



To the Honorable City Council
of the City of Tustin, California

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Tustin, California (City) as of and for the year ended June 30, 2010, which collectively comprise the City's basic financial statements, and have issued our report thereon dated January 24, 2011, except for Note 6 as to which the date is March 1, 2011. In planning and performing our audit, we considered the City of Tustin's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. We noted certain matters involving the internal control over financial reporting and its operation that we considered to be a material weakness under auditing standards generally accepted in the United States of America reported to the City Council in a separate letter dated January 24, 2011. We also noted other control deficiencies, which are discussed below.

ASSESSMENT OF INTERNAL CONTROLS

Comment

The City has a fiduciary responsibility as a steward of public funds. In order to fulfill this responsibility, the City has implemented internal controls that serve as the first line of defense in safeguarding assets. Additionally, these controls are designed to ensure: (1) effective and efficient operations, (2) reliable financial reporting and (3) compliance with applicable laws and regulations.

The Committee on Sponsoring Organizations of the Treadway Commission (COSO) has established a nationally recognized framework for internal control in its *Internal Control – Integrated Framework* and its related *Guidance for Smaller Public Companies: Reporting on Internal Controls over Financial Reporting*. The COSO framework establishes five elements of internal control: (1) Control Environment; (2) Risk Assessment; (3) Control Activities; (4) Information and Communication; and (5) Monitoring. Risk Assessment and Monitoring are integral parts of internal control and management should periodically evaluate the risks and monitor the changes facing the City. This process involves evaluating both previously identified risks and potential new risks and providing assurance that (1) controls are designed properly to address significant risks and (2) controls are operating effectively.

The Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) adopted a set of eight Statements on Auditing Standards (SAS No. 104 through 111), which, among other things, require auditors to assess an organization's design of controls and determine whether the controls have been placed in operation for all elements of internal control over financial reporting. If controls do not exist, are poorly designed or not operating effectively, the auditor must evaluate the control deficiency and report the deficiency to management, including whether the control deficiency is a significant deficiency or material weakness.

The City's management has documented some of its internal controls over significant accounting areas (e.g. cash receipts, cash disbursements). The City does not have a formal monitoring plan to ensure procedures are adequate and effective to continually mitigate potential risk to financial reporting.

This finding was also included in the management letter dated February 24, 2010, which was issued as a result of the fiscal year 2008/09 audit.

Recommendation

We recommend the City review its existing internal control assessment process and formalize a comprehensive risk assessment plan, which would include monitoring the adequacy and effectiveness of internal control procedures. This risk should be evaluated at least annually to consider any changes to the City's operating environments.

Management Response

The City will review its existing internal controls and formalize a comprehensive risk assessment plan. Due to current fiscal issues, lack of funds available to hire outside consultants, and lack of staff, the Finance Department will work on two to three areas within the next fiscal year and continue until it has completed a comprehensive risk assessment plan.

POLICIES AND PROCEDURES

Comment

We noted that the City does not have a comprehensive policies and procedures manual for all of the accounting functions of the City.

This finding was also included in the management letter dated February 24, 2010, which was issued as a result of the fiscal year 2008/09 audit.

Recommendation

We recommend the City identify the major transaction streams and processes with the greatest potential risk of fraud or misstatement of the financial statements to begin the process of developing a policies and procedures manual for all accounting functions of the City. This will ensure consistent application of internal controls and City policies.

Management Response

The City will begin to look at each of the accounting functions and identify the major transaction streams and processes with the greatest potential risk of fraud or misstatement of the financial statements and develop policies and procedures documented in a manual. Due to limited staff this endeavor will be an ongoing project. Dates will be set for expected completion for each accounting area.

CREDIT CARD POLICY

Comment

We noted that the City does not have a formal credit card policy. The absence of a credit card policy that requires receipts be attached to the monthly billing statements for reconciliation purposes and review of propriety of charges through the approval for payment process, increases the risk of fraud and abuse related to items purchased with a credit card. During our testwork, nothing came to our attention to indicate fraud or abuse existed in credit card transactions.

