City of Houston, Texas

Report to Management for the
Year Ended June 30, 2006

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June 6, 2007

The Honorable Mayor, Members of
City Council and City Controller
of the City of Houston, Texas

In planning and performing our audit of the basic financial statements of the City of Houston, Texas (the "City") for the year ended June 30, 2006 (on which we have issued our report dated June 6, 2007), we considered its internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the City's internal control. However, we noted a certain matter involving the City's internal control and its operation that we consider to be a reportable condition under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the City's internal control that, in our judgment, could adversely affect the City's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable condition that we noted is summarized below.

Finding: The City's financial accounting and reporting process is not adequate to ensure that accounting transactions are being properly captured and recorded by the City in its financial statements.

Background: Due to the City's diverse operations, there are a number of complex accounting and financial reporting transactions that are entered into each year. The City was required to record a significant number of material auditor proposed adjustments to properly reflect the financial operations of the City. Included within these audit adjustments were items related to accounts payables, deferred revenue, capital assets, federal & state grant activities, revenues and debt.

Recommendations for corrective action: The City should evaluate its current financial accounting and reporting process. Within the evaluation there should be a critical review of the way in which financial information flows to and from departments and the City Controller's Office. The City should also evaluate the current financial accounting and reporting structure to assure that there are adequate resources in place to limit the likelihood of future accounting errors.

Our consideration of the City's internal control would not necessarily disclose all matters in the City's internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We believe that the reportable condition noted above is a material weakness.

We will also submit, in Exhibit I, our comments concerning certain observations and recommendations relating to other accounting, administrative, and operating matters. These recommendations resulted from our observations made in connection with our audit of the City's financial statements for the year ended June 30, 2006.

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

We will be pleased to discuss these comments with you and, if desired, to assist you in implementing them suggestion.

Yours truly,

Deloitte & Touche LLP

EXHIBIT I

A. PROPERTY

The City's accounting for property transactions does not appear to be a coordinated effort and contains numerous errors. We noted instances in which the property subledger contained incorrect information as additions, disposals and transfers from construction-in-progress were invalid, recorded in error or lacked adequate support resulting in adjustments to the General Government, Convention & Entertainment Fund and the Combined Utility System ("CUS") Fund totaling approximately $3.6 million, $2.7 million and $2.6 million, respectively. Depreciation expense was incorrectly calculated resulting in an adjustment to depreciation expense to the General Government and the Combine Utility System ("CUS") Fund for approximately $105 million and $19 million, respectively. Assets substantially complete were not transferred out of construction-in-progress resulting in adjustments to the General Government and CUS Fund of approximately $6.6 million and $14.7 million, respectively. Capitalized interest for the Convention & Entertainment Fund of approximately $2.1 million was not properly transferred out of construction-in-progress and for the CUS Fund the amount transferred was overstated by approximately $10.3 million. The asset value transferred from construction-in-progress for substantially completed assets excluded the retainage portion resulting in adjustments to asset cost and depreciation expense on assets in the Houston Airport System Fund. In addition, the property subledger was not reconciled to the City's general ledger system for capital outlay accounts.

B. STALE BALANCES

The City should continue to perform a detailed review and analysis of accounts with stale balances that have not changed between years.

C. MONITORING OF LIEN RECEIVABLES

The City has hired a third party to manage and collect outstanding lien receivables. The City does not appear to take an active role in ensuring that such lien balances or the related allowance for bad debts are fairly stated since the City receives the data from the third party with no supporting documentation. The City should take more responsibility and a more active role in accounting for the liens and the related allowance for bad debts. In addition, the City should request the third party to provide the supporting documentation related to lien balances, review for reasonableness and take responsibility for the information.

D. ACCOUNTS RECEIVABLE AND RELATED ALLOWANCE FOR DOUBTFUL ACCOUNTS

The allowance for doubtful accounts related to certain accounts receivables are determined based on old historical collection data that has been carried forward for several years. The City should establish policies and procedures for calculating the allowances based upon historical experience taking into consideration collections in recent years.

E. CONSTRUCTION REVENUE AND RECEIVABLES

The City enters into construction contracts in which other organizations help to fund such contracts. We noted errors both overstatement and understatement pertaining to the recognition of revenue and receivables associated with these contracts resulting in a reduction of revenue in

Capital Projects and Combined Utility System of approximately $18 million and $17.5 million, respectively. In addition, we noted that the City does not bill and collect on these construction type projects in a timely manner.

F. WORKING TRIAL BALANCES

The City prepares its working trial balances based on the period 13 close. A significant number of adjustments were still required to be posted to the working trial balances. The City should review its year-end closing process and evaluate the adjustments posted after the period 13 close to determine the cause of such adjustments and if such adjustments can be processed prior to the period 13 close. In addition, the City should ensure that the working trial balances are closed in a more timely manner.

G. SCHEDULE OF FEDERAL AND STATE GRANT AWARDS

The City does not adequately identify and record grants that it receives for proper reporting purposes. Particular attention should be paid to construction type projects that include a grant component to the overall funding formula.

H. INTERDEPARTMENTAL CHARGES

The City does not bill and collect, in a timely manner, interdepartmental charges in the area of solid waste, electricity and telecommunications expenses.

