

CITY OF LAWRENCE, MASSACHUSETTS

MANAGEMENT LETTER

JUNE 30, 2011



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

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Lawrence as of and for the year ended June 30, 2011, (except for the Lawrence Contributory Retirement System which is as of and for the year ended December 31, 2010) in accordance with auditing standards generally accepted in the United States of America, 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.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the deficiencies noted in the table of contents constitute a material weakness.

We also became aware of other matters that are opportunities for strengthening internal controls and enhancing operating efficiency. The memorandum that accompanies this letter summarizes our comments and suggestions concerning those matters.

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

February 8, 2012

CITY OF LAWRENCE, MASSACHUSETTS

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MATERIAL WEAKNESS

STRUCTURAL BUDGETARY CONTROL (MATERIAL WEAKNESS)

Prior Comment

Since approximately FY2003 the City has used non-recurring revenues, free cash, unobtainable revenue estimates, and debt service reserves to meet short-term budgetary goals at the expense of long-term financial sustainability. These budgetary actions have created and prolonged what is, in effect, a structural deficit. In other words, the City has been using budgetary techniques that, without modification, are inefficient to sustain the City's current and future operations.

The Massachusetts Department of Revenue, Division of Local Services (DOR), did an extensive review of the City's financial operation in February 2008. This report included a number of recommendations designed to eliminate the continuation of the City's budgetary and operating deficiencies. The majority of these recommendations have not been implemented.

As a result of the above, on December 31, 2009, the Governor of the Commonwealth of Massachusetts proposed legislation "An Act Providing For The Financial Stability of The City of Lawrence" (Act). Under this Act, there will be the establishment of a Fiscal Overseer appointed by the Secretary of Administration and Finance (Secretary) vested with comprehensive authority over all of the City's finances, including appropriations, borrowings, transfers of funds, and municipal spending authorizations. The Act establishes a City of Lawrence Fiscal Stability Fund, into which will be deposited up to \$35 million of borrowing, to maintain and operate the City for fiscal years beginning July 1, 2009, and July 1, 2010. Amounts may be disbursed from this fund under conditions approved by the Commissioner of Revenue. The Act also provides that if the Fiscal Overseer concludes at any time after January 31, 2011 that the City is unable to achieve a balanced budget and fiscal stability, the Secretary may terminate the existence of the Fiscal Overseer and appoint a Finance Control Board (Board). Under the Act, the Board would not only have all of the powers of the Fiscal Overseer, but also the power to exercise any function or power of any municipal officer or employee, whether elected or otherwise, including certain powers to approve or disapprove contracts and have control over all personnel matters.

The need to rely on the Commonwealth of Massachusetts (Commonwealth) resources, and possibly be subrogating to a control board, indicates that the City is not able to manage its operations competently at the current time.

There are a number of recommendations in this report and the report issued by the DOR that, if implemented, would enhance the internal controls over several areas of the City's operations and help mitigate, if not eliminate, the need for reliance on the Commonwealth.

PRIOR YEAR COMMENTS

ESTABLISH FORMAL DEPARTMENTAL RECEIPTS PROCEDURES

Prior Comment

The City has several departments that receive and process receipts and that many of these departments have small administrative staffs that created an inherent risk that the receipts may not be properly reported, remitted or safeguarded. We noted that there has been improvement in this area, however, documentation of procedures and a more extensive implementation has not yet occurred.

We recommend that the City establish formal City-wide departmental receipt policies and procedures that would provide a framework upon which department heads could assess existing internal controls and, where deemed necessary, develop such controls via documented examples. It was also recommended that the City Comptroller's Office track revenue trends of departmental receipts and perform periodic site visits to assure compliance with City policies, with the goal being to improve oversight and reduce the risk of errors or irregularities occurring and going undetected.

WATER AND SEWER OPERATIONS

Prior Comment

The City has struggled in the past in making water and sewer operations sustainable to meet its current and long-term costs of operations. While the City has made progress in this area we noted that personnel resources allocated to the department may be insufficient. The City, in the past, has relied on outside consultants to assist in the development of usage rates and, among other day-to-day activities, fixed asset accounting.

While recognizing the improvement in revenue generation through an adjustment in rates, we recommend that the City create an organizational structure that will be able to meet both the current and long-term needs of these enterprise funds.

FRAUD RISK ASSESSMENT

Prior Comment

The opportunity to commit and conceal fraud exists where there are assets susceptible to misappropriation and inadequate controls to prevent or detect the fraud. To address this risk, we recommend that the City perform a risk assessment to identify, analyze, and manage the risk of asset misappropriation. Risk assessment, including fraud risk assessment, is one element of internal control. Thus, ideally, the City's internal control should include performance of this assessment, even though our annual financial statement audits include consideration of fraud.

