



City of Richmond

Report to Committee

To: Finance Select Committee
From: Andrew Nazareth
Manager - Budgets & Accounting
Re: 2001 KPMG Audit Management Letter

Date: July 10, 2002

File:

That the 2001 KPMG Management Letter (dated May 31, 2002, from Don Matthew, Partner KPMG) be received for information. For ease of reading the letter has been broken down into three categories:

Appendix I – New matters arising from the 2001 Audit (3 items).

Appendix II – Matters carried forward from 2000 that have not yet been fully rectified (4 items).

Appendix III – Matters carried forward from 2000 that have been rectified (11 items).

Andrew Nazareth
Manager - Budgets & Accounting

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CONCURRENCE OF GENERAL MANAGER



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PRIVATE & CONFIDENTIAL

Mr. Jim Bruce
Finance & Corporate Services Administrator
The City of Richmond
6911 No. 3 Road
Richmond BC V6Y 2C1

May 31, 2002

Dear Mr. Bruce

We recently completed our examination of the financial statements of the City of Richmond (the "City") for the year ended December 31, 2001. The primary purpose of our examination is to enable us to form an opinion on the City's financial statements for the year ended December 31, 2001. As part of our examination, we reviewed and tested the City's financial systems and related internal controls as required by Canadian generally accepted auditing standards. Our study and evaluation with respect to these financial systems was not designed for the purpose of expressing an opinion on internal controls. It would not necessarily disclose all weaknesses in the systems. The purpose of this letter is to bring to your attention certain matters, which were encountered in the course of our work, and to offer our comments and recommendations.

We have not reviewed these matters since March 15, 2002, the date of our auditors' report. These comments, by their nature, are critical, as they relate solely to weaknesses and do not address the many strong features and controls within the City's systems. We would be pleased to discuss our comments and recommendations with you and to assist with implementation of the recommendations.

Our recommendations are presented in the attached appendices in three sections. First, we have discussed new matters, which have arisen this year. Second, we have brought forward matters from 2000, which have not yet been fully rectified. And third, we have brought forward points from our 2000 letter, which have been satisfactorily rectified.

We would like to take this opportunity to thank you and the staff of the City for the helpful and courteous manner in which we were treated during the course of our audit.

Yours very truly

Don Matthew
Partner
(604) 646-6383

cc: George Duncan, Chief Administrative Officer
Office of the Mayor



NEW MATTERS ARISING FROM THE 2001 AUDIT

CASH AND TREASURY

Investment management

At December 31, 2001, the City held investments totaling \$199 million. The return on the City's portfolio for the year ended December 31, 2001 was 4.4% compared to 5.7 % in 2000. As a comparison, the MFA benchmark that is often referred to is the SCM T-Bill Index which was 5.89% for 2001.

One reason for the lower rate of return is the timing of investment purchases and sales which do not appear to be properly matched to the cash needs of the City. In the period from January 25, 2001 through February 23, 2001 investments totaling \$43 million were sold prior to reaching full maturity. As a result, the amount of income earned for the period the investments were actually held was reduced by a total of \$1.8 million. In other words, the rate of return earned on these investments was reduced because they were sold before reaching full maturity. Also, during the same period, investments of approximately \$20 million were made, usually at rates of return that were lower than what would have been earned if the investments cashed in early were held to maturity. It should be noted that in no case was there any loss of original amounts invested.

Recommendation

The City must forecast its cash needs and position for the year and match the investment activities and maturities to this forecast in order to maximize the investment return realized on cash resources.

Management Response

The YTD return on the City's portfolio of 4.4% compared to 5.7 % in 2000 is a result of the inclusion of the total discount of various sales of investments prior to their maturity.

