



THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Recommendations for an Independent External Audit of the City's Internal Controls

OVERVIEW

On March 5, 2012, the Audit Committee discussed factors to be considered in commissioning an independent audit of the City's internal control environment in FY 2013. Acknowledging the City Comptroller's concern that the City be ready for an internal controls audit before initiating the audit, the Committee requested the IBA use feedback from the Office of the City Comptroller and other sources to 1) develop a proposed Statement of Work for the audit to be discussed at their Committee meeting in April and 2) develop RFP language for the Committee to consider no later than their June meeting.

This report provides background information and discusses the City's readiness for an internal controls audit. We additionally discuss audit goals, audit approaches and statements of work that should be guided by audit objectives. Finally, we present options for retaining an internal controls auditor and note challenges associated with obtaining audit cost estimates at this time.

FISCAL/POLICY DISCUSSION

Background

The Kroll Report was issued in August of 2006 and included approximately 145 recommendations to be addressed by the City. These recommendations can be found in Section XII (beginning on page 240) and Appendix M of the Report. Two years ago, the City Comptroller reported that approximately 97% of these recommendations had been remediated. Perhaps the only significant remaining Kroll recommendation to be addressed is for the City to obtain an independent audit of its internal controls. Specifically, the recommendation on page 248 of the Kroll Report reads as follows:

“A reputable independent auditing firm should be retained by the City’s new Audit Committee, which should, in connection with the annual audit of the financial statements of the City for the fiscal year ending June 30, 2008, conduct an audit of the City’s internal controls, in accordance with the applicable auditing standards, and issue a report thereon. Such report should, among other things, identify any material weaknesses and be included as part of the City’s CAFR.”

This Kroll recommendation followed release of the City’s Annual Report on Internal Controls (dated January 1, 2006) in which the then City Auditor & Comptroller reported “we are unable to conclude that the City’s internal controls over financial reporting are adequate to assure timely and accurate financial reporting.” Kroll recommended that the internal control weaknesses identified in the 2006 Report be tested and remediated before initiating an independent audit of the City’s internal controls.

Private sector companies have been required to obtain annual independent internal control audits since the adoption of the Sarbanes-Oxley Act of 2002. It is important to note that public agencies (i.e., cities) are not required to obtain independent audits of their internal controls. A city’s independent financial statement auditor will routinely perform a limited review of internal controls to assess organization risk and determine the appropriate level of audit procedures or testing necessary for an annual financial statement audit; however, this limited review does not constitute a comprehensive audit of an organization’s internal controls. It is reasonable to conclude that Kroll’s 2006 recommendation was atypical and indicative of their concern about the City’s internal control deficiencies.

In making a motion for the City Council to receive and file the City’s FY 2009 CAFR on February 1, 2010, Councilmembers Faulconer and DeMaio requested the IBA consult with the Mayor’s staff and develop a recommendation for the timing of an independent audit of the City’s internal controls. At the time, the City Comptroller’s schedule called for 263 of 264 process narratives to be completed by December 2010. Based on that information, the IBA recommended an independent audit of the City’s major internal control processes be conducted over the course of a year, beginning in January 2011, in order to be considered in the financial statement audit process for either FY 2011 or FY 2012 (IBA Report 10-22 dated March 4, 2010). In his Third Annual and Final Report (dated February 4, 2010), the City’s Independent Consultant also recommended the City strive to initiate an internal controls audit in 2011.

Changing circumstances and priorities challenged the aforementioned recommendations. Numerous additional processes were identified which necessitated Process Narrative development. The City’s new financial system was being installed/developed. Key staff was also focused on the City’s financial statements. Although the City Comptroller’s Internal Controls Section (ICS) has continued to make steady progress in developing and documenting the City’s internal controls, the Comptroller recently reported that the City is still not ready for a comprehensive audit of its internal controls.

Process Narrative Update and Readiness for an Internal Controls Audit

The development and documentation of Process Narratives for identified internal control processes is one important measure for gauging the City’s readiness for an internal control audit. Other factors for assessing audit readiness include internal control testing, staff training, SAP system integration and control adjustments following testing. In the most recent Annual Report on Internal Controls, dated December 29, 2011, the City Comptroller notes the number of identified Process Narratives has grown to 415. Comptroller staff has informed the IBA that 247 Process Narratives have been completed to date and another 25 are under development.

With respect to internal controls over financial reporting (ICOFR), Comptroller staff indicates 336 of the 415 identified Process Narratives are ICOFR related. Approximately 228 of the 336 ICOFR processes have been completed or are underway. It should be noted that based on the recent pace of Process Narrative development, approximately 100 of the 415 identified Process Narratives may not be completed by November 2012 – many of which may be ICOFR controls.

At the last Committee meeting, the Comptroller noted there was some risk associated with implementation of the recently released SAP Governance, Risk and Compliance module (GRC 10.0). The GRC 10.0 module will allow the ICS to expand its testing and monitoring capabilities beyond current levels. Given the possibility of GRC module implementation challenges and that approximately 100 Process Narratives may remain to be developed, the IBA has some question about the City's readiness for a comprehensive internal controls audit in November 2012. Noting that the City has at least one more year of structural development of its internal controls environment until reaching a steady operational state, the CFO concluded the Annual Report by stating that management will be prepared for an external risk audit beginning November 2012.

