

CITY OF NEWTON, MASSACHUSETTS

MANAGEMENT LETTER

JUNE 30, 2012



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, 2012, 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. We also want to make you aware of a recently issued accounting standard that will significantly impact your financial statements in future years. The memorandum that accompanies this letter summarizes our comments and recommendations regarding those matters. This letter does not affect our report dated November 26, 2012, 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 26, 2012

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Comments and Recommendations

Water and Sewer Billings

Comment

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

1. Some water and sewer bills continue to be based on estimates. We identified that some accounts had as many as 12 consecutive estimates and overall approximately 5% of users have multiple estimated bills.
2. Some water and sewer bills were based on "false reads", resulting from a faltering reading system.

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 \$4,000,000 in abatements during fiscal year 2012, a decrease of approximately \$800,000 from fiscal year 2011. The cause of a substantial amount of these abatements is as follows:

1. Overestimates (approximately \$3,100,000)
2. False readings (approximately \$116,000)

The City began the installation of new meters and reading devices in February 2010 and is expected to be completed by December 2012. As of June 30, 2012 approximately 99% of these new meters had been installed, but the reading system was not entirely functional. As part of our subsequent audit work, we identified that abatements totaling approximately \$130,000 had been granted for July and August 2012 billings, a decrease of approximately \$343,000 from the same period of the previous fiscal year. 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.

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 at 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

The new meter and meter reading systems should be fully operational shortly. Only properties with piping issues remain to be completed, which represents 0.8% of the total project. With actual readings being transmitted, the City anticipates abatements needing to be processed will be minimal, particularly in light of the fact that notification of exceptional usage has already been implemented.

City-Wide Grants Administrator

Comment

Excluding local aid distributions and state grants received for school construction and roadway repairs and reconstruction, the City has received approximately \$60 million in federal and state grants over the past three (3) fiscal years.

The City's current structure places the responsibility of administering federal and state grants at the Department level. Although the City's School and Planning and Development Departments employ grant administrators, no such position exists for the remainder of the City's Departments. We believe the current structure places the City at risk in the administration and adherence to compliance requirements of state and federal grants.

Failure to comply with federal and state grant compliance requirements can potentially result in the City repaying monies that were not spent in compliance with grant requirements or may lead to a reduction of future grant awards due to the inadequacy of the internal controls surrounding grant programs.

Recommendation

We recommend the City consider employing a City-wide Grants Administrator (federal and state grants) that possesses significant knowledge of federal and state guidelines (i.e., OMB Circulars A-133, A-87, etc.) and compliance requirements, and is familiar with federal and state grant contracts and agreements.

Management's Response

Given the expiration funding for all federal stimulus (ARRA) programs and likely further reductions in federal spending, it is not clear that the City of Newton will have sufficient federal grant activity outside the Newton Public Schools and Planning and Community Development Department, to support a full time position devoted to federal grants administration. We will, however, evaluate other options for enhancing the level of control and oversight over federal grant programs in departments other than the Newton Public Schools and Planning and Community Development Department with existing staffing.

Parks and Recreation

Comment

We documented the system of internal control surrounding the Parks and Recreation Department's (Department) cash receipt activities and identified the following:

- Although daily bracelets are utilized at each swimming facility (Gath Pool and Crystal Lake), no log is maintained that identifies the starting and ending bracelet number sold for each day. In addition, no documentation exists that reconciles the number of daily bracelets sold to the actual cash receipts collected. The current process inhibits the ability to reconcile cash collections to the use of the facilities.
- The Schedule of Payments to City Treasurer (Schedule) submitted by the Department does not contain the signature of the preparer or reviewer of the document. As a result, key controls are not being documented, which is a weakness in internal control.
- There is no documentation (i.e., an initial or signature) supporting the review/reconciliation of the deposit made to the bank to the summary report of receipts entered into the Department's internal database (SportsMan).

Recommendation

We recommend the use of a manual log that identifies the starting and ending bracelet number sold each day. In addition, we recommend a daily formal reconciliation be prepared that reconciles the number of bracelets sold to cash collections.

We recommend the Schedule contain preparer and reviewer signatures.

We recommend the Department's bookkeeper formally document (i.e., a signature or initials) the reconciliation of deposits to receipts entered into SportsMan.

Management's Response

The Comptroller is in agreement with these recommendations and will work with the Parks Department to implement the improvements. Departmental cash receipt collections will be a primary area of focus for the City's Audit Committee during the next year.