The sale and redemption of the investments were entered into to:

- a. Introduce additional liquidity into the portfolio by purchasing investments with a shorter maturity period, hence the lower rates of return.
- b. Meet payment for unexpected late invoices
- c. Deal with the cash flow inefficiencies resulting from the transition in changing banking accounts from Royal Bank to Scotiabank. The City was obligated to continue funding the Royal Bank banking accounts for a period of six months for all cheques which had been issued prior to the change over.

We concur that there were inefficiencies in the cash flow during this period of January and February 2001. These inefficiencies have subsequently been corrected. A revised cash flow has been completed and implemented

Cheques received by mail

Mail is sorted by mailroom personnel who then allocate the mail to various departments (i.e. Business & Licenses, etc.). The departments match the cheques to an invoice and forwards the package to the Accounts Receivable department. The Accounts Receivable department ensures the cheque and the invoice match and then forwards the receipts to the cashier for entry.

Recommendation

Since cheques are handled by staff who also have access to the accounting records, there is the potential for misappropriation of funds. To mitigate this, the City needs to ensure that all write-offs of receivables are authorized by the appropriate persons.

Management Response

Accounts Receivable staff have limited access to the Accounts Receivable and Billing Module of the financial system. This security and access allows only one staff member to perform billings, another staff member to apply the payments and another staff member to perform the maintenance. Cheques are forwarded to the Accounts Receivable staff so that the correct allocations can be performed when no supporting documentation is attached. There is an independent reconciliation of the Receivable Cash Clearing general ledger account performed by the Supervisor to ensure that all cheques are allocated correctly. It is the City's current policy to ensure that all write-offs of receivables are authorized by authorized signatories only. This is further supported by the reconciliation performed on the Bad Debt general ledger account.

LONG-TERM DEBT

Retirement of long-term debt

The City of Richmond currently has a significantly greater amount of liquid investments than their debt with the Municipal Finance Authority (“MFA”). In addition, the investments earned a significantly lower average rate of return than the average cost of debt in 2001.

Recommendation

While we understand that the City may be locked in with respect to the MFA debentures, the City may wish to review whether sinking fund contributions could be increased to reduce the net debt.

Management Response

The City’s Long Term Debt is established by Bylaws and entered into with the Municipal Finance Authority. During July 2000, an analysis was undertaken to assess the cost of retiring selected high interest rate debt issues. Our findings indicated:

- The penalties that would be paid would be onerous.
- The terms and conditions of the financing require some of the issues to be refinanced during 2002. This would result in lower financing costs.

Based on these findings, the Finance Select Committee agreed not to retire any of the long term debt.

MATTERS CARRIED FORWARD FROM 2000 THAT HAVE NOT YET BEEN FULLY RECTIFIED

PAYROLL

Manual payroll cheque controls

Most of the City's payroll disbursements are automated by the PeopleSoft Human Resource Information System. Each pay period, the City also prints some "manual" payroll cheques to satisfy various employee requests. However, the City's PeopleSoft Payroll system does not print an electronic cheque number on these "manual" cheques. When the bank scans the cheques, the cheque numbers do not appear on the bank statement. Without cheque numbers, bank reconciliations are more difficult and time-consuming, and there is an increased risk of fraud or error.

Recommendation from 2000

We recommend that the City address this control weakness as soon as possible by modifying the PeopleSoft system to print the cheque number in both human and machine-readable form on each cheque.

Management response from 2000

The City is currently reviewing the capabilities of the PeopleSoft HRMS 8.0 upgrade module as a solution to the above-noted matter and still trying to determine the feasibility of purchasing a third party software.

Status in 2001

The City has completed its upgrade of PeopleSoft HRMS 8.0 from HRMS 7.02. The City is currently in the process of determining the capability of printing cheque numbers on cheques in MICR to comply with bank requirements.

Management response for 2001

In June 2002, the system was modified to print electronic cheque numbers on the cheques as per the recommendation.

