

CITY OF ROCHELLE, ILLINOIS

MANAGEMENT LETTER

April 30, 2011



Certified Public Accountants & Advisors



998 Corporate Boulevard • Aurora, IL 60502

The Honorable Mayor
Members of the Council
City of Rochelle, Illinois

Ladies and Gentlemen:

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 Rochelle, Illinois as of and for the year ended April 30, 2011, 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 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 of Rochelle, Illinois' internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore there can be no assurance that all such deficiencies have been identified. However, as discussed on the following pages, we identified certain deficiencies in internal control that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control 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 material weakness is a deficiency or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the City'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 that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

Aurora, Illinois
August 5, 2011

A handwritten signature in black ink, appearing to read 'A. J. J.', written in a cursive style.

MATERIAL WEAKNESSES

We consider the following to be material weaknesses:

1. Revenue Recognition

During our testing of governmental revenues, we noted that the amounts recorded by the City for various state shared revenues and receivables were incorrect and did not agree to the amounts reported by the State. Sikich reviewed the general ledger detail for these accounts and noted that the underlying reason for the differences was due to prior year audit entries that were not properly posted. Furthermore, the fund balances in the General Fund and Sales Tax Fund did not agree to the prior year audited financial statements due to these errors. We proposed an adjusting journal entry which the City reviewed and posted to record the correct amounts of revenue, receivable and fund balance. We recommend that the City incorporate a year end process to review the revenue and receivable accounts to verify the proper amounts of revenue are recorded in compliance with Governmental Accounting Standards Board (GASB) Statement No. 33.

2. Fund Balance/Net Assets

It was noted during our testing of fund balances/net assets that the City had multiple funds in which the fund balance/net assets did not agree to the prior year audited financial statements. Additionally, we noted that certain closing entries in the Water, Water Reclamation and Electric Fund that were erroneously posted to net assets. Finally, we noted two instances during the year in which the City created new funds (Foreign Fire Insurance Fund and Technology Center Fund) and recorded the opening balances for these funds by posting adjustments to fund balance/net asset accounts which is not in accordance with GASB Statement No. 34. We recommend that after all audit adjustments have been posted that the City reconcile its fund balance/net asset accounts to the prior year audited financial statements to ensure that its opening balances are accurately stated. Additionally, after these balances have been reconciled, we recommend that the City not post any entries to fund balance/net asset accounts after the year end closing has been performed.

SIGNIFICANT DEFICIENCY

We consider the following to be a significant deficiency:

1. Foreign Fire Insurance Fund

The City established a Foreign Fire Insurance Board (the Board) in accordance with Public Act 96-0505, and the City established a separate fund to account for the activity of the Board which is required to be audited as part of the City's financial statements. While the Board has jurisdiction and authority over the administration and use of the Fund within statutory limits, it was noted that the City was not provided reports throughout the year with regards to the ongoing activity of the Board. Further, it was noted that the Board was commingling funds from the Fire Department Ambulance account and Fire Department Social account which are not recorded on the City's general ledger, which is not appropriate. We recommend that the Board provide the City with monthly or quarterly financial statement information. Additionally, we recommend that the Board maintain the foreign fire insurance funds in a separate bank account and general ledger to ensure that the activity for the foreign fire funds is accurately recorded in the City's general ledger and not commingle these related funds with any other funds.

DEFICIENCIES

We consider the following to be deficiencies:

1. **Cash and Investments**

We noted during our testing of cash and investments that there were two bank accounts opened in the City's name but not recorded on the City's general ledger. These accounts include the Police K-9 account and the Fire Department Ambulance Donations account. We recommend that the City require approval from the City Council to open any new accounts in the City's name and that the Finance Department is notified of any new approved accounts to ensure all City accounts are appropriately recorded on the general ledger.

2. **Developer Reimbursements**

During our review of developer reimbursement revenues, we noted that the City had not accrued a receivable for additional work that had been performed by the City that was billable to outside developers at year end. We recommend that the City implement a process to coordinate between various departments to capture all amounts to be billed by the City are recorded in the correct fiscal year.

3. **Compensated Absences**

During testing of compensated absences, it was noted that payments due to the Illinois Municipal Retirement Fund were being included in the calculation which is not in accordance with GASB S-16, which states: "An accrual for the required contribution to a defined contribution or a cost-sharing multiple-employer defined benefit pension plan should be made if the employer is liable for a contribution to the plan based on termination payments made to employees for vacation leave, sick leave, or other compensated absences. An additional accrual should not be made relating to single-employer or agent multiple employer defined benefit plans." Additionally, we noted that FICA was not being included in the accrual for the Rochelle Municipal Utilities Funds. This treatment is also not in accordance with GASB S-16. We recommend that the City modify its spreadsheets to reflect these calculations and include the proper amounts in its compensated absences liability.