Service Organization Controls

Comment

The City, like many local governments in Massachusetts, engages third-party service providers (service organizations) to process certain financial transactions (i.e., Deputy Tax Collector). In such instances, the related financial transactions are affected by the City's internal controls and the controls employed by the service organization. Therefore, as part of its monitoring efforts to ensure that internal controls over financial reporting are effective and functioning as intended, City management must evaluate whether service organization controls are suitably designed and effective.

Furthermore, service organizations often have information regarding employees and customers that must be protected (e.g., social security numbers). Such controls generally relate to the security, availability, processing integrity, confidentiality or privacy of information. Therefore, as part of its monitoring efforts to ensure the privacy and protection of its employees and customers' information, management must evaluate whether service organization controls are suitably designed and effective.

The most effective and efficient way for the City to accomplish its monitoring efforts is to obtain the appropriate *Service Organization Control (SOC)* reports from its third-party service providers.

There are two types of SOC reports that service auditors provide to service organizations for the benefit of their users, which are as follows:

- SOC 1 (previously SAS 70) reports – provide an opinion on controls at a service organization that are likely to be relevant to a user entity's internal control over financial reporting
- SOC 2 reports – provide an opinion on controls at a service organization that are related to the American Institute of Certified Public Accountants (AICPA) Trust Service Principles, which are (1) security; (2) availability; (3) processing integrity; (4) confidentiality; and (5) privacy.

Service organizations should be engaging a service auditor to provide the appropriate SOC report(s) and should make the resulting report available to their customers (e.g., the City).

Recommendation

We recommend the City identify each service organization utilized and request the applicable SOC report (annually).

Because all service organizations are an extension of the City's internal control, we recommend all service organization contracts include a requirement to obtain the appropriate SOC report (annually).

Management's Response

The Comptroller is in agreement with this recommendation and will work with the Treasurer and Planning and Community Development Department; and Retirement Board to implement the recommendation during the second half of fiscal year 2013.

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 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 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

The City's Audit Committee and management are in agreement with this recommendation and will continue to work to implement such activities.

Police Details

Comment

The City currently has approximately \$33,000 of police detail accounts receivables that are greater than one-year old. The receivables greater than one-year old date as far back as May 2008. For financial reporting purposes, the City considers these amounts uncollectible.

A formal policy that addresses the actual "write-off" of uncollectible police detail accounts receivable would assist the City in maintaining a fair and accurate accounts receivable balance and, in turn, identify amounts that must be funded from the General Fund timely.

In addition, the Police Department utilizes an internally developed access database to account for its police detail billings and collections. We believe the use of software specifically designed for billing and collection would provide clearer audit trails and the ability to produce billing and collection reports effectively and efficiently.

Recommendation

We recommend the City develop and implement a formal policy regarding uncollectible police detail accounts receivable and the "write-off" of such receivable balances.

We recommend the City consider purchasing "off the shelf" software to maintain its police detail billing and collection activities.

Management's Response

The City's Law Department continues to work with the Police Department in an effort to collect all delinquent unpaid police detail bills. A process is currently in place whereby the Police Department and Law Department review outstanding detail receivables and based upon their joint analysis recommend the write off of any amounts not judged to be collectible to the Comptroller. A total of \$34,451 in such unpaid accounts was written off at June 30, 2012, using unexpended police salary funds as a financing source. The City's existing police detail receivable system is currently being modified to allow for the calculation and accounting and reporting of interest on delinquent accounts. Weekly uncollectible account reports are also now being forwarded to the Law Department; Engineering Department; and Comptroller. We will continue to evaluate options to existing billing and collection software.

Student Activity Funds

Comment

The City maintains student activity funds at many 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.”

Consistent with prior years, an annual audit or agreed upon procedures was not performed on the City’s student activity funds. However, subsequent to fiscal year end, the City internally performed agreed upon procedures on the Newton North and Newton South High Schools’ student activity funds.

Internally performed audits and/or agreed upon procedures are considered acceptable in complying with the related requirements of MGL Chapter 71, Section 47. However, the Massachusetts Association of School Business Officials’ (MASBO) *Student Activity Accounts Guidelines for Massachusetts School Districts* recommends an independent audit firm conduct the audits and/or agreed upon procedures at least once every three (3) years.

Recommendation

We recommend the City continue to make a concerted effort to comply with the requirements of MGL Chapter 71, Section 47 by, having an annual audit or agreed-upon procedures performed on *all* of its student activity funds.

We recommend the City consider the MASBO recommendation to have an independent audit firm conduct the student activity fund audits and/or agreed upon procedures at least once every three (3) years.