I. CASH RECONCILIATIONS AND NEGATIVE CASH

The City did not research and correct large reconciling items in a timely manner related to cash balances. In addition, we noted large negative cash balances in the Grant Fund due to the General Fund as most grants are on a reimbursement basis. Such negative balances were not properly reclassified to due to General Fund resulting in a reclassification of approximately $22.4 million.

J. ACCOUNTS PAYABLE

The City did not properly accrue for accounts payables at year-end, which resulted in significant time delays and material adjustments of approximately $51 million during the performance of the audit.

K. AMBULANCE RECEIVABLE BALANCES

The City does not reconcile ambulance receivables to a detailed listing provided by the City's outside third party service provider. Without proper monitoring of receivable balances, it is difficult to monitor the effectiveness of the third party administrator.

L. INVENTORY

The City posted entries to the trial balance related to inventory balances in which adequate supporting documentation was not provided to support such entries. In addition, the City keeps tracks of several inventory locations on excel spreadsheets instead of utilizing an inventory control program. We noted errors in the excel spreadsheets which resulted in adjustments to the financial statements.

M. DEBT

The City initially records debt payments, inclusive of principal, to the statement of activities which requires an adjustment at the fund level for the enterprise funds. For the Combined Utility System, the City failed to post the adjusting entry to reclassify approximately $20.4 million of principal payments from the income statement and reduce the outstanding principal balance. Amortization of premiums, discounts and refunding gain/losses were incorrectly reflected as an expense in maintenance and operations instead of interest expense resulting in an adjustment of approximately $9 million to properly classify such amortization. In addition, accrued interest expense was understated by approximately $3.2 million.

N. CAPITALIZED INTEREST RATE

The Convention & Entertainment Department has utilized a rate of 5% for the determination of capitalized interest. The rate being used by the Department has not changed since fiscal year 2004. The Convention & Entertainment Department should adjust the capitalized interest rate on an annual basis to ensure that such interest charges are being appropriately capitalized.

O. LOANS RECEIVABLES

The Housing and Community Development Department maintains a number of loans in which collectability requires monitoring. The City properly analyzed the collectability of the loans, but failed to record the proper adjustment to the financial statements resulting in a $13 million adjustment. In addition, certain loans are forgiven based on the nature of the loan. The underlying support for the amortization amount did not take into consideration loans that had been paid off properly, resulting in an adjustment of $1.6 million.

P. GRANTS ACCOUNTS RECEIVABLE AND DEFERRED REVENUE

The City records year-end entries to equalize revenue and expenditures for certain grant programs, however we noted that multiple entries were recorded for fiscal year 2006 and as each additional entry was posted, the entries did not take into consideration prior entries resulting in an overstatement of accounts receivable and deferred revenue of approximately $12.4 million.

Q. CONTRACTUAL OBLIGATIONS

The Convention & Entertainment fund maintains certain agreements that require the City to remit to the organizations a certain percentage of hotel tax collections. The contractual obligation at year-end was based on the initial projections of hotel tax collections was not adjusted based on actual activity, which resulted in an adjustment of approximately $3 million.

R. COMPONENT UNIT TRANSACTIONS

The City has entered into agreements with certain of its component units. We noted that the City failed to properly reconcile and record certain of the transactions with these component units. More specifically, the Convention & Entertainment Fund's due to component unit was overstated by approximately $10 million and due from component unit was overstated by approximately $6.8 million with the net activity overstating the statement of activities by approximately $3.2 million. In addition, certain amounts due from component units were not properly classified in the Grants Fund requiring a reclassification of approximately $8.2 million. The Houston Area Water Corporation ("HAWC") is a blended component unit and provides the same function as

the Combined Utility System Fund, however, we noted transactions between these two funds were not properly reflected as transfers resulting in adjustments of approximately $19.9 million.

S. REVENUE CLASSIFICATION

We noted numerous classifications errors related to revenue sources primarily in the Other Non-Major and Combined Utility System funds resulting in the reclassification of revenue in the Statement of Activities of approximately $16.2 million and $7.9 million, respectively.

T. INTRAFUND ELIMINATION

The City maintains numerous funds within each major fund. Certain transactions are reflected in one fund then transferred or posted to the general fund within the major fund resulting in the duplication of entries in a major fund. Many of these entries are used for tracking purposes. In recording the year-end entries to eliminate such duplication, the City failed to record certain transactions, primarily in the Combined Utility System Fund, related to impact fees and inventory totaling approximately $15.6 million and $3.3 million, respectively.

U. REQUESTS FOR COUNCIL APPROVAL

The City's methodology related to ascertaining that funds are available for payment, as required by City Charter does not always consider the allowance for doubtful accounts or deferred revenues as components of the calculation which could result in an overstatement of funds available for expenditures.

V. RELATED PARTY TRANSACTIONS

The City requires certain employees to complete a conflict of interest statement; however, it does not appear that the City is tracking such related party transactions for disclosure in the City's annual financial report.

W. SYSTEM MODIFICATIONS AND CHANGE CONTROLS

The City does not retain documentation of formal test plans associated with application systems implementation and maintenance; database maintenance and support and network support; system software support.