

Draft Report

City of Beaumont

Review of Internal Controls over Cash Receipts
and Disbursements

Date



Certified Public Accountants.

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Ad Hoc Committee on Internal Controls
C/o Nancy Carroll, City Treasurer
City of Beaumont
550 E. 6th Street
Beaumont, CA 92223

Dear Ms. Carroll:

I am pleased to present to the Ad Hoc Committee our draft report covering the Review of Internal Controls over Cash Receipts and Disbursements. We will be pleased to meet with you and the Committee to discuss this report at your convenience. Please call me at (213) 408-8666 or Byron Matson, Manager, at (916) 765-3337 if you have questions or concerns.

Very truly yours,

Scott P. Johnson, CPA
Partner

EXECUTIVE SUMMARY

WHY WE PERFORMED THIS REVIEW

The City of Beaumont's (City) City Council created an Ad Hoc Committee (Committee) to look into the repeated findings by the City's independent external financial auditors that controls over receipts and disbursements were weak. A Request for Proposal was issued and MGO Advisory Services was selected to perform a review of the internal controls over receipts and disbursements. MGO was also tasked by the Committee to perform a financial analysis of inter-fund transfers and other issues affecting City finances. That financial analysis was delivered to and accepted by the City Council in May 2015.

WHAT WE FOUND

The City's processes used by the Finance Department to receive and disburse funds are not adequately controlled. The primary cause is that the overall control environment is weak as evidenced by the following general observations:

- Lack of management emphasis on internal control
- Lack of city-wide policies and procedures for key finance activities.
- Separation of duties, especially in information technology areas, needs to be better defined and monitored.
- Key reconciliations are not performed adequately or on a regular basis.

Specifically, the issue we found include:

- Lack of overall emphasis by elected officials and Finance staff on improving the processes that control the City's finances.
- Lack of controls and defined roles and access related to the City's Information Technology systems for the City's cash receipts and general accounting processes and procedures.
- Reconciliations are not performed adequately or on a regular basis.
- Documentation of the daily recording of bank deposits into the "Great Plains" accounting system needs a more standardized approach
- Documentation for purchases are not maintained that indicate compliance with the City's Municipal Code and State Law.
- The method the City employs to pay Sales and Use Taxes on purchases may not be appropriate.
- Payments to electrical supply vendors are not properly supported by documentation.
- Payments of all types are not always approved by all required parties.
- Controls over petty cash are lacking.

WHAT WE RECOMMEND

A detailed account of each observation is provided in the Principal Results section of this report. Following is a summary of our recommendations to the City, which includes:

Improving the Control Environment

- Create a strong internal control environment, led by City Council, which requires City management to periodically report on the efforts to improve controls, and in particular, the progress made in implementing the recommendations made in this report.

Creating City-wide Policies and Procedures for Finance Functions

- Updating the step-by-step instructions now available for certain functions and including them in creating a comprehensive set of policies and procedures for financial operations. These policies and procedures should be clearly written, easily assessable by all staff, titled, numbered, dated, signed by the authorizing official and periodically reviewed and revised as needed. City Council should be periodically briefed on how well controls are functioning.
- Developing a purchasing policy to be part of the City's comprehensive policies and procedures.
- Formulating a more complete policy and procedure for petty cash transactions. This policy should include the requirement that the standard reimbursement form be used, the circumstances under which the \$50 maximum can be exceeded, and the requirement that replenishments be completed by a means other than cash withdrawal.
- Obtaining guidance on the appropriateness of the City's method to record Sales and Use Tax transactions for transactions occurring outside of City limits.
- Requiring invoices for all amounts paid to electrical supply vendors. The invoices (or a summary spreadsheet) should indicate on which City projects the materials were used. The appropriate City Department Manager should review the invoices to ensure and validate that the materials purchased were for City projects.
- Including instructions on all required approvals in a detailed policy and procedure document that clearly states all approvals must be obtained prior to the payment being scheduled for check printing or electronic payment.

Ensuring adequate separation of duties, especially in Information Technology Access and Roles

- Performing a complete review of gateway access, to include remote access, if applicable, and access and roles in major finance applications such as Incode and Great Plains. We recommend that a policy to regularly review IT access be instituted. We further recommend that employee access be immediately terminated when employees leave City employment or transfer to other City departments.

Performing key reconciliations adequately and on a regular basis.

- Bringing the bank reconciliations up-to-date and establishing a procedure to reconcile the Incode balances to Great Plains.
- Developing a template to be used to ensure that all deposit activity for each day is recorded into the Great Plains system in a consistent and structured manner. In addition, the daily reconciliation should be regularly reviewed by someone not directly involved in the process.