4. **Prepaid Insurance/Expenditures**

It was noted during the testing of prepaid insurance and expense that the monthly journal entry was not taking the correct amount of expense due to a formula error in the City spreadsheet, causing insurance expenditures to be understated. We proposed a journal entry which the City reviewed and posted to record the correct amounts. We recommend the City review the prepaid asset balance and expenditure account as part of the year end reconciliation process.

OTHER INFORMATION

Future Accounting Pronouncements

The Governmental Accounting Standards Board (GASB) has issued a number of pronouncements that will impact the City in the future.

GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, provides clearer fund balance classifications that can be more consistently applied and clarifies the existing governmental fund type definitions. Also, the definitions of the general fund, special revenue fund type, capital projects fund type, debt service fund type, and permanent fund type are clarified by the provisions in this Statement. The statement is effective for the City's fiscal year ending April 30, 2012.

GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, is intended to address issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer other postemployment benefit (OPEB) plans (that is, agent employers) and is effective for financial statements for periods beginning after June 15, 2011. (City fiscal year ending April 30, 2013.)

GASB Statement No. 59, *Financial Instruments Omnibus*, is intended to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools. Statement No. 59 is effective for the City's fiscal year ending April 30, 2012.

GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, is intended to improve financial reporting by establishing recognition, measurement and disclosure requirements for service concession arrangements (SCA), which are types of public-private or public-public partnerships. This statement provides accounting and financial reporting guidance for governments serving as transferors and those serving as operators in SCAs. Statement 60 is effective for the fiscal year ending December 31, 2012.

GASB Statement No. 61, *The Financial Reporting Entity: Omnibus - an amendment of GASB Statements No. 14 and No. 34*, is intended to improve guidance for including, presenting, and disclosing information about component units and equity interest transactions of a financial reporting entity. This Statement modifies certain requirements for inclusion of component units in the financial reporting entity and amends the criteria for reporting component units as part of the primary government. Statement No. 61 is applicable for the fiscal year ending December 31, 2013. Earlier application is encouraged.

GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, is intended to improve financial reporting by contributing to the GASB's efforts to codify all sources of generally accepted accounting principles for state and local governments so that they derive from a single source. This Statement intends to provide more consistent application of applicable guidance in financial statements of state and local governments. Statement No. 62 is applicable for the fiscal year ending December 31, 2012. Earlier application is encouraged.

**APPENDIX A
STATUS OF PRIOR YEAR RECOMMENDATIONS**

MATERIAL WEAKNESSES

We consider the following to be material weaknesses:

1. Revenue Recognition

During our testing of governmental revenues, we noted that the City was recording certain taxes, state shared revenues and grants on the incorrect recognition period. This recording was not in accordance with GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*. We proposed a prior period adjusting journal entry which the City posted to properly record this revenue. We recommend that the City review its revenue recognition policies in order to ensure that all revenues are being properly recorded in accordance with the respective GASB guidance.

Status - This comment still applicable at April 30, 2011, see current year material weakness #1.

2. Accounts Payable, Retainage Payable and Year End Cut Off

We noted during our testing of the City's expenditures that a prior year amount for retainage payable had been overstated on the City's 2009 financial statements. Our review of the invoices related to this amount revealed that the amount had been overstated at April 30, 2009, and consequently, expenses in fiscal year 2010 were also overstated as this amount had not been reversed out of the liability account. We proposed a prior period adjusting journal entry which the City posted to properly record the liability and expenditure amounts.

Additionally, during our testing of subsequent disbursements, it was noted that the City did not accrue accounts payable related to transactions occurring in fiscal year 2010, even though the goods were received or services were provided by April 30, 2010. We proposed a journal entry which the City posted to properly record these liabilities.

Last, it was noted during our internal control walkthrough of accounts payable and disbursements that the City does not have an appropriate process to track and record retainage liability amounts for construction projects at year end. We recommend implementing procedures to accurately track the progress of construction projects in order to properly record retainage balances at year end. It was also noted that the City does not have a formal process or system for reviewing and approving vendors. We recommend implementing a process to review and approve vendors in the master vendor file. Also, we recommend that when approving the bills list and the payroll list that the Council should enter the dollar amount approved for each (in total) in the minutes as an additional control.