INFORMATION TECHNOLOGY

Disaster recovery planning

The City has developed a formal plan to recover its information systems in the event of certain types of disasters, but the plan has not been fully tested. Also, the plan addresses recovery of the City's information systems, but it does not address continuity/recovery of the City's critical

business processes. Meanwhile, a proposal to revise the City's overall disaster recovery plan, of which IT is one component, has been submitted to Council. As the City becomes more dependent upon information technology, the need for a fully tested disaster recovery plan becomes increasingly important. However, critical City services must continue to operate while and after IT systems are restored in the event of a disaster. Therefore, it is important that the City's disaster recovery plan address not only the IT systems, but also continuity of key business processes. Without a fully integrated and tested recovery/contingency plan, which includes core business processes and related support processes such as IT, the City may experience significant downtime and incur financial losses in the event of a disaster.

Recommendation from 2000

We support the City's efforts to update and test its disaster recovery plan. We recommend that the City expand its disaster recovery plan to address continuity and recovery of its key business processes in the event of a disaster.

Management response from 2000

The City is in the process of developing a new disaster recovery plan in concert with the implementation of new technology solutions as well as the City's overall review of alternative backup sites.

Status in 2001

The City has put forward a Budget request to secure funds to retain a consultant to further assist the city to properly formalize a plan. KPMG was requested in 2002 to provide input to this, although no formalized project has been undertaken yet due to the funding request.

Recommendation for 2001

The City should increase its efforts to obtain the funding required to continue the development of the disaster recovery plan since this plan is significant to the continued operations of the City.

Management response for 2001

The City has recently obtained funding for this project and will make the disaster recovery plan a high priority.

Termination procedures

Last year the City did not have a formal procedure to ensure timely removal of employee computer privileges upon termination. The City has now developed a draft termination checklist designed to ensure that the Information Systems department is informed of all employee terminations, and removes related computer access on a timely basis. We understand Human Resources is reviewing this checklist which will be updated to reflect the current environment.

Recommendation from 2000

We recommend that this new policy be formally approved and endorsed by senior management, and implemented as soon as possible. The City should consider similar procedures to review systems privileges and data access when employees change positions, roles and responsibilities.

Management response from 2000

The "Use of IT Resources" policy and procedures, which addresses termination procedures, has been approved and adopted by Council in July 2001.

Status in 2001

A number of accounts still exist for users who are no longer employed by the City, including accounts with powerful access rights. For example, the profile of the previous Manager of Budgets and Accounting is still active on the system.

Recommendation for 2001

All accounts that exist for users who are no longer employed by the City should be made inactive in PeopleSoft.

Management response for 2001

All users that are no longer employed by the City are immediately denied access to the network. This effectively ensures that they cannot access any system City-wide. As per the recommendation we will ensure that these accounts are also simultaneously inactivated in Peoplesoft.

ACCOUNTS PAYABLE**Authorization of Corporate Visa Card Expenses**

The City has issued more than 400 Visa cards to staff for various purchases including airfare, hotel, and meals. As part of our audit, we examined Visa purchase reports on a test basis to ensure that the charges had been properly authorized and that receipts had been attached. None of the reports we examined were signed by the department supervisor and in some instances no receipts were attached. This poses a risk in that staff could use the cards for personal use.

Recommendation from 2000

All expense reports should be reviewed and authorized by the department supervisor, who should also ensure that appropriate receipts are attached.

Management Response from 2000

We concur with the above recommendation and will tighten our controls with regards to Corporate Visa Card expenses.

Status in 2001

During our control testing, we found that some of the reports were still not being signed off by the cardholder and/or the department supervisor. Also, in some instances, no receipts were attached.

Recommendation for 2001

All expense reports should be signed off by the cardholder and reviewed and authorized by the department supervisor, who should also ensure that appropriate receipts are attached.

