

# City of Houston, Texas

Report to Management for the  
Year Ended June 30, 2012



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December 18, 2012

City of Houston, Texas  
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In planning and performing our audit of the financial statements of the City of Houston, Texas (the "City") as of and for the year ended June 30, 2012 (on which we have issued our report dated December 18, 2012), in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion 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 over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting. However, in connection with our audit, we identified, and included in the attached Appendix, deficiencies related to the City's internal control over financial reporting as of June 30, 2012, that we wish to bring to your attention.

We have also issued a separate report to the Mayor, Members of City Council, the City Controller and management, also dated December 18, 2012, which include a certain matter involving the City's internal control over financial reporting that we consider to be a significant deficiency under standards established by the American Institute of Certified Public Accountants.

The definitions of control deficiencies are also set forth in the attached Appendix.

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

Yours truly,

**SECTION I —DEFICIENCIES**

We identified, and have included below, deficiencies involving the City’s internal control over financial reporting for the year ended June 30, 2012, that we wish to bring to your attention:

**A. RECONCILIATION AND REVIEW OF BALANCE SHEET ACCOUNTS**

The City does not regularly reconcile and review the accounts receivable sub-ledger. The lack of timely reconciliations and reviews led to adjustments in the classification of receivables.

The City does not perform consistent reconciliation and review procedures related to deferred revenue and allowance accounts. The lack of reconciliation and review led to adjustments when reconciling the general ledger to the underlying support. The City should perform regular and timely reconciliation and review of balance sheet accounts.

**B. WORKING TRIAL BALANCES**

The City prepares its working trial balances based on a period 12 soft close. A significant number of adjustments were posted to the working trial balances after the soft close. The City should review its year-end closing process and evaluate the adjustments posted after the period 12 soft close to determine the cause of such adjustments and if such adjustments could be processed prior to the period 12 soft close. In addition, the City should ensure that the working trial balances are closed in a more timely manner.

**C. FIXED ASSETS**

The City continued to improve upon the understanding and usage of the fixed asset system and subledger during fiscal year 2012. Although the City performs reconciliations and reviews annually, these reconciliations and reviews should be performed more frequently. The City should perform regular and timely reconciliations and reviews, as the lack of frequent reconciliations and reviews caused multiple material revisions of such rollforwards during the audit. Multiple revisions were due in part to the following:

- Late transfers of completed projects out of work in process (WIP)
- Inaccurate descriptions of assets

**D. COMPENSATED ABSENCES**

The compensated absences liability report did not add up properly as there was a formula error in the totals, which resulted in an initial classification error between short term and long term compensated absences. The City should increase efforts to review the liability report to ensure that it is accurate and complete.

Additionally, during our testing, we noted that the report was inappropriately considering usage of accumulated hours by employees after year-end. As a result, the City had to prepare an extensive reconciliation. The City should prepare the compensated absences report as close to year-end as possible.

## **E. DEBT**

The City generally records adjustments to debt during the period 12 soft close. However, there was a delay in recording these adjustments, and many of them were not recorded until after the end of the period 12 soft close. The City should record debt issuances, refundings and adjustments as they occur during the year.

Additionally, the City utilizes numerous spreadsheets to support debt adjustments and footnote disclosures. As a result of the delay in recording adjustments, there was a lack of timely and effective review of these spreadsheets and the general ledger, which resulted in audit adjustments and revisions to the debt roll-forward schedules, supporting schedules and footnote disclosures.

The City refunded debt during the year that was part of the notional amount of an interest rate swap. This resulted in a material adjustment to the deferred refunding gain/loss calculation and additional consideration necessary regarding the assessment of hedge effectiveness. When the City enters into unique transactions, the City should assess the impact on the financial statements in a timely manner.

## **F. NET ASSET ALLOCATION**

The City prepares the net asset allocations each year. The City did not properly allocate net assets for several funds. The City should perform a review of the calculation, as the lack of review led to adjustments to the net asset allocation for several funds.

## **G. DRAINAGE REVENUE**

Throughout the year, the City records expenditures related to street projects by debiting various expenditure accounts and crediting cash or accounts payable. At year-end, in order to capitalize the street resurfacing, bridge replacement and concrete repair projects, instead of reversing out the expenditures the City recorded a debit to the capitalized asset and a credit to revenue. The City made the entry in this manner in order to preserve the expenditure data in the accounting system. While the entry maintained the integrity of the Budget vs. Actual expenditure reports used by City, this resulted in the City's revenue and expenditures being overstated, requiring an adjustment to the City's financials. The City is pursuing an alternative method to resolve the issue next fiscal year.

## **H. SELF-INSURED HEALTH PLAN**

The current fiscal year was the first full year that the City had a self-insured health plan and the first year to have an incurred but not reported ("IBNR") actuarial valuation. During testing of the IBNR actuarial valuation, the third party provider was able to provide some underlying support for the Lag Reports. This underlying support included check registers with issued check dates and service dates for periods selected by audit team. The City should work on acquiring the lag report data in a timely basis.

## **I. SCHEDULE OF FEDERAL AND STATE AWARDS**

The City did not properly account for certain grants that it received which resulted in the initial draft of the Schedule of Federal and State Awards ("SEFA") to be misstated. The SEFA was subsequently corrected for this issue.

## **J. INFORMATION SECURITY**

During our review of information security related to the CourtView Application, we noted that while an application password is required to gaining access to the CourtView application, the password settings (password complexity, minimum password change interval, account lockout policy, etc.) are not available to be set within the CourtView application. Security surrounding the Courtview Application should be enhanced to require a separate password setting.

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## SECTION II — DEFINITIONS

The definitions of a deficiency, a material weakness, and a significant deficiency are as follows:

A *deficiency* in internal control over financial reporting 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 and correct misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A *material weakness* is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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