

## Appendix A

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### Analyses, Conclusions and Remediation Measures

## Appendix A – Analyses, Conclusions and Remediation Measures

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### *Overview*

The results of our review of the City’s internal controls over financial reporting together with our conclusions and recommendations for improvement are presented in this appendix. For clarity of presentation, each of the five elements of internal control is considered individually although our overall conclusion as to the efficacy of internal controls is based upon the effective interaction of each of these elements within the broader internal control framework of the organization. The five elements of internal control are as follows:

- A1: Control Environment
- A2: Risk Assessment
- A3: Control Activities
- A4: Information and Communication
- A5: Monitoring

Each of the five control elements is presented in this appendix in the following format:

- I. Background** - Information concerning the nature of the control element with pertinent examples.
- II. Analysis** - Details of the analysis and evaluation of the work performed.
- III. Conclusions** - A statement of conclusions drawn and underlying rationale.
- IV. Remediation Measures** - Suggested actions to mitigate control weaknesses identified and/or to design and implement additional controls.

For purposes of clarity, the term “management” refers to elected officials, appointed officers and senior executives of the City.

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▶ **A1: Control Environment**

A2: Risk Assessment

A3: Control Activities

A4: Information &  
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### ***I. Background***

The report of the Committee of Sponsoring Organizations of the Treadway Commission (COSO Report), which is the authoritative literature on internal controls, states that the control environment sets the tone of the organization. It is the foundation for all other components of internal control, providing discipline and structure throughout the organization.

A healthy, positive control environment will help facilitate a climate of honesty and openness that allows people to feel safe enough to discuss difficult issues.

Control environment factors include:

- Management's philosophy and operating style,
- Integrity, and ethical values of the entity's personnel,
- The entity's organizational structure and the Audit function, and
- Management's attitude towards and communication of its support for internal controls.

Evaluating the control environment component of the internal control framework is often considered the most difficult because it necessitates a certain degree of subjectivity be applied in drawing conclusions. The nature of the control environment factors listed above suggest this.

The rationale for conclusions on an organization's control environment can be logically based on such factors as an evaluation of past management actions, the methods of communication employed by management, the opinions of an entity's employees, ongoing programs designed to reinforce and communicate management's values, and finally, an analysis of the distribution of responsibility and oversight within an organization. A description of the five factors of the control environment follows:

#### **Management's philosophy and operating style**

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Management's philosophy and operating style directly impacts the quality of financial reporting. The extent to which management objectively identifies and deals with operational challenges while applying a long-term focus closely correlates with the accuracy of financial reporting and the ongoing fiscal health of an organization. The following excerpt from the COSO Report underscores the impact of the operating style of management:

*In many cases, fraudulent financial reporting is the culmination of a series of acts designed to respond to operational difficulties. Initially, the activities may not be fraudulent, but in time they may become increasingly*

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*questionable. When the tone set by top management permits or encourages such activities, eventually the result may be fraudulent financial reporting.<sup>1</sup>*

Governments have tools at their disposal that if implemented properly, safeguard against the causal factors of fraudulent financial reporting noted by the Treadway Commission. These tools include an open and transparent budget development process, frequent periodic monitoring of budget results, multi-year budgeting of large capital intensive projects, development of an overall multi-year financial plan and a commitment to excellence in financial reporting in accordance with accounting and auditing standards.

By using these tools, management demonstrates a commitment to avoiding the shortsighted decisions that impact long-term fiscal health. However, management should demonstrate a commitment beyond the mere existence of these management tools. That is, management should integrate these tools into the decision making process.

### **Integrity and ethical values of the entity's personnel**

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The integrity and ethical values of the entity's people typically flows from and is often consistent with the organization's "tone at the top." The report of the National Commission on Fraudulent Financial Reporting (Treadway Commission) released in 1987 states:

*The tone set by top management - the corporate environment or culture within which financial reporting occurs - is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.<sup>2</sup>*

As noted by the Treadway Commission it is important that an organization's culture be pervasive and extend beyond a written code of conduct. This includes a program for communicating and reiterating the importance of values to all levels of the organization as well as a program to enforce the laws intended to promote ethical values. Often it is appropriate to separate the education and communication components of these programs from the compliance and enforcement elements.

Separating the education and compliance components can instill ethical values using an approach that reinforces appropriate conduct and ethical

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<sup>1</sup> Report of the National Commission on Fraudulent Financial Reporting pg. 24

<sup>2</sup> Report of the National Commission on Fraudulent Financial Reporting pg. 38

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values because it is “the right thing to do” rather than achieving compliance with codes of conduct through fear of repercussions for non-compliance.

Additionally, it is a helpful tool to involve the employees of the organization in the creation of a written code of conduct; this promotes employee ownership of the code and strengthens adherence to it. Finally, the code of conduct must have the broad support of all members of management.

### **The entity’s organizational structure and the Audit function**

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The organizational structure of an entity has a direct impact on its financial reporting and operational efficiency. The assignment of authority and reporting conduits of the organization’s officers are significant components of the structure. Additionally, the effectiveness of individual human resource policies and practices impact management’s ability to hire, empower, train, and motivate competent employees at all levels in the organization thereby directly impacting the effectiveness and integrity of the organization’s financial reporting processes.

In its publication *Evaluating Internal Controls: A Local Government Manager’s Guide*, the Government Finance Officers Association (GFOA) references the following attributes as evidence of an organization’s commitment to ensuring competence:<sup>3</sup>

- Establishing and maintaining up to date job descriptions,
- Following appropriate hiring policies,
- Assignment of authority in an appropriate manner,
- Ensuring that employees are properly trained,
- Periodic reviews and documentation of performance, and
- Setting of appropriate goals and performance for promotion.

As mentioned above, an evaluation of the organization also includes looking at the reporting conduits of the organizations officers and the divisions of responsibility between said officers. In the context of financial reporting, a fundamental component is the extent to which the Chief Financial Officer and Chief Audit Executive of a government organization are independent from the policy makers. This independence can be established through the use of long-term employment contracts, independent audit committees or the creation of elected offices for the execution of some or all of these responsibilities.

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<sup>3</sup> Evaluating Internal Controls: A Local Government Manager’s Guide pg. 16

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### **Management's attitude towards and communication of its support for internal controls**

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The GFOA's publication also describes management's communication of the importance of internal controls to all levels of employees as an important component of a favorable control environment. Specifically, the GFOA states:

*To be truly effective, such guidance must be communicated in a practical way to all staff and reviewed with them periodically.<sup>4</sup>*

The communication can take the form of a written body of policies governing the activities and operations of the organization. However, it should be reinforced through periodic communications and the availability of training programs. Finally, the GFOA urges that for internal controls to be effectively promulgated through the organization, swift and appropriate disciplinary action must be taken for those who violate the standards of conduct. Failure to do so undermines the effectiveness of the standards and ultimately "sends a message" that management is not fully committed to maintaining strong internal controls.

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<sup>4</sup> Evaluating Internal Controls: A Local Government Manager's Guide pg. 14

### ***II. Analysis***

#### **Management's philosophy and operating style**

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The very nature of governmental operations and accounting presents significant challenges to objective long-term financial planning. Governments are tasked with continually improving services using resources limited by the willingness of the citizens to pay increased taxes and fees.

In an effort to facilitate City Management's ability to think more strategically and long-term in the decision making process, the Financial Management Department developed a multi-year Financial Plan for the first time in fiscal year 2005 in conjunction with the development of the fiscal year 2006 budget. The Plan will evolve each year and is intended to be a useful tool for planning purposes and decision making. Financial Management is intending to establish performance measures for each department in future updates to the multi-year financial plan. An evaluation of past management decisions reveals that a multi-year plan is critical to the achievement of the City's long-term fiscal health. The existence of a multi-year plan during the negotiation of previous salary and benefits agreements may have served to illustrate the risks of such agreements to the City's long-term financial health.

While having a long-term focus is essential, management must also be aware of short-term impacts of their decision-making. Management's short-term focus is apparent in some aspects, but not in others. For example, the lack of adequate training budgets, failure to modernize in general, reliance on over-budget revenues, and the practice of deferring maintenance all indicate a short-term financial focus. At the same time, the City's current budgeting process focuses on producing annual departmental budgets, without considering a monthly breakdown. Monthly budgeting is more useful than only budgeting on an annual basis. By including monthly detail in an annual budget, management can measure performance throughout the year and perform analytical procedures to identify spending trends. Monthly budgeting will allow necessary adjustments to be identified in a timely manner and ensure that management and Council are aware of those adjustments and the operational challenges they present.

#### **Integrity and ethical values of the entity's people**

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The City of San Diego has employed a number of mechanisms to promote the Integrity and Ethical Values of the entity's people. These mechanisms include:



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- A comprehensive set of governmental ethics laws,
- An Ethics Commission,
- Codes of conduct and conflict of interest codes, and
- New Employee Orientation, Supervisory and Leadership Training Programs that incorporate components of a comprehensive value-based education curriculum.

Although the Ethics Commission is a compliance and enforcement organization not a value-based program, the existence of such an entity adds value to the organization's control environment. The Commission ensures that the City's management team is aware of laws and regulations that are intended to promote ethical behavior among those City employees that set the example for thousands.

Codes of conduct can be used to ensure compliance with laws and regulations and to promote a value-based ethical environment in the organization. Although the City has adopted several documents relating to codes of conduct and conflict of interest codes, the guidance provided does not reinforce the importance of value-based ethical training.

The City's Organizational Effectiveness Program (OEP) provides three types of value-based training for City employees:

1. *New Employee Orientation* – This 1 day training is mandatory for all new City employees, classified and unclassified. The content includes discussions about the code of conduct, conflicts of interest, and the City's visions and values, including integrity and ethical values.
2. *Supervisor's Academy* – This 7 day training is mandatory for all supervisors, classified and unclassified. The training covers various topics, including reviews of applicable ordinances, administrative regulations, and labor laws. The training also includes a half day on ethics values training.
3. *Leadership Development Program* – This 10 day training is voluntary for classified employees who receive nominations to attend. The training is not based on ordinances or administrative regulations, but is a value-based training on decision making.

The one-time trainings are only an introduction to the concept of ethical values. Supplemental activities are required to reinforce ethical values and strengthen the ethical climate of the City.

### **Opinion Surveys and Ethics**

Although the results of the preliminary questionnaires and (non-anonymous) control environment assessments distributed to management employees reflected positive scores on control environment issues, results

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of confidential interviews, presentations by the City Auditor to various union and management groups, personal observations and other analyses reflected a control environment highly influenced by political considerations and anticipated public perceptions. In contrast to conclusions drawn from the results of the control environment assessments, it appears that there is an unwillingness of people to make their opinions public, thereby impeding communication throughout the organization. On several occasions during the course of both our interview and survey processes, individuals expressed concerns about the confidentiality of materials as well as comments and concerns about public inquiry. Some comments also gave us the impression that the City's management team wants to "focus on the positive" and sometimes ignores or is unaware of negative implications of certain situations. The contradictory results of the opinion surveys and interviews with members of the management team are representative of a control environment which sets a tone of bureaucracy and not one of encouraging contrary opinions or open discussion.

### **The entity's organizational structure and the Audit function**

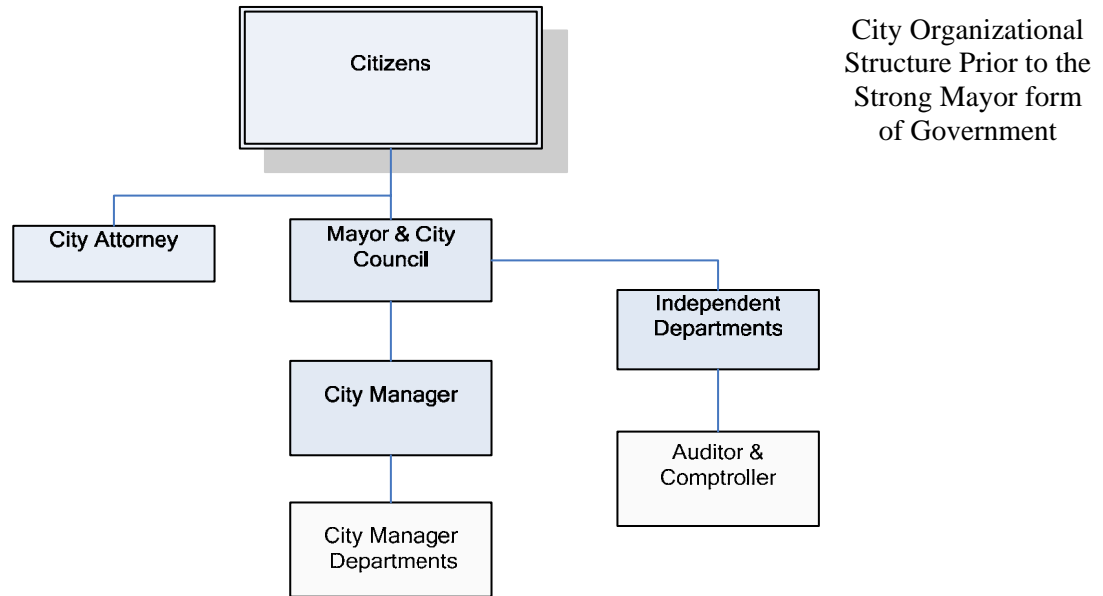
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#### **Auditor Independence**

The Auditor & Comptroller's responsibilities include advising the Mayor, the City Council, and the public of the City's financial condition to help ensure the financial health of the City of San Diego. The Auditor & Comptroller must also make recommendations on City programs and operations, fiscal policies, and financial transactions. In order to effectively carry out the role of the Auditor & Comptroller, the office must be independent, or free from the control or influence of others in the normal chain of command.

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Within the City's current organizational structure, the Office of the Auditor & Comptroller is considered an 'independent' office in that the City Auditor is not hired by nor does the position report to the City Manager. The Auditor & Comptroller is appointed by Mayor and Council for an indefinite term and reports directly to Mayor and Council. **In the Audit Division's most recent Peer Review (Fall 2005), external auditors noted that although the Audit Division meets industry independence standards, the division's independence could be enhanced if it also reported regularly to the entity's independent audit committee and/or an appropriate government oversight body.**

Upon transition to the strong mayor form of government, the independence of the Auditor & Comptroller will be impacted. Specifically, Article 15 section 265 (b) 10 and 11 of the City Charter sets forth the following:

- The Mayor shall have the authority to appoint the City Auditor & Comptroller; subject to confirmation by the City Council.
- The Mayor shall have the authority to dismiss the City Auditor & Comptroller; subject to appeal by the Auditor & Comptroller to City Council.

The concept of an auditor's independence is an essential element in the Codes of Ethics of both the accounting and auditing professions. An auditor's 'stock-in-trade' is her or his opinion. The value of the auditor's opinion is rooted in the auditor's *objectivity*. The auditor's objectivity is rooted in the auditor's *independence* within the organization. To the

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extent that an auditor's opinion is less than objective, the value (and reliability) of that opinion is diminished.

In practice, this independence serves to provide an environment of 'checks and balances', helping to ensure that policy makers and the public are privy to the full disclosure of data and other information critical to an informed decision-making process. The concept of 'checks and balances' and the controls inherent therein, are diminished as least perceptively, and often in reality, when the auditor is hired by and reports to the Chief Executive Officer (CEO) through the Chief Operating Officer (COO) of the organization.

### **Organization of the Auditor & Comptroller's Office**

Under the current organizational structure of the City almost all of the City's accountants reside within the Auditor & Comptroller's office. This centralization of professional staff has, in our opinion, directly contributed to ineffective financial controls. This ineffectiveness is largely the result of a lack of professional accounting knowledge at the service level departments where transactions are initiated.

Currently, departments provide the Auditor & Comptroller's office with the specific accounting information used to record transactions that occur within their department. Accountants in the Auditor & Comptroller's office are responsible for verifying the accuracy of the accounting information provided but are not involved in the decision-making process and may not have been privy to the nature of the expenditure or revenue. Therefore, the accountants may be unaware of significant milestones or non-financial components that would alter the specific accounting information previously provided.

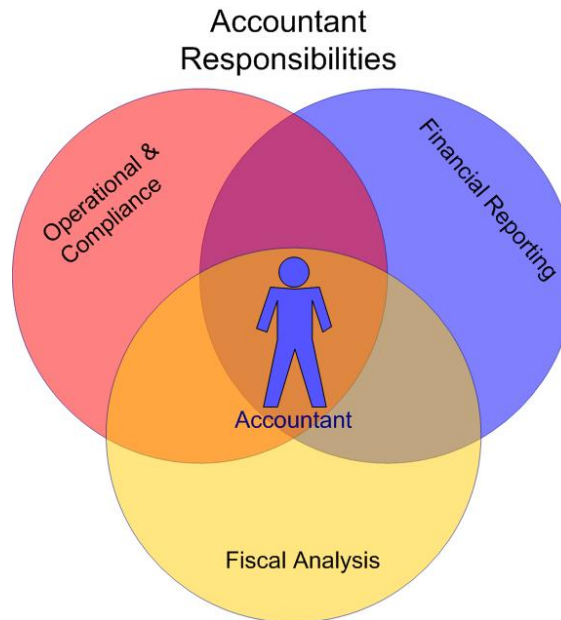
We believe that by involving accountants in the process of initiating the transaction, the overall quality of information supplied to the Auditor & Comptroller's office could be improved and the control framework of the City could be enhanced. Finally, by having accountants report directly to the departments they serve, the concept of "ownership" is further reinforced.

Currently, Accountants in the Auditor & Comptroller's office are responsible for performing numerous functions. These functional responsibilities can be broadly categorized into three major functions that encompass the large majority of the office's mission statement. These broad categories are defined as Operational & Compliance, Financial Reporting and Fiscal Oversight.

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At the most basic level, the results of operational and compliance activities form the fundamental basis for which financial reports are compiled and on which fiscal analysis is performed. As such, the operational and compliance function level must be achieved successfully prior to performance of the other two functions. Furthermore, the extent to which fiscal analysis is effectively performed can directly impact the accuracy of financial reporting.



An objective analysis of the results from operational and compliance duties during the fiscal year ended June 30, 2005 reveals that departmental staff accountants processed 66,371 Direct Payment requests. Allocated equally, this results in an average of 2,212 Direct Payments per staff accountant per year and by extension a workload of approximately 9 Direct Payments per day. In practice, depending on the fund assignments, this workload varies from accountant to accountant. In addition to this workload, the typical accountant was responsible for processing other departmental forms such as Auditor Funding Certifications, Requests for Manager Actions, the performance of daily and monthly reconciliations, preparation of interim financial reports and ad hoc financial analysis along with a series of analytical control activities designed to monitor and effectively control account balances and safeguard the City's assets.

While the performance of all functional responsibilities at the department level is necessary, the overlap of these functions at the individual accountant level has hampered overall effectiveness. Specifically, through interview process we identified that the need to maintain and keep up with operational and compliance responsibilities has hindered effectiveness in the achievement of activities contained in other functions. The impact of the need to facilitate day to day operational activities such as processing direct payments is to delay the performance of fiscal analysis. The hampered effectiveness of our fiscal analysis has in turn impacted the effectiveness of financial reporting.

