

CITY OF WORCESTER, MASSACHUSETTS

MANAGEMENT LETTER

JUNE 30, 2012



Certified Public Accountants

SULLIVAN, ROGERS & COMPANY, LLC

Corporate Place I, Suite 204 • 99 South Bedford Street

Burlington, Massachusetts 01803

P • 781-229-5600 F • 781-229-5610 www.sullivan-rogers.com

To the Honorable Mayor and City Council
City of Worcester, Massachusetts

In planning and performing our audit of the financial statements of the City of Worcester, Massachusetts (City) as of and for the year ended June 30, 2012 (except for the Worcester Contributory Retirement System, which is as of and for the fiscal year ended December 31, 2011), 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 October 31, 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 Mayor, the City Council and others within the organization and should not be used by anyone other than these specified parties.

Sullivan, Rogers & Company, LLC

October 31, 2012

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Comments and Recommendations

Off-Street Parking

Comment

The City contracts with a third-party service provider, Republic Parking System (Republic), to manage its off-street parking operations. We reviewed the City's contract with Republic to evaluate compliance with certain aspects of the contract and identified the following:

- Republic is responsible for billing and collection related to parking garage customers that pay on account. Our review of Republic's June 30, 2012 accounts receivable report identified several significant, old outstanding amounts owed to the City.

By far, the most prominent of these accounts receivable relates to amounts owed by the Hilton Garden Inn (Hilton). Based on Republic's records, Hilton owed the City a total of \$707,500 at June 30, 2012. Of this amount, \$664,000 was greater than 90 days old.

In addition:

- Per inquiry of City personnel, it is unclear what efforts, if any, the City is making to collect the amounts owed from Hilton
 - Records maintained by the City's Finance Department identify a different accounts receivable balance than what is reported by Republic. As of June 30, 2012, the Finance Department's records identify accounts receivable from Hilton of \$956,100, as compared to the \$707,500 balance reported by Republic.
 - Information related to accounts receivable for parking garage services are not forwarded by the DPW to the City Auditor's office for entry in the general ledger. As a result, accounts receivable are understated in the general ledger. While the parking accounts receivable balances at June 30, 2012 were immaterial to the City's financial statements, the City is at risk of misstating its financial statements when these amounts are not recorded on the general ledger.
- Since Republic serves as a service organization for the City and their duties involve the processing of financial transactions, the financial transactions are affected by the City's internal controls and the controls employed by Republic. 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 Republic's internal controls are suitably designed and effective.

As detailed in our comment and recommendation on page 10, the most effective and efficient way for the City to accomplish its monitoring efforts is to obtain the appropriate *Service Organization Control (SOC)* report(s) from Republic. Per inquiry of Republic management, Republic has not obtained a SOC report. In addition, per inquiry of DPW personnel, the City has never requested a SOC report from Republic.

- The City's contract with Republic authorizes the City to audit and/or examine all non-confidential records and data maintained by Republic. Per inquiry of DPW personnel, the City has never performed an audit of Republic's operations or financial data. The City's monitoring efforts are observational in nature in which pertinent observations and recommendations made by DPW personnel are verbally communicated to Republic management. Formal reports are not prepared and issued to Republic.

The City's current risk assessment and monitoring policies and procedures are inadequate given the lack of SOC reporting by Republic (as referred to previously) and the volume of financial transactions processed by Republic. As a frame of reference, Republic collected (on-behalf of the City) approximately \$3 million of parking garage receipts during fiscal year 2012.

In addition, we selected a sample of fiscal year 2012 off-street parking receipts and identified the following:

- For 16 of the 17 receipts tested, the deposit support maintained by DPW contained dollar amounts that had been crossed-out and were illegible. Therefore, we were unable to determine if the deposit amounts reconciled to the related transactions posted to the general ledger. Proper internal control requires the DPW to file and maintain a clear and adequate audit trail of all off-street parking deposits and receipts.
- Our sample identified delays in the cash receipts process that inhibited timely financial reporting. The delays in the cash receipts process are summarized as follows:
 - One (1) of the seventeen (17) receipts tested was reviewed by a DPW supervisor ten (10) days after the related deposit was made
 - Ten (10) of the seventeen (17) receipts tested were processed by the Treasurer/Collector's office between six (6) and eleven (11) days after the related deposit was made
 - Six (6) receipts tested were posted to the general ledger by the City Auditor's office between seven (7) and twelve (12) days after the receipts were processed by the Treasurer/Collector's office

Recommendation

We recommend the City implement policies and procedures to:

- Investigate all off-street parking accounts receivable greater than 90 days old as of June 30, 2012 to determine the proper amounts outstanding and coordinate efforts to collect amounts owed. Moving forward, reviews of accounts receivable and coordination of collection efforts should be performed monthly.
- Forward off-street parking accounts receivable balances, and related supporting documentation, to the City Auditor's office monthly to record amounts in the general ledger for financial reporting
- Request the appropriate SOC report from Republic. Moving forward, the City's contract with Republic (and/or any other service organization involved in processing off-street parking financial transactions) should include a requirement to obtain the appropriate SOC report annually.
- Develop and implement a formal risk assessment and monitoring program for its off-street parking operations, to include the performance of periodic audits/examinations in accordance with its service organization contract. All audits/examinations must be formally documented to include the procedures performed, findings and recommendations.