Status - This comment is still applicable at April 30, 2011. While the City did identify retainage at year end, the incorrect amounts were accrued.

DEFICIENCIES

We consider the following to be deficiencies in controls

1. Fund Balance/Net Assets

It was noted during our testing of fund balances/net assets that the City had multiple funds in which the fund balance/net assets did not agree to the prior year audited financial statements. We recommend that after all audit adjustments have been posted that the City reconcile its fund balance/net asset accounts to the prior year audited financial statements to ensure that its opening balances are accurately stated.

Status - This comment is still applicable at April 30, 2011. See current year material weakness #2.

2. City Investments

We noted during our review of the City's investment policy that the policy does not address credit risk or market risk related to investments. Disclosures on these risks are required to be reported in the notes to the financial statements under GASB Statement 40. We recommend the City review its investment policy to address the risks to which the investments are exposed.

Status - This comment is still applicable at April 30, 2011.

3. Police and Firefighters' Pension Fund Investments

During the testing of the Police and Fire pension investments, it was noted that the funds were not recording accrued interest on its investments in debt securities at year end. We recommend the funds implement a year end process to accrue interest receivable and the related revenue on debt securities.

Status - This comment partially implemented at April 30, 2011, the Police Pension Fund recorded accrued interest at year end. However, the Firefighters' Pension Fund did not record an amount for interest receivable.

4. Pension Property Tax Levies

We noted during our testing of property taxes and personal property replacement taxes that the pension funds were directly recording their portion of the tax levy and allocated replacement taxes. GASB Statement 27 requires that the City record the related levies for police and fire pension in the general fund or another governmental fund and then shows a subsequent contribution to the pension fund to report the cost of the City financing the pension funds (employer contributions). Also, taxes receivable are not a valid asset of the pension funds and should not be recorded in the pension funds. We proposed a journal entry which the City posted to properly record these transactions.

Status - This comment is partially implemented at April 30, 2011. The City correctly recorded property taxes and the related receivables in the General Fund; however, replacement taxes were incorrectly shown directly in the Police and Firefighters' Pension Funds.

DEFICIENCIES (Continued)

5. Police and Firefighters' Pension Fund Pension Benefit Payments

We noted during our testing of the pension fund benefit payments that the funds are making the monthly payments one month in arrears (i.e., the City record the payments for April 2009 - March 2010) on the general ledger. Additionally, we noted that the funds had not recorded a liability for the April 2010 amounts, which caused liabilities to be understated at April 30, 2010. We recommend that pension expenses be recorded when due.

Status - This comment is implemented as of April 30, 2011.

6. Internal Controls over Payroll

It was noted during the internal control walkthrough of the City's payroll procedures that there is a lack of subsequent review and approval of the payroll register and direct deposit lists before payroll is processed and the funds are transferred. It was also noted that the City's payroll module seems to be lacking a master file change log showing all changes made to payroll information. As a result, there is no regular review of changes made in the payroll system by management. We recommend the Human Resources and Finance work to review the payroll register against the direct deposit and manual checks on a test basis and also to review changes made to the payroll module on a regular basis.

Status - This comment is partially implemented at April, 30 2011. The City has designated an appropriate level of management to subsequently review the payroll register and direct deposit lists before the payroll is processed. However, the City's payroll module is still lacking a master file change log showing all changes made to payroll.

7. Internal Controls over Utility Billing

It was noted during the internal control walkthrough of Utility Billing that all Customer Service Staff in the Utility Billing department have access to the combination safe where the daily deposits are maintained. While we understand that different individuals work different shifts and therefore multiple people will need access to the safe (i.e. to open, close), we recommend that individuals not working in those positions do not have access to ensure appropriate controls are maintained.

It was noted during the internal control walkthrough of Utility Billing that all Customer Service Staff in the Utility Billing Department have full access rights in the billing module to perform certain tasks, including creating new customer and modifying existing customers, changing rates in the system, and posting adjustments. We recommend that access privileges be restricted for those employees who are not posting adjustments, entering rates, etc.

Status - Comment has been implemented at April 30, 2011.

DEFICIENCIES (Continued)

8. Internal Controls over Cash and Investments

During our testing of cash and investments, we noted certain opportunities for the City to improve its internal control.

First, we noted during our testing of the City's cash accounts that the City has two accounts that had a significant amount of outstanding checks, with some dating back as far as January 2005. We noted that the City did not have a formal policy related to outstanding checks. We recommend the City develop a policy related to unclaimed property to ensure the City maintains compliance with the State unclaimed (escheat) property laws.