REVIEW OBJECTIVE, SCOPE AND METHODOLOGY

Objective

The objective of this review is to “focus on the administrative efficiency and effectiveness of each type of receipt and disbursement process as it relates to internal controls and potential improvement in those controls.”

Scope

The scope of work included all cash receipt and cash disbursement processes, with the exception of payroll. We reviewed all key controls within these processes, including manual, semi-manual and automated information technology controls.

Methodology

The primary professional guidance for evaluating internal controls comes from The Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Using COSO as a general guide, our review approach included:

- Interviewing all key staff involved in each process.
- Reviewing any existing policies and procedures for each process.
- Testing samples of transactions to measure the effectiveness of existing controls.

We evaluated the Control Activities for each process under review in terms of (1) gaining a full understanding of the flow of work, (2) documenting the required elements of each control, (3) evaluating that control by testing, if necessary, to determine if the required elements are present and functioning effectively, and (4) reviewing the segregation of duties among personnel to assess the adequacy of the City’s assignment of personnel to cash receiving and disbursing activities. Our testing procedures included the following:

We selected the period from March 1, 2014 to February 28, 2015 for our testing of transactions. This period allowed us to observe controls in use spanning parts of two different fiscal years, and also to determine what current controls were in place as of the start of our review.

For detailed testing of cash receipts, we selected four days spaced throughout the year. Each day had approximately 15-25 individual deposits into the City’s bank account. Our testing included reviewing the individual “Incode¹” receipt reports, tracing the receipt report amounts back to the Great Plains accounting system, and verifying that the same amounts were deposited in the bank.

¹ Incode is a commercial software package for local governments that the City uses for utility billing and cash receipts.

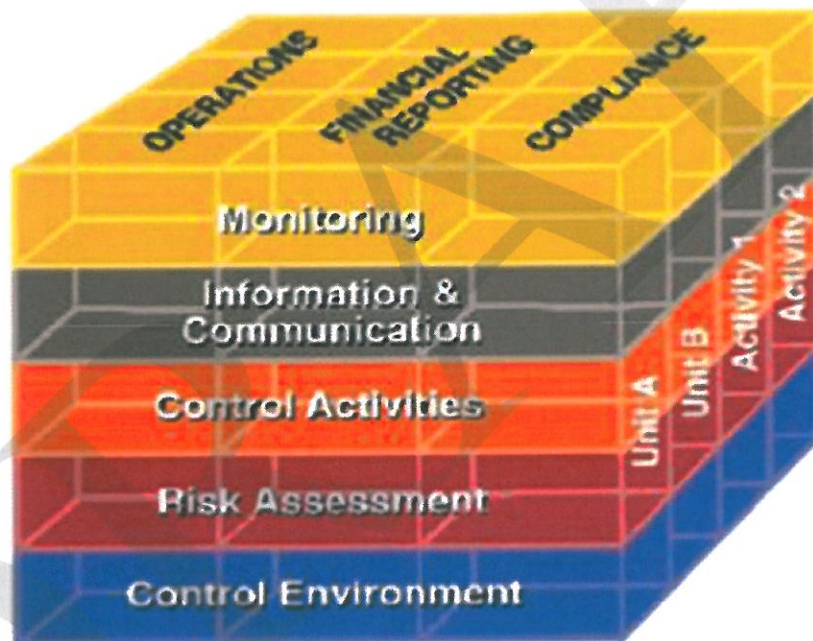
For cash disbursements, we judgmentally selected 25 transactions throughout the year based on information recorded in the City's Great Plains accounting system. We determined if properly approved supporting documents in the correct dollar amount existed for each payment and if the transaction complied with the City's Municipal Code.

It should be noted that our selection of 25 disbursement transactions included one payment to Urban Logic Consultants. On April 22, 2015, the Riverside County District Attorney's Office and the Federal Bureau of Investigation served a search warrant at City Hall and seized financial records related to transactions involving Urban Logic Consultants. Therefore, we were unable to review the supporting documents for this transaction.

BACKGROUND

As noted above, in addressing the City's need for improved controls, we undertook a comprehensive review using COSO as our guide. COSO was developed to provide a comprehensive framework for evaluating internal controls in organizations of all types. COSO defines internal control as a *"process, effected by an entity's board of directors, management and other personnel. This process is designed to provide reasonable assurance regarding the achievement of objectives in effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations."*

As shown in the "COSO Cube" illustration below, the framework consists of 5 elements-monitoring, information & communication, control activities, risk assessment, and control environment. The Cube illustrates that these elements of internal control span an organization's operational, financial reporting and compliance functions.