Management’s Response

The Newton Public Schools will work with the Comptroller to follow the MASBO recommended guidelines for student activity fund audits on a three year basis. The plan will be to continue the internal audits and to establish a schedule for independent audit review on approximately one third of the school accounts each year during the three year period, subject to available funding.

Unclaimed Checks

Comment

At June 30, 2012, the City's general ledger reports a liability for unclaimed checks totaling approximately \$500,000. However, a current list of check numbers, check dates, payee names, address and related amounts that support the amount reported on the general ledger was not provided to us. This information is critical when following up and resolving unclaimed check amounts.

Recommendation

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

We recommend the Treasurer/Collector's office implement procedures to investigate and resolve the unclaimed check amounts in accordance with Massachusetts Abandoned Property Laws.

Management's Response

Documents supporting the \$500,000 were sent to the Auditors on 11/26/12. It should be noted that this balance is approximately \$225,000 less than originally reported to the Comptroller, representing cleared items. The remaining items will be posted to the City's internet and handled much the same as old checks. Also, as part of Treasury's effort to finalize procedures. The City adopted MGL 200, Sec 9A, allowing the City to retain unclaimed proceeds, but requiring a process taking over one year.

Old Outstanding Checks

Comment

The vendor and payroll outstanding checklists maintained by the Treasurer include many checks greater than three (3) months old totaling approximately \$214,000. Typically, checks greater than three (3) months old reflect checks that have been void, lost, misplaced or stolen.

Recommendation

We recommend the Treasurer/Collector's office implement monthly procedures to investigate and resolve outstanding checks greater than three (3) months old. Implementation of this recommendation will strengthen internal controls over cash disbursements.

Management's Response

A system to address old checks was initiated in April 2012. Checks greater than 3 months old have been posted on the City's website since that time. A claim form has been made available as well. Claimed and reissued checks are deleted and new checks are added to the list on a monthly basis.

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 the City develop and implement a financial policies and procedures manual.

Management's Response

Both the Audit Committee and management are in agreement with this recommendation and will continue to work to implement it.

Disaster Recovery Plan

Comment

In our prior year management letter, we identified that although the City had a documented disaster recovery plan that addressed its financial data and related software, it did not have a plan that addressed the hardware required to access the data or the location(s) to operate the hardware. As a result, in the event of a disaster, the City's financial data and software could be recovered, but the City may not have the ability to physically run the software and access the financial data to maintain financial operations.

During fiscal year 2012, the City addressed the hardware required to access the data and location to operate the general ledger software (Finance Plus). However, the hardware required to access the detailed accounts receivable data (MUNIS) has not been addressed by the City.

Recommendation

We recommend management update the current disaster recovery plan by addressing the hardware requirements to access the detailed accounts receivable data.

Management's Response

The City's Information Technology Department presented the Audit Committee with a detailed disaster recovery plan that addresses all issues that have been raised in the management letter earlier this fall.

Pension Accounting and Financial Reporting

Comment

In June of 2012, the Governmental Accounting Standards Board (GASB) issued Statement No. 68, *Financial Reporting for Pension Plans – an Amendment of GASB Statement No. 25*, which revises and establishes new financial reporting requirements for governments that provide pension benefits to its employees and retirees.

The implementation of this Statement will represent a significant change in the accounting and reporting of pension expense and the related liability. For the first time, the City will be required to recognize its long-term obligation for pension benefits as a liability in its government-wide financial statements. The implementation of this Statement will also:

- More comprehensively measure the annual costs of pension benefits
- Place conditions on the use of the discount rate used to measure the projected benefit payments to their actuarial present value
- Require the use of the “entry age” actuarial cost allocation method, with each period’s service cost determined by a level percentage of pay (referred to as attribution method)
- Expand pension related note disclosures
- Expand pension related required supplementary information disclosures

The requirements of this Statement will improve the decision-usefulness of pension information in governmental financial statements and will enhance the comparability of pension information between governmental entities.

Given the significance of the pension fund liability, the financial reporting impact under the new standard will significantly affect the City’s financial statements.

It should be noted that the implementation of GASB Statement No. 68 is strictly a financial reporting standard and does not constitute a state or federal mandate regarding the funding of the net pension obligation.

The City’s required implementation date of GASB Statement No. 68 is fiscal year 2015.

Recommendation

We recommend management familiarize itself with GASB Statement No. 68 to prepare for its implementation.

Management’s Response

The Comptroller is in complete agreement with this recommendation. We will be working with the Retirement actuary and management of the Commonwealth of Massachusetts PRIM fund to make certain that required disclosures are available for implementation.