This finding was also included in the management letter dated February 24, 2010, which was issued as a result of the fiscal year 2008/09 audit.

Recommendation

We recommend the City develop a policy and procedure for City issued credit cards. The procedure should require receipts to be attached to the monthly credit card statements, the statements should be reviewed and approved by appropriate personnel in a timely manner. This will ensure proper authorization of charges on the credit card and reduce the risk of fraud or abuse related to charges on credit cards and ensure timely payment of call credit card payments.

Management Response

The City will develop a policy and procedure for City issued credit cards.

CASH RECEIPTING PROCEDURES

Comment

We noted that the internal controls over the cash receipting procedures in the City's Police Department are not adequately documented. The informal internal control procedures do not require the pre-numbered voided cash receipts to be maintained, increasing the risk of fraud and misappropriation of assets. We also noted that the physical controls over the cash lockbox are not adequate to reduce the risk of fraud and misappropriation of assets.

This finding was also included in the management letter dated February 24, 2010, which was issued as a result of the fiscal year 2008/09 audit.

Recommendation

We recommend the City develop policy and procedures to require that all pre-numbered cash receipts be maintained and the physical controls over the cash lockbox be improved in order to reduce the risk of fraud and misappropriation of assets.

Management Response

The City will implement automated cash receipting at the Police Department using our current Springbrook cash receipting software. Policies and procedures will also be developed to ensure physical control over the cash drawer/lockbox to reduce the risk of fraud and misappropriation of assets.

BANK RECONCILIATIONS

Comment

We noted that the June 30, 2010 bank reconciliation did not indicate the date the reconciliation was prepared. The bank reconciliation was initialed and dated by the reviewer on October 18, 2010.

Recommendation

We recommend the City follow its procedures to document the timing of the preparation of the bank reconciliation and that the preparation and review occur within 60 days after the month-end..

Management Response

The June 30, 2010 bank reconciliation was completed in October 2010 due to the implementation of new finance software. Management will ensure the bank reconciliations are completed within 60 day after the month-end once the finance software implementation is complete.

INDIRECT COST ALLOCATION PLAN

Comment

During our review of interfund charges, we noted expenses from various departments were allocated to various funds based on an informal allocation plan, which may result in the related costs that were allocated to the funds to not be in accordance with relative benefits received.

Recommendation

We recommend the City develop, document, and implement policies and procedures to ensure expenses are allocated in accordance with relative benefits received and in accordance with standard accounting practices and 2 CFR Part 225, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87) Attachment A (3) (a), "A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received."

Management Response

Management will hire a consulting firm to develop, document and implement policies and procedures to ensure expenses are allocated in accordance with relative benefits received and in accordance with standard accounting practices and 2 CFR Part 225 *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87).

INFORMATIONAL COMMENT

New Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*

In February 2009, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. GASB Statement No. 54 significantly changes the accounting and financial reporting for the City's governmental fund balance classifications and categorization of individual funds. This standard requires the City to evaluate and recast its fund balance classification based on a hierarchy weighed on the extent to which the City is bound to observe constraints imposed upon the use of the resources reported in governmental funds. This standard requires the City establish a policy on the priority of how resources are expended in the various categorizations. This standard also provides guidance for classifying stabilization ("rainy day") amounts on the face of the balance sheet and would require disclosure of certain information about stabilization arrangements in the notes to the financial statements. In addition, the definitions of individual governmental fund types have been clarified whereby the City's use of special revenue funds and capital project funds could be recast. It is possible that this standard will change the City's current fund structure; accordingly, the City should give consideration to the impact on the City's budgetary process and whether any changes to the budget would facilitate financial reporting. The requirements of this standard are effective for the fiscal year ending June 30, 2011.

The City's management responses to our comments from our audit are disclosed above. We did not audit the City's responses and accordingly, express no opinion on them.

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

We would like to express our appreciation for the courtesy and assistance extended to us during our audit by all of your staff.

We would be pleased to discuss with you at your convenience the matters contained in this letter or any other matters, which you would like to discuss.

Macias Fini & O'Connell LLP

Certified Public Accountants
Newport Beach, California

March 1, 2011