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### **Management's attitude towards and communication of its support for internal controls**

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Ongoing investigations of the City's CAFR misstatements and bond offerings have given City management the incentive to reevaluate the importance of and their awareness of the City's internal controls.

### **Ordinance Number O-19320**

Ordinance 19320 was adopted by the City Council on October 11, 2004 in an effort to address issues relating to the City's financial reporting and disclosure practices. The Ordinance assigned various responsibilities to the Department of the Auditor & Comptroller, mainly regarding the participation in a Disclosure Practices Working Group (DPWG) and the submittal of an annual report on internal financial controls to the City Council and Financial Reporting Oversight Board. It appears that the intent of City Council was to fashion the Ordinance in the spirit of the Sarbanes-Oxley Act of 2002<sup>5</sup> (SOX). While the objectives of our review were similar to those of SOX reviews performed in the private sector, our review was not equivalent to a SOX review, including the scope, documentation, or testing.

The Ordinance requires the City Manager and Auditor & Comptroller (City Auditor) certify, in the Annual Report, that they:

- are responsible for establishing and maintaining the City's internal financial controls,
- have designed such internal financial controls to ensure that material information is made known,
- have evaluated the effectiveness of the City's internal financial controls as of a date within 90 days prior to the Annual Report,
- have presented in the Annual Report their conclusions about the effectiveness of their internal controls,
- have disclosed all significant deficiencies in the design or operation of internal controls that could adversely affect the City's ability to record, process, summarize, and report financial data,
- have identified any material weaknesses in internal controls and any fraud, whether or not material, that involves management or other employees who have a significant role in the City's internal controls, and
- have indicated in the Annual Report whether or not there were significant changes in internal controls, including any corrective action with regard to significant deficiencies and material weaknesses.

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<sup>5</sup> [http://www.pcaobus.org/About\\_the\\_PCAOB/Sarbanes\\_Oxley\\_Act\\_of\\_2002.pdf](http://www.pcaobus.org/About_the_PCAOB/Sarbanes_Oxley_Act_of_2002.pdf)

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As a result of Ordinance 19320, the City Auditor established an Internal Control Review Project Team (ICR Team) to perform the annual evaluation of internal financial controls. The team was responsible for evaluating the controls of the City on a test basis and reporting its findings to the City Auditor.

### Internal Control Training

One way for management to show its support for internal controls is to provide internal control training to City employees. Throughout Fiscal Year 2005 and the beginning of Fiscal Year 2006, the Auditor & Comptroller's office provided several training programs for employees in a variety of classifications, including:

- Audit division training for Directors & Assistant Directors,
- City-wide Internal Control Training provided by the Institute of Internal Auditors for management and non-management employees,
- GFOA Sponsored Training on evaluating internal controls for members of the ICR Project team, and
- Sarbanes-Oxley and Process Mapping training for ICR Project team members.

While each training had specific objectives, the overall goal of all the training programs was to reinforce the importance of internal controls and emphasize management's responsibility for internal controls. Some common objectives included:

- increasing overall awareness of internal control throughout the organization, and
- impressing upon City employees a core job responsibility: ownership and accountability for internal control.

### **III. Conclusions**

The City of San Diego's Control Environment, in our opinion, appears to have several noteworthy elements, but the environment as a whole does not effectively set an ethical tone for the organization or establish the foundation for other elements of internal control. Setting an ethical tone is different from being ethical. The City's management team may be ethical, but the tone of the organization fosters an environment that does not seek contrary opinions and encourages a short-term financial focus.

- It is apparent that a fear of open communication exists within the City. During our review, employees were reluctant to openly communicate with the ICR Team. The contradictory results of the opinion surveys and interviews with members of the management team are representative of a control environment which sets a tone of bureaucracy and not one of encouraging contrary opinions.
- Although the City has adopted a five year financial plan, other evidence suggests that management makes decisions based on a short-term financial focus. Management's short-term financial focus is apparent in the lack of adequate training budgets, management's failure to modernize in general, their reliance on over-budget revenues, and their practice of deferring maintenance. Although management may have good intentions in addressing immediate needs, consideration is not necessarily given to the effect of decisions on the future commitment of resources.
- Many factors influence the Control Environment of the organization, including the structure of the organization. The City's current organizational structure does not facilitate the preparation of accurate or timely financial statements. The centralization of accounting knowledge in the Auditor & Comptroller's office hinders the ability of the City's Department Directors (or process owners) to ensure the fiscal health of their businesses. The physical centralization of accountants also hinders the Auditor & Comptroller's office from truly understanding departments' businesses and the effects they have on the City's financial statements. Accountants in the Auditor & Comptroller's office have varied responsibilities and cannot dedicate the necessary time or resources to completely understand the business of every City department.
- Although the Office of the Auditor & Comptroller is considered an 'independent' office in the City's current organizational structure, according to both the General Accounting Office and an external peer review the office's independence will be enhanced if it also reports regularly to an independent audit committee and/or an appropriate government oversight body. The independence of the Auditor &



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Comptroller's office serves to provide an environment of 'checks and balances', helping to ensure that policy makers and the public are privy to the full disclosure of data and other information critical to an informed decision-making process. By reporting to an audit committee, the actual and perceived independence of the Auditor & Comptroller's office will mitigate the risk of information from the Auditor being subject to political bias. Alternatively, we believe that an arrangement whereby the City Auditor is retained via a long-term (ten-year) contract is a viable option. The current City Auditors in the cities of San Jose and San Francisco have ten-year contracts. Least desirable of the available alternatives, in our opinion, would be the establishment of an elected auditor's position – for several reasons. The most significant, from the author's many years of observation, is the Auditor's susceptibility to pressures from special interest groups and other politically powerful members within the entity. To ensure one's re-election, the office holder cannot avoid being cognizant of her/his dependency on those who wield local political influence and the impact of her/his decisions on those individuals and/or groups.

- The City offers both compliance and value-based ethical training. Although the compliance training provides guidance related to the governmental ethics laws, it does not distinguish between what is illegal and unethical. Currently, value-based training provides an introduction to the concept of ethical values, but there are no policies to continue or reinforce the development of ethical values in City employees, especially management.

### ***IV. Remediation***

The following items represent our recommendations for mitigating the control weaknesses documented in the conclusions section.

- **Provide a confidential channel for employees to report waste, fraud, abuse or other ethical issues.**

In an effort to be proactive in improving City Employees' access to the senior management of the organization, the Internal Control Review Team has initiated the installation of the Auditor's Hotline. The hotline is being administered by The Network™, a company that provides hotline services to approximately 45% of the companies listed on the Fortune 500. In order to disseminate information regarding this hotline to all city employees, promotional materials were sent out with employee time cards, and the hotline will continue to be advertised in the Auditors newsletter and on the Auditors intranet web site. Along with procuring a service provider for the hotline, the Auditor & Comptroller's office worked with other departments to create the dissemination and escalation teams, ensuring that appropriate responses are made for each reported incident.

- **Mandate annual ethics training for management employees.**
- **Promote a Control Environment that seeks contrary opinions and encourages open and honest communication.**
- **Continue to develop a long-term financial focus.**
- **Budget monitoring and development of future budgets could be further enhanced through a monthly allocation of the annual budget. An allocated budget would facilitate enhanced monitoring and thereby enable the Mayor and Council to be apprised of budgetary differences in a more timely manner. Timely notification would also allow for the appropriate action by City Council to reprioritize resources in a flexible budgeting process.**
- **Continue to support the Auditor's Reorganization Plan.**

Effective October 1, 2005, the Auditor & Comptroller's office has reorganized the department to include a Financial Reporting and Budget Division which will focus on and be responsible for the timely and accurate preparation of the City's CAFR, other financial reporting and regulatory reports. Additionally, the Accounting Operations and Disbursements Division will continue to be responsible for preparation of the City's bi-weekly payroll and payments to outside vendors and

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contractors. *This division has also assumed the general accounting operations previously housed in the Accounting Division.*

- **Exhibit the City's commitment to Internal Controls by providing the resources and support to effectively and efficiently report on the state of the Internal Controls.**

If the intent of City Council was to impose requirements similar to those of Section 404 of the Sarbanes-Oxley Act of 2002, several dedicated staff positions within the Auditor & Comptroller's office devoted solely to this effort will be necessary. A survey by Financial Executives International, an industry group of corporate CFOs, treasurers, tax executives, audit-committee members and other financial professionals, found that companies vastly underestimated the costs of Section 404 compliance. They surveyed 217 of the organization's members which revealed that companies will spend \$4.36 million on average for first-year Section 404 compliance.

The Sarbanes-Oxley Act of 2002 currently does not apply to governmental entities; however the City Council's adoption of a municipal code with similar goals is a proactive approach to increasing awareness of and maintaining effective internal controls.

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### ***I. Background***

Risks are potential obstacles that can hinder management's ability to achieve the entity's goals and objectives. As such, it is important that management be aware of such risks whether existing or potential, so the risks may be appropriately addressed through the development of effective control policies and procedures. As pointed out in the COSO Report, the process of identifying and analyzing risk is an ongoing iterative process and is a critical component of an effective internal control system. A comprehensive risk assessment process involves the analysis of two components:

- The setting of management objectives, and
- Identification of risks that affect management's objectives.

To be effective, the risk assessment process should involve all levels of the organization from line management to senior management, and all operating sectors of the organization. Specifically, the Treadway Commission stated:

*“Individuals at all levels of the company, including operating management, attorneys, financial managers, and internal auditors, participate in the assessment, but top-level corporate management, such as the CEO and the CFO, must supervise the process. In addition, the audit committee of the board of directors should review periodically the company's risk assessment process and management's responses to significant identified risks.”*

#### **Setting Objectives**

Objectives can be explicit or implicit. An implicit objective may direct management to maintain the status quo or perform a function that is implied by the organization's mission. Explicit objectives, which leave little or no room for interpretation, tend more strongly to direct an organization's behavior or performance and are thus more effective. The objectives set by management can be viewed as hierarchical in nature, beginning with “entity – wide” objectives which influence the overall direction of the entity and extend down to the “activity level” which influence the performance of specific tasks. “Activity level” objectives should be constructed to support “entity-wide” objectives.

The COSO internal control framework sets forth three types of objectives: operational, financial reporting and compliance. Operational objectives are those that pertain to the organization's primary goals and responsibilities. Financial reporting objectives relate to the compilation and dissemination of financial data to the organization's stakeholders. Compliance objectives relate to the laws and regulations which govern the entity's operations.

## Appendix A2 - Risk Assessment

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Operational objectives ensure that the entity's goals and objectives are carried out in an efficient and effective manner. An evaluation of operational objectives must take into account whether they are relevant to the City's mission and whether they can be achieved with relative certainty. In local government, this evaluation must be conducted using performance measures at the activity level (e.g. the number of trash pickups done in a year) of the organization.

Financial reporting objectives ensure reliable and fairly presented financial reports. These objectives are designed so that the appropriate accounting principles are applied, and that the financial statements present sufficient information in a manner reasonable to allow an organization's stakeholders to make informed decisions. Ultimately, the financial statements need to present the financial position and results of operations in the most accurate manner possible. Underlying the financial statements are the following five major management assertions:

- The assets and liabilities presented do in fact exist and the transactions reported have occurred,
- The financial statements are complete and reflect all the transactions and other events that have occurred within reporting period,
- The entity has the rights to the assets presented and the obligation to repay the liabilities presented,
- The valuation and allocation of account balances are accurate and in conformance with Generally Accepted Accounting Principles, and
- The financial statements are fairly presented, account balances are accurately described and relevant disclosures have been made.

The development of management objectives should ensure that the assertions listed above are met and made in good faith by management. Therefore, in setting objectives for financial reporting it is a best practice for management to consider how activity and task level objectives relate to these five assertions and in turn contribute to the fair presentation of financial statements.

Compliance objectives ensure that the organization follows the laws and regulations that govern its activities. The nature of government operations is such that many of its functions are heavily regulated by state and federal law. For example, the provision of water sanitation is heavily regulated by state and federal agencies. In local government, operational policy decisions set by the legislative body, which by their very nature are operational objectives, can also be considered compliance objectives. This is because often times these decisions are memorialized in the government's municipal code.

Similar to the overlap that occurs between operational and compliance objectives in local government, financial reporting objectives can also overlap operational and compliance objectives. This is exemplified in many of the operational objectives employed as best practices in the Accounting and Treasury functions. For example, an operational objective such as performance of a Cash Reconciliation within 7 days of the close of the accounting period is connected to the process of producing financial reports.

### **Identifying Risks**

As mentioned at the beginning of this section, the process of identifying risks is iterative. Similar to the setting of management objectives, the identification of risks can take the form of “entity-wide” risks and “activity level” risks. Additionally, risks can be from external sources as well as internal sources. The process of identifying these risks includes relating them to specific management objectives.

Many methodologies exist to identify risks, some quantitative and others qualitative. Best practices indicate that a mixture of both quantitative and qualitative methodologies is preferable. Qualitative identification includes holding meetings with management and discussing operational, financial reporting and compliance objectives. In these discussions the goal is to identify factors that would prevent the successful achievement of management’s objectives. The advantage of this process is to leverage the experience of management to identify the risks most relevant to the operations. The downside is that the process is not objective and free of bias.

Quantitative processes involve the identification of measurable sources of output and input (e.g. revenues, expenditures, units of goods) related to management objectives. Once identified, the outputs and inputs are considered in terms of materiality to the success of the entities objectives. The advantage of quantitative processes is that they are objective and free from influence; the disadvantage is that many of management’s objectives do not directly correlate to measurable inputs and outputs. Additionally, the process of capturing the necessary statistics is often not cost effective.

In addition to a process of assigning risks to specific management objectives, the COSO report illustrates several factors that demand special attention in the risk assessment process; those relevant to the local government are:

- Changes in the operating environment,
- New personnel,
- New Information Systems and Technology,



## Appendix A2 - Risk Assessment

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- New services, and
- Organizational restructurings.

In order to identify the occurrence of these events, procedures and mechanisms should be in place to identify the event and to inform management.

**II. Analysis**

This first annual analysis reflects the first step in an ongoing risk assessment process. The results from this initial endeavor should be considered preliminary in nature and will be subject to refinement in later reporting periods. In order to present a balanced analysis, results of self assessments were evaluated against financial reporting risks known to the Auditor & Comptroller’s office through other channels of information. These channels include a history of past reporting failures and the working knowledge of Auditor & Comptroller managers with regard to current and past reporting practices. An analysis of the results of the self-assessments was conducted in the context of generally established business cycles. The following presents what we believe to be salient items from the self assessment process.

We evaluated management’s assessment of the adequacy of the control activities for primary key controls (management objectives). We did not perform testing of management’s responses. Management’s assessments for the primary key controls are summarized below:

<b>Cycle</b>	<b>% “Adequate”</b>	<b>% “Inadequate”</b>	<b>% “Not Applicable” or blank</b>	<b>Total %</b>
Fixed Assets	49%	13%	38%	100%
Revenue	62%	8%	30%	100%
Other	67%	7%	26%	100%

Although the assessments of control activities as “adequate”, “inadequate”, or “not applicable” were not always consistent across departments, the information provided in management’s responses, taken as a whole, generally provided for consistent conclusions. In several departments’ responses, we identified inconsistencies between the assessment of the control activities and the information/comments provided in the Basis for Conclusion and/or the Control Activity columns. We also recognized inconsistencies between the objectives assessed by departments and the control weaknesses documented by the External Auditors.

In determining whether the control activities identified by management adequately met management objectives, we noted several areas for improvement:

- Citywide policies and procedures,
- Compliance with laws and regulations,
- Budget methodology (e.g. inconsistencies between the level of service to be provided and resources available),
- Communication within and between departments, and
- System capabilities.

### **Policies and Procedures**

Citywide policies and procedures are promulgated through Administrative Regulations (A.R.) issued by the City Manager. Policies and procedures are road maps that help departments achieve both Citywide and departmental objectives. In our evaluation of control activities, we noted that in many cases, current Citywide policies are either out-dated or non-existent. For example, adequate guidance for the treatment of transactions in the fixed assets cycle should include a fixed asset policy that addresses, but is not limited to, the following:

- Capitalization of fixed assets,
- Authorization,
- Recording and valuation of donated or developer-contributed assets, and
- Recording of capital projects

By not having established a formal Citywide fixed asset policy, the City risks that these transactions will not be treated appropriately or consistently. Without standardized policies and procedures, there is a greater risk of errors and inconsistencies in the CAFR.

### **Laws and Regulations**

Complying with laws and regulations is a preventative control that if effectively implemented, decreases the risk of lawsuits, investigations or other legal action that have the potential to damage an organization's reputation and result in fines and penalties. As evidenced by recent litigation against the City by the SEC and other agencies, compliance with laws and regulations presents a significant risk to City. Lawsuits and investigations hinder employee productivity and the ability to continue routine business. Since the investigations began, the City has not been able to issue bonds resulting in a shortage of revenue to fund capital projects. As a result, the General Fund budget was decreased to make up for the funding shortage and capital projects are on hold. Additionally, employees must prioritize compliance with subpoenas over regular job duties, delaying routine business.

### **Budgeting & Resources**

Using the budget as a benchmarking standard, an organization ensures that managers are implementing its plans and objectives. Their actual performance can be measured against budgeted performance. If budgets do not accurately reflect expected revenues and/or expenditures, neither the Auditor & Comptroller's office nor the process owners are able to effectively monitor or forecast departmental revenues and expenditures.

The budget is also an analytical tool to estimate the resources needed to provide a certain level of service. If the level of expected service is

## Appendix A2 - Risk Assessment

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constant while the amount of resources decreases, either departments have to become more efficient with their use of resources, or if already at maximum efficiency, the department will use resources beyond what was budgeted. During our review, departments consistently expressed that a lack of resources has caused the latter approach to be more common. As a result, the tendency for departments to exceed appropriations hinders the City's ability to effectively monitor and control its financial health.

### **Communication Within and Between Departments**

Many processes require the cooperation of multiple departments and the quality of their relationships depend on the ability of information to be communicated freely between departments. Currently, not all departments use the same software, programs, etc. Departments also prioritize processes differently. The risk of the City not having a good foundation for communication is that direction can be unclear within or between departments, ambiguities exist, and processes are not completed in a timely manner.

### **System Capabilities**

The success of many control activities depends on the capability and reliability of the system used to monitor control activities. Systems throughout the City are out-dated and are not aligned with current technology or strategic plans. Current technology would allow users to communicate, compile information, and analyze information by providing timely and more accurate data. Investment in new technology is an investment in the welfare of the City. The City's inadequate systems create a risk that management and external users will not have access to timely and accurate information to monitor business operations and make effective decisions.