Source: COSO Framework, 2013

In the case of the City, internal control has been an issue for some time. A number of audit reports have cited weak or non-existent controls. With the current financial situation the City finds itself in, stronger controls are badly needed to safeguard assets and resources; deter and detect errors, fraud and theft; ensure accuracy and completeness of accounting data; produce reliable and timely financial and management information; and ensure adherence to City policies and procedures.

PRINCIPAL RESULTS

SIGINIFICANT INTERNAL CONTROL ISSUES NEED IMMEDIATE ATTENTION

The overall control environment is weak as evidenced by the following general observations:

- Lack of management emphasis on internal control
- Lack of city-wide policies and procedures for key finance activities.
- Separation of duties, especially in information technology areas, needs to be better defined and monitored.
- Key reconciliations are not performed adequately or on a regular basis.

Lack of management emphasis on the internal control environment.

It is management's responsibility to set the tone for a strong internal control environment, also referred to as "tone from the top" by COSO. We found that this emphasis does not exist at either the elected governance or management level. COSO describes the control environment as the foundation for all internal control activities. While our emphasis in this review was internal controls over receipts and disbursements, it is clear that City management did not have the necessary policies and procedures to ensure a strong control environment, including ensuring that there was some type of monitoring process to give management and the City Council feedback on how the controls were functioning, especially in terms of addressing the risk of fraud, waste and/or mismanagement of City funds.

We recommend that the City Council set the tone for creating a strong control environment by implementing the a process whereby City management periodically reports on efforts to strengthen controls, which includes implementing the recommendations contained in this report.

Lack of comprehensive, current policies and procedures for Finance Department activities.

Policies and procedures are a basic tool organizations use to ensure that transactions are appropriate and properly recorded, and that tasks are consistently completed in an approved manner. Policies and procedures help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties. The lack of standardized policies and procedures is a serious internal control weakness.

Cash receipts and cash disbursements affect a wide number of accounts in the accounting system. Implementing detailed written policies and procedures are an essential element of internal control over these accounts, The City has no set of policies and procedures for procurement other than what is provided under the City's Municipal Code (Code). The Code provides the legal foundation for purchasing, while policies and procedures provide the implementing operational instructions. While the Code requires competitive bidding under certain circumstances, City staff have no specific guidelines or instructions on how to document the bidding process or how much documentation should be retained. There should be specific instructions on when competitive bidding may not be possible, for example, due to time constraints or the lack of qualified vendors. There also should be clear instructions on the chain of approval so that all

participants fully understand the requirements and that such control is set in place to ensure appropriate competitive processes are followed.

We believe that policies and procedures for all Finance functions should be created. We did observe the City created a set of step-by-step instructions over several years for approximately 40 finance-related tasks. These instructions are saved to the City's "shared" network drive so that employees can access the instructions if needed. During our work, we noted that the last "date modified" for these files ranged from March 2005 to May 2014, and that many instructions contained out of date information. Additionally, the instructions are not in a standardized format and did not cover all essential areas of Finance. While these instructions are important, they do not constitute a well-defined, comprehensive set of policies and procedures.

We recommend the City update the step-by-step instructions and include them in creating a comprehensive set of policies and procedures. These policies and procedures should be clearly written, easily assessable by all staff, titled, numbered, dated, signed by the authorizing official and periodically reviewed and revised as needed. Further, we recommend that City Council be periodically advised about how the controls are working.

Financial systems access is not adequately restricted or reviewed on a regular basis

The City uses the Incode system to bill for sewer and trash services, and Great Plains to record accounting transactions. The City does not maintain their information technology (IT) systems "in house", but instead hires an outside vendor to provide and manage IT services. This outside vendor sets up employee access to the IT systems as requested by managers.

While reviewing IT system access, we noted all employees who were given access to the Incode system were granted unrestricted access, including the ability to record receipts, establish and modify billing accounts, and write off account balances. We also noted that twelve employees who had access to these functions either were no longer employed by the City or had moved to positions that do not require Incode access. Additionally, we noted that all employees who were given access to the Great Plains accounting system were granted unrestricted "power user" access to all accounting functions, and that one employee with this access no longer worked in the Finance department.

Granting employees restricted access to IT systems based on their job functions and authority levels is a basic component of segregation of duties used to reduce the ability of employees to mismanage or misappropriate funds.

