Annual Report on Internal Financial Control

Calendar Year 2018

Department of Finance
March 1, 2019

The City of
SAN DIEGO

Executive Summary

This Annual Report on Internal Control is issued pursuant to City of San Diego Municipal Code (SDMC) §22.0706, adopted by the City Council in October 2004 via Ordinance 19320 to achieve a high standard of quality in and efficacy of the City of San Diego's (City's) financial reporting and disclosure practices. SDMC §22.0706 requires that management:

1. Perform an annual evaluation of the City's internal financial controls;
2. Submit a written Annual Report to the Audit Committee and the City Council on management's annual evaluation of the City's internal financial controls;
3. Submit a Certification by City Management regarding the design, maintenance, and effectiveness of the City's internal financial controls.

The objective of a system of internal controls over financial reporting is to provide reasonable assurance that the financial information produced is reliable and that it reflects the City's transactions and events for the reporting period. It is not intended to be perfect by eliminating all risk, as this would be cost prohibitive. Rather, the controls are intended to be effective in mitigating the risk of financial reporting errors to a level that is acceptable based on considerations of materiality. Materiality is the threshold above which missing or incorrect information in financial statements is considered to have an impact on the decision making of users.

Establishing effective internal controls is a continuous process. Management actively assesses risk, as financial reporting standards or requirements change and new software or technology is implemented. Risk can also increase as accounting and reporting processes change and as there is turnover in management and staff. As new risks are identified, management responds by implementing or enhancing controls to mitigate such risks.

Within the last 90 days, management evaluated the City's internal financial controls. Based on this evaluation, management concludes that the internal financial controls over financial reporting are effective.

This report summarizes management's approach to maintaining an internal control system that provides reasonable assurance that financial reporting objectives are met. The City's internal controls over financial reporting improved significantly with the implementation of its Enterprise Resource Planning System (SAP). SAP, combined with hundreds of processes and controls that have been developed through the years allow for the production of reliable financial information. This report includes some of the significant enhancements that have been achieved during the year and some of the potential risks that were identified, either by management or through the audits performed by independent auditors and the Office of the City Auditor (City Auditor). Other than what has been included in this report, management did not identify any 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.

The list below identifies the most significant financial reporting achievements and internal control improvements implemented by the Department of Finance (DoF) during the assessment period.

Financial Reporting Achievements and Internal Control Improvements

- Received an unmodified (clean) audit opinion on the City's Comprehensive Annual Financial Report (CAFR). No material adjustments and no material weaknesses or significant deficiencies in internal controls over financial reporting were identified through the fiscal year 2018 CAFR independent audit.

- Received a Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association (GFOA) for the fiscal year 2017 CAFR. This is the fourth consecutive year the City has received this award. In order to be awarded a Certificate of Achievement, the City had to publish an easily readable and efficiently organized CAFR that satisfied both generally accepted accounting principles and applicable GFOA program requirements.

- Implemented a new CAFR enhancement software in 2018, which enhanced the preparation and controls over the City's Comprehensive Annual Financial Report (CAFR). DoF gained process efficiencies for this important document, which is relied on by many stakeholders in various financial and investment industries.

- Delivered assessments of currently documented significant processes to the process owners to evaluate continued relevance and effectiveness. Worked with process owners to revise processes and related controls identified for changes during the calendar year 2018 assessment.

- Trained all professionals in the DoF on budget and financial reporting to ensure that staff understands and is aware of the importance of internal controls which are necessary to perform their job duties.

- Established a Finance Academy to educate newer and established staff on the variety of financial topics spanning Budget, Treasury, Debt, and Accounting functions. These Academies are intended to be held annually.

- Additional updates made to the SAP Governance Risk and Compliance module (GRC) which is utilized to identify and mitigate risk across system user access rights, segregation of duties and process performance.

- Actively working with key departments in monitoring salary overtime trends and remedies. In addition, put in place an Overtime Dashboard Reporting Tool to allow department management to view overtime budget, costs, and hours in the organization.

- The Citywide effort to update all Administrative Regulations (A.R.) continued with many revised A.R.'s being issued during calendar year 2018.