### ***III. Conclusions***

Every organization is susceptible to risk. Control activities are put in place to mitigate that risk. In the City's risk assessment, we identified the following broad categories of obstacles that appear to constitute significant risks facing the City:

- Many *Citywide financial policies and procedures* are either outdated or non-existent. Departments are not given the proper guidance or tools to effectively and efficiently run their business.
- *Non-compliance with laws and regulations*, illustrated by the current litigious environment within the City, can hinder employee productivity and the ability to continue routine business.
- *Budgets do not reflect actual expenditures* especially when departments are asked to provide a certain increased level of service with no additional resources. As a result, budget forecasts are not accurate.
- *Communication within and between departments* needs to be strengthened and consistent as many processes surrounding accurate and timely financial reporting rely on the cooperation of multiple departments. Any breakdown in communication or lack thereof can create a hostile, stressful and inefficient work environment.
- *System capabilities* need to be current and up-to-date. For many control activities to be successful, a capable and reliable financial system is needed to effectively extract, compile and analyze data that management can use to make informed decisions.

### ***IV. Remediation***

The following items represent our recommendations for resolving the control weaknesses and risks documented in the conclusions section.

- **Establish a working committee of senior management and a representative of the Mayor's office, supported by staff to perform an ongoing review of the City's Administrative Regulations. Proposals should be presented to the Mayor for consideration and adoption to ensure that Administrative Regulations reflect the current business environment.**
- **Support the creation of standardized Citywide policies and procedures to ensure that controls for similar transactions are consistent across departments.**
- **Ensure management and department staff are familiar with pertinent laws, regulations, and business practices and techniques to facilitate the effective and efficient performance of their duties. By providing adequate training budgets to departments, the City can ensure that staff maintain the knowledge, skills, and abilities to effectively accomplish departmental goals and objectives while complying with applicable laws and regulations.**
- **Create a budget that realistically considers both expected levels of services and the expected resources available. To ensure employees stay motivated, it is necessary to set challenging but realistic service goals that are within the resources available. Furthermore, consider modifying the budget structure and Appropriations Ordinance to improve transparency and give the City Council enhanced control over budget adjustments.**
- **Promote an atmosphere of open communication and stress the importance of working together to accomplish both departmental and Citywide goals and objectives.**
- **Provide reliable and up-to-date technology to all departments, ensuring management has the tools necessary to efficiently and effectively meet increasingly complex business goals and objectives.**

The Auditor & Comptroller's office has initiated the installation of an up-to-date decision management system. For a detailed description, please refer to Appendix A4: Information and Communication.

## Appendix A

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A1: Control Environment

A2: Risk Assessment

▶ **A3: Control Activities**

A4: Information &  
Communication

A5: Monitoring

### *I. Background*

Control activities are the policies and procedures that serve to mitigate risk and help ensure that management's objectives are met. Control activities occur throughout the organization, at all levels and in all functions. They include a diverse range of activities such as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties (COSO Report).

Control activities include both preventative and detective controls. Preventive controls are those designed to prevent the realization of an unwanted outcome or risk. Conversely, detective controls inform management of the realization of risk or unwanted outcome subsequent to its occurrence. In developing and applying control activities to ensure that financial reporting objectives are met, management needs to apply sufficient preventative control activities to ensure quality in recording and production of financial data. Simultaneously, management should effect a comprehensive set of detective controls that monitor the effectiveness and outcomes dictated by these preventative controls.

Since control activities serve to mitigate risks within an entity, ineffective control activities, or control deficiencies, increase the entity's exposure to risk. As defined in the American Institute of Certified Public Accountant's (AICPA) Statement of Auditing Standards 60 (AU 325), control deficiencies can be described in accordance with the level of risk they present to the entity. When a control weakness results in more than a relatively low risk of material misstatement to the financial statements it is termed a "material weakness." Control deficiencies identified as material weaknesses are the most severe and may result in a qualified opinion. Findings that do not merit the material weakness designation, but are considered significantly deficient in their design or operation, are termed "reportable conditions." Finally, operational suggestions or noted deficiencies that do not meet the criteria of a material weakness or reportable condition are referred to as a general deficiency in design or operation of internal control. For the purposes of this report we will identify material weaknesses and reportable conditions when noted as such by the External Auditors, and for all other identified deficiencies we will use the term "control weakness."

To effectively evaluate known and likely areas of control weakness within the City, we performed the following:

- Weaknesses were identified through discussions with the external auditors: KPMG for the fiscal year 2003 audit and Macias & Gini (M&G) for the fiscal year 2004 audit. The discussions centered on observations made during the course of their fieldwork. As such,



## Appendix A3 - Control Activities

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we deemed it necessary to review these control weaknesses and determine potential remediation efforts considered by the City.

- Restatements reported in Draft 4 of the fiscal year 2003, Government-Wide financial statements were analyzed. Restatements are indicative of accounting errors and usually are the direct result of control weaknesses. We evaluated the restatements to identify weaknesses and determine potential remediation efforts considered by the City.

### Discussions with External Auditors

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Statement of Auditing Standard 60 (SAS 60) gives guidance to external auditors on reporting of internal control conditions observed during the audit with an entity's audit committee or its equivalent. One of the requirements of SAS 60, is to communicate, either orally or in writing, any reportable conditions found through the audit process. They can also communicate other matters, such as control deficiencies not deemed to be reportable conditions.

Control deficiencies represent failed control activities and can be grouped within control cycles. A control cycle is a sequence of procedures applied by an entity in processing a particular type of recurring transaction.<sup>6</sup> Some control activities span through each of the different cycles (e.g. segregation of duties is pertinent to each control cycle) while others are unique (e.g. an allowance for doubtful accounts estimation is unique to the revenue cycle). Furthermore, control cycles are unique to individual businesses depending on the organizational structure and industry.

Below, in alphabetical order, are examples of common control cycles. Information on these cycles comes from a compilation of several different sources.

- Budgetary – The Budgetary Cycle includes control activities over preparing, adopting and executing the budget.
- Cash & Investments – The Cash & Investments Cycle includes control activities over handling and depositing cash receipts, signing checks, investing cash, and maintaining custody of cash.<sup>7</sup>
- Expenditure – The Expenditure Cycle includes control activities where goods or services are purchased in exchange for cash or a promise to pay cash.<sup>8</sup>

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<sup>6</sup> Ray Whittington and Kurt Pany, Principles of Auditing, 13<sup>th</sup> edition. (New York: Irwin/McGraw-Hill Companies, Inc., 2001) 272.

<sup>7</sup> Whittington 385.

<sup>8</sup> Mark Fronk, MS, CPA, et al., eds. Micromash CPA Review Textbook: The Micromash Way to Pass (PassMatrix Learning Systems, Inc., 2004) 256.

## Appendix A3 - Control Activities

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- Financial Closing and Reporting – The Financial Closing and Reporting Cycle includes control activities over recording items into the general ledger, performing reconciliations, and preparing financial statements.
- Financing – The Financing Cycle includes control activities over obtaining funds from investors and creditors, paying dividends and repaying borrowings.<sup>9</sup>
- Fixed Assets – The Fixed Asset Cycle includes control activities over purchasing, disposing, transferring, and depreciating fixed assets. Fixed assets normally encompass a large portion of the assets held by an entity.
- Human Resources – The Human Resources Cycle includes control activities over hiring, firing, training, and compensating employees.
- Inventory – The Inventory Cycle includes control activities over valuing, safeguarding, and selling inventory. In the case of the City, this includes land held for resale by the redevelopment agency.
- Procurement – The Procurement Cycle includes control activities over purchasing and receiving fixed assets, supplies, services, etc.
- Revenue – The Revenue Cycle includes control activities over sale of goods or services in exchange for cash or a promise to pay.<sup>10</sup>

In performing our review of internal controls, we utilized a ‘top-down, risk-based approach’ as recommended by the SEC and performed our review based on the cycles previously identified.

### Restatements

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According to Accounting Principles Board Opinion 20, restatements are the result of errors in the financial statements. These errors can be the result of mathematical mistakes, mistakes in the application of accounting principles, and oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgment. Thus, an error is distinguishable from a change in estimate.

In our review we found that individual restatements were often associated with multiple control weaknesses. These weaknesses spanned through all financial statement line items. Some of the most pervasive control weaknesses included:

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<sup>9</sup> Fronk, et al. 257.

<sup>10</sup> Fronk, et al. 256.

## Appendix A3 - Control Activities

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- Inadequate training,
- Inadequate supervision and analytical procedures,
- Inadequate lines of communication,
- Inadequate financial closing and reporting process, and
- Over-reliance on sources of information outside of the Auditor & Comptroller's office.

In order to optimize limited internal resources available for this project, we focused on those areas posing the greatest risk of having materially adverse impacts on the accurate and timely preparation of the City's annual financial statements.

### II. Analysis

#### Discussions with External Auditors

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The control cycles discussed below are prioritized according to the risk presented to the financial reporting process. This prioritization reflects our judgment in the context of challenges facing the City of San Diego and may be different in other organizations. The control weaknesses and remediation efforts herein have been summarized and are presented to inform the reader of basic concepts. In practice, the factors contributing to each of these items are very complex and require nuanced analysis. **Note that all weaknesses are documented in Appendix B.**

#### Financial Closing and Reporting Cycle

All activities in the Financial Closing and Reporting Cycle directly affect the financial statements. Both of the City's External Auditors indicated a need to improve the processes relating to financial closing and reporting. The majority of processes identified for improvement reside in the Auditor & Comptroller's office. However, certain deficiencies identified by the External Auditors as potential reportable conditions reside in other departments.

This cycle contains two potential reportable conditions that are both related to the City's process for managing and/or reporting contingent liabilities and claims against the City.

- The City's process for monitoring the estimated reserve amounts for active litigation against the City needs improvement. Reserve amounts are recorded in the City's CAFR as liabilities based on calculations made by the City's Actuary. Weaknesses in the process of providing data to the Actuary could potentially result in misstatement of the City's liabilities and/or an incorrect estimation of the City's insurance premiums. Remediation for this weakness is currently being coordinated and new procedures regarding interdepartmental communication and claim reporting have been drafted and are in the process of being implemented.
- Policy and process documentation for managing claims against the City is inadequate. The potential impact is a misstatement of liabilities similar to those noted above. Remediation efforts and city management's concurrence with this condition is still being evaluated.

In addition to the potential reportable conditions identified above several other weaknesses in this cycle impact various areas of financial statement production and operational accounting. The weaknesses include a complex accounting system, a manually intensive and complicated year-end closing

## Appendix A3 - Control Activities

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process and inadequate supervisory review and approval of accounting transactions. Considered in the aggregate, the aforementioned weaknesses may be considered material. For example, an exception in the year-end closing process could potentially have a direct impact on any element of the CAFR. As a result of these inadequacies the reporting process is expensive, time consuming and susceptible to error.

In our opinion, the control weaknesses identified above are largely the result of inadequate information systems to support financial accounting and poor interdepartmental communication. Furthermore, we believe that the City has inadequate and inconsistent reporting policies. For example, there are no consistent procedures for the period closing and financial statement production; controls vary significantly across the individual functional sections within the Auditor & Comptroller's office. These controls involve the use of multiple data analysis tools and many manual procedures. Remediation is to be developed over time. It involves, but is not limited to, condensing the number of funds used, purchasing and/or building and implementing new accounting software, and creating new policies and procedures.

Another factor contributing to control weaknesses in this cycle is the City's internal audit division's inadequate risk assessment process. While this process does not relate directly to the production of financial statements or closing of the City's accounting records, it is related to a quality control mechanism that ensures other controls in this area are functioning properly. Communications with External Auditors indicated internal audits are planned based on mandates from governing bodies and senior management. See the Monitoring section in Appendix A5 for a detailed review of the role of internal audit.

See Appendix B for all documented Financial Closing and Reporting Cycle weaknesses.

### **Inventory Cycle**

A deficiency identified in the City's accounting for land-held-for-resale may be designated as a material weakness by the External Auditors. Communication challenges between Auditor & Comptroller's office and outside agencies regarding required adjustments for completeness, existence and valuation of assets is the basis for the weakness. There is a significant risk to the accuracy of the City's financial reporting due to the considerable dollar value of individual adjustments in land-held-for-resale account. This weakness is also discussed in the Restatement's "Inadequate Communication" section.

To alleviate the communication problems between the Auditor & Comptroller's office and outside agencies, a periodic "Auditor Briefing" is

## Appendix A3 - Control Activities

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to take place with all parties. Accountants in the Auditor & Comptroller's office will read through board minutes to search for any new debt approvals. Additionally, new forms and procedures are being developed to capture and summarize pertinent data.

### **Fixed Asset Cycle**

Fixed assets represent a large component of the City's balance sheet and typically entail large dollar-value transactions. Similar to the Financial Closing and Reporting Cycle, both External Auditors identified opportunities to improve accounting for fixed assets.

Several of the weaknesses relate to the accounting for work in process (WIP) and capital contributions. For example, completed projects and capital contributions have not been capitalized on a timely basis. These weaknesses affect management's completeness, valuation and presentation/disclosure assertions and could potentially result in the misstatement of fixed assets and related depreciation. In our opinion, factors that contribute to the weaknesses include an inadequate asset management system to support accounting for WIP and the absence of a documented capital asset policy. The Auditor & Comptroller's office in conjunction with multiple administering departments throughout the City plan to remediate this weakness by developing and implementing a city-wide capital asset policy. This policy will include, but is not limited to, processes for capitalization of large projects and for analyzing asset impairment.

As mentioned above, several weaknesses are the result of an inadequate asset management system. The City's current system, FAMIS, does not possess the ability to track WIP. Therefore, the City's management of WIP is manually intensive and susceptible to error. As a result of these weaknesses, fixed assets and depreciation are subject to misstatement. The Auditor & Comptroller's office is reviewing policies and procedures relating to accounting for WIP in FAMIS.

Additional weaknesses affecting the Fixed Asset Cycle relate to annual inventories, impairment analyses, and reconciliations of additions/deletions between FAMIS and the general ledger. It was noted that Management disagreed with the weakness relating to the reconciliation process. The weaknesses specifically related to the inadequate process of reconciling all subsidiary ledgers to FAMIS and the lack of audit trails available. Ideally, the City should have one fixed asset register with a true beginning balance, additions, deletions, transfers and ending balance, which is at this time not available. Currently, the Auditor & Comptroller's office is reconciling FAMIS to subsidiary ledgers and is also working with other departments to create a capital asset policy as mentioned above.

### **Cash & Investments Cycle**

The liquid nature of cash increases the risk of undetected fraud.<sup>11</sup> External Auditors identified the City's difficulty in reconciling cash in the general ledger to cash in the bank as a potential reportable condition that stems from lack of communication between relevant City Departments and an inadequate reconciliation process. In conjunction with our review, the Auditor & Comptroller's office initiated a separate internal audit of the cash and investment reconciliation process focusing on reengineering the process. This review is ongoing and is also intended to determine the accurate cash balance for fiscal year ending 2005.

Preliminary findings from the internal audit include the lack of and/or untimeliness of the existing monthly cash reconciliation process. This weakness affects the City's ability to promptly report cash and investments and also delays the year-end reconciliation process. The existing process allows for reconciling items to remain outstanding for long periods of time, potentially resulting in a loss to the City. During Internal Audit's analysis, two of the six accounts reviewed were not completely reconciled and contained unknown suspense items. Descriptions and remarks were inconsistent, and at times, inaccurate. As a result, the reconciliations are difficult to understand and hinder the review process. None of the exceptions appear to be individually material in nature; however, these weaknesses could potentially cause misstatements of the City's cash balance and delays in discovering errors and irregularities. Remediation efforts are in process and will be addressed subsequent to the issuance of this report.

### **Financing Cycle**

Since a large portion of the City's capital projects are funded with municipal bonds, accounting for debt is a crucial part of the financing cycle. Based on our discussions with the External Auditors, the City needs to improve their accounting for debt issuance costs. In conjunction with our analysis of the Restatements (discussed later in this Section), we determined that debt issuance costs were not capitalized and amortized over the life of the debt. The risk of not properly accounting for debt is the understatement of deferred costs and amortization expense, and overstatement of expenses in the year of debt issuance. Remediation for this weakness is being coordinated by the Auditor & Comptroller's office and includes reorganizing the Department. Since the reorganization is intended to address several weaknesses, it will be discussed in detail later in this appendix.

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<sup>11</sup> Whittington 383.

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### Revenue Cycle

The City's Revenue Cycle includes the levying and/or collection of property, sales and other taxes. This control cycle also governs the collection of grant receipts and fees collected for services.

The External Auditors noted the City does not reconcile accounts receivable to relevant subsidiary ledgers. In our opinion, this weakness is the result of inadequate and obsolete software which leads to time-consuming, manually intensive processes that are susceptible to error. The City has several subsidiary ledgers including but not limited to Customer Information System (CIS), the billing system for Water and Sewer, and Accounts Receivable Information System (ARIS), the accounts receivable billing system for various services provided by the City. Failure to reconcile the general ledger to the subsidiary ledgers potentially causes misstatements in accounts receivable and revenues. Plans to remediate this issue include increasing training and reorganizing the Auditor & Comptroller's office. Again, the reorganization will remediate several weaknesses and will be discussed in detail later in this appendix.

The City was also inadequately adjusting year-end accounts receivable balances for the Water and Sewer funds. Failure to adjust the accounts receivable balance at fiscal year end for material transactions occurring subsequent to fiscal year end can result in misstated accounts receivable and revenue balances. In our opinion, limited reporting from antiquated billing systems contributed to this error. In order to mitigate the risk of misstatement, Auditor Management deemed it necessary to analyze credits and rebills in the water billing system (CIS) just after fiscal year end. If the net amount of the offsetting credits and re-bills exceeds \$50,000, the accounts receivable at June 30 is appropriately adjusted.

Based on testing performed during the Internal Control Review Project, Management's remediation plan has been implemented. However, further research is necessary to conclude on the efficiency and accuracy of this new procedure.

### Expenditure Cycle

The expenditure cycle encompasses control activities of a business' day-to-day activities. The control weakness in the cycle observed by the External Auditors related to the inadequate year-end accruals. Since the City closes the books in mid-August and ceases accruing for expenses relating to the prior fiscal year, accounts payable and expenses for those invoices received after mid-August that relate to the prior fiscal year are understated in the accounting records. Management's remediation plan includes creating and disseminating a list of all subsequent disbursements greater than \$100,000. The disbursements are to be researched and accrued for, if necessary.



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Based on testing performed during the Internal Control Review Project, Management's remediation plan has been implemented. However, we noted inconsistencies between accrual policies in different Accounting Sections and we noted necessary accruals were not appropriately recorded. For example, one section would accrue an entire disbursement over \$100,000 despite the individual funding sources, while another section would not accrue the disbursement unless the individual funding sources relating to the disbursement were over \$100,000. The new list appears to be an appropriate means for detecting unrecorded liabilities, yet the procedures used to analyze the list should be improved.

Management is further defining and documenting the procedures relating to analyzing the list for fiscal year 2006. Furthermore, we noted that the threshold has been reduced from \$100,000 to \$50,000 for fiscal year 2006. Testing of the new, prospective procedures will be performed at a later date after Management has sufficient time for implementation.