- Maintain a clear and adequate audit trail of all off-street parking deposits and receipts at the departmental level (i.e., DPW)
- Improve the timeliness of the off-street parking cash receipts cycle such that receipts are posted to the general ledger within five (5) business days (at a minimum) of the related deposits

Management's Response

The City, the Department of Administration and Finance and Department of Public Works & Parks, has initiated a comprehensive financial review of the operations of the City wide parking assets, inclusive of the four (4) municipal garages. The scope of said review includes the means and methods of revenue and receivable recognition systems utilized by the respective contractors utilized by the City in the administration of these parking assets, including the potential receivable recognition into the City's integrated financial management system through the City Auditor. Additionally, periodic reviews shall be undertaken by the City to ensure parking system financial activity is properly furnished to the City in accordance with the respective underlying management contracts, as well as the City's financial practices.

Police Off-Duty Details

Comment

We evaluated the systems of internal control related to police off-duty details and identified the following deficiencies:

- The City annually transfers amounts from the General Fund to the police off-duty details (police details) fund to fund deficits in the police details fund. The following summarizes these transfers over the past five (5) fiscal years:

<u>Fiscal Year</u>	<u>Transfers</u>	<u>Police Detail Expenditures</u>	<u>Transfers as a Percentage of Police Detail Expenditures</u>
2008	\$ 7,933	\$ 6,098,759	0.13%
2009	-	5,464,803	0.00%
2010	41,433	6,402,396	0.65%
2011	55,769	6,934,185	0.80%
2012	350,163	8,387,906	4.17%

As identified in the table above, the fiscal year 2012 deficit transfers to the police detail fund increased significantly both in total dollar amount and as a percentage of expenditures. This could be indicative of a breakdown in the internal controls over police detail billings and/or collections.

- For financial reporting purposes, the City annually records an allowance for uncollectible police detail accounts receivable. However, the City does not have formal policies and procedures for writing-off amounts that are not collectible.

At June 30, 2012, we identified that approximately \$255,000 of the total accounts receivable balance of approximately \$896,000 was greater than one (1) year overdue.

- We tested a sample of police detail payroll transactions during fiscal year 2012 and identified the following:
 - For one (1) of twenty (20) transactions tested, the police detail hours worked per the payroll journal (source document for payroll charges to the general ledger) did not reconcile to the related timesheet signed by the officer and direct supervisor. Such variances create the risk of improper amounts paid and recorded in the police detail fund.
 - For two (2) of the twenty (20) transactions tested, timesheets were not signed by a direct supervisor. Proper internal controls over payroll require supervisory reviews of timesheets to ensure proper amounts are paid and recorded in the police detail fund.

Recommendation

We recommend the City evaluate its current police details billing and collection processes to determine if improvements can be made to enhance the billing and/or collection processes to eliminate or reduce the need for funding from the General Fund.

We also recommend the City implement policies and procedures to:

- Periodically (annually at a minimum) write-off uncollectible police detail accounts receivable
- Reconcile timesheets to payroll journals prior to processing police detail payroll transactions
- Require supervisor sign-offs on timesheets prior to processing police detail payroll transactions

Management's Response

The City Treasurer's Office shall establish formal annual "write-off" procedures for Police Off Duty Detail receivables for receivables in which all means of collection have been exhausted. Additionally, procedures shall be implemented at the Worcester Police Department Off Duty division to ensure that reconciliations and supervisory signoffs on Off Duty assignments are performed prior to the respective billings to contractors and payments to employees for services rendered.

Veterans Services

Comment

We evaluated the systems of internal control related to veterans services and identified the following deficiencies:

- The Treasurer/Collector's office prepares a monthly reporting package documenting various aspects of veterans' services financial activities. We reviewed the monthly reports for fiscal year 2012 and identified the following deficiencies:
 - With the exception of July 2011, none of the monthly reports contained a reconciliation of the veterans' benefits paid by the City to the reimbursement approved by the Commonwealth of Massachusetts (Commonwealth). These reconciliations would provide assurance that the City is being appropriately reimbursed for veterans' benefits.
 - The monthly reports each contained reconciliations of veterans' benefits reported to the Commonwealth (and requested for reimbursement) to veterans' benefits recorded in the City's general ledger, with the exception of October 2011. Each of the monthly reports should include these reconciliations to provide assurance that the City is requesting the appropriate reimbursement from the Commonwealth.
- The Treasurer/Collector's office is responsible for reviewing, approving and submitting reimbursement requests to the Commonwealth. The April 2012 reimbursement requests were not submitted until late June 2012. Lack of timely reimbursement requests has a negative impact on cash flows and investment income.