- Merger of the Office of the City Comptroller and Financial Management departments. In an effort to promote operational efficiencies and customer service, the Office of the City Comptroller and Financial Management merged into the DoF during the year. The consolidation will allow for the reduction of certain redundancies and creating a more efficient, consistent work load throughout the fiscal year.

Background

The City is accountable to San Diego residents and outside stakeholders for the management of the City's financial and economic resources. It meets this responsibility in large part by preparing a CAFR each year. The CAFR is the most significant financial report produced by the City for external users. It is available on the City's website and can be accessed by residents, investors, rating agencies and other interested parties. The CAFR is a comprehensive financial document that includes the balances and activity of all funds and component units of the City and related disclosures. The report typically takes five months to prepare and involves the work of numerous staff in the DoF, as well as key outside department staff who provide necessary information for required disclosures. The CAFR is prepared in accordance with Generally Accepted Accounting Principles (GAAP), which are established by the Governmental Accounting Standards Board (GASB). The CAFR is audited annually by an independent auditing firm who expresses an opinion on whether or not the basic financial statements are fairly presented in all material respects in accordance with GAAP.

The City also produces other financial reports for external use such as the Schedule of Expenditures of Federal Awards, which summarizes all expenditures of federal awards for the fiscal year and is subject to a single audit by an external independent auditor (Single Audit). Annually, the City's external independent auditor also conducts an audit of the schedule of costs related to the Metropolitan Wastewater System and the City's allocation of such costs to Participating Agencies (MWWD Allocation of Billing Schedule). There were no reportable findings or material weaknesses noted during the last audit periods.

Internal control over financial reporting is defined as a process established by an entity's governing body, management and other personnel, which has been designed and implemented to provide reasonable assurance regarding the achievement of financial reporting objectives. The main internal control objective in preparing external financial reports is that the information included in the report is reliable and that it reflects the City's transactions and events for the reporting period in accordance with GAAP or other reporting requirements.

The most authoritative guidance on internal control over financial reporting is the integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The City's internal control program is based on this framework. The framework put forth by COSO is comprised of five fundamental components which, when present and functioning together, work towards the goals of reducing risk to an acceptable level and achieving objectives for reliable financial reporting. These five fundamental components include (1) Control Environment, (2) Risk Assessment, (3) Control Activities, (4) Information

and Communication, and (5) Monitoring Activities. Our assessment of internal control over financial reporting focused on an evaluation of each of these five components.

Control Environment

The Control Environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The Control Environment sets the tone of the organization and represents what is commonly referred to in the private sector as an entity's "corporate culture." It encompasses the City's integrity and ethical values; the City Council and Mayor's oversight, responsibilities, and delegation of authority; the process for attracting, developing and retaining employees; and the measures, incentives and rewards used to manage accountability and performance. The City has established policies and practices that provide for a strong control environment through the City Charter, San Diego Municipal Code, Management Policies and Practices, and a comprehensive Financial Training Program.

City Charter

The San Diego Charter governs the daily governmental functions of the City. It identifies the rights and authority of the Mayor, City Council, and other City departments. City Charter Section 39 gives supervision and oversight responsibility over all financial accounts of the City to the Chief Financial Officer. It requires that all financial transactions of the City be performed based upon forms prescribed by the Chief Financial Officer. Charter Section 39 also establishes an independent audit committee to oversee the City's auditing function. The Audit Committee is composed of two members from the City Council and three members from the public who possess the appropriate technical expertise to carry out this responsibility.

Charter 39 also establishes independent departments to assist the City Council in establishing checks and balances over the executive branch, including the Independent Budget Analyst and the City Auditor. The Independent Budget Analyst provides budgetary and policy analysis for the City Council. The City Auditor is responsible for the internal audit function of the City, with authority to investigate any material claim of financial fraud, waste or impropriety within any City department. The City Auditor reports to the Audit Committee.