Another weakness discovered during the testing of accruals is the outdated accounting system. Post closing adjustments are not reflected in the mainframe system and accruals cannot be verified online. Manually intensive procedures are necessary to determine if an invoice is adequately accrued.

### **Budgetary Cycle**

One particular weakness discussed with the External Auditors pertains to budgeting for the Public Liability Fund. Historically, the budget for this fund has been understated and general fund monies have been transferred to meet the public liability fund's disbursement needs. This methodology increases the risk of inaccurate budgeting and difficulty managing costs. Management plans to mitigate this weakness by creating a "sub-fund" within the Public Liability Fund. Management indicated that the budget is typically accurate for actual claims losses, but not accurate for "non-claim" losses. Creating the "sub-fund" would allow claim expenses to be tracked separately and would allow the City to analyze past expenses and trends in determining the appropriate budget amount for this sub-fund.

### **Miscellaneous**

External auditors observed three weaknesses that are pertinent to the operations and financial reporting of the City but are difficult to categorize within a particular cycle. Of the three weaknesses, two relate to billing participating agencies (PA's) for use of the City's sewage pipelines. The control weaknesses allow for the potential misstatement of either expenses or receivables and revenues. Depending on whether the City or the PA's used the pipelines, staff must code pipe usage as either "metro" or "muni." Because adequate training was not provided, staff was incorrectly coding

## Appendix A3 - Control Activities

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pipe usage resulting in incorrect charges to both the City and the PA's. Additionally, during fiscal year 2004, new sewage meter reading equipment was installed, but was unable to track flow accurately. As a result, the amount of "usage" expenses billed to the PA's was based on prior year meter readings.

Management's remediation plans for the expense coding weaknesses include placing accountants out to the departments they service as part of the reorganization. Also, the remediation plans include adding an accountant position to the responsible Department's staff. The new accountant will be responsible for training appropriate staff and providing an analysis of the various expenses to ensure sufficient back-up is submitted and costs are accurately recorded between "muni" and "metro." Remediation plans specific to the meter reading equipment include using additional testing or other relevant evaluation methodologies where appropriate in the selection of future service providers.

See Appendix B for all documented miscellaneous weaknesses.

### **Procurement Cycle**

The majority of the weaknesses in the Procurement Cycle reside in departments outside the Auditor & Comptroller's office. Most of these weaknesses are operational in nature and could potentially result in loss to the city, inadequate compliance with regulations and poor audit trails. Although operational weaknesses have no direct effect on the financial reporting process the weaknesses could affect the City's operational effectiveness if not addressed. Operational weaknesses include the department's ability to procure non-engineering consulting services without obtaining expertise from the appropriate City departments. We also noted challenges to the City Auditor's ability to control contracts with regard to the City's internal policies. As noted above, this weakness may lead to misappropriation of assets and creation of fraudulent vendors.

The City intends to make a boiler plate for RFPs (Requests for Proposals) available on the Citynet Page that can be used by any department to ensure all the City's legal requirements are met. In addition, the City is rewriting AR25.60 and AR25.70 to create a more effective process for hiring consultants.

In our opinion, numerous control weaknesses exist within the contracting process the City has the ability to exceed the \$250,000 threshold for consulting services without initially seeking City Council's approval. We believe this weakness is the result of an inadequate tracking process. Management plans to revise AR25.60 and AR25.70 so that consulting contracts are paid via a purchase order (PO) rather than via a direct payment (DP). Subsequent to remediation, Purchasing will be able to

## Appendix A3 - Control Activities

monitor all activity, by consultant, by fiscal year via the OPIS database. The revisions have not yet been made; however, this is a priority for the City.

See Appendix B for all documented Procurement Cycle weaknesses.

### Restatements

As of the writing of this report, a sample of 17 out of 30 Government-wide Restatements were reviewed and documented. The restatements described below are numbered in accordance with the complete schedule of restatements obtained from Draft four of the 2003 CAFR and can be found in Appendix C. Since the restatements were categorized by balance sheet line item, the Internal Control Review Team was able to conclude which type of accounts (e.g., Current Assets, Long-Term Liabilities) were the most susceptible to misstatement due to control weaknesses. See breakdown of the restatements below:

**Table Documenting Reviewed Restatements**

Balance Sheet Category	# of Documented Restatements	Overall Government-Wide Net Effect on Net Assets	Effect on Governmental Net Assets	Effect on Business-Type Net Assets
Current Assets	4	\$ (50,384,000)	\$ (51,602,000)	\$ 1,218,000
Fixed Assets	4	(364,901,000)	(219,891,000)	(145,010,000)
Current Liabilities	4*	(42,186,000)	(34,034,000)	(8,152,000)
Long-Term Liabilities	4	14,163,000	12,746,000	1,417,000
Reclassifications	1	-	6,098,000	(6,098,000)
<b>TOTALS</b>	<b>17</b>	<b>\$ (443,308,000)</b>	<b>\$ (286,683,000)</b>	<b>\$ (156,625,000)</b>

\*Note that \$4,048,000 of Restatement 17 and (\$312,000) of Restatement 21 related to Business-Type Net Assets have not been documented due to time constraints.

**Table Documenting Restatements to Be Reviewed**

Balance Sheet Category	# of Un-documented Restatements	Overall Government-Wide Net Effect on Net Assets	Effect on Governmental Net Assets	Effect on Business-Type Net Assets
Current Assets	4	\$ 3,914,000	\$ (349,000)	\$ 4,376,000
Fixed Assets	5	(201,792,000)	(105,738,000)	(95,920,000)
Current Liabilities	0	-	-	-
Long-Term Liabilities	2	629,000	-	-
Reclassifications	2	(1,136,000)	44,767,000	(44,767,000)
<b>TOTALS</b>	<b>13</b>	<b>\$ (198,385,000)</b>	<b>\$ (61,320,000)</b>	<b>\$ (136,311,000)</b>

The amounts on this schedule are presented for illustrative purposes only. All information is unaudited and subject to change.

## Appendix A3 - Control Activities

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Twelve unique control weaknesses were identified during the review of the 17 Restatements. Of these weaknesses, five account for 70% (45 of 65 separate instances) of the total instances of control weakness discovered. Therefore, rather than discuss all control weaknesses found the five most pervasive deficiencies above will be discussed individually below. These control weaknesses are as follows: (1) inadequate training, (2) inadequate supervision/review and analytical procedures, (3) inadequate line of communication, (4) inadequate financial closing and reporting process, and (5) over-reliance on information provided to the Auditor & Comptroller's office. See Appendix C for a complete list of all documented weaknesses noted during restatement testing.

### **Inadequate Training<sup>12</sup>**

During our review, inadequate training was a reoccurring weakness identified in 15 of the 17 documented Government-Wide Restatements (Restatements 1, 11, 24, 27, 9, 18, 25, 7, 17, 21, 22, 2, 3, 16, and 28).

Without adequate training, innovation is stifled and best practices are not integrated into the day-to-day operations. In fiscal year 2004, the total training budget for the Auditor & Comptroller's office was approximately \$4,600; actual funds spent totaled \$1,250.67, an average of \$16.24 per professional employee. This calculation does not include salaries of staff time charged to training. In a profession with highly technical and frequently changing principles and applications, the City has placed inadequate importance on training and is relying on the adequacy of employees' previous knowledge base. The City of San Diego needs to realign training efforts to effectively improve its financial controls.

Many of the restatements may have been avoided had adequate training been provided. For example, Restatements Two and Three addressed the failure to properly capitalize and amortize specific bond costs. Government Accounting Standards Board Statement 34 (GASB 34), effective June 15, 2001, established Government-Wide financial statements based on full accrual accounting. Full accrual accounting restructures much of the information that governments have presented in the past. The City was required to apply the new accounting principles in fiscal year 2002; however, because staff had not received adequate training the new accounting principles were incorrectly applied.

Additionally, Restatement Seven had issues relating to inadequate training. This restatement required an adjustment due to incorrectly accounting for the Net Pension Obligation (NPO). Specifically, the City incorrectly accounted for transactions and interpreted accounting principles relating to San Diego City Employee's Retirement System (SDCERS). This resulted in a failure to increase an NPO (a liability of the

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<sup>12</sup> This is also discussed in the Information and Communication section of the report.

## Appendix A3 - Control Activities

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City). Since Auditor staff did not receive training on retirement accounting pronouncements, this error was never identified. Additionally, the City did not have personnel with retirement accounting expertise on staff and relied heavily on outside consultants (external auditors and actuaries) for technical accounting interpretations.

### **Inadequate Supervision and Analytical Procedures**

During our review, inadequate supervision and analytical procedures were reoccurring weaknesses identified in nine of the 17 documented Government-Wide Restatements (Restatements 11, 9, 18, 25, 21, 3, 16, 28, and 27).

A consistent control weakness identified during the restatement testing was inadequate management review. For example, Restatement 16 adjusted for misclassification of revenue and understatement of liabilities. Grant revenues received from San Diego Association of Governments (SANDAG) were recorded and immediately recognized as tax revenues; these revenues should have been recognized as deferred revenue. In our opinion, a manager would most likely have recognized the misclassification that contradicted the true substance of the transaction. This was supported by the fact that this restatement was identified by Auditor staff through subsequent review of transactions.

As a related function of supervision, the performance of analytical procedures helps to ensure that account balances and transactions appear appropriate based on a predetermined benchmarks. With a few known attributes, questions and expectations can start to be formulated as a double check against current balances for appropriateness. For example, hypothetically speaking, last year the City paid \$7.6 million for employee insurance, while this year the insurance expense account balance is \$5.0 million. We know two things in relation to this balance, the insurance rate has increased per employee in the current year, but the total number of City employees has decreased. Based on these two details, further analytics can be performed such as finding the average cost per employee in the previous year and comparing it to the average cost in the current year. This will help us to ascertain if further detailed research is necessary.

By using analytical procedures management attempts to determine the reasonableness of financial data by comparing its behavior with other financial and non-financial data. The application of analytical procedures may have prevented a number of deficiencies documented during our review. For example, Restatement 25 adjusted for the overstatement of Work in Process (WIP) assets due to the failure to expense abandoned projects. All WIP assets are accounted for in a “Grant Project Status Report (GPSR)”, which tracks WIP expenses to date. A comparison of the

## Appendix A3 - Control Activities

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prior year report to the current year report would ensure that inactive WIP projects were appropriately investigated. Since the GPSR was not reviewed, multiple old projects that had been previously abandoned were not removed from WIP.

Weaknesses involving a lack of supervisory review and analytical procedures occurred in many different functions of the Auditor & Comptroller's office. Recommended remediation efforts were tailored to meet the demands of each function. In general, emphasis has been placed on increasing performance of analytical procedures, but this is reliant on decreasing accountants workload (unnecessary manual processes) to allow additional time for analysis. Additionally, reviews are being performed by higher level staff as well as requiring back-up documents for review and filing.

### **Inadequate Communication**

During our review, inadequate communication was a reoccurring weakness identified in eight of the 17 documented Government-Wide Restatements (Restatements 27, 9, 13, 18, 25, 2, 3, 28).

Communication is a prerequisite that sets accountancy apart from many other professions and is key to producing cohesive, consistent and comprehensive financial statements. Communication lapses between the Auditor & Comptroller's office, other City departments and outside agencies were the direct cause of many restatements. For example, Restatement 27 amends the incorrect accounting for a number of the Redevelopment Agency (RDA) asset transactions in the Land Held for Resale account. An analysis was conducted in fiscal year 2005 of the Land Held for Resale account, which uncovered approximately 29 discrepancies at the time the restatement was reviewed affecting the fiscal year ended June 30, 2002 account balance.<sup>13</sup> Responsible accountants were not notified of significant transactions in a timely manner due to inadequate communication of operating activities (reporting procedures) between the Auditor & Comptroller's office and RDA administrators.

### **Inadequate Financial Closing & Reporting Process**

During our review, inadequate financial closing and reporting processes are recurring weaknesses identified in six of the 17 documented Government-Wide Restatements (Restatements 1, 24, 9, 13, 18, 25).

Financial closing and reporting activities include: performing reconciliations, consolidating stand-alone financial statements and other responsibilities involved in preparing the CAFR. Inefficiencies in these tasks may lead to the inaccurate and untimely production of financial

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<sup>13</sup> As of the writing of this Report additional adjustments have been made to the CAFR. These are not the final amounts.

## Appendix A3 - Control Activities

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statements. For example, Restatement 13 relates to Open Space Park Land (Open Space), which was double counted in the CAFR, due to incorrect coding in the Fixed Asset Management Information System (FAMIS). As a blended component unit of the City, the operating results and account balances reported in the stand-alone financial statements are integrated into the CAFR. For the last several years, reconciliations between the Open Space financials and FAMIS were not performed to ensure the correct fixed asset values were consolidated into the CAFR. With the proper financial closing and reporting processes in place the overstatements in the CAFR may have been discovered in a timelier manner or even prevented.

### **Over-reliance on Information provided to the Auditor & Comptroller's Office**

During our review, over-reliance on information provided to the Auditor & Comptroller's office was a recurring weaknesses identified in six of the 17 documented Government-Wide Restatements (Restatements 24, 27, 9, 18, 25, 21, 23).

A lack of adequate training and professional skepticism in the Auditor & Comptroller's office contributed to its over reliance on information provided by outside organizations or departments. Staff in the Auditor & Comptroller's office often relied on outside sources, such as external auditors, actuaries, outside agencies and other City departments for information, calculations and updates. Information provided to the Auditor & Comptroller's office was often accepted to be complete and accurate without further review.

Many of the restatements could have been avoided had Auditor & Comptroller's office staff been encouraged to maintain professional skepticism. For example, Restatement Nine resulted from an over-reliance on the Work in Process (WIP) project status provided to the Auditor & Comptroller's office by other City departments. The City was required to value and record all capital assets including all WIP infrastructure assets in fiscal year 2002 in accordance with GASB 34. The CIP section of the Auditor & Comptroller's office was responsible to account for all WIP assets through their existing ledgers. However, there were many inaccuracies in CIP's records as items included in WIP had previously, unknown to accounting, been placed into service by departments. As a result of being placed into service, these assets should have been removed from the WIP category and moved to the Fixed Asset Ledger to be depreciated. The Auditor & Comptroller's office did not perform analytical procedures on the WIP listing for appropriateness and relied on City departments to furnish accurate information relating to WIP project status.

### **III. Conclusions**

We cannot conclude that the City of San Diego's control activities, as a whole, are adequate to meet management's objective of ensuring timely and accurate financial reporting.

We found through communications with the External Auditors that the City, in general, has inadequate financial policies and procedures and outdated technology. Most of the remediation efforts proposed by management require the creation of or revisions to policies and procedures. For example, most of the fixed asset weaknesses can be mitigated with the creation of a city-wide capital asset policy. Inadequate technology was indirectly related to several findings. Furthermore, the outdated mainframe does not reflect post-closing adjustments in the fiscal year end balances and creates manually intense processes as a result. Additionally, FAMIS currently does not have the ability to track construction in process. Again, this created manually intense tracking processes.

Similar to weaknesses found through analysis of the restatements discussed below, the External Auditors found weak lines of communication and inadequate training. For example, the weak lines of communication caused problems in redevelopment accounting and in accounting for reserves while the inadequate training resulted in erroneous expenditure coding.

To build on the control weaknesses above, in terms of the restatement testing, the five weaknesses with the most pervasive effect on the timeliness and accuracy of financial reporting are:

- Inadequate training,
- Inadequate supervision and analytical procedures,
- Inadequate lines of communication,
- Inadequate financial closing and reporting process, and
- Over-reliance on information provided to the Auditor & Comptroller's office.

For the remaining control weaknesses noted throughout the documented Restatements, see Appendix C. All of the above mentioned control weaknesses were determined to be key weaknesses as they were recurring and affected a wide range of activities. In the Auditor & Comptroller's office and throughout all City departments' communication issues and difficulties brought on by inadequate information systems are hindrances to timely financial reporting. For example, completed capital projects were not capitalized timely as a result of poor communication between City Departments and the Auditor & Comptroller's office. Training is also a prevalent issue for general fund departments, notably in the Auditor & Comptroller's office and other non public safety departments; this is an



## Appendix A3 - Control Activities

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obstacle for accurate financial statement preparation. Staff recorded liabilities, bond issuance costs, and land-held-for-resale transactions incorrectly due to inadequate training. It was also noted repeatedly during testing that supervisory review and performance of analytical procedures is lacking, causing unnecessary errors, rework and back-tracking. Another significant problem in producing accurate financials is the inadequate documented financial closing procedures or lack thereof, which includes reconciliations, consolidating stand-alone financial statements and all responsibilities involved with preparing the CAFR. Finally, the last prominent item was the abundant amount of reliance placed on a number of sources outside of the Auditor & Comptroller's office for financial information. Outside sources included, the external auditor's, actuaries, other City departments and outside agencies.

Note that additional issues arose during analyses performed in the Control Activities Section which will require follow up review. See additional discussions regarding open items in Appendix D: Work Performed.

### ***IV. Remediation***

To mitigate or alleviate some of the exposed control deficiencies, numerous remediation efforts were devised. Among the most significant plans are reorganizing the Auditor & Comptroller's Department, implementing new policies and procedures, increasing communications, and increasing training efforts. Note that not all of these remediation efforts have been tested for effectiveness either due to time constraints or due to lack of implementation.

#### **Reorganization**

The main remediation plan includes the reorganization of the Auditor & Comptroller's Department. The purpose of the reorganization is to re-align duties and responsibilities within the Auditor & Comptroller's office to better reflect the office's priorities while enhancing the efficiency, timeliness and quality of the office's business processes. We believe the current allocation of job tasks, workflow, span of authority, and supervisory responsibilities has led to unclear concepts of accountability within the department, duplicative effort, lack of adequate automation of repetitive tasks, and ultimately a work product that needs to be improved as to accuracy and timeliness.

As part of the reorganization, a new operating division was established and certain tasks were realigned among existing divisions. For example, to permit the Accounting Division (renamed the Financial Reporting and Budget Division) to more effectively focus on CAFR preparation, general accounting operations was reassigned to the Payment Services division (renamed Accounting Operations and Disbursements). Additionally, certain proprietary and intergovernmental accounting functions are in the process of being decentralized. This will enable those individuals doing the accounting work for the Water Department, Sewer Department, and SDCERS, for example, to become part of the management team for each of those departments. Finally, a 'Chief Accountant' position was established. This individual must be a Certified Public Accountant, responsible for setting City-wide accounting policies to assure accurate CAFR preparation and accounting disclosures in accordance with Government Accounting Standards Board (GASB) standards.

With the reorganization still in progress, accountants are currently transitioning to their new positions and are still responsible for both their old and new tasks. Furthermore, the Chief Accountant position has not yet been filled.

#### **New Policies and Procedures**

In response to the control weaknesses found by the External Auditors, several new policies and procedures were either revised or created. For example, to mitigate the weaknesses relating to recording fixed asset

## Appendix A3 - Control Activities

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transactions, the Auditor & Comptroller's office in conjunction with multiple administering departments throughout the City are developing and implementing a City-wide capital asset policy. This policy will include, but is not limited to, processes for timely capitalization of capital projects and for analyzing assets for impairment.