We recommend that the City perform a complete review of gateway access, to include remote access, if applicable, and access and roles in major finance applications such as Incode and Great Plains. We recommend that a policy to regularly review IT access be instituted. We further recommend that employee access be immediately terminated when employees leave City employment or transfer to other City departments.

Key reconciliations are not performed adequately or on a regular basis

The City uses the Incode system for the billing and receipting funds and the Great Plains system to record accounting transactions. While daily receipts are reconciled to Great Plains and the bank account the outstanding balances per the Incode system are not reconciled to the Great Plains accounts receivable balances. The last month for which the Great Plains accounting system had been reconciled to the bank account statements was October, 2014.

The lack of complete and timely reconciliation of asset amounts increases the susceptibility of misappropriation of those assets. We recommend the Finance Department bring the bank reconciliations up-to-date and establish a procedure to reconcile the outstanding Incode balances to Great Plains.

THE FINANCE DEPARTMENT NEEDS TO IMPROVE OVERALL CONTROLS OVER CASH RECEIPTS

Documentation of the daily recording of bank deposits into the “Great Plains” accounting system will improve internal controls.

The City receives cash, credit card, and check payments at several locations using the Incode system. The Finance Department records electronic payments deposited directly at the bank. Each day’s receipts are typically deposited in a three-day period. Check payments are electronically deposited on the same day received, cash is transported to the bank by a City police officer the day after it is received, and credit card receipts are electronically deposited by the processing company one or two days after the date of the transaction. This process results in each day’s banking activity report usually containing a minimum of 15 individual bank deposits, composed of checks, cash, and credit card payments from three separate days, which complicates the reconciliation process.

A banking activity report listing the day’s deposits is printed and reconciled to the supporting documentation including Incode reports. The printed report and support is scanned into a .PDF document which is retained electronically on the network drive. Depending on activity levels, this .PDF document can approach 100 pages. The reconciliation currently being performed consists of handwritten notes, “tick marks”, and highlights on the daily banking activity report.

While this method appears functional, we believe it could be difficult for another employee or a reviewer to perform the same task or research deposit information in the event the primary preparer of this reconciliation is not available. This reconciliation is not signed off by a reviewer, an important control for any major reconciliation. At a minimum, these daily reconciliations of Incode to Great Plains and back to the bank deposits should be reviewed by someone outside of the process to ensure (1) mathematical accuracy, (2) completeness, and (3) consistent preparation.

Given the complexity of the reconciliation, we recommend a template be developed and used to ensure that all deposit activity for each day is recorded into the Great Plains system in a consistent and structured manner. We also recommend that the daily reconciliation be regularly reviewed by someone not directly involved in the process.

THE FINANCE DEPARTMENT NEEDS TO IMPROVE OVERALL CONTROLS OVER CASH DISBURSEMENTS

The City does not retain documentation that purchases are in compliance with Municipal Code and State Law

Title 3 of the Beaumont Municipal Code contains sections related to purchases made by the City. These sections are based on requirements stated in the California Government Code and California Public

Contract Code, and establish conditions under which competitive bidding is required for purchases of supplies, equipment, personal property, professional services, and public works projects. The sections also state the requirements for competitive bidding, including the use of a request for proposal, the solicitation and evaluation of proposals received, and the awarding of contracts. Due to its small size, the City does not have a purchasing department. Instead, each department head is assigned the purchasing duties for their department.

During our testing of controls over cash disbursements, we noted payments for several purchases that exceeded the minimum amount requiring competitive bidding. Documentation of the required competitive bidding process could not be located. Based on our inquiries with several department heads, they believe the purchases were competitively bid but that they were not required to retain documentation of the process. Additionally, we noted that the City has no mechanism in place whereby the availability of budgeted funds is verified prior to the purchase. The authorization for each fiscal year's transactions is initiated by the City Council passing a budget. Management must be fiscally accountable to show that resources are expended in compliance with the legal and financial restrictions placed on them by the Council. An integral internal control is for management to verify that budgeted funds are available prior to committing the City to expend funds for a purchase.

We recommend the City include a purchasing policy as part of the comprehensive policies and procedures. This policy should include sections pertaining to

- Compliance with the municipal code requirements
- The criteria used to evaluate proposals
- The method by which the competitive bidding and purchasing process is to be documented
- Verification that budgeted funds are available prior to items being purchased

The method the City employs to Pay Sales and Use taxes on purchases may not be appropriate

When the City makes a purchase from a vendor located within the City of Beaumont, the City pays sales tax to that vendor. However, if the vendor is located outside of the City, a “resale certificate” issued to the Beaumont Financing Authority is used to purchase the item without sales tax. The City eventually pays the required sales tax by filing a use tax return. In effect, this shifts the local portion of the sales tax revenue from the various cities in which the vendor is physically located to the City of Beaumont.