San Diego Municipal Code

The City of San Diego Municipal Code (SDMC) incorporates all ordinances passed by the City Council and approved by the Mayor. On October 11, 2004, Ordinance No. 19320 incorporated Division 41: *Securities Disclosure*, which establishes the Disclosures Practices Working Group (DPWG), a group of senior City officials and disclosure counsel responsible for ensuring compliance by the City with federal and state securities laws, and for promoting the highest standards of accuracy in disclosures relating to securities issued by the City or by its related entities. As required by the SDMC, the DPWG has developed the Disclosure Controls and Procedures to effectuate its responsibilities under the SDMC.

The Disclosure Controls and Procedures establishes process requirements over the development of documents that have disclosure obligations under applicable federal and state securities laws, including bond documents and the City's CAFR. It establishes responsibilities for development and review of the financial documents and requires certification by those department heads that contribute information for development of such documents.

In addition, the SDMC establishes the Ethics Commission, which contributes towards a strong control environment for the City. As an independent department, the Ethics Commission monitors, administers and enforces the City's governmental ethics laws, conducts investigations, refers violations to appropriate enforcement agencies, reviews disclosure statements and advises and educates City officials, candidates, political committees, and lobbyists about governmental ethics laws.

Management Policies and Practices

The Chief Operating Officer issues Administrative Regulations (A.R.'s) to establish policies and procedures of a continuing nature and to direct operations within the City. Additionally, departments involved in complicated, lengthy, or detailed operations are required to work with the Internal Controls Section in the DoF to develop and issue Process Narratives and Work Instructions to detail the performance of these operations. Also, citywide Policy Memorandums are sent out as necessary to clarify or establish policies and procedures for the City's Mayoral departments. The City's policies and procedures are communicated to employees via Citywide email or by posting on the City's intranet and internet.

In 2017, A.R. 95.39–*Management Responsibilities for Internal Financial Controls* was established to provide a strong enhancement over the City's control environment. The A.R. establishes responsibility for developing citywide financial policies and procedures within the Finance Branch, including citywide dissemination of such policies and training as appropriate. It also emphasizes the role of the Executive Management Team in creating an organizational culture that supports the internal control environment

Financial Training Program

The City has implemented a comprehensive financial training program adopted on December 6, 2006 by Resolution R-302243. Financial Statement Overview training is one component of the program for elected officials providing them a general understanding of the City's financial statements. Other financial trainings are conducted for the City Council as appropriate, including a commercial paper overview program held in January 2019. In addition, the City has established mandatory securities law training for members of management, relevant City staff and elected officials, which will be scheduled during calendar year 2019.

Continuing education for professional staff who have financial responsibilities is critical for delivering comprehensive and accurate financial information to the City's stakeholders. The City's Chief Financial Officer requires financial professionals to grow and maintain their

professional competencies in all areas of accounting, reporting, compliance, internal controls, grant analysis, debt management, ethics, and any other finance related field. This is accomplished through training policies that have been tailored to promote competencies in each department's respective area. The DoF training policy requires that staff engaged in accounting, financial reporting, budget, and payroll functions participate in a minimum of 40 hours of formal subject matter training per year. A list of training courses provided by the City are accessible through the City's intranet and through SuccessFactors Learning. SuccessFactors is a system designed to manage all the City's learning needs allowing employees to register for courses and track progress.

Other

Other practices and policies contributing to a strong control environment for the City include the adoption of an Employee Code of Conduct, the Fraud, Waste and Abuse Hotline, and the Annual Report on Internal Financial Control.

Risk Assessment

A continuous and effective assessment of risk is a critical component of the internal control framework because it allows management to form a basis for determining how risk should be managed and mitigated. It allows management to identify the need for control and monitoring activities, improvements to the flow of information and communication or the need for changes to the control environment.

COSO defines "risk" as the possibility that an event will occur and adversely affect the achievement of objectives. As noted earlier, the main objective in preparing the CAFR is that the information included in the report is reliable and that it reflects the City's transactions and events for the reporting period in accordance with GAAP or other reporting requirements. The policies and procedures established for financial reporting include controls that have resulted from management's risk assessment and its efforts to mitigate such risks.