Management response for 2001

We recently cut-over the City's purchase card program from Visa to Mastercard as we get more versatility with web based reporting and achieve better vendor enabling capabilities. As part of the transition we ensured that all controls were tightened as evidenced by the extensive manual we prepared for each cardholder and the classroom training provided to each department administrator. In addition, each cardholder was asked to sign a compliance statement prior to receiving their new purchase card accepting full responsibility. As a result, failure to adhere to the requirements in the manual could result in loss of card privileges, disciplinary action and in some extreme cases even termination. We believe that this deterrent effect will help us attain full compliance with regards to the submission of receipts. As far as signoff by department supervisors is concerned we have also taken the transition opportunity to reinforce this audit requirement with all parties concerned and expect compliance to improve considerably as a result.

MATTERS CARRIED FORWARD FROM 2000 THAT HAVE BEEN RECTIFIED

CASH AND TREASURY

Reconciling items

In several cases, the cash balances in the general ledger were not adjusted to reflect all reconciling items identified on the bank reconciliation.

Recommendation

While none of these amounts were material, all of these items should be recorded.

Management response from 2000

We concur and will ensure that these balances accurately reflect the reconciling items.

Status in 2001

All cash balances in the general ledger have been adjusted to reflect all reconciling items identified on the bank reconciliation for 2001.

Segregation of duties

At the time of our audit, the following functions were performed by the Manager, Treasury Services:

- Investing activity
- Recording and tracking of investments
- Review of the bank reconciliations
- Preparation of journal entries
- Handling cash (buying and selling, receipt of income, etc.)
- Cash flow management

The fact that one person performs these functions raises the possibility for the misappropriation of funds without timely detection.

Recommendation

Management should review the duties performed by this individual and segregate them where practical. KPMG has assisted other municipal entities with the development of an integrated treasury risk framework and would be pleased to assist or provide more information.

Management response from 2000

Due to staff shortages and the loss of key personnel, all of the above-noted duties were assigned to the Manager, Treasury Services. These duties have since been reviewed and additional staff has been employed to ensure the segregation of duties. Also, to mitigate any breach of duties, it is the City's policy to ensure that all investments and transfers of cash are authorized by a third party signatory. Consequently, the Manager, Treasury Services does not have any signing authority but is allowed under the provisions in the Investment Policy to conduct financial transactions on behalf of the City.

Status in 2001

Additional staff have been employed and the administrative staff is now responsible for:

- Recording and tracking of investments
- Preparation of journal entries
- Securing all supporting documentation for proper cash flow management

The Manager, Treasury Services is responsible for the review of the bank reconciliations, the investing activity, and the overall cash flow management.

INVESTMENTS

Accrued interest

The City's policy is to defer and amortize premiums and discounts greater than \$50,000 over the term of the investment and recognize premiums and discounts less than \$50,000 in income immediately. The City is using amortization schedules to calculate interest income and the related interest receivable on a compounding basis, when appropriate.

However, there were several errors made in the calculation of interest income and accrued interest as at December 31, 2000 including the following:

- Several miscalculations in the amortization schedules.
- An incorrect opening balance for accrued interest receivable.
- An omission of the opening accrued interest receivable balances for investments purchased in prior years that matured in 2000. This caused the related interest income to be incorrectly calculated.

After accrued income was calculated (at year-end only), the total investment income for the year was allocated to various reserve accounts. For 2000, the investment income amount allocated to

the reserves was incorrect for the reasons noted above. This resulted in inefficiencies for both City staff and KPMG as these entries had to be corrected, reversed and redone.

Recommendation

The calculation of both accrued interest and interest income should be reviewed for accuracy prior to the allocation to the reserve accounts and before the working papers are subject to audit.

Management may wish to consider preparing accruals on a periodic basis rather than at year-end only.

Management response from 2000

We will review the accrued interest and interest income for accuracy prior to allocating to the reserve accounts. However, there may be some challenges faced in accruing all the securities on a periodic basis as several of them have call options that may result in duplication of effort in that they will have to be reversed and reallocated.