Goals and Possible Approaches for an Internal Controls Audit

In addition to satisfying the outstanding Kroll recommendation, the IBA believes the City should have a goal or objective for the contemplated internal control audit. If the City believes it is ready for a comprehensive internal controls audit, the goal should be to receive an unqualified audit opinion. An unqualified audit opinion would be an independent/expert assessment that the City has developed a sound internal control environment. It would further acknowledge the City's significant fiscal reforms and also provide assurance to the public and capital markets.

Alternatively, if the City does not believe it is ready for a comprehensive audit, the goal for an audit might be to receive an independent assessment of how much progress we have made, what remains to be done and if our current approach is sound. Audit findings might be used to improve current internal control development processes and/or to comment on the significant work that has already been performed by City Comptroller staff. It should be noted that the City's SEC recommended Independent Consultant (Stan Keller) retained the independent audit firm of McGladrey & Pullen LLP to assess, and work with, Comptroller staff two to three years ago as they were initially developing the current approach to address internal control deficiencies. To a limited extent, the City received the benefit of McGladrey & Pullen's expert oversight/feedback early in the internal control development process.

If the Committee's goal is to receive an unqualified opinion on a comprehensive internal controls audit, the IBA recommends the Committee have reasonable assurance from the Comptroller that the City's internal controls environment is ready for a successful audit. While the outcome of an audit cannot be known in advance, Comptroller staff are the in-house experts and in the best position to advise the Committee. The CFO has indicated that the City will be ready for the audit in November; however, there appears to be some uncertainty as to the City's readiness at that time.

Proposed Statement of Work

If the Audit Committee decides to pursue a comprehensive internal controls audit, the IBA believes it makes sense to replicate key elements of internal control audits required in the private sector. Based on feedback from independent audit firms and City Comptroller staff, there is agreement that such an audit should be structured around the two frameworks that provide private sector guidance on internal control systems: 1) Committee of Sponsoring Organizations of the Treadway Commission (COSO) and 2) Control Objectives for Information and Related Technology (CobiT).

City Comptroller staff prepared an internal controls plan entitled **Internal Controls Roadmap – Progress and Future Activities** (Attachment 1 to the 2011 Annual Report on Internal Controls). This plan provides a good overview of the COSO and CoBiT frameworks; discusses what an internal controls audit might focus on; and describes their plan to prepare for an internal controls audit. The IBA believes the Comptroller’s Roadmap can serve as a good starting point for developing a detailed statement of work for a comprehensive internal controls audit - once the Audit Committee determines the City’s internal controls are ready to be audited.

If, alternatively, the Audit Committee prefers to initiate an internal controls audit before November 2012 or before the City’s internal control system is ready to be audited, a more limited audit could be requested. For example, the statement of work could be to 1) request a consulting opinion on the City’s internal controls development approach or 2) request a targeted audit of major internal control process areas (e.g., payroll or accounts payable).

Options and Estimated Costs for Retaining an Independent Internal Controls Auditor

Perhaps the best option to quickly retain an internal controls auditor would be to consider the City’s independent financial statement auditor - Macias Gini & O’Connell (MGO). The City has a five-year agreement with MGO that allows for optional audit services (this would reasonably include an internal controls audit). MGO is familiar with the City’s operations and capable of providing any of the above discussed approaches to this audit. They are also in the best position to rely on internal control audit findings in performing the financial statement audit for FY 2013.

Alternatively, the City could develop a Request for Proposals (RFP) to solicit other independent audit firms to perform any of the above discussed approaches to an internal controls audit. If an RFP were to be developed and issued in June, an independent auditor could reasonably be selected by November 2012.

The IBA inquired about the estimated costs associated with different internal audit approaches. Understandably, audit firms are reluctant to estimate costs until a statement of work can be clearly defined. Once the Audit Committee provides direction on the type of audit they would like and the goals for that audit, the IBA should be able to return to Committee with cost estimates for consideration in the FY 2013 budget process.

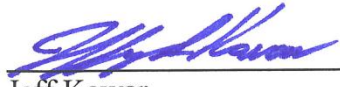
CONCLUSION

The IBA understands and supports the Audit Committee's longstanding desire to address the remaining Kroll recommendation for an independent audit of the City’s internal control environment. A positive/unqualified audit opinion would further acknowledge the City's significant fiscal reforms and also provide assurance to the public and capital markets. It might also help to reduce future financial statement audit costs.

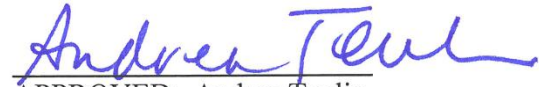
However, we do not recommend proceeding with a comprehensive internal controls audit until the Committee receives reasonable assurance from the Comptroller that the City's internal controls environment is ready for a successful audit. An unfavorable or qualified audit opinion provides limited benefit to the City. If the Comptroller does not have certainty about an audit readiness date, the Audit Committee may wish to ask if additional resources or alternative resource deployment could accelerate audit readiness.

Alternatively, the Audit Committee may wish to consider a limited audit of certain internal control process areas or request an auditor opinion on the City's current internal controls development approach. While these alternatives could be pursued more quickly and at a lesser cost, the resulting benefits would be different than a favorable audit of the City's overall internal control environment.

It should also be noted that any of the aforementioned audit approaches will probably require significant interaction with the Comptroller's ICS staff thereby reducing their time to continue to build the City's internal control environment. This should also be a consideration to the extent that one of the more immediate audit approaches is considered.



Jeff Kavar
Fiscal & Policy Analyst



APPROVED: Andrea Tevlin
Independent Budget Analyst