Management's Risk Assessment on CAFR

At the beginning of each CAFR preparation cycle, management communicates areas of potential risk to the City's independent auditor based on management's risk assessment and ongoing monitoring activities, including management's response to such risks through development and implementation of additional controls. Additionally, several manual processes that are vulnerable to human error have been mitigated with the implementation of new software used for the FY 2018 CAFR. Built-in automation for complex data table updates and document version control are among the benefits recognized during the reporting period. As experience with the program increases, so will the opportunities for efficiencies and controls over CAFR reporting processes.

Changes in Accounting Standards

To mitigate the risk associated with changes in accounting standards, the DoF staff that have primarily CAFR preparation responsibilities are provided training throughout the year, including an annual GFOA training introducing new accounting pronouncements, and further disseminating this information through cross-training within the department. Staff actively review all new standards to determine the applicability and requirements to properly implement in the effective reporting period. Staff will also work closely with the City's outside auditors to ensure full compliance with reporting standards are met.

Each fiscal year, the Department of Finance identifies new accounting standards promulgated by the Governmental Accounting Standards Board (GASB) and evaluates it for potential financial impact. Research is assigned to the appropriate accounting section in the department for in-depth analysis and implementation. In Fiscal Year 2018, the City successfully implemented GASB Standard No. 75 regarding Other Post-Employment Benefits and is currently researching the standards applicable for the Fiscal Year 2019 CAFR.

Changes in Technology

The City continues to modify and add modules to the core ERP system in order to maximize the efficiency and span of control over business operations and reporting. Each of these changes introduces the risk of system generated errors, which are mitigated through configuration testing. The impacted departments such as, the DoF, Department of Information Technology (DoIT), Purchasing and Contracting, Risk Management, and City Treasurers all work closely to ensure that any changes or improvements to the system are all fully tested for operational needs and for the impact to financial reporting. At the completion of testing, sign-offs are required by the individuals involved.

In 2018 the City launched I AM San Diego Enterprise Asset Management module to more efficiently deliver various service needs to residents and for city facilities. The complexities of the program from an internal controls perspective necessitated several iterations of comprehensive testing from work request initiation, payroll and settlement processing, and proper role assignments to affected groups. Both phases of the project were implemented according to schedule with minimal impacts to existing payroll processing or other critical financial control activities.

We have not identified significant deficiencies over internal financial controls that could impact the financial statements. However, due to the interrelationship between the SAP modules, there is a risk that changes to a module could impact others. There is also a risk that system errors are not identified through testing. To address these risks, the production changes are reviewed after implementation and newly identified system errors are communicated for correction. Management identifies the significant financial risks that require additional monitoring.

Risks associated with system changes and SAP enhancements are also mitigated with training, feedback and question & answer workshops which are provided to end users before and after implementation. Additionally, users can access training videos which are readily available online via SuccessFactors. Work Instructions or Process Narratives are also developed or updated as needed.

Risks identified through Internal Audit Function

The DoF participates in City Auditor audit entrance and exit meetings with City departments. This allows the department to be aware of and to efficiently and effectively address concerns that have an impact on accounting and financial reporting, safeguarding of City assets, and issues affecting the internal control environment. The DoF also participates in the remediation of performance and hotline audits if the City Auditor directs departments to work with the Internal Controls Section to document processes and or to strengthen internal controls. Currently the DoF Assistant Director is the mayoral designee that sits on the Audit Committee as a non-voting member to advise and assist the committee as needed or requested.

In 2018, the City Auditor identified potential weaknesses in the City's payroll procedures related to Paid Time Off for Court Leave – Jury duty that could allow employees to receive compensation for service that was never performed and made a recommendation to establish and implement review procedures to ensure that backup documentation is on file as required by the Personnel Manual. The Internal Controls Section is finalizing the creation of a recurring monitoring exercise to ensure compliance with the City Auditor's recommendation and that the City has proper internal controls over Paid Time Off for Court Leave – Jury duty and are adhered to. It is important to note that this issue did not have material impact on the City's Financial Statements.

