



THE CITY OF SAN DIEGO

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## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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**IBA Report Number:** 12-25

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# Update on Discussions of How to Best Address Audits of the City's Internal Controls

## OVERVIEW

At the Audit Committee meeting on April 9, 2012, the IBA presented Report 12-14 discussing considerations and recommendations related to an independent audit of the City's internal controls. In recent years, the Audit Committee has repeatedly expressed their desire to initiate an independent audit of the City's internal controls in response to an outstanding recommendation from the 2006 Kroll Report (the Kroll Report provided a Remediation Plan with numerous recommendations seeking to achieve the following four principal compliance objectives: enhanced accountability; greater transparency; increased fiscal responsibility; and independent oversight). Management has expressed concerns about the potential cost, benefit and readiness for a comprehensive audit of the City's internal controls.

IBA Report 12-14 recommended the City initiate an internal controls audit when the Comptroller is able to provide the Committee with reasonable assurance that the City's internal controls are ready for a successful audit. The Comptroller had previously informed the Committee that the City may be ready for an independent audit of internal controls by November 2012, but would continue to provide periodic readiness updates. Based on subsequent discussions with the Comptroller and his Internal Controls staff, the IBA noted that as many as 100 internal controls may remain to be documented, implemented and tested in November 2012. Without reasonable assurance that the City is in a good position to receive an unqualified audit opinion, the IBA would not support the estimated expense and staff time required to facilitate a comprehensive audit of the City's internal controls.

The Audit Committee has alternatively discussed the possibility of initiating annual audits of City process areas where updated internal controls are in place. This approach could enable the City to initiate targeted internal control audits at a lesser cost with a greater expectation of a successful audit result. This report provides a brief update on recent discussions on how to best address internal controls audits.

## FISCAL/POLICY DISCUSSION

Chairman Faulconer recently convened a meeting with the COO, Comptroller, City Auditor and IBA to discuss considerations associated with initiating audits of the City's internal controls. The participants agreed the City may not be ready for a comprehensive internal control audit in FY 2013 and that the cost of such an audit could be significant (over \$1 million). There was further agreement that the City could alternatively be responsive to the Kroll recommendation by performing annual audits of internal controls for select City process areas, particularly those process areas related to financial reporting. The Comptroller suggested disclosure, payroll and treasury functions as initial internal control audit possibilities.

There was also discussion as to whether internal controls audits could or should be performed internally by the Office of the City Auditor, or whether they should be assigned to outside independent audit firms (i.e., Macias Gini & O'Connell, the City's current independent auditor). If asked to perform the audits internally, the City Auditor has indicated he would either need to add staff with internal control audit experience or obtain specialized training for existing staff.

The City Auditor was asked to research/report back on cost considerations and options for either performing these audits internally or externally. As of the date of this report, the City Auditor is in the process of researching internal control audit options and associated costs. Based on preliminary research, the City Auditor has informed the IBA they are exploring the following options:

1. Using an employment placement agency, specializing in audit and finance professionals, to annually provide audit staff with internal control audit experience on an as-needed basis.
2. Reviewing the existing agreement with Macias Gini & O'Connell to see if limited internal control audits could be performed in conjunction with the financial statement audits for FY 2012 and FY 2013 - within the current annual compensation limits.
3. Checking the cost, availability and interest of other independent audit firms with internal control audit experience.
4. The Office of the City Auditor could endeavor to hire auditors possessing internal control audit experience OR obtain specialized training for existing staff.

Funding for an internal controls audit was not included in the FY 2013 Proposed Budget. Depending on the results of the City Auditor's research, annual internal control audit work may be able to be absorbed within the current independent auditor agreement or by seeking specialized training for City Auditor staff. However, the IBA is recommending setting aside \$150,000 for internal controls audits in FY 2013 until further information is available.

## CONCLUSION

On April 9, 2012, the Audit Committee discussed initiating audits of the City's internal controls. Following that discussion, the IBA was asked to develop an audit scope of work that could be incorporated into a request for proposals; however, it was difficult for the IBA to respond to this direction without knowing if any, or all, of the City's internal controls over numerous process areas were ready to be audited (subject controls/process areas need to be described in detail in

order for audit firms to develop bids for the work). Given this circumstance, Chairman Faulconer called for a meeting with the COO, Comptroller, City Auditor and IBA to discuss how to best initiate audits of the City's internal controls.

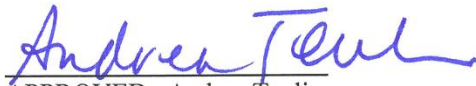
The meeting yielded two significant understandings: 1) the City may not be ready for a comprehensive audit of all internal controls in FY 2013 and that the cost of such an audit could be significant (over \$1 million) and 2) the City could be responsive to the Kroll Report recommendation for an internal control audit by annually undertaking smaller internal control audits over process areas that impact financial reporting.

The Comptroller suggested disclosure, payroll and treasury functions areas might be good candidates for initial internal control audits in FY 2013. The City Auditor is in the process of researching cost considerations and options for either performing these audits internally or externally. As noted in this report, there appear to be several viable approaches for performing smaller internal control audits.

Depending on the results of the City Auditor's research, annual internal control audit work may be able to be absorbed within the current agreement with Macias Gini & O'Connell or by seeking specialized staff/training for the Office of the City Auditor. In the event a decision is made to hire an independent audit firm to perform these audits, the IBA is recommending setting aside \$150,000 for internal control audits in FY 2013.



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