Instructions from the State Board of Equalization (BOE), which regulates sales and use taxes, notes that “Purchasers who are engaged in the business of selling tangible personal property may issue resale certificates when purchasing items they will sell in the regular course of their business operations.” We question whether the Beaumont Financing Authority is “engaged in the business of selling tangible personal property” and “purchasing items they will sell in the regular course of their business operations.” According to our discussion with the Finance Director, there is no written guidance from the BOE as to the appropriateness of the use of the Financing Authority to shift sales tax revenue to the City. If the BOE were to audit the use tax returns and determine that it is inappropriate to use the Financing Authority in this manner, the City could be subject to repayment of the tax revenue received.

We recommend that the City obtain guidance from BOE as to the appropriateness of these transactions.

Payments to electrical supply vendors are not properly supported by documentation

Our testing included two payments to electrical supply companies (Graybar and Walter’s Wholesale Electric). The only supporting document for each of these payments was a spreadsheet prepared by Beaumont Electric Inc., listing the supply company’s invoice date, invoice number, and invoice amount. The spreadsheet contains an area to list the City’s corresponding “job name”, however, this information was not filled in. The corresponding invoices from the electrical supply company are not included in the documentation the City receives from Beaumont Electric, and there was no City Department Manager approval on the spreadsheets for these two payments. Under this system, there is no documentation providing evidence that the invoices exist and are for materials used on City projects. This process raises a potential for fraud.

We recommend the City require invoices for all amounts paid, and that those invoices or the summary spreadsheet indicate on which City projects the materials were used. We also recommend that the appropriate City Department Manager review the invoices to ensure that the materials purchased were for City projects.

Alternatively, we recommend that the City consider replacing the practice of paying third-party suppliers with the requirement that Beaumont Electric pay the suppliers directly and then invoice the City for materials as they are used.

Payments are not always approved by all required parties

The City's procedure for paying invoices require the approval of the appropriate Department Manager and review by the Finance Director prior to payment. Requiring the approval of both is an appropriate control to lessen the probability of making an inaccurate or inappropriate payment. During our testing, we noted 20 percent of transactions tested (5 out of 25 items selected) where the invoice was approved by only one of the authorized signers.

We recommend that all required approvals be outlined in a detailed policy and procedure document that clearly states all approvals must be obtained prior to the payment being scheduled for check printing or electronic payment.

Controls over petty cash could be improved

A petty cash fund is maintained at City Hall. Documentation related to this fund includes a standard "petty cash reimbursement" form and a very brief set of instructions entitled "How to process petty cash reimbursements". During our review of one petty cash replenishment consisting of 30 transactions we noted:

- One request for reimbursement was not signed by the requestor.
- One request for reimbursement did not have a supporting receipt.
- Four transactions exceeded the \$50 maximum reimbursement.
- The Police Department uses a non-standard reimbursement form that does not document City Hall approval.
- The replenishment was completed via a cash withdrawal at the bank.

While the instructions do state "the maximum reimbursement amount is \$50.00 (special circumstance may be approved)," implying that the \$50 maximum may be exceeded, the instructions do not state the conditions under which this can occur or require documentation of the "special circumstance".

We recommend the City formulate a more complete policy and procedure for petty cash. This policy should include the requirement that the standard reimbursement form be used, the circumstances under which the \$50 maximum can be exceeded, and the requirement that replenishments be completed by a means other than cash withdrawal.

CONCLUSIONS

The City should take immediate actions to strengthen internal controls over cash receipts and cash disbursements. The receipt and disbursement processes are fraught with risks of all types, and it is of paramount importance that these processes be well-controlled. The recommendations we suggest will help the City in this effort.

In addition, the City should look at all finance and operational controls and adopt a COSO-like framework. This framework must start from the top. The City Council should institute an across-the-board internal control framework covering financial reporting, compliance with laws and regulations and operations that provides not only stronger control activities, such as comprehensive policies and procedures, but also creates a strong control environment that requires managers to assess risks, improve information and communications to staff, and creates a mechanism to monitor these activities. These improvements will not only improve the management of the City but would give the City Council and the public a renewed confidence that City finances and operations are functioning effectively.