The fraud risk assessment can be informal and performed by a management-level individual who has extensive knowledge of the City that might be used in the assessment. Ordinarily, the management-level individual would conduct interviews or lead group discussions with personnel who have extensive knowledge of the City, its environment, and its processes. The fraud risk assessment process should consider the City's vulnerability to misappropriation of assets. When conducting the self-assessment, questions such as the following can be considered:

- What individuals have the opportunity to misappropriate assets? These are individuals who have access to assets susceptible to theft and to records that can be falsified or manipulated to conceal the theft.
- Are there any known pressures that would motivate employees with the opportunity to misappropriate assets? Pressures may relate to financial stress or dissatisfaction. In assessing whether these pressures may exist, the assessor should consider whether there is any information that indicates potential financial stress or dissatisfaction of employees with access to assets susceptible to misappropriation.
- What assets of the City are susceptible to misappropriation?
- Are there any known internal control weaknesses that would allow misappropriation of assets to occur and remain undetected?
- How could assets be stolen? Assets can be stolen in many ways besides merely removing them from the premises. For example, cash can be stolen by writing checks to fictitious employees or vendors and cashing them for personal use.
- How could potential misappropriation of assets be concealed? Because many frauds create accounting anomalies, the perpetrator must hide the fraud by running through an adjustment to another account. Generally, fraud perpetrators may use accounts that are not closely monitored.

We recommend that management implement a fraud risk assessment program to identify, analyze, and manage the risk of asset misappropriation.

ESTABLISH AN INTERNAL AUDIT FUNCTION

Prior Comment

The City does not have an internal audit function. We believe that the City has grown to a size and complexity that warrants consideration of an internal audit function. Internal auditing is an independent appraisal activity within the City for the review of accounting, financial, and other operations. The overall objective is to carry out a program of tests of the City's financial and operational activities and transactions to provide management with information about the effectiveness (and efficiency) of established accounting and operational policies, procedures, and controls, and the extent to which they are being followed. In the course of gathering such information, the reliability of accounting and other data generated within the City may be evaluated. Another objective is the prevention and detection of fraud through the performance of audit tests and procedures.

Establishment of an internal auditing function could result in substantial benefits to the City in terms of strengthened internal control and increased efficiency. Some benefits of an internal audit function are as follows:

- Strengthening the City's internal controls over assets and increasing the reliability of the accounting records.
- Reducing the time spent by management in the development of City procedures.
- Increasing assurance that City policies are being adhered to and that departmental procedures and controls are being reviewed objectively.
- Ensuring that each department is accounting and reporting in a consistent manner and that they are operating in accordance with management's wishes.
- Making procedural reviews to determine that the various departments are operating efficiently.
- Providing an excellent training ground for future secondary and top management positions.

We recommend that management evaluate the costs and potential benefits of establishing an internal audit function.

We offer the following recommendation of steps for the internal auditor, once hired, to take in setting up an internal audit function:

- Meet with the Mayor and senior management to obtain a clear idea of their expectations for the internal auditor, including their assessment of the most significant risks the City faces and problems the auditor should address. The internal auditor would also establish his or her expectations of those parties' support of the internal audit function and that they will promote the internal audit function, and call for cooperation with it, throughout the City.
- Obtain and review the City's written policies and procedures, including those relating to management's responsibilities in managing the City.
- Identify the departments, locations, processes, and operations (including IT) that will be subject to internal audits.
- Meet with department heads and operations (including IT) managers to gain an understanding of their concerns and the risks they face.
- Meet with the independent auditors and review their communications to identify internal control issues or deficiencies they may have identified and to learn their perspective of the risks the City faces.
- Assess the internal and external risks the City faces.
- Develop a charter for internal audit that includes a description of its objectives, authority, independence, responsibility, and scope of work.
- Develop an internal audit plan, based on the risk assessment and requests from management.
- Develop a budget for internal audit, including personnel and travel, if necessary.
- Develop a staff training plan, if applicable.
- Establish a reporting channel and process for following up on recommendations in internal audit reports.

We believe that this blueprint can demonstrate the City's commitment to the internal audit function, convey the City's expectations of the internal auditor, and serve as a guide to the auditor in meeting those expectations. The City can obtain free guidance (such as sample internal audit charters) and information about resources on establishing an internal audit function from the Institute of Internal Auditors' website at www.theiia.org (select the "guidance" tab).