### **Enhanced Communication**

As a means for improving communications, "Auditor Briefings" between accounting and RDA administrators will occur periodically to elevate some of the Redevelopment communication issues. Additionally, quarterly meetings will occur between relevant parties regarding pending litigation and reserve estimates. Furthermore, the reorganization of the Auditor & Comptroller's office will aid in improving communication within the Auditor & Comptroller's office as all the related accounting functions will be together in form and in function.

### **Increased Training**

Without adequate training, innovation is stifled and best practices are not integrated into the day-to-day operations. In fiscal year 2004, the total training budget for the Auditor & Comptroller's office was approximately \$4,600; actual funds spent totaled \$1,250.67, an average of \$16.24 per professional employee. This calculation does not include salaries of staff time charged to training. In a profession with highly technical and frequently changing principles and applications, the City has placed a grossly inadequate importance on training and is relying on the adequacy of employees' previous knowledge base.

A renewed emphasis has been placed on training in the Auditor & Comptroller's office and is coupled with the reorganization of the Auditor & Comptroller's office. For fiscal year ending 2005, actual funds spent totaled \$36,752.66, an average of \$465.22 per professional employee. This calculation does not include salaries of staff time charged to training. Some of the training included:

- Government Finance Officers Association (GFOA) class for all entry-level accountants, which discusses governmental accounting, auditing and financial reporting,
- Access database training classes, and
- Beginning in April 2005, key personnel have been sent to seminars in order to obtain specialized knowledge vital to correctly accounting for the City's operations.

All of these measures increase the knowledge base and efficiency of staff and in turn decrease financial reporting errors. The current state of the City's financial affairs coupled with the turnover in upper management of the Auditor & Comptroller's office is responsible for the renewed focus on training.

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## Appendix A

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A1: Control Environment

A2: Risk Assessment

A3: Control Activities

▶ **A4: Information &  
Communication**

A5: Monitoring

### ***I. Background***

Information and communication are pervasive characteristics that affect all aspects of the internal control framework. For an entity to effectively achieve its objectives, it is essential that current, accurate and appropriate information be made available on a timely basis to those who need it.

As the Government Finance Officers Association (GFOA) points out in its publication “Evaluating Internal Controls”, to be truly effective, communication must be multi-directional. Not only should top-level management be able to communicate its directives to management and staff at all levels, but staff and management at all levels must be able to communicate with higher management. Moreover, special procedures should be in place to allow lower level management and staff to bypass their immediate supervisors if the latter are implicated in inappropriate conduct.

#### **Information**

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Information from both external and internal sources should be available to employees. Management should provide a host of mechanisms to access this information. Examples include effective computer systems to track internally generated data, and access to training materials and external information concerning industry trends and other market conditions affecting the enterprise. Information systems should also support the strategic initiatives of the organization.

In the context of financial reporting, accounting systems should support the production of financial reports. Mechanisms should exist that allow direct communication of sensitive information to the officials responsible for the production of financial reports. In evaluating the effectiveness of its information and communication systems, management should ascertain if the results are accurate, timely, relevant and accessible.

#### **Communication**

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Communication is an essential component of effective governance. Management must have a comprehensive plan for outreach to all levels of employees. This outreach can be demonstrated through the use of newsletters, regularly scheduled meetings and other initiatives. In implementing a comprehensive communication plan management should not overly rely on the “chain of command” to be the sole conduit of information. While the chain of command is an important tool in management’s communication plan, excessive reliance can result in discouraging lower levels of management from approaching senior management.

## Appendix A4 - Information and Communication

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In evaluating the effectiveness of management's communication plan, one must evaluate its focus, clarity and consistency. Management should focus on addressing the role of employees in accordance with both the entity's strategic objectives and the employees' individual responsibilities. Their message should also contain information about the status of ongoing initiatives and external factors affecting the achievement of those initiatives.

### **II. Analysis**

#### **Auditor & Comptroller's Information Systems**

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The majority of information used in the financial reporting process is generated and reported using various computer based financial systems. In addition to applications maintained in other departments, the Auditor & Comptroller's office currently maintains five primary systems designed to capture information relevant to management's decision making process and contribute directly to the production of the City's Comprehensive Annual Financial Report (CAFR). These primary systems are the General Ledger, Payroll, Procurement & Accounts Payable, Accounts Receivable and Fixed Asset systems. Each of these primary systems are composed of several subsidiary applications designed to achieve specific activities. AMRIS is the name that was given to the General Ledger system upon its implementation and while each of these primary systems has a separate name and function, for the purposes of this analysis we will refer to them collectively as "AMRIS", unless otherwise noted.

The development of AMRIS began in the late 1970's and continued over time with the addition of subsidiary systems. Except for some of the subsidiary systems, the large majority of the City's financial information system is mainframe based and the majority of development was done by City of San Diego employees. Since the implementation of the base AMRIS system, the City has experienced many changes in its business climate. These changes include the addition of new accounting principles, multiple changes to the budgeting process and a host of new laws and regulations governing the way the City must operate. Finally, the sheer volume of information being processed by these systems has increased significantly since implementation.

During the course of our review we noted several instances where operational efficiency was hindered by an inability to conform AMRIS to the current business climate. In our opinion, the ability of the City to modify AMRIS is constrained by a number of factors, including workforce attrition and an inflexible system architecture which makes modification of program logic difficult. Specifically, the system was developed using now outdated computer languages and employees skilled in the development of these systems are scarce. Managers in the City have

## Appendix A4 - Information and Communication

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compensated for the inflexibility of AMRIS by instituting labor intensive processes. These processes are more susceptible to error and miscalculation than automated counterparts and result in increased costs per iteration.

In addition to the technical rigidity of the AMRIS system, there are significant flaws in the business logic employed in the system. In the course of our review, we noted that the Chart of Accounts employed to capture and track accounting information is overly complex. At its inception, it appears that the system was developed using one cost accounting methodology which over time, was changed to accommodate new budgeting practices and operational needs. However, rather than completely redefining the chart of accounts and establishing consistent definitions for the new methodology, it appears this process was approached incrementally and without a strategic long-term vision.

As a result, there is no methodology to consistently describe the organizational structure of the City, thus there is no way to easily identify the reporting responsibility for each department director. The production of meaningful financial data for operational decision making is also difficult. To produce senior management reports, institutional knowledge is required along with a significant amount of manual data processing and calculations.

Not only does the systems chart of accounts inconsistently apply definitions to the organizational structure of the system, but it also uses the same fields to describe functions and tasks. For example, a specific “Job Order” (the most basic unit of cost accounting for the City) will often represent a task such as report distribution, but another job order will describe a functional project which is composed of many individual tasks. This makes consistent analysis of activities and outcomes challenging. The task to develop data on what it costs for the government to produce an outcome or service requires a great level of manual data manipulation.

Finally, compounding this is the lack of a standardized process for exporting data from the accounting system. In order to produce schedules and perform detailed analysis, employees often must request that a custom report be generated by a member of the Systems staff. This process results in delays and an inability to produce timely analysis. With modern systems, any line employee with an intermediate ability to use standard Microsoft Office software can perform meaningful analysis.

### **Other Information Systems**

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Throughout our review the efficacy of information systems was identified as a major risk. Specifically, the greatest risk was often identified as obtaining information from Information Systems that did not adequately



## Appendix A4 - Information and Communication

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support operations. One manager even described the City's approach to funding its information systems as "pennywise and pound foolish." Our survey noted that a majority of the financial systems currently used by the City employ outdated technologies. Outdated systems throughout City departments ultimately have an effect on the accuracy and timeliness of the City's financial statements.

### **Access to Training Materials and other external sources of information**

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As mentioned in the background section of this appendix, access to adequate training materials and awareness of market conditions affecting the enterprise are integral to a strong internal control environment. Without adequate training and access to information concerning trends in government management, innovation is stifled and best practices are not integrated into day-to-day operations.

During our review, it became apparent that training is inadequate Citywide. This is particularly true for professional and other positions that require a higher level of job knowledge and skill. In an effort to decrease overall spending, management noted that training budgets were often significantly reduced or eliminated, impacting the quality of services delivered to the public.

In the course of our analysis, we did note that the city has a Training Advisory Committee and by extension an in-house training program which appears to provide a modicum of support for employee training. However, this program is not without limitations. A review indicates that the training is largely focused toward administrative, clerical and field labor functions. Additionally, an examination of the classes offered that concern financial reporting topics reveals they are mainly designed to promote a greater understanding of the operational procedures employed by the City to record financial data. It is noted that these classes strengthen the effectiveness of specific operational control activities when they are taught.

However, while these classes demonstrate an overall commitment to training, it does nothing to demonstrate the City's commitment to maintaining a highly informed and skilled management team. Furthermore, departments contended that there is not adequate funding for training employees in professional and managerial classes. It would appear that in light of the current challenges facing the city, this is where training is needed most.

The City offers a tuition reimbursement program in which employees can be reimbursed a total of \$900 for courses that are part of an education plan, \$450 of which can be used for seminars and other training or

## Appendix A4 - Information and Communication

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educational events. For today's professionals, the cost of maintaining a premium skill set will likely exceed the amount available for reimbursement. While the City's in-house training program is prominently displayed on its intranet site, it is difficult to locate any information on the Tuition Reimbursement Program. For the program to be effective, it is crucial that employees can easily access up-to-date information on the requirements and restrictions of the program.

To demonstrate the lack of adequate training to staff, we conducted an analysis of training issues in the Auditor & Comptroller's office. Training for Auditor & Comptroller's staff was extremely low. Upon review of our financial results, the Auditor & Comptroller's office spent \$1,250.67 on training during the fiscal year ended June 30, 2004. This amounted to \$16.24 per professional employee. This calculation does not include salaries of staff time charged to training. This commitment should be evaluated against United States General Accounting Office standards which require a minimum of 80 hours of training every two years, if auditors are to perform fieldwork under those standards. If a similar standard were to be applied to all professional accountants in the office regardless of their job responsibilities, and the City committed to providing for only 50% of the required training, the current level of appropriations would be very deficient.

### **Administrative Regulations and Policy Documentation**

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Administrative Regulations are the primary vehicle for defining policy and procedures Citywide. It is this set of regulations that governs the application of many organization-wide internal controls over contracting, budgeting, procurement and other functions that are material to the financial reporting process. These regulations describe in detail the processes for how to effect certain types of business transactions.

A review of the procedures available on the City intranet reveals that some policies have not been revised in over 25 years, while the average age of policies related to budgeting, procurement and contracting are approximately 13 years old. The fact that policies governing critical business processes are aged is indicative of a failure to react to changing market conditions and adopt technological advancements that breed efficiency and result in reduced labor costs.

In regard to financial reporting, our review of the restatements to the City's CAFR revealed an overall lack of documentation regarding the processing of manual transactions and application of accounting principles. Discussions with Staff Accountants in the Auditor & Comptroller's office revealed that many were in the position of having to learn their jobs on their own with little formal guidance. This lack of formal process documentation and an allocation of duties that emphasized

## Appendix A4 - Information and Communication

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the distribution of functional responsibility across many accountants, contributed greatly to misstated financial reports.

### Communication

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As noted in the background section of this appendix, management must employ a comprehensive strategy for communicating with all levels of the organization. In order to accomplish this, the City has many structured mechanisms in place for communicating with employees. These mechanisms include Quarterly Management Meetings, Monthly Leadership Team Meetings, and Periodic Town Hall Meetings for all employees and a Monthly Human Resources Newsletter.

The City Manager has employed the Organizational Effectiveness Program (OEP) to coordinate the majority of these meetings. The City Manager and the director of OEP control agendas for the Quarterly Management Meetings and Monthly Leadership Team meetings and are also involved in planning and moderating discussion at the meetings. These meetings appear to focus more on the dissemination of information downwards and out through the organization than multi-directional communication. Because attendance to the City Manager's Leadership Team meetings is limited to Department Directors and, on rare occasions, to Assistant Department Directors, we were not able to determine if the meetings are an effective tool to encourage open dialogue and communication of controversial issues that affect the organization.

Quarterly Managers Meetings are moderated by the City Manager and Director of OEP. Of the meetings attended by the Internal Control Review Team, the meeting agendas appeared to address issues pertinent to the organizational challenges facing the city. Examples of topics discussed include a presentation on the City's Norms and Values program, recognition for high performing employees and other Citywide updates such as the Strong Mayor transition and the Internal Control Review project. These meetings have given middle management a vehicle to address concerns about issues and challenges facing the City in a group setting.

The City Manager in coordination with the Deputy Mayor has held "Town Hall Meetings" which were open to all employees. These meetings were designed to allow communication between the most senior members of management and all City employees. The meetings included a question and answer format which allowed management to directly respond to employees' concerns. In addition to the aforementioned meetings, the Human Resources department sends out a monthly newsletter. This newsletter contains information about topics such as recent appointments,

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retirements and resignations of high ranking employees, updates on Citywide initiatives and news on employee benefit programs.

We also noted that there are many documented policies which provide direction to employees on how to escalate concerns regarding specific events. For example the EEO policy provides employees with avenues of recourse should they be unfairly discriminated against or treated in a manner that violates federal or state law. Additionally, we noted that for classified employees, (those represented by the Civil Service Commission and Unions) there are additional grievance procedures available. Unions allow employees to address inappropriate management actions with the assistance of counseling and representation. Under the direction of the Civil Service Commission, the Personnel department can investigate and remediate situations involving improper actions by employees. It appears that these conduits provide employees with modicum of protection and representation when it is deemed necessary to escalate grievances for management action.

In addition to issues highlighted in the appendix on Control Environment, it is also relevant to note here that in the performance of fieldwork for this report, we noted in several instances a reluctance of employees to communicate openly. Many employees expressed concern over the documentation of their opinions and recollections of events concerning events and topics considered controversial. While it appears that the majority of this concern is the result of the constant negative portrayal of the City and its employees in the news media, it became apparent that there was also an underlying culture in the City that discouraged employees from actively discussing and escalating controversial issues for fear of negative consequences. When directly questioned regarding these topics, the typical response from interviewees was that past management preferred to focus on the positive attributes of City operations while ignoring issues that would result in unflattering publicity.

Candid responses were often followed by a request to not document such opinions in our workpapers. Ultimately, if we were to subject the source of these comments to the public by documenting these concerns we felt it would unduly inhibit the audit process. However, we felt it necessary to disclose the fact that we had not documented any of these concerns in order to maintain the integrity of this report.

### **III. Conclusions**

#### **Information**

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- The information systems used to capture and record financial data are outdated and difficult to maintain. Manually intensive procedures have been established to compensate for the shortcomings of the AMRIS system. These procedures impact the efficacy and accuracy of the financial reporting process by consuming an inordinate amount of employee time and exposing the underlying data to risk of corruption.
- Subsidiary systems that impact the financial reporting process are outdated and do not integrate well with the AMRIS system. The result of this is to require the performance of numerous manual processes by Auditor & Comptroller staff. These include the entry of large volumes of data into the financial system and significant amounts of staff time dedicated to the research of reconciling items.
- Of the subsidiary systems that feed information into the General Ledger, the most pressing issues to address are the replacement of the Fixed Asset Management Information System, Accounts Payable, and Accounts Receivable systems.
- The Chart of Accounts in the financial system has not been maintained with a strategic long-term focus. Specifically, each department's framework for tracking costs is unique. This makes the application of consistent business rules for the development of management reports and Citywide financial analysis very difficult. As a result, the production of financial statements and access to data for meaningful management decisions is limited.
- Citywide expenditures for training are insufficient. For the Auditor & Comptroller's staff, training funds were inadequate to provide enough funds for training to be in compliance with professional standards. Furthermore, the majority of funds provided for training are reimbursements and the tuition reimbursement program is not advertised to employees. As a result of a failure to maintain a high level of commitment to training professional staff, we believe the quality of services particularly in the area of financial management has suffered.
- There is no formal process in place for a periodic review of Citywide Policies and Procedures.

### Communication

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- Within the City of San Diego, there exists a comprehensive program and strategy for communicating information from Management out to all levels of the organization.
- While communication flows freely from management down through the organization, we noted that there is no formal process for communicating information up from the line level to the most senior levels of management in a confidential manner. This finding is especially relevant for the lower levels of unclassified staff. In the context of the recent challenges facing the City, access for this segment of employees may have been the most critical in preventing unwanted outcomes.
- With the exception of policies governing the reporting of specific activities or instances, we noted that there is generally a reliance on the chain of command for communication of information to management. The conduits that do exist are often public forums and therefore may discourage some discussion of sensitive issues.
- We noted an overall reluctance of employees to communicate openly regarding controversial topics. This was demonstrated by concern over the content of work papers and repeated requests not to document specific statements.

### IV. Remediation

The following items represent our recommendations for resolving the control weaknesses documented in the conclusions section.

#### Information

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- **Begin the process of designing and implementing a new comprehensive financial management system that provides for a seamless integration of the various subsidiary systems that now exist.**

The Auditor & Comptroller's office has begun this transition by initiating the installation of a decision management system which is designed to copy data from legacy mainframe applications and store it using modern relational database technology. This application will facilitate:

- Enhanced access to operating results by facilitating data extraction to desktop software.
- Allow the creation of a database capable of storing multiple years of operating results (the current system is limited to two years of historical data).
- Create a platform capable of supporting the automated compilation of financial statements and supporting schedules.

In pursuing this remediation, the Auditor & Comptroller's office recognizes that the ongoing remediation efforts will only partially address the most critical shortcomings of the current system with regard to the City's current challenges. In developing this solution, care has been taken to assure flexibility of integration with the wide variety of options available to address the City's operational needs. These options include the installation of enterprise resource planning systems or an internally developed system.

- **Perform a comprehensive review of the current chart of accounts and develop a cost accounting methodology that enables consistent application of business rules across the financial reporting and budgeting entity.**

Simultaneous to the implementation of the decision management system the Auditor & Comptroller's office has convened a project team consisting of members of the Financial Management and Auditor & Comptroller's office to review the current Chart of Accounts and propose revisions. These revisions will be implemented as a "parallel view" to the current chart of accounts in the AMRIS system. The advantage of this process is allow for a trial and error period to analyze

## Appendix A4 - Information and Communication

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the results of proposals without impacting the underlying chart of accounts and business processes currently employed by departments.

- **Simultaneous to the development of the decision management system, begin the process of identifying standards for the eventual replacement of the General Ledger and workflow systems including the Fixed Asset Management Information System, Accounts Payable, and Accounts Receivable systems.**
- **Review the role of the Organizational Effectiveness Program in facilitating Citywide training initiatives. Consider increasing departmental training budgets and establishing guidelines including mandatory training minimums for select professional class employees.**
- **Establish a working committee of senior management and a representative of the Mayor's office, supported by staff to perform an ongoing review of the City's Administrative Regulations. Proposals should be presented to the Mayor for consideration and adoption.**

### Communication

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- **Implement an employee hotline to facilitate access to management from the lowest levels of the organization.**

This remediation opportunity has already been implemented. For a detailed description, please refer to Appendix A1: Control Environment.