The main reason for the errors in 2000 was the fact that the template we were using for calculating the amortization had systematic formula errors resulting in incorrect accrued interest balances. This has subsequently been corrected.

Status in 2001

The calculation of both accrued interest and interest income was reviewed for accuracy prior to its allocation to the reserve accounts and before working papers were prepared and submitted to KPMG for audit purposes.

ACCOUNTS RECEIVABLE

Reconciliation of subledger

At December 31, 2000, there was a \$3 million discrepancy between the General Receivables account 1010-10 balance in the general ledger and the supporting balance in the accounts receivable subledger. This discrepancy arose due to several on-line journal entries being posted to the general ledger, but not being picked up in the accounts receivable subledger. The differences between the two would likely have been identified if monthly reconciliations were being performed.

Recommendation

The accounts receivable subledger should be reconciled to the general ledger on a monthly basis and all reconciling items should be appropriately adjusted.

Management Response

We concur with this recommendation. In future, we will ensure that there is a monthly reconciliation between the general ledger and accounts receivable subledger.

Status in 2001

The accounts receivable subledger was reconciled to the general ledger and any reconciling items have been appropriately adjusted and accounted for in the City's working papers for the 2001 audit.

CAPITAL ASSETS**Non-City Sources of Funding**

The City receives donations, contributions, and grants from outside sources. Grants are recorded in the Work in Progress (WIP) Grant Revenue Sharing account while all other non-city sources of funding are recorded in the WIP Investment account. However, when a project is capitalized, the WIP Grant Revenue Sharing account is credited for the entire amount of the non-city sources of funding, consequently causing the WIP Grant Revenue Sharing account to be understated and the WIP Investment account to be overstated. Although it has no effect on the financial statements and we understand this accounting is done as a way of tracking these sources of funding, this should be properly accounted for in order to have correct account balances.

Recommendation

When a project is capitalized, the City should credit the WIP Grant Revenue Sharing account for the amount of non-city sources of funding related to grants, and credit the WIP Investment account for the remaining non-city sources of funding.

Management response from 2000

There is no impact on the financial statements. We will change the name of the Peoplesoft account to more accurately reflect its use. The account should be called WIP Non-City Sources of Funding rather than WIP Capital Revenue Sharing Grant which appears to be the cause for confusion.

Status in 2001

The account name has been changed to WIP Non-City Sources of Funding in PeopleSoft. The City is in the process of developing a new system to track capital projects.

ACCOUNTS PAYABLE

Accruals

The City often allocates a portion of interest income directly to accrual accounts, such as the gratuities accrual account. This has the effect of understating interest income in the statement of financial activities and does not accurately reflect the allocation of revenues to these accrual accounts.

Recommendation

All interest income should be recorded as such in the statement of financial activities. The allocation of some of this interest income to accrual accounts should also be recorded through this statement.

Management response from 2000

There are two gratuity accounts that the City uses. One is for exempt employees gratuities and the second one is for unionized employees gratuities. The exempt employees gratuity program has been discontinued. The amount in the accrual account was earned when the program was in place and will be paid out when the qualifying employees leave the City at some future date. The program stipulated that the existing contributions in this account would grow at the annual investment rate of return; hence, investment income was allocated to this account.

On the other hand, the unionized gratuities program is still in place and the accrual account gets built up based on an employee's current earnings level. The gratuity payouts are made at a future date and are based on an employee's earnings level at that point in time. Consequently, annual investment income was allocated to this account's annual balance in order to keep pace with the inflationary earnings.

We will comply with your recommendation and will stop directly allocating investment income to these accounts. We will ensure that the resulting investment income does go directly to the interest income account on the statement of financial activities and will instead reflect the interest contributions to these accounts as expenses.

Status in 2001

The City has allocated the gratuities income to the Investment Income account and has charged the transfer to the provision against interest expense.

