for preparation of required documentation between now and June 30, 2011, with the objective of having documentation complete over the course of the next twelve months.

New Accounting and Financial Reporting Requirements for Fund Balances

Comment

The Governmental Accounting Standards Board (GASB) has issued Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions. The objective of this Statement is to enhance the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and to clarify the existing governmental fund type definitions. This Statement establishes 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 initial distinction that will be made in reporting fund balance information is identifying amounts that are considered *nonspendable*, such as fund balance associated with loans receivable. This Statement also provides for additional classification as restricted, committed, assigned, and unassigned based on the relative strength of the constraints that control how specific amounts can be spent.

Governments will also be required to classify and report amounts in the appropriate fund balance classifications by applying their accounting policies that determine whether restricted, committed, assigned, and unassigned amounts are considered to have been spent. Disclosure of the policies in the notes to the financial statements will be required.

This Statement also provides guidance for classifying stabilization funds on the face of the balance sheet and requires disclosure of certain information about stabilization funds in the notes to the financial statements.

The definitions of the general fund, special revenue fund type, capital projects fund type, debt service fund type, and permanent fund type are clarified by the provisions in this Statement. Interpretations of certain terms within the definition of the special revenue fund type have been provided and, for some governments, those interpretations may affect the activities they choose to report in those funds. The capital projects fund type definition also was clarified for better alignment with the needs of preparers and users. Definitions of other governmental fund types also have been modified for clarity and consistency.

Implementation of this statement will improve financial reporting by:

- Providing fund balance categories and classifications that will be more easily understood
- Eliminating the *reserved* component of fund balance in favor of a *restricted* classification to enhance the consistency between information reported in the government-wide statements and information reported in the governmental funds financial statements
- Requiring governments to classify amounts consistently, regardless of the fund type or column in which they are reported
- Providing disclosures to give users information necessary to understand the processes under which constraints are imposed upon the use of resources and how those constraints may be modified or eliminated
- Reducing uncertainty about which resources can or should be reported in the respective governmental fund types

Given the significance of fund balance amounts (both quantitatively and qualitatively), the fund balance reporting under the new standard will have a significant impact on the City's financial statements.

The City's required implementation date of GASB Statement No. 54 is fiscal year 2011.

Recommendation

We recommend that management familiarize itself with GASB Statement No. 54 to prepare for its implementation. We would be pleased to assist the City with its preparation for implementing the new standards.

Management's Response

The Comptroller will implement GASB statement 54 for June 30, 2011 external financial reporting.