Next, we noted that the Flexible Spending Account is held in the City's name but is not recorded/maintained by the City on its general ledger. We recommend the City record any open accounts on the general ledger, even if the City is only operating in an agent capacity for the funds.

Last, we noted during our review of deposits with financial institutions that the City did not have written collateral agreements on file for many of its deposit accounts. It is imperative for the City, especially with the current state of the banking market, to have adequate documentation file for all accounts where collateral is being pledged.

Status - This comment is still applicable at April 30, 2011. See current year deficiency #1.

9. Foreign Fire Insurance

We noted during our testing of foreign fire insurance revenues that the City was netting the associated revenues/expenditures associated with the Foreign Fire Insurance funds. Additionally, the Fire Association erroneously deposited the foreign fire funds into the incorrect account and the City/Association did not remedy this error until after the fiscal year end. We recommend recording revenues/expenditures gross, and reviewing the total for this account as part of the year end close process. In addition, the City should consider accounting for the foreign fire insurance funds in a separate fund.

Status - This comment is still applicable at April 30, 2011. See current year significant deficiency #1.

10. Health Insurance Accounting

It was noted during our testing of the health insurance charges to other funds that the amounts being recorded as revenue in the health insurance internal service fund include various other insurance transactions, as do the expenditure/expense amounts in various funds. We recommend recording the internal service component of these transactions be accounted for in a separate account so the amounts paid from other funds to the internal service fund can be balanced at the end of the fiscal year.

Status - This comment is still applicable at April 30, 2011.

DEFICIENCIES (Continued)

11. Capital Assets

During our testing of capital assets, we noted that the City does not maintain detailed capital asset records that identifies each capital asset owned by the City. The City does have detailed lists of capital asset for some departments and for some classes of assets (e.g., vehicles), but not complete lists for all assets (e.g., most infrastructure assets is one figure for each "class" of infrastructure). If individual capital asset records are not maintained, it is not possible to track the associated cost, useful life, and accumulated depreciation associated with a particular asset and to remove the asset from the City's records upon disposal. In addition, a lack of complete detailed records could reduce the City's ability to maintain controls over its capital assets for custody purposes and could reduce its ability to accurately support a claim for a capital asset, should the need arise. Depreciation expense is calculated in the aggregate, making it difficult to determine what portion of the expense is attributable to each individual asset or whether assets are being over depreciated.

Also, we noted in the utility funds that the general ledger only showed one account for accumulated depreciation. Governmental Accounting Standards Board (GASB) Statement 34 requires that the City present accumulated depreciation in the notes to the financial statements by asset class.

We recommend that the City begin recording detailed capital assets records for all capital assets and consider performing an inventory and valuation over existing capital assets where records are deficient to improve controls over capital asset custody, accounting and reporting.

Additionally, we noted that the City does not utilize an interactive account group on its accounting system for recording governmental fixed asset activity. This account group is an integral part of the City's controls over financial reporting for capital assets as it allows the City to track capital asset activity for the fiscal year in the manner necessary to convert from the modified accrual basis/current financial resources measurement focus to the full accrual basis/economic resources in the City's annual financial report.

We recommend the City set up an interactive account group for tracking and maintaining capital asset records as part of its accounting system in order to improve controls over financial reporting for capital assets.

Status - This comment is still applicable at April 30, 2011. Additionally, we noted that the City was capitalizing expenses that do not add to the useful life of the capital asset (i.e. painting).

DEFICIENCIES (Continued)

12. Inventory

During our testing of inventory, we noted certain opportunities for the City to improve its internal control over its inventory.

First, during our inventory observation, we noted multiple differences in the inventory listing maintained in the general ledger and what was counted as part of the year end physical inventory. Per discussion with City officials, it was determined that one of the primary causes for these differences is that contractors often use materials but do not report usage to the City in an accurate or timely manner. We recommend the City consider the use of a perpetual inventory system to mitigate this weakness and require prompt and accurate reporting of all inventory usage.

Next, we noted during our physical inventory observation that there appear to be items in inventory that appeared to be completely obsolete, potentially overstating the inventory balance and that no allowance for obsolescence has been established by the City. Per discussion with City officials, there is not a formal policy on disposal of obsolete inventory. We recommend that the City create a formal policy over its inventory in order to ensure that there are adequate processes in place to record, track, and maintain adequate inventory records and establish a reserve for obsolete inventory by fund.

Status - This comment is still applicable at April 30, 2011.