DEVELOP INTERNAL PROCEDURES MANUAL

Prior Comment

During our examination, we noted that a number of departments do not maintain a formal internal procedure manual documenting day-to-day processing and controls. Since the City is limited in its number of employees, the City is at risk if critical tasks cannot be completed due to an extended absence.

We recommend that each department-head develop an internal procedure manual. The document should be written with sufficient detail to allow a new employee the ability to complete day-to-day tasks. This document should be updated for any system changes and a master manual of all procedures should be maintained and stored in a secure location.

CURRENT YEAR COMMENTS

DEPOSIT AND INVESTMENT POLICY

Comment

GASB Statement 40 requires financial statement disclosure of key policies affecting the management of cash deposits and other long term investments of the Town. This new accounting standard highlighted the need for governmental entities to consider adopting cash and investment policies that take into account custodial, credit and interest rate risk. Such policies establish guidelines for matters such as 1) the types of banks the District should have deposits with; 2) the maximum period that an investment can be held and; 3) the highest concentration the District can have in any one investment type or issuer.

Current disclosures indicate that there are no specific policies in place to ensure that deposits and investments are managed prudently or that such items are not subject to extraordinary risk.

We recommend that the Treasurer adopt a deposit and investment policy that addresses key areas of the GASB Statement 40. Among other items, the policy should address collateralization of uninsured cash deposits and limits placed on the ability to invest in certain debt or equity issuers.

AUDIT OF STUDENT ACTIVITY FUNDS

Comment

The Massachusetts Association of School Business Officials (MASBO) published a student activity accounts manual in May of 2007 to assist school districts with the operation and management of student activity accounts under the provisions of Massachusetts General Law (MGL), Chapter 71, Section 47, as amended by Chapter 66 of the Acts of 1996.

To comply with the MGL, the MASBO recommends that annual audits of the student activity funds be performed. The audit may be an internal audit conducted by the school business administrator, if so approved by the School Committee. However, at least one time every three years, the audit should be performed by an independent audit firm.

We recommend that the City implement these policies and procedures to comply with the MASBO recommendation.

BUDGETED OPERATING TRANSFERS

Comment

During the year the City voted transfers to fund capital projects, debt service, internal service fund and water and sewer enterprise indirect costs. We noted that several of these transfers were either posted directly to fund balance or as an offset to an expenditure. Voted transfers between funds should be recorded as a transfer-in and a transfer-out between the applicable funds. Amounts should be recorded as an "other financing source/use" and not be posted to fund balance or as a reduction to an expense.

We recommend that all transfers between funds be recorded as an other financing source or use.

PAYROLL PROCESSING AND SYSTEMS

Comment

The City's payroll is processed using several different payroll systems. The School, City, and certain boards and commissions all use distinctly different, non-integrated systems to process payroll. Separate functions include the printing of checks, filing of W-2's, and communication/report filings with the Internal Revenue Service (IRS).

Due to the existence of these individual separate systems the City:

- is not able to monitor and coordinate internal controls over payroll processing and reporting in a cohesive and efficient manner,
- repeatedly receives correspondence from the IIRS due to City records not agreeing with the IRS and,
- certain authorization processes are duplicated each payroll.

In general, the payroll environment lacks standard operating policies, places reliance on manual interfaces, and demonstrates an inconsistent use of technology.

We recommend that an evaluation be conducted of all City payroll processes. The evaluation should focus on enhancements to internal controls, the elimination of inefficiencies, and a coordination in the use of technology aligned with best practices.

GRANT MANAGEMENT AND THE USE OF BUDGETS

Comment

The City receives millions of dollars in federal and state funds annually. The administration of these funds requires controls over compliance with laws and regulations and financial reporting. In reviewing these controls we noted that grant expenditures, unlike general fund expenditures, are not being monitored at a line item budgetary level in MUNIS.

The use of a budget is a fundamental control over the authorized spending limit of an appropriation or grant award. We recommend that a budget be created in MUNIS for all grant awards.

AUTOMATION OF TREASURY FUNCTION

The Treasurer serves as the City's cash manager. In this role, the Treasurer maintains custody of all municipal funds and possesses responsibility for the deposit, investment and disbursement of these monies. The Treasurer must administer the municipality's resources to ensure the availability of adequate liquid assets to pay obligations as they become due.

In this capacity the Treasurer must monitor all the receipts and disbursements of the City and, each month, reconcile the monthly balances to the general ledger. For the most part this responsibility has been carried out using a combination of spread sheets and manual processes using information extracted from MUNIS.

MUNIS has a Treasury Management module which can automate and streamline many of the functions currently performed manually by the Treasurer's office. We recommend that this module, or a similar type program, be considered as an upgrade to existing systems and processes.