- **Perform a review of management's communication plan and the role of the Organizational Effectiveness Program in planning and moderating employee communication. This review should focus on providing an environment that fosters open discussion of issues and emphasizes communication up through management.**



## Appendix A

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A1: Control Environment

A2: Risk Assessment

A3: Control Activities

A4: Information &  
Communication

▶ **A5: Monitoring**

### ***I. Background***

The GFOA publication “Evaluating Internal Controls”, points out that the purpose of control related policies and procedures (i.e. ‘control activities’) is to counteract the various risks that could hinder or prevent management from achieving its objectives. It is therefore essential that management monitor control-related policies and procedures *on an ongoing basis* to ensure that they are continuing to function properly. Likewise, management must monitor potential problems in internal controls to ensure that such situations are corrected or otherwise resolved on a timely basis. The process of monitoring the continued operation of control related policies and procedures as well as the resolution of potential weaknesses disclosed by controls forms the fifth component of the comprehensive framework of internal controls.

Although testing of the monitoring function Citywide was limited, our review included an analysis of the role of Internal Audit and the City’s financial integrity legislation.

#### **The Role of Internal Audit**

Ongoing monitoring of internal controls by management is often supplemented by separate evaluations of the effectiveness of control-related policies and procedures. Internal auditors, for instance, often target controls in specific areas as part of their annually developed work plan. Internal audit’s work plan should be tailored to address the areas of greatest risk to effective governance, to establish and monitor an effective control framework and finally to assist in identifying and mitigating the entities exposure to risk. Specifically, International Standards for the Professional Practice of Internal Auditing set forth:

“The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes *using a systematic and disciplined approach.*”<sup>14</sup>

#### **Financial Integrity Legislation**

Some governments, such as the City of San Diego, have passed ‘financial integrity legislation’ that requires management itself to undertake periodic reviews of internal controls and to report on the results of these self-assessments to the governing body. In the case of the City of San Diego, this legislation was modeled after the Sarbanes - Oxley Act of 2002, which was designed to improve corporate governance and the efficacy of financial reporting in the private sector. While Sarbanes-Oxley does not currently apply to government, the consensus opinion among our professional peers is that this or similar legislation will, within the next few years, become mandatory for governmental entities. It has been

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<sup>14</sup> International Standards for the Professional Practice of Internal Auditing, Section 2100, IIA.org

## Appendix A5 - Monitoring

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widely discussed in local government auditing forums the need to improve internal controls and governance in state and local governments. This need is underscored by the fact that many local governments participate either directly or jointly in public securities markets, as such effective governance is a top priority.

At a basic level, financial integrity legislation involves a three pronged approach to accomplishing the desired outcome. These are the implementation of governance mechanisms, a formal assessment of internal controls and establishment of financial statement certification requirements. Mirroring those requirements, the legislation adopted by City Council calls for the establishment of a Financial Reporting Oversight Board, defines an additional set of controls governing financial disclosures, and provides for a mandatory assessment and certification of internal controls by the Auditor & Comptroller and City Manager.

### **II. Analysis**

Our analysis of the role of Internal Audit is based on the results of an independent evaluation of the Internal Audit Division of the City of San Diego, discussions with the City's External Auditors and the professional knowledge of managers responsible for the oversight of the division. Analysis of the financial integrity legislation was conducted through an objective evaluation of Ordinance 19320 (the Ordinance) along with a review of the steps taken to implement the Ordinance.

#### **The Role of Internal Audit**

Budgeted for approximately 22 positions, the organizational structure of the Audit Division is comprised of two separate sections: Revenue Audit and Internal Audit. As of our report date, the staffing levels were limited to five revenue auditors, two internal auditors and five internal control review team members. The revenue audit section focuses its efforts on auditing contracts, leases, revenue agreements and compliance with City tax levies. The role of the internal audit section is described in the budget as conducting operational audits, evaluating performance measures and determining compliance with City directives and internal controls.

For the fiscal years ended June 30, 2002 through June 30, 2004 the Audit Division completed 677 audits. Of these, 158 were internal audits and the remaining 519 were revenue audits. In evaluating the apparent disparity between the performance of revenue and internal audits, the reader should be aware that the internal audit process is typically more involved and time consuming. Revenue audits are focused primarily on assessing the accuracy and legitimacy of payments to and from the City. In this context they do not evaluate or contribute to the efficacy of the City's Internal Control Framework. However, revenue audits do result in significant cost saving and revenue generation for the City.

For the period evaluated, the Audit Division in total generated over \$13 million in revenues and cost savings combined. Approximately, 54% of this was the result of new revenue generation and recoveries, the remainder was the result of cost savings. It should be noted that while the majority of these revenues were the result of external audit activities, the internal audit division did contribute significantly to the total. The recently completed independent evaluation of the Audit Division also found that:

*"The Audit Division's quality control system, in effect for the audit period of FY 2001-02 to FY 2003-04, met the professional standards for governmental auditing, and the Division complied with its system of quality control"*

However, this independent evaluation also noted some opportunities to improve the audit process. Specifically, the evaluation found that the

## Appendix A5 - Monitoring

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Audit Division did not have a formal planning procedure in place for large engagements and can also improve its audit documentation. The impact of these findings is a risk of non-compliance with governmental auditing standards, audit activities not performed in a timely manner and audits that are susceptible to unnecessary audit procedures.

In addition to the independent evaluation of the Audit Division, discussions with the City's External Auditors identified an opportunity to improve the general audit planning process undertaken by the internal audit section. Specifically, it was noted that the section lacked an objective and formal basis for the selection of audits.<sup>15</sup> This is a significant weakness in relation to the City's overall commitment to monitoring an effective internal control framework. The impact of this lack of an objective planning process for internal audit is, in our opinion, supported by a review of the audits being performed by the section.

Upon its arrival, the Auditor's new management team noted that the internal audit section has typically been performing audits at City management's request. These audits focused on accountability and compliance rather than an objective study of policy and procedure failures in the context of mitigating future risks to the City. In practice, while it is normal for internal auditors to perform a limited number of audits certifying transactions and investigating specific instances of fraud or misappropriation of assets, it is not intended to form the bulk of the function's activities. The consequence of this orientation is that it appears that the internal audit section was reacting to events rather than taking a proactive approach to mitigating risks facing the entity. As such, the role of internal audit in the governance structure of the organization was minimized.

The impact of this was to prevent an objective review of the many processes and control activities that have been identified in this report as deficient. This revelation is underscored by the fact that many of the weaknesses identified in this report have been known to accountants in the Auditor & Comptroller's office for many years. However, because the section lacked an effective planning process, the weaknesses were never addressed.

An evaluation of the role of internal audit in the organization is not complete without an examination of the section's independence and reporting conduit. As noted above, the lack of a formal and objective planning process for the section appears to have indirectly impacted its independence through determining the selection of audits. Additionally, it appears that the section very rarely made presentations and engaged the City Council in open session. The failure to access and engage the highest

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<sup>15</sup> This weakness was also discussed in the control activities section of this report.

## Appendix A5 - Monitoring

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levels of City management directly, in effect removed the section from the City's governance structure.

### **Financial Integrity Legislation**

As noted in the background section of this appendix the City has voluntarily passed financial integrity legislation. This puts the City at the forefront of an ongoing initiative in this country to improve internal controls, mitigate risk and improve its governance practices. Ultimately, a byproduct of this legislation is to institute a mandatory program for monitoring the City's internal controls. In our review we concluded that the Ordinance itself is an "internal financial control".

In October 2004 the City passed Ordinance 19320. The Ordinance instituted three primary reforms to address the ongoing fiscal and legal challenges facing the City:

- The creation of a Disclosure Practices Working Group (DPWG).
- The creation of a Financial Reporting Oversight Board (FROB).
- A mandated Annual Review of Internal Controls.

The Ordinance also specified rules and standards for the creation of the DPWG and the FROB and the responsibilities of each group.

Based on our analysis of the report released by the law firm Vinson & Elkins L.L.P (V&E), it appears that the creation of the DPWG was designed to facilitate enhanced communication regarding the City's internal controls over financial disclosure and to ensure that interdepartmental communication and review procedures are adequate to provide for the accurate disclosure of financial data to public markets. The law firm was also instrumental in assisting with the passage of Ordinance 19320 (sometimes referred to as the V&E Ordinance); its report details control failures in the disclosure process and apparent challenges in interdepartmental communication.<sup>16</sup>

The Ordinance describes the DPWG as an "internal working group" chaired by the City Attorney and composed of the Deputy City Attorney for Disclosure, City Auditor & Comptroller, City Treasurer, Deputy City Manager responsible for the financial management functions of the City and any necessary financial managers of the City, and the City's outside disclosure counsel, currently Hawkins, Delafield and Wood. The Ordinance tasks the group with meeting on a regular basis, designing and monitoring disclosure controls, performing a review of all disclosure materials related to the issuance of securities and reporting the results of its work to the City Council<sup>17</sup> every November 1<sup>st</sup>.

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<sup>16</sup> <http://www.sandiego.gov/press/retirement040916.pdf>

<sup>17</sup> The organization structure and responsibilities are defined in S.D.M.C. §22.401

## Appendix A5 - Monitoring

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As described in the introduction to this report, our reading of the Ordinance led us to conclude that development and implementation of controls regarding disclosure to securities markets is the domain of the DPWG and not the Auditor & Comptroller, who is tasked with developing sound “internal financial controls.” The terminology is vague and does not clearly define the scope of the Auditor’s review. For the first reporting cycle, we decided to focus primarily on controls related to the accurate production of the City’s CAFR and what we viewed as issues critical to the overall control framework of the City. This in essence limited our review to entity-wide controls related to the CAFR and elements of the Control Environment.<sup>18</sup>

The DPWG has drafted, circulated and presented their annual report to Council. In drafting their report and procedures, the DPWG recognized the ambiguities of the Ordinance language defining its jurisdiction and intends to address these issues in the upcoming reporting period. They also identified challenges related to resource constraints, awareness of departmental initiatives, jurisdiction limitations and dissemination of information likely to reach financial markets. Specifically, the DPWG could not monitor all communications from the Mayor, Council, and City Attorney’s Office that have the potential to reach financial markets.

The Ordinance also required the DPWG to make formal recommendations regarding disclosure controls to the City Manager no later than December 30, 2004<sup>19</sup>. As of our report date, the DPWG has not made formal recommendations; however, on October 27, 2005<sup>20</sup> they formally adopted disclosure controls and procedures to allow for the development of the formal recommendations. Additionally, the City Treasurer has made considerable progress in developing controls for covenant compliance and other related procedures for which they are responsible.

Each section of the Ordinance has specific milestones. Although not all milestones were fulfilled, certain factors influenced the accomplishment of objectives. These factors include the complexity of developing a plan for internal controls related to financial reporting and disclosure, stringent timelines set forth in the Ordinance, and environmental constraints. Specifically, at the time the Ordinance was passed, it was anticipated that a conclusion to the City’s legal and financial challenges was close at hand. Additionally, the impending resignation of the City’s Mayor was not known. As of the report date, the newly elected Mayor has communicated his plan to modify the organizational structure of the City to support the accomplishment of internal control related objectives.

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<sup>18</sup> The Auditor & Comptroller’s responsibilities with regard to internal controls are defined in S.D.M.C. §22.0708

<sup>19</sup> S.D.M.C. §22.4105

<sup>20</sup> Page 3 of the DPWG’s FY 2005 annual report

## Appendix A5 - Monitoring

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The second primary reform instituted by the Ordinance was to create a Financial Reporting Oversight Board, similar to an audit committee, that will serve as an advisory body to the Mayor, Council, and City Manager regarding financial matters. The Ordinance (Amended on 4-18-2005 per O-19368) required that board members be appointed by December 31, 2005; however, due to ongoing investigations, appointment of the board was delayed and the City hired Kroll and Associates, Inc. to perform an independent investigation. Kroll and Associates, Inc. was designated by Council to also serve as the City's Audit Committee until the investigations are complete. However, these consultants have not been performing the duties and functions of the Financial Reporting Oversight Board as set forth in the Municipal Code<sup>21</sup>.

The final primary reform mandated an Annual Report on Internal Controls. This report accurately identifies the results and conclusions of our review detailed in the previous appendices. Although some guidance was provided, language in the Ordinance is vague and open for interpretation. Some objectives are unreasonable, for example, the Ordinance requires an 'absolute assurance' regarding the disclosure of any significant deficiencies in internal control<sup>22</sup>. In the practice of auditing, absolute assurance can never be guaranteed; in fact, the typical audit opinion indicates that audit procedures are designed to provide 'reasonable assurance' with regard to the reliability of the audited financial statements. Accordingly, our ongoing review is designed to support a conclusion that provides reasonable assurance regarding the efficacy of the City's internal controls based on our interpretation and application of the standards set by the Public Company Accounting Oversight Board (PCAOB). PCAOB's Audit Standard No. 2 defines management's responsibility for "reasonable assurance" as:

*"Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance."*<sup>23</sup>

The Ordinance also requires that the Annual Report on Internal Controls be presented to Council by January 1<sup>st</sup> of each year. Because the City produces its annual financial reports on a fiscal year basis ending June 30<sup>th</sup>, the certification of internal controls would be more appropriately performed by fiscal year end. Similarly, the Sarbanes-Oxley Act of 2002 requires the certification of internal controls to coincide with the issuance of a publicly traded entity's financial reports. By minimizing the gap

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<sup>21</sup> S.D.M.C. §26.1703

<sup>22</sup> S.D.M.C. §22.0708(b)5, S.D.M.C. §22.0708(b)6

<sup>23</sup> We have not yet reached a conclusion on whether or not the controls are adequate and we do not at this time provide any assurance.



## Appendix A5 - Monitoring

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between the issuance of the City's CAFR and the Annual Report on Internal Controls, the information provided with the certification will be more meaningful for financial markets and other users.

### **III. Conclusions**

- Although the Audit Division maintains sufficient quality control standards, it does not have a formal planning procedure in place for large engagements and can also improve its audit documentation. The risk associated with the lack of formal planning procedures is non-compliance with governmental auditing standards; audit activities are not performed in a timely manner and audits that are susceptible to unnecessary testing.

The internal audit division lacked an objective and formal basis for the selection of audits.<sup>24</sup> The current process appears to be reacting to events and is not proactive in monitoring the effectiveness of the internal control framework.

- Certain milestones for the DPWG were not fulfilled. Specifically, the certification by the City Auditor & Comptroller and City Manager have yet to be completed. Additionally, formal recommendations regarding disclosure controls were not made to the City Manager by December 30, 2004. However, progress has been made towards the milestone with the DPWG's adoption of procedures on October 27, 2005 and the City Treasurer's development of controls for covenant compliance and other related procedures.
- Certain challenges face the DPWG in its compliance with the Ordinance, including resource constraints, awareness of departmental initiatives, DPWG jurisdiction, and dissemination of information likely to reach financial markets. All communications from the Mayor, Council, and City Attorney cannot be completely monitored for potential impacts to financial markets.
- Language throughout the Ordinance does not provide adequate guidance for the fulfillment of milestones.
- The Financial Reporting Oversight Board has not yet been appointed due to ongoing investigations and the hiring of consultants who are serving as the City's audit committee.
- Although the Ordinance requires absolute assurance regarding the disclosure of any significant deficiencies in internal control<sup>25</sup>, absolute assurance can never be guaranteed. Accordingly, this report and our ongoing review is designed to support a conclusion

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<sup>24</sup> This weakness was also discussed in the control activities section of this report.

<sup>25</sup> S.D.M.C. §22.0708(b)5, S.D.M.C. §22.0708(b)6

## Appendix A5 - Monitoring

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that provides reasonable assurance regarding the efficacy of the City's internal controls.

- The requirement to submit the Annual Report on Internal Controls by January 1<sup>st</sup> of each year does not coincide with the City's fiscal year end; thus, the information presented in the report is not as meaningful as if the report was based on testing performed within 90 days preceding the fiscal year end.

### ***IV. Remediation***

The following items represent our recommendations for resolving the control weaknesses documented in the conclusions section. We have also disclosed any ongoing initiatives to remediate the identified weaknesses by the Auditor & Comptroller's office.

- **Consider adopting the following modifications to the Ordinance:**
  - **Incorporate the City's new Strong Mayor government structure, particularly in the certification of internal controls by the City Auditor & Comptroller and City Manager.**
  - **Require the City Auditor & Comptroller and City Manager provide reasonable, not absolute, assurance when certifying internal controls.**
  - **Require the Annual Report on Internal Controls be submitted to Council by June 30<sup>th</sup> of each calendar year beginning with June 30, 2007.**
  - **Further define the scope and responsibilities of the DPWG.**
  
- **Require the internal audit division adopt a comprehensive risk assessment and planning process that proactively addresses more than financial reporting and accounting activities. The division should base audit plans on both a subjective analysis of comments from senior management and an objective analysis of financial and operating data. The overall plan should then be presented to the Financial Reporting Oversight Board as well as the Office of the Mayor and City Council.**

The internal audit division is currently undergoing many initiatives to enhance its role in the City's governance structure. For example, five of the division's thirteen personnel have been assigned to the Internal Control Review Team, resulting in an immediate focus of the section on promoting a stronger control framework and mitigating potential risk to the entity. Most importantly, the division can base the planning process for the next fiscal year on the Internal Control Review Project's risk assessment.

The Audit Division's process for planning individual audits is currently being evaluated and a new work paper format is being implemented. The internal audit division is also implementing new procedures for automated work papers, and upon successful implementation and testing, the procedures

## Appendix A5 - Monitoring

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will be extended to the revenue audit section. Additionally, audit managers will review procedures to ensure that all appropriate planning documentation is prepared.

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## Appendix B

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## Control Weaknesses

## Appendix B - Control Weaknesses

Information below represents an accumulation of control weaknesses and is based on communications with the external auditors. Potential reportable conditions and material weaknesses are bolded.

### Financial Closing and Reporting Cycle

FINDINGS	
1.	<b>The City does not update litigated case files timely as a result of poor communication lines between relevant departments.</b>
2.	<b>The City does not effectively monitor all risks: litigated and non-litigated claims are not centrally monitored by one department.</b>
3.	The City's year-end closing process is complicated and manually intense: numerous accountants use Excel spreadsheets to consolidate over 2,300 funds.
4.	The City has a complex accounting system.
5.	Several journal entries lacked adequate approval.
6.	Internal Audit lacks a risk assessment process; internal audit activity should be based on risk assessments undertaken at least annually.
7.	The City lacks justification for certain estimates.
8.	The City does not review the preliminary interest allocation prior to execution.
9.	Requested audit schedules were not prepared timely.

### Inventory Cycle

FINDING	
1.	<b>The City does not communicate well with relevant sources when accounting for land-held-for-resale transactions.</b>

### Fixed Asset Cycle

FINDINGS	
1.	CIP has no specific accounting code and cannot be tracked in FAMIS; The CIP tracking/rec process is manually intense and prone to errors; Depreciation on completed CIP projects was done manually and separate from other capital projects.
2.	Completed projects are not capitalized timely.
3.	Capital contributions are not capitalized timely.
4.	Reconciliation of additions/deletions between FAMIS and G/L is not performed.
5.	Annual inventories of fixed assets are not performed.
6.	Impairment analyses of fixed assets are not performed.