Recommendation

We recommend the Treasurer/Collector's office implement policies and procedures to:

- Reconcile (monthly) benefits paid by the City to the reimbursement approved by the Commonwealth and document the reconciliations by including them in their monthly reporting package related to veterans services
- Reconcile (monthly) benefits reported to the Commonwealth (and requested for reimbursement) to the City's general ledger and document the reconciliations by including them in their monthly reporting package related to veterans services
- Submit monthly reimbursement requests to the Commonwealth no later than 30 days after month-end

Management's Response

The City Treasurer's Office shall augment the current Veteran's Benefits reconciliation process to include a reconciliation of reimbursements received from the Commonwealth.

DCU Center

Comment

The DCU Center (Center) is owned by the City and managed by a venue management company (SMG). Our firm performed a separate audit of the financial activities of the Center as maintained by SMG for the fiscal year ended June 30, 2012.

Our audit of the Center identified the following (as reported in the Center's *Management Letter*):

Surplus Distributions to the City

The management agreement between the City and SMG requires SMG, on a quarterly basis, to distribute surplus to the City. The management agreement defines surplus as the amount by which operating revenue for the prior quarter exceeded operating expenses for the prior quarter, less the projected cash flow shortfall for the subsequent quarter.

The required quarterly surplus distributions were not made throughout fiscal year 2011 and fiscal year 2012. Subsequent to June 30, 2012, SMG distributed the fiscal year 2011 surplus (\$122,409) to the City. However, the fiscal year 2012 surplus, totaling \$666,730, had not been distributed to the City as of August 2012.

Food and Beverage Accounting

A significant aspect of the Center's food and beverage operations involves the purchase and sale of food and beverage items during arena and convention center events. The Center utilizes an automated "Point-of-Sale" (POS) system to account for inventory (i.e., food and beverage) purchases and sales.

However, the POS system is not integrated with the Center's general ledger. As a result, the general ledger is not automatically updated for inventory purchases and sales. Instead, the Center uses data from the POS system to prepare numerous spreadsheets and analyses. These spreadsheets and analyses are used to prepare and post journal entries to the general ledger to capture food and beverage activity.

The current process is inefficient and prone to human error. Given the volume of activity of the Center's food and beverage operations, a fully integrated accounting system with POS capabilities and automatic updates to the general ledger for purchases and sales of inventory would increase efficiencies and reduce the risk of financial reporting errors.

Recommendation

We recommend the City work with SMG to resolve the matters summarized above and reported in the Center's *Management Letter*.

Management's Response

The City and the Department of Administration & Finance, shall implement quarterly reviews of the DCU Center financials to determine if the distribution of a quarterly surplus is in order taking into consideration the projected cash flow of the subsequent quarter. Additionally, the Department of Administration and Finance is currently undertaking a review of the existing "Point of Sale" (POS) system at the DCU Center and conducting a cost benefit analysis of implementing a POS system which is integrated with the facilities general ledger system.

Tax Rate Recapitulation

Comment

The City annually prepares the "Tax Rate Recapitulation" (Tax Recap) that is submitted to the Massachusetts Department of Revenue (DOR) and provides the foundation for the fiscal year's tax levy calculations.

The Tax Recap reports property valuations by class (residential, commercial, etc.), excluding property values that are exempt from taxation. The property valuations by class determine the percentage of the total tax levy applied to each class of property.

We identified that the fiscal year 2012 Tax Recap incorrectly reported the total property valuations. This was caused by the incorrect reporting of exempt properties. While this did not impact the calculation of the total tax levy, the tax levies by class of property were incorrectly reported on the Tax Recap.

Subsequent to the certification of the Tax Recap and prior to the issuance of tax bills, the City detected and corrected the error. As a result, actual tax bills issued by the City were correctly calculated.

However, the reporting errors on the Tax Recap indicate a deficiency in internal controls. Inaccuracies on the Tax Recap could potentially cause tax bill errors that negatively impact the City's financial operations, cash flows, etc.

Recommendation

We recommend the City implement policies and procedures to prevent, or detect and correct errors in the annual Tax Recap prior to submission and certification by the DOR.

Management's Response

The calculation of the City's "actual" tax bill (tax rate recapitulation) involves independent processes of the Assessors Office, the Treasurer's Office and the Technical Services Department, each of which has their own distinct procedures manual. The Treasurer's Office shall consolidate these independent manuals into a comprehensive "actual" tax bill (tax rate recapitulation) manual to ensure the detection and correction of any errors occurs prior to the issuance of the "actual" tax bill.