PAYROLL

Vacation liability

The vacation liability amount accrued in the accounts at December 31, 2000 was \$1.6 million. The City's estimation of the liability was \$2.8 million resulting in an understatement of the vacation liability of \$1.2 million. This difference formed part of our audit differences, which in the aggregate were not material to the financial statements.

Recommendation

The vacation liability should be fully accrued in the future.

Management response from 2000

We will ensure that the vacation liability account is fully accrued in future. If there is an arising Surplus in 2001 we will use it to cover the current shortfall of \$1.2 million.

Status in 2001

The vacation liability has been fully accrued for in 2001.

Payroll maintenance forms

We understand that City policy requires that maintenance forms, which are used to initiate new hires or payroll changes, be approved by both the Payroll and Human Resources Departments. We examined a sample of these documents and noted that several forms were missing the signature from the Payroll Department.

Recommendation

All maintenance forms should be properly authorized by both departments.

Management response from 2000

Payroll maintenance forms are initiated by the HR department to advise Payroll of hires or changes to employee data. These forms are date stamped with a "Payroll Stamp" as indication of acceptance by Payroll. Although these documents are not always signed off by the Payroll clerk, it is not a problem to identify the clerk who has been responsible for the processing the information since each clerk is assigned specific Pay Groups.

Status in 2001

The Payroll Clerk responsible for processing the payroll maintenance forms has been signing the forms to indicate her approval.

INFORMATION TECHNOLOGY

Off-site backups

The City stores its daily backup tapes at an off-site location in Vancouver once per week. During the week, the daily backup tapes are stored in a tape library in the computer room. The City could potentially lose up to one week of data and program changes if a significant disaster such as a fire or flood were to take place in the City's main computer room. Most organizations take their critical backup tapes off-site on a daily basis. Since the City is becoming more reliant on its information systems (e.g., PeopleSoft, document imaging), more frequent backup procedures are necessary. The City is planning to implement a better backup process which may eventually involve continuous transmission of data to an off-site facility.

Recommendation

We support the City's efforts to implement a better backup process. We strongly recommend that the City store its backup tapes at a secure off-site location on a daily basis until a better solution is implemented.

Status in 2001

Daily backups are being picked up every day beginning in August 2001 and stored at Iron Mountain Storage's (formerly FACS Canada) vault facility.

Security policies and procedures

The City began updating its formal policies and procedures in 2000 and intends to continue reviewing and updating them on an annual basis. The document addresses security requirements for most of the City's significant information systems, but responsibility for approving access to key applications is vague.

Recommendation from 2000

We support the City's efforts to update its formal policies and procedures. As these policies are updated, they should be formally approved by senior management and communicated to all employees with access to City information systems. We recommend that the draft security policy specify the need for individuals responsible for ownership and approving access to each significant application, module, or data set along with a formal procedure to review and approve access requests. Ideally, requests for access to key applications should be initiated by the user's supervisor to ensure that the access request is based on the user's role and responsibility and to ensure appropriate segregation of duties. However, final approval should rest with the manager of the department that owns the data or application. This should include approving access to particular modules or functions within an application (e.g., PeopleSoft) and could initially be

conducted based upon job classification, and then on an exception basis. Finally, user access privileges should be reviewed on a periodic basis for currency.

Management response from 2000

This matter has been resolved and is addressed in the City's "Use of IT Resources" policy and procedures, which was approved and adopted by Council in July 2001.

OTHER

Municipal Affairs Reporting Forms - School Act (M59)

School Tax collected during September is to be remitted to the Minister of Finance and Corporate Relations on or before the tenth business day of October. For 2000, this remittance was to have been made by October 16, 2000. The actual transaction date for the remittance was October 17, 2000, one day past the due date.

Recommendation

All School Tax collections should be remitted to the Minister of Finance and Corporate Relations in accordance with the due dates stated in Part 8 of the School Tax Act.

Status in 2001

All School Tax collections are being remitted on appropriate due dates.