## Appendix B - Control Weaknesses

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### Cash & Investments Cycle

FINDINGS	
1.	The City experiences difficulty in determining the general ledger cash balance (even though a reconciliation is performed).
2.	The monthly Cash Reconciliations carry outstanding items for several months.
3.	Bank Reconciliations are not performed in a timely manner.

### Financing Cycle

FINDING	
1.	Bond issuance costs are not properly accounted for.

### Revenue Cycle

FINDINGS	
1.	Accounts receivable is not reconciled to accounts receivable subsidiary ledgers on an annual basis.
2.	Unbilled revenue only includes a portion of the adjustments for credits and rebills.

### Expenditure Cycle

FINDING	
1.	Year end accruals are understated for accounts payable as a result of the books being closed early.

### Budgetary Cycle

FINDING	
1.	In the past several years, the City has not properly budgeted sufficient resources for the Public Liability Fund in order for it to meet its annual expenditure requirements.

### Miscellaneous

FINDINGS	
1.	The City purchased a new metering system in the current year that was unable to track the solids within the sewer flow accurately resulting in the City basing their allocation of current year costs to Participating Agencies on prior year readings.
2.	Classification of Metro versus Muni expenses is inadequately controlled.
3.	The City had to pay self-imposed penalty payments due to lapsing of the fourteen day deadline on worker's compensation disability settlements for a number of cases.

## Appendix B - Control Weaknesses

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### Procurement Cycle

FINDINGS	
1.	The City does not have a documented procurement process (including applicable laws/regulations).
2.	Projects exceeding \$250,000 are not appropriately approved.
3.	Controls over use of requisition forms are weak (Form PA2610). These forms are used in the same capacity as checks/vouchers.
4.	The procurement process lacks segregation between the initiator and the approver of orders.
5.	Non-engineering consulting services can be procured without the assistance of the appropriate department.
6.	The procurement process lacks an official form to initiate orders.
7.	Smaller city departments lack segregation of duties (e.g. they have the ability to request and receive orders).

### Human Resources Cycle

FINDING	
1.	Upon hire, no review is performed to ensure all pertinent documentation is included in the employee personnel file (information is not centralized).

## Appendix C

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### Restatements to the FY 2003 CAFR

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Amounts are in thousands

Rst #	Adjustment	Component Units					Total	Documented
		Government Type	Business Type	SDCCC	Housing Corporation	San Diego Medical Services Program		
<b>Current Assets</b>								
1	Adjustment for Overstatement of Allowance for Bad Debt		\$1,218				\$1,218	X
11	Overstatement of Contributions	(48,648)					(48,648)	X
12	Overstatement of Grants Receivable		(6,602)				(6,602)	Unaudited
14	Overstatement of Operating Revenues				(113)		(113)	Unaudited
20	Understatement of Operating Revenue		9,471				9,471	Unaudited
24	Remove Cash with Custodian	(198)					(198)	X
27	Land Held for Resale	(2,756)					(2,756)	X
30	Interfund Land Held for Resale Transaction	(349)	1,507				1,158	Unaudited
							(\$46,470)	
<b>Fixed Assets</b>								
4	Correction to Carrying Value of Land		\$12,353				\$12,353	Unaudited
5	Change in Capitalization Threshold				(134)		(134)	Unaudited
8	Depreciation of Completed Capital Improvement Projects		(147,411)				(147,411)	Unaudited
9	Infrastructure	(147,164)					(147,164)	X
10	Overstatement of Accumulated Depreciation		39,138				39,138	Unaudited
13	Correction to Carrying Value of Land	(15,828)					(15,828)	X
18	Structures and Infrastructure Depreciation	(11,711)					(11,711)	X
25	Write Off Abandoned Capital Improvement Projects	(45,188)	(145,010)				(190,198)	X
29	Remove all Zoo Capital Assets	(105,738)					(105,738)	Unaudited
							(\$566,693)	
<b>Current Liabilities</b>								
7	Cumulative Adjustment of Recomputed Annual Pension Costs	(\$52,519)	(\$11,200)				(\$63,719)	X
17	Recognition of Deferred Revenue	40,534	4,048				44,582	X
21	Unrecorded Liabilities	(18,805)	(312)				(19,117)	X
22	Employee Offset Liability	(3,244)	(688)				(3,932)	X
							(\$42,186)	
<b>Long Term Liabilities</b>								
2	Amortization of Bond Discounts, Premiums and Accretions	(\$1,010)					(\$1,010)	X
3	Capitalization of Bond Issuance Costs	13,922	1,417				15,339	X
15	Reclassification of a Grant to a Loan				512		512	Unaudited
16	Deferral of Grant Receipts	(1,540)					(1,540)	X
19	Transfer of Restricted Cash for Facility Restoration Fund			117			117	Unaudited
28	Long - Term Debt	1,374					1,374	X
							\$14,792	
<b>Reclassifications</b>								
6	City's Percentage of Non - Controllable Interest					(\$1,136)	(\$1,136)	Unaudited
23	Reclassify SDDPC as an Internal Service Fund	6,098	(6,098)				0	X
26	Reclassify Interfund Receivables and Payables as Transfers	44,767	(44,767)				0	Unaudited
							(\$1,136)	
<b>Total</b>		(\$348,003)	(\$292,936)	\$117	\$265	(\$1,136)	(\$641,693)	

The amounts on this schedule are presented for illustrative purposes only. All information is unaudited and subject to change.

**Appendix C - Restatements**

**Government-Wide FY03 Restatements Disclosures  
Internal Control Review and Compliance Project**

**NOTE: Restatements obtained from Draft 4 of the FY03 CAFR**

**Current Assets**

- 1 Upon review of the accounts receivable account balances, it was determined that the allowance for bad debt was overstated due to the fact that the previous year’s allowance total had not been reversed. The resulting adjustment was an increase in accounts receivable and an increase in Business-Type net assets of \$1,218.

**Control Weaknesses noted during testing:**

1	Inadequate financial closing/reporting process; reconciliations between the general ledger and subsidiary ledgers is not performed. Supporting documentation is not retained and readily available for review.
2	Inadequate training and high turnover of fund accountants and desk responsibilities leads to misapplication of accounting.

- 11 An analysis of transactions of the PETCO Park Ballpark project identified an overstatement of project contributions. This was the result of erroneously recording the Padres’ investment assets towards the project as City assets. The resulting adjustment was a decrease to Governmental net assets of \$48,648.

**Control Weaknesses noted during testing:**

1	Inadequate review, as such one accountant has sole control over interpreting complex financial agreements and over setting up funds to account for these agreements.
2	Inadequate training and use of outside accounting resources, such as GAAP guidance or consultation with the outside auditor on complex issues.
3	Lack of communication in the Auditor & Comptroller’s department.
4	Management override capabilities, which has led to a lack of professional skepticism (not enough questions asked).
5	No analytical procedures performed to expose irregular account fluctuations.

- 12 An analysis and reconciliation of the Metropolitan Wastewater Utility grant receivable accounts identified previous years’ grant receivable balances that were not reversed in the fiscal year that the receivables were collected. The resulting adjustment was a decrease in construction grants receivable and a decrease in net assets of \$6,602.

**No testing was performed as of the report date**

- 14 Housing Commission identified an overstatement of Operating Revenues which resulted in a decrease to net assets of \$113.

**No testing was performed as of the report date**

- 20 An analysis and reconciliation of the deferred revenue account related to the revenue received from the Metropolitan Wastewater Utility Participating Agencies identified an overstatement of deferred revenue and a subsequent understatement of Treatment Plant Services for Others revenue. The resulting adjustment was a decrease in deferred revenue and an increase in net assets of \$9,471.

**No testing was performed as of the report date**

## Appendix C - Restatements

- 24 During a review of loans outstanding it was determined that collateral being held with a custodian for the San Diego Housing Commission (SDHC) had been transferred to the SDHC to take over the Rehabilitation Loan Program. The resulting correction was a decrease in Governmental net assets of \$198.

### Control Weaknesses noted during testing:

1	Debt functions are decentralized; as a result debt related entries can be overlooked due to a lack of knowledge and communication.
2	High turnover of fund accountants and desk responsibilities leads to misapplication of accounting.
3	Inadequate training.
4	Over reliance on external auditors to perform management functions.
5	Inadequate cash reconciliation process.

- 27 An analysis of Redevelopment Agency land held for resale identified one parcel purchase in June 1999 and two parcels sold in February and April of 2002. The resulting correction to land held for resale was a decrease to Governmental net assets of \$2,756.

### Control Weaknesses noted during testing:

1	Inadequate level of staff reviewing Distribution Developer Agreements (DDA). As such, events requiring accounting treatment were overlooked.
2	Over reliance on agency administrators to keep accurate records.
3	Inadequate lines of communication, therefore, when events occur in one section or department they do not flow to the Auditor & Comptroller's office in a timely manner. Additionally, it was noted by IGA accountants that poor communication within the agency administrator's organizations creates lapses in information provided to the Auditor & Comptroller's office.
4	Inadequate training.
5	No analytical procedures performed to expose inappropriate account balances.

- 30 A loan agreement was identified between the Water Utility and the City whereby the Water Utility financed the purchase of property with a carrying value of \$1,327, and the City was to repay the Water Utility for the acquisition costs plus 8% simple interest. The resulting adjustment was an increase to business type net assets of \$1,507 and a decrease in governmental activities net assets of \$349.

**No testing was performed as of the report date**

## Fixed Assets

- 4 An analysis of land identified corrections to the carrying value of parcels of land. The resulting adjustment was an increase in capital assets and an increase in Business-Type net assets of \$12,353.

**No testing was performed as of the report date**

- 5 A change in the capitalization threshold for the Housing Commission resulted in a decrease in net assets of \$134.

**No testing was performed as of the report date**

## Appendix C - Restatements

- 8 A comprehensive analysis of Business-Type capital assets identified capital improvement projects which were substantially completed and placed into service prior to the point in which the projects were considered completed in years prior to fiscal year 2003. Projects that had not previously been reported as completed were also identified. Had the Proprietary funds used the substantially completed date identified during this review, the recognition of depreciation expenses would have started in the earlier year identified. The resulting adjustment was a decrease in capital assets and a decrease in net assets of \$147,411.

**No testing was performed as of the report date**

- 9 In fiscal year 2002, the city implemented GASB 34 and retroactively capitalized city owned infrastructure assets. The city engaged a consultant, who worked with various city departments, to assist in the valuation of all city owned infrastructure which was added to the city's capital assets. Analysis completed during preparation of the fiscal year 2003 financial statements identified infrastructure projects which were also added to the city's capital assets via its capital improvement program, resulting in an overstatement of infrastructure capital assets. The resulting correction was a decrease to Governmental capital assets and net assets of \$147,164.

Control Weaknesses noted during testing:	
1	Lack of open lines of communication within the Auditor & Comptroller's office as well as between Citywide departments and other agencies. As such, accounting is not notified timely when capital assets are placed into service.
2	Accounting was over reliant on city departments to communicate infrastructure status. Additionally, the closing of job orders can happen long after an asset is completed, which delays capitalization.
3	Inadequate training such as definition of when an asset is considered "placed in service" was not universally understood throughout city departments. Departments outside of accounting were unaware of the difference between financially complete for accounting purposes verses budgetary purposes.
4	Inadequate review and analytical procedures performed. As such, projects remained on the "Grant Project Status Report" for years with no activity.
5	Inadequate reconciliations performed due to limited resources (not enough people in department). Additions to WIP should = total capital project expenses in CAFR with reconcilable differences.
6	No documented procedures exist for the treatment of capital assets.

- 10 Depreciation expense from prior years was recorded in error for certain assets. This adjustment resulted from identified errors in either book values or estimated years of useful life for those assets. The resulting adjustment was an increase in Business-Type capital assets and an increase in net assets of \$39,138.

**No testing was performed as of the report date**

- 13 A comprehensive analysis of Governmental capital assets identified valuation corrections to open space land parcels which were overstated. The resulting adjustment was a decrease to Governmental capital assets and net assets of \$15,828.

Control Weaknesses noted during testing:	
1	Lack of communication in the Auditor & Comptroller's office.
2	Reconciliation of FAMIS detail to financial reports is not completed on an annual basis.



## Appendix C - Restatements

3	All City Departments are not using FAMIS to record fixed asset acquisitions and disposals, therefore, increasing the possibility of misstatement.
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- 18 A comprehensive analysis of Governmental capital assets identified capital improvement projects which were substantially completed and placed into service prior to the point in which the projects were considered completed in years prior to fiscal year 2003. Projects that had not previously been reported as completed were also identified. Had the governmental activities used the substantially completed date identified during this review, the recognition of depreciation expenses would have started in the earlier year identified. The resulting adjustment was a decrease in capital assets and a decrease in net assets of \$11,711.

### Control Weaknesses noted during testing:

1	Lack of open lines of communication within the Auditor & Comptroller's office as well as between Citywide departments and other agencies. As such, accounting is not notified timely when capital assets are placed into service.
2	Accounting was over reliant on city departments to communicate infrastructure status. Additionally, the closing of job orders can happen long after an asset is completed, which delays capitalization.
3	Inadequate training, as such, definition of when an asset is considered "placed in service" was not universally understood throughout city departments. Departments outside of accounting were unaware of the difference between financially complete for accounting purposes verses budgetary purposes.
4	Inadequate review and analytical procedures performed. As such, projects remained on the "Grant Project Status Report" for years with no activity.
5	Inadequate reconciliations performed due to limited resources (not enough people in department). Additions to WIP should = total capital project expenses in CAFR with reconcilable differences.
6	No documented procedures exist for the treatment of capital assets.

- 25 The comprehensive analysis of capital assets mentioned in items 8 and 18 above also identified various projects where certain planning, pre-design, and preliminary costs had been incurred but the projects were later canceled or abandoned prior to fiscal year 2003. This resulted in an overstatement of capital assets. The resulting adjustment was a decrease in Governmental capital assets and net assets of \$45,188, as well as a decrease in Business-Type capital assets and net assets of \$145,010.

### Control Weaknesses noted during testing:

1	Inadequate lines of communication within the Auditor & Comptroller's office as well as between Citywide departments and other agencies. As such, accounting is not notified timely when capital assets are abandoned.
2	Accounting was over reliant on city departments to communicate infrastructure status.
3	No Citywide Capital Asset policy exists; therefore, there is no defined timeframe for when an asset is considered abandoned or impaired.
4	Inadequate review and analytical procedures performed. As such, projects remained on the "Grant Project Status Report" for years with no activity.

## Appendix C - Restatements

5	<b>Inadequate reconciliations performed due to limited resources. Additions to WIP should = total capital project expenses in CAFR with reconcilable differences.</b>
6	<b>No documented procedures exist for the treatment of capital assets.</b>

- 29** In 1915, the Zoological Society of San Diego (“Society”) entered into an operating agreement with the City of San Diego (“City”). Under the terms of the agreement, as amended, the Society has agreed to operate and maintain the San Diego Zoo and in 1969 opened the San Diego Wild Animal Park. While the Society is responsible for the operation and maintenance of the parks, the titles of all property (animals, exhibits, plants, and improvements) are 100% vested with the City, except those acquired through separate grant agreements that the Society procured. While legally the City holds title to all property, the Society controls the property and can secure indebtedness with such property. The City has been capitalizing the assets of the Zoo and Wild Animal Park as governmental assets based on a misinterpretation of the operating and lease agreements. After discussions with the outside auditors it was determined that these assets should be removed as they have been deemed leasehold improvements of the Society. The resulting adjustment was a decrease in governmental activities net assets of \$105,738.

**No testing was performed as of the report date**

### Current Liabilities

- 7** Net Pension Obligation was recomputed for prior fiscal years, beginning with the inception of GASB 27 in fiscal year 1997, which required the reporting of an NPO, including a 10 year look back period to 1987. This recalculation of NPO was mainly due to the City’s treatment of post-employment health care benefits. The City, in accordance with SDMC Section 24.1502 and 24.1203, was designating a portion of its annual Employer Contribution to SDCERS for deposit in the SDCERS retiree health insurance reserve. The City had recognized the full amount of payment, including the amount that was designated for retiree health as an Employer Contribution. It has now been determined, after the closing of FY 04, that the portion designated for retiree health, for pension accounting purposes, should not be recognized as an Employer Contribution. In addition, Corbett settlement payments have also been included in the re-computation of the NPO. The resulting adjustment was an increase in NPO and a decrease in Governmental net assets of \$52,519 and a decrease to Business-Type net assets of \$11,200.

#### Control Weaknesses noted during testing:

1	<b>Inadequate technical training.</b>
2	<b>Lack of accountability: responsibility for the retirement calculation was not designated to one person or division.</b>
3	<b>Appropriate supervisory review of retirement calculations does not exist.</b>
4	<b>Heavy reliance on external consultants.</b>

- 17** An analysis and reconciliation of deferred revenue accounts identified transactions that were shown as deferred revenues in prior fiscal years but subsequently met the criteria for recognition as revenues. The resulting adjustment was a decrease in deferred revenue and an increase in Governmental net assets of \$40,534 and an increase in Business-Type net assets of \$4,048.

## Appendix C - Restatements

<b>Control Weaknesses noted during testing:</b>	
1	<b>Inadequate training and use of resources, such as GAAP guidance.</b>
2	<b>Management override capabilities, which led to a lack of professional skepticism (not enough questions asked).</b>
3	<b>No documented procedures for analyzing the deferred revenue account.</b>

- 21** A review of transactions between the City and San Diego Association of Governments (SANDAG) identified loans which were not recorded as long term liabilities. This was the result of recording receipts as revenue rather than loan proceeds. The resulting adjustment was an increase in SANDAG loans payable and a decrease to Governmental net assets of \$18,805. An analysis performed on cash disbursements identified energy expenses which were not accrued as liabilities in the Business-Type Activities. This was the result of recording energy expenses on a cash basis rather than an accrual basis. The resulting adjustment was an increase in accounts payable and a decrease in net assets of \$312.

<b>Control Weaknesses noted during testing:</b>	
1	<b>Inadequate training – GASB 34 requires government-wide presentation of debt outstanding. Both the schedule provided by SANDAG and the recording of the debt payments as debt service expenditures at the fund level should trigger recording a long-term liability at the Government-wide level.</b>
2	<b>Debt functions are decentralized, as a result debt related entries are inconsistent.</b>
3	<b>Inadequate management supervision.</b>
4	<b>Over-reliance of information provided to the Auditor’s Office.</b>

- 22** An analysis was performed on the funding by the City for the offset paid towards the employees’ retirement contribution amount. In fiscal year 1998, the City set aside funds from the Pension Trust Fund’s undistributed surplus earnings to fund an Employee Contribution Rate Reserve and annually added interest to this reserve based on the balance at the fiscal year end using undistributed surplus earnings. It has now been determined that the portion of the offset payment funded from undistributed surplus earnings should be recognized as a liability by the City. The resulting adjustment was an increase in Employee Offset Liability and a decrease in net assets of \$3,244 in Governmental Activities and \$688 in Business-Type Activities.