Assessors Office

Comment

We identified the following deficiencies related to the Assessor's Office:

Abatements

During our testing and internal controls evaluation of real estate tax abatements, we identified the following:

- Approved abatement applications for two (2) of the twenty-five (25) abatements tested could not be located. Approved applications should be kept on file for all abatements to provide evidence supporting the appropriateness of each abatement.
- Abatement applications for two (2) of the twenty-five (25) abatements tested did not contain signature evidence documenting the approval of the application

Tax-Exempt Properties

During our testing and internal controls evaluation of tax-exempt properties, we identified that a State Tax Form 3ABC (Form 3ABC) could not be located for four (4) of the twenty-five (25) exempt properties tested. Form 3ABC should be kept on file for all tax-exempt properties to provide evidence supporting each property's tax-exempt status.

Recommendation

We recommend the City implement policies and procedures requiring approved abatement applications, containing signature evidence of approval, be filed for all abatements.

We recommend the City implement policies and procedures requiring Form 3ABC be obtained and filed for all tax-exempt properties.

Management's Response

The City Assessors Office shall implement procedures to ensure that copies of original (executed) abatement applications, granted abatements and Form 3ABC are maintained both manually and digitally.

Service Organization Controls

Comment

The City, like many local governments in Massachusetts, engages third-party service providers (service organizations) to process certain financial transactions (e.g., off-street parking receipts). 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 Department of Administration and Finance - Purchasing Division shall review all service contracts, in which City funds are collected on behalf of the City by the respective service provider, with the respective contracting department and the City Treasurer to make a determination if the prospective bid solicitation should include the submission of a Service Organization Control (SOC) report with their respective bid response.

Record Retention

Comment

A significant volume of paper and records are processed, maintained, and stored in departments throughout the City. We identified the City does not have formal records retention policies and procedures.

Formal records retention policies and procedures would provide the following benefits:

- Legal and tax protection
- Convenience and assistance in records retrieval
- Maximized use of limited storage space

Recommendation

We recommend the City develop, adopt and implement formal records retention policies and procedures. The following considerations should be investigated:

- Federal and state legal retention requirements for each type of record and document
- Internal retention requirements of certain records and documents not covered by legal dictate (such as contract records)
- Availability of storage facilities (electronic/scanned records require less space than original paper source documents)
- Cost of scanning records versus the cost of storing the original document
- Frequency of referral to documents (electronic/scanned document indexing and access may be less time consuming than retrieval of paper source documents)
- Indexing documents for destruction after the expiration of the retention period

Management's Response

The administration shall review with each respective department, the guidelines promulgated by the Commonwealth's Secretary of State to formulate record retention protocols specific to the respective department.

Authorized and Unissued Debt

Comment

At June 30, 2012, the City has several old borrowing authorizations for which debt has not been issued and the authorizations have not been rescinded. This matter has been reported in prior years' Management Letters.

As a frame of reference, the following table summarizes authorized and unissued borrowing authorizations greater than two (2) years old as of June 30, 2012:

<u>Fiscal Year of Loan Authorization</u>	<u>Authorized and Unissued Debt Balance</u>
1988	\$ 400
1994	230,000
1995	78,000
1996	330,500
1998	4,041,500
2000	125,000
2001	1,030,000
2002	11,585,000
2003	885,688
2004	2,290,000
2005	5,865,000
2006	66,043,435
2007	99,025,000
2008	5,350,000
2009	10,535,000
2010	<u>13,644,500</u>
Sub-total - Greater than 2 years old	\$ <u>221,059,023</u>
Total at June 30, 2012	\$ <u>294,727,000</u>
Percentage of total greater than 2 years old	<u>75.0%</u>

While some of the authorized and unissued debt identified above relates to ongoing projects or projects the City is still planning to undertake (for example, a majority of the fiscal year 2006 authorized and unissued debt relates to the CitySquare project), there may be authorized and unissued balances for projects the City no longer intends to borrow money for. As an example, the authorized and unissued balances from fiscal year 1988 through 2000 (as identified above) remained unchanged from fiscal year 2011.

While the City is allowed to use old borrowing authorizations to fund new projects similar to the original purpose of the authorizations, the new projects might not meet the intent of the original authorizations.

Recommendation

We recommend the City implement policies and procedures to periodically review unissued borrowing authorizations and to rescind authorizations for projects the City no longer intends to borrow money for.

Management's Response

The City's Capital Improvement Program (CIP) generally spans multiple fiscal years in terms of the term of specific projects as well as the funding of specific projects. As previously reported, the administration shall annually review all outstanding loan orders with the submission of the City's five year capital improvement program and will recommend the rescission of any loan order which it determines not to be required.

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

We are very familiar with the accounting changes required by GASB 68 and plan to implement them in the 2015 CAFR.