<b>Control Weaknesses noted during testing:</b>	
1	<b>Inadequate technical training.</b>
2	<b>Lack of accountability/decentralized Accounting Department: responsibility for the retirement calculation was not designated to one person or division.</b>
3	<b>Appropriate supervisory review of retirement calculations does not exist.</b>
4	<b>Too much reliance on external consultants.</b>

## Appendix C - Restatements

### Long-Term Liabilities

- 2 An analysis of accounts identified bond issuance costs which were not capitalized as deferred charges. This was the result of recording costs related to the issuance of bonds as an expense rather than being capitalized as deferred charges. The analysis further identified bond discounts, premiums, and accretions were not being amortized over the debt period. The amortization of these bond discounts, premiums and accretions resulted in a decrease to Governmental net assets of \$1,010.

#### Control Weaknesses noted during testing:

1	Debt functions are decentralized, as a result debt related entries are inconsistent.
2	No open lines of communication. As such, when changes or policy decisions are made by one section or department they do not flow to the other sections/departments in a timely manner. Additionally, accounting is not notified timely of the existence of new debt.
3	Inadequate training.

- 3 An analysis of accounts identified bond issuance costs which were not capitalized as deferred charges. This was the result of recording costs related to the issuance of bonds as an expense rather than being capitalized as deferred charges. The analysis further identified bond discounts, premiums, and accretions were not being amortized over the debt period. The resulting adjustment was an increase to Governmental net assets of \$13,922 and an increase in Business-Type net assets of \$1,417.

#### Control Weaknesses noted during testing:

1	Debt functions are decentralized, as a result debt related entries are inconsistent.
2	No open lines of communication. As such, when changes or policy decisions are made by one section or department they do not flow to the other sections/departments in a timely manner. Additionally, accounting is not notified timely of the existence of new debt.
3	Inadequate training.
4	Inadequate review procedures.

- 15 Housing Commission reclassified a grant to a loan which resulted in an increase to net assets of \$512.

No testing was performed as of the report date

- 16 An analysis of the Transnet capital projects fund revealed grant receipts which had not been deferred in FY 2002. The resulting adjustment was a decrease to Governmental net assets of \$1,540.

#### Control Weaknesses noted during testing:

1	Inadequate training.
2	Lack of detective controls, such as analytical reviews or periodic reviews of G/L accounts, to detect misclassifications.
3	Inadequate management supervision.

## Appendix C - Restatements

- 19 San Diego Data Processing Corporation identified a transfer of restricted cash for the Facility Restoration Fund which resulted in an increase to net assets of \$117.

**No testing was performed as of the report date**

- 28 An analysis of Redevelopment Agency long-term debt identified one developer loan which had not been reported, another developer loan which had been paid off but not removed, and a tax allocation bond which had been defeased but not removed. The resulting correction was an increase to Governmental net assets of \$1,374.

### Control Weaknesses noted during testing:

1	Inadequate lines of communication within the Auditor & Comptroller's office as well as between Citywide departments and other agencies. As such, accounting is not notified timely of the existence of new debt or obligations. Furthermore, debt related entries can be overlooked due to a lack of knowledge and communication.
2	Inadequate review procedures as well as over reliance on agency administrator's records and DDA interpretations.
3	No analytical procedures performed to expose irregular account balances or fluctuations.
4	Inadequate training and high turnover of fund accountants and desk responsibilities leads to misapplication of accounting. Furthermore, inexperienced accountants are continually positioned in the IGA Division, which is a section requiring an increased level of specialized knowledge.

### Reclassification

- 6 The city restated the beginning net assets of SDMSE in order to reflect its fifty percent ownership and present the non-controllable interest of Rural/Metro of San Diego Inc. resulting in a decrease to net assets of \$1,136.

**No testing was performed as of the report date**

- 23 During a review of the FY 2003 financial statements it was determined that San Diego Data Processing Corporation should be reclassified as an Internal Service rather than an Enterprise fund as previously classified. The resulting change was an increase to Governmental Net Assets and a corresponding decrease to Business-Type Net Assets of \$6,098.

### Control Weaknesses noted during testing:

1	Over reliance on external auditors.
2	Prevalent management override capabilities.

- 26 An analysis performed on interfund receivables and payables identified loans which are not expected to be repaid within a reasonable amount of time. In previous fiscal years, initial investments made from lender funds to establish working capital in borrower funds were recorded as interfund receivables and payables. Amounts not expected to be repaid within a reasonable time are now recorded as interfund transfers. The resulting adjustment was an increase to Governmental net assets of \$44,767 and an equal decrease to Business-Type net assets.

**No testing was performed as of the report date**

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## Appendix D

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### Work Performed

## Appendix D – Work Performed

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During the period beginning in June 2005 through the issuance of this report, we employed various evaluation methods and tools in assessing the state of the City’s internal controls. Our conclusions were drawn from not only the results or findings from one tool, but from the collective results and findings from all work performed.

Materiality was evaluated in the context of potential impacts on the Government-Wide financial statements. Professional judgment and the prevalence and nature of certain findings (restatement causes and control weaknesses identified by external auditors) served as the basis for disclosure in this report. Due to the limited testing of controls performed during this reporting period, we deferred conclusions regarding materiality of individual findings into future periods.

### Employee Training and Opinion Surveys

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In consideration of the control environment, we provided training to over 116 City employees who were designated as departmental Internal Control Liaisons (ICL). The training was based on a curriculum developed and presented by a professional trainer from the Institute of Internal Auditors (IIA). The training addressed all of the elements of the COSO internal control framework, as described in earlier appendices of this Report, and the individual components of the control environment, described in greater detail in the background section of Appendix A. At the conclusion of the training, a survey titled “preliminary questionnaire” was distributed to ICLs who were then requested to distribute the survey to a representative sample of employees from all levels of their department.

Direction was given that employees were to evaluate the questions in the “preliminary questionnaire” and respond with their opinions concerning the control framework as employed within their own department. The survey was distributed to approximately 257 employees in the City across 32 departments and operating programs. The number of respondents in each department varied from one for the smaller operating programs to 45 for larger departments.

While the preliminary questionnaire addressed control environment factors within individual operating segments of the organization, it did not address the “tone at the top” being set by the senior management and policy makers of the City. Accordingly, we identified the need to perform an assessment of the elements of the greater control environment of the City. In order to ascertain sentiment towards the top level of city government, a second survey titled “Control Environment Assessment” was distributed to and completed by department and program directors.



## Appendix D – Work Performed

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Prior to the distribution of the “Control Environment Assessment”, the City Auditor made a series of orientation presentations to senior management at the City Manager’s Leadership Team meetings. The presentations outlined the general concepts of the COSO Internal Control Framework and illustrated the impacts of the control environment on the operations and financial reporting activities of the City.

In the “Control Environment Assessment,” we requested that department and program directors of the City complete a survey designed to capture and measure their sentiment on the control environment being promulgated by the policy makers in the organization. In this survey, we requested that the participants evaluate several components of the control environment. Specifically, the extent to which the City Manager, Mayor and Council demonstrate and effect:

- Uncompromised integrity and ethical values,
- Competence requirements for the performance of critical duties,
- Oversight of effective internal controls,
- A strong control environment,
- Awareness of their responsibilities in regard to internal controls,
- Proper delegation of authority to ensure organizational goals are met,
- The active involvement of the Human Resources and Personnel Departments in helping to develop policies and procedures to ensure competence and integrity,
- Clear and consistent management objectives within each department,
- A comprehensive process for assessing organizational risk,
- A reliable system of controls designed to inform and provide a basis for reaction to changing business conditions,
- Appropriate policies and procedures for the conduct of City business,
- Reliable information systems designed to capture and communicate management information, and
- Timely response to irregularities, fraud and ethics issues.

### Interviews

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In addition to our analysis of the consensus opinions of the City’s management, we also met with and discussed the role of certain operating segments and commissions. Specifically, we met with the leaders of the City’s Ethics Commission, Organizational Effectiveness Program, and the following departments: Human Resources, Personnel, Risk Management, and Financial Management. Our discussions centered on evaluating and analyzing the respective roles of each department, commission or program in ensuring compliance with existing ethics laws, the promotion of value-

## Appendix D – Work Performed

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based education within the organization, organizational commitment to competence and the controls in place to achieve this commitment. In preparation for these meetings, we examined the ordinances which created the roles, responsibilities and jurisdiction of each entity. After this analysis the meetings took the format of led discussions based around the impacted elements of the internal control framework. Additionally, during these meetings we discussed the results of our surveys and solicited opinions on best practices, and how the organization can improve its commitment to competence and strengthen the Human Resources and Personnel practices of the organization.

### Organizational Analysis

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In the process of evaluating management’s activities with regard to human resources policies and procedures, we also performed an analysis of the organizational structure of the City. This analysis was geared towards evaluating the reporting conduits of departments that have critical responsibilities in ensuring:

- The accuracy of financial reporting,
- Safeguarding of assets and other highly material financial controls, and
- The communication and appropriate handling of risks facing the enterprise as they arise.

### Risk Assessment

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In setting the “tone at the top” it is important for management to exhibit an awareness of the risks that could hinder the organization’s ability to meet its goals and objectives. Based on guidance from Ordinance 19320 and limited resources we chose to limit the scope of our first report and focus solely on financial reporting objectives. This limitation on scope enabled the Auditor & Comptroller’s office to concentrate on the areas having the greatest impact on the most immediate challenge facing the city: the issuance of its Comprehensive Annual Financial Report (CAFR). In future reporting periods we intend to extend our evaluation to both operational and compliance based objectives to account for overlap and to address other risks facing the City of San Diego.

Our risk assessment process began with a high level preliminary evaluation of the financial reporting entity of the City of San Diego. In the preliminary evaluation, we made three key observations:

- The majority of the accounting and comptrollership function is performed in the Auditor & Comptroller’s office,

## Appendix D – Work Performed

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- The policy making authority for functions and related financial controls is concentrated in relatively few departments, and
- Defined bureaucratic processes exist, which concentrate the control and levels of authorization for significant transactions, that materially affect the financial statements.

During our preliminary analysis, we also concluded that critical financial statement risk areas (those that are highly material) at the service level of the organization concern processes that control the transmission of information regarding the following: collection of revenues, disposition of assets and capital projects, inventory balances, contingent liabilities and items related to financial disclosure. The existence of these risks is also supported by the fact that these areas were also the subject of various restatements to the fiscal year 2003 CAFR, which are analyzed in subsequent appendices. To address these risks the Internal Control Review Team constructed an “activity level” risk assessment vehicle.

### **Activity Level Control Activities Self Assessment**

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Construction of the “activity level” risk assessment vehicle began with the identification of over 1,000 management objectives relevant to the activity of financial reporting in the private sector. These objectives were identified using information from internal audit professional practice forums. They reflect a combination of management objectives identified and employed in the process of several private sector Sarbanes – Oxley implementations.

The next phase of construction began with the culling and redevelopment of these management objectives to ensure relevance to the operations of the City of San Diego. Once all relevant activity level objectives were identified, the process of identifying the risks related to the failure of these objectives began. Throughout this process, care was taken to identify risks that would help the person responsible for completion of the assessments to identify related internal control activities designed to mitigate the risks and strengthen the likelihood that the associated management objective would be achieved.

## Appendix D – Work Performed

A sample of the Control Activities Assessment:

CONTROL OBJECTIVE (Provided)	POTENTIAL RISK (Provided)	ACTION / CONTROL ACTIVITY (Filled out by Department)	EVALUATION / CONCLUSION (Filled out by Department)			
			Adequate	Inadequate	N/A	Basis for Conclusion
Review Add-on Pay credentials to ensure pay is appropriate.	Employees are improperly paid.	Payroll Clerk maintains a spreadsheet of Add-On Pay received by each employee and the associated prerequisites for each type of Add-On Pay. This spreadsheet contains relevant information for each prerequisite and is reviewed on a quarterly basis.	X			The payroll clerk updates his/her schedule periodically and the schedule is reviewed and initialed by the Supervisor quarterly.

Upon completion, the Self Assessment was distributed to the Internal Control Liaisons (ICL) in 33 departments, component units and operating programs that are reported in the City of San Diego's CAFR. ICLs, all of whom previously attended internal control training, were asked to distribute the vehicle to appropriate personnel in the department who would complete the Self Assessment by identifying control activities that mitigate the identified risk and contribute to the success of the related management objective. ICLs were then asked to form an overall conclusion about the adequacy of the control activity documented and explain the basis for the conclusion. Finally, department managers were asked to convene meetings and assimilate individually completed assessments into one global departmental assessment, which they would review and submit to the Internal Control Review Team (ICR Team).

A total of two months were provided for the completion of the Self Assessment vehicle. During the first month the ICR team provided 12 workshops, an email helpdesk and a call-in helpline. Newsletters were distributed identifying and responding to frequently asked questions received via the helpline, helpdesk and workshops. Upon receipt of the Self Assessments, the ICR team analyzed the results and conclusions formed by departments.

### Administrative Control Activities Assessment

In our preliminary risk assessment, we identified several departments responsible for the majority of processes and activities that routinely impact the financial statements. These departments set policies and

## Appendix D – Work Performed

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perform entity-wide control functions. This has resulted in a set of homogenous control processes that govern outcomes regardless of which department is applying or executing a transaction. For example, the Auditor & Comptroller's office monitors, analyzes and documents the balances of financial statement accounts to ensure their accuracy.

We determined that additional analysis is needed in the following areas controlled by administrative departments:

- Controls over the Cash and Investments pool and related revenues.
- Controls over the calculation and execution of payroll and retirement expenditures.
- Controls over the execution of warrants and recording of the related expenditures.
- Appropriations and budgeting controls.
- Controls over the procurement process.
- Controls over indebtedness issuance and covenant compliance.
- Controls over monitoring of capital assets and related expenditures.
- Controls over contingent liabilities, litigation, and risk management.

As of the writing of this report, the analysis of the above areas is ongoing. The process employed for the analysis is similar to the methodology employed in the Activity Level Control Activities Self Assessment. The administrative assessments differ from the activity level assessments in that they are completed through an interview process and in some cases are being performed in conjunction with additional audit procedures.

### Control Activities Analysis

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Control activities are the policies and procedures that serve to mitigate risks, helping management meet its objectives. Management must periodically evaluate control activities to ensure their effectiveness and that risk is mitigated to an acceptable level.

Several factors, including control weaknesses identified through discussion with the City's external auditors, and the 30 Government-Wide Restatements identified as of draft version four of the fiscal year 2003 CAFR influenced our plan for analyzing the Control Activities segment of the Internal Control Framework. Remediation efforts were designed to address the control weaknesses exposed. In consideration of these factors, our analysis included:

- An evaluation of the control weaknesses identified by the City's external auditors and the related remediation efforts,

## Appendix D – Work Performed

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- An examination of the cause, effect, control weaknesses and remediation efforts of each Government-Wide Restatement to the fiscal year 2003 CAFR, and
- Research of Generally Accepted Accounting Principles (GAAP).

### **Discussions with External Auditors**

In our control activities analysis, we discussed with the External Auditors observations made during their audit process. We then reviewed remediation plans deemed appropriate by City Management for mitigating weaknesses observed, if applicable. Because the status of remediation efforts varied, some testing was performed on remediation efforts that were implemented prior to the report date, but follow-up testing is necessary. Additionally, since audits are not yet complete, additional control weaknesses may be identified and/or some may be reconsidered.

As part of our review, managers from the Auditor & Comptroller's office attended a meeting facilitated by our team to discuss remediation plans for control weaknesses that were recently identified by the External Auditors or that needed revisions to remediation plans. Management from other departments who were contacted regarding non-accounting related findings also provided draft responses regarding remediation efforts. Testing of these remediation efforts will be performed at a later date.

### **Evaluation of Restatements**

We evaluated and independently documented a total of 17 out of 30 Government-Wide Restatements in draft version four of the fiscal year 2003 CAFR. The procedures for evaluating each restatement included:

- Researching each accounting issue identified for compliance with current GAAP guidance,
- Organizing and categorizing restatements into logical balance sheet and business cycle segments,
- Documenting the details surrounding the need for the restatement through interviews with the responsible managers and knowledgeable staff, and
- Identifying and describing the five most pervasive control weaknesses noted during testing and their related effect to financial statement preparation.

Due to the ongoing nature of our review, 13 restatements remain to be evaluated. The Auditor & Comptroller's office is responsible for eight of the restatements and intends to review them at a later date. The other five restatements are the responsibility of component units.

Although remediation efforts are in progress for some of the restatements and control weaknesses, the implementation of the Strong Mayor form of government will initiate a major organizational change, including the

## Appendix D – Work Performed

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structure of the City's fiscal management. As a result, the design and implementation of remediation efforts may require modification.

### Collective Analysis

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Because information and communication are pervasive characteristics that affect all aspects of the internal control framework, all work performed in the course of fieldwork is related to information and communication. Both formal and informal analyses, as well as institutional knowledge and experience, influenced the conclusions drawn regarding information and communication. For example, results of opinion surveys and the restatement analysis influenced conclusions, as well as informal reviews of information systems, training programs, and policies and procedures documented on the City's intranet website.

**Throughout our analysis, candid responses were often followed by a request to not document such opinions in our work papers. Ultimately, if we were to subject the source of these comments to the public by documenting these concerns we felt it would betray the audit process. However, we felt it necessary to disclose the fact that we had not documented any of these concerns in order to maintain the integrity of this report.**

### Work To Be Performed

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In order to effectively monitor the City's internal controls, our review is ongoing and will not conclude with the issuance of this report. As we address the issues that arise in the process of our review, we will inform the Office of the Mayor and the City Council of major efforts underway. We will also continue to provide a comprehensive report on our efforts annually.

While there is not a definite timeline for completion of the implementation phase of this project, it should be noted that similar reviews have taken over two years to complete in the private sector. Our approach has been to mirror that implementation, while making use of far fewer resources than those available in publicly traded corporations. To fully implement the City Council's intent with regard to Ordinance 19320, we will:

- Complete assessments of administrative departments.
- Complete review of control weaknesses noted by the external auditors.
- Complete review of restatements to the fiscal year 2003 CAFR beginning balances.
- Develop consistent control guidelines for financial reporting and operational accounting.

## Appendix D – Work Performed

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- Implement revised procedures for and documentation of work processes for financial reporting and operational accounting.
- Test financial reporting and operational accounting control implementation.

Completion of these procedures will result in a sound approach to financial reporting and operational accounting for the City. After the implementation phase is completed, financial reporting and accounting controls have been fully documented and are considered to be effective; the project team will develop procedures for the ongoing monitoring and maintenance of the installed control framework. At this point we will have accomplished the development of a system of controls that is fully integrated and produces certifiable financial reports.

At this time the Office of the Mayor and the City Council may want to consider expanding the scope of this review and the team's charter to include review of operational and compliance controls. This would result in the implementation of a comprehensive risk management and quality assurance program similar to those seen in the private sector.