The City Auditor also determined that the City was not completing all of the State's reporting requirements of Compensation Reports submitted annually to the State Controller's Office. Although the information by individual eligible employee was not available via the San Diego City Employees Retirement System, the defined benefit pension contribution amount was not included in the total compensation amounts per position classification. An allocation methodology to apply the annual defined benefit cost among eligible employees has been established and will be added to Compensation Reports in a restated 2017 version and all subsequent submissions. Also important to note is that the State did not deem the City out of compliance with prior filed reports.

Control Activities

Control activities are the next logical step in response to risks identified through management's risk assessment. COSO defines *control activities* as the actions established through policies and procedures that help ensure that management's directives to mitigate risks are carried out. In the preparation of financial reports for external use, these are the

policies and procedures, with embedded controls, that management develops and implements to mitigate risks of errors and omissions that could affect the reliability of the information presented in the reports. It also includes controls embedded within the City's ERP system.

Budgetary Control

The City adopts an annual budget authorizing the expenditure of funds based on current financial resources. Budgetary control and monitoring is a fundamental element of a government's system of internal controls. Through the budget preparation process, management estimates annual revenues providing a basis for evaluating actual revenue as it is recorded during the fiscal year. Similarly, expenditures are monitored against those expenditure levels authorized in the budget. For the City, budgetary control is exercised at the department level for the General Fund and at the fund level for all other funds. In addition, the budget authorized for personnel expenditures (salaries and wages) for a fund or department may not be used for non-personnel expenditures. The City's financial system incorporates embedded controls in which non-personnel expenditures cannot be incurred if a budget appropriation is not available. The City also uses an encumbrance system of accounting as a mechanism to accomplish effective budgetary control. The budget and accounting structure that SAP maintains for expenditure control has the added benefit of ensuring that expenditures are properly categorized in the CAFR by function. For example, expenditures charged against the Police department's budget will be reported as "Public Safety Expense" in the CAFR, with very low risk of misclassification.

Transaction Control Activities

The implementation of SAP provides the foundation for a well-designed internal control framework. SAP allows internal controls to be embedded in the system through restricted access, segregation of duties and authorization workflows. These controls allow for review, validation and approval of transactions, not only mitigating the risk of fraud but also preventing transaction errors or instances of non-compliance with laws and regulations.

The majority of user interactions within SAP occur in various departments as they perform their core responsibilities. Often transaction workflows cross departments in order to properly segregate duties and mitigate the risk of fraud. For example, the DoF processes employee payroll, but only the Personnel department can change an employee's hourly compensation rate in SAP. Other transactions include vendor payments, generation of City invoices, cash deposits, payroll transactions, journal entries, most of which segregate the creator of the transaction from the approver. These interactions make their way into the financial system either through direct input or through some type of interface application. The City's financial activity is consolidated with similar types of activities and is eventually presented in the CAFR and other financial reports.

Over the years, the City has implemented a variety of control activities over financial transactions. Where automated controls are not available, manual controls are used. These

control activities ensure that the financial information is complete, accurate and valid. Below are some of the control activities embedded in the City's multiple accounting and financial reporting processes:

- Authorizations and approvals that affirm that a transaction is valid, such as the approval of a journal entry or an invoice payment;
- Verifications- comparing two or more items with each other, such as comparing goods received against a purchase order;
- Physical controls, such as comparing fixed asset inventories against control records;
- Reconciliations – comparing two data elements and taking action when differences are identified to bring the data into agreement, such as reconciling bank accounts to the general ledger;
- Supervisory controls that assess whether other transaction control activities are being performed completely, accurately and in accordance with policy; and
- Application Controls are those related to procedures to check the accuracy of the output data, including follow-up on exceptions, the Business System Analysts in DoIT and the Business Process Coordinators in City departments (including the DoF) validate and approve any functional changes in the SAP system. Security related changes are also reviewed by the Internal Controls Section. The Control Change Board reviews documentation, testing, and approvals before implementing the change in production.

Internal Controls Section

The Internal Controls Section of the DoF provides dedicated staff focused on maintaining and enhancing the City's control environment. The Internal Controls Section is involved with the implementation or monitoring of new software modules, including the recent launches of IAM San Diego and ARIBA. The Internal Controls Section reviews the projects for process gaps, control weaknesses, segregation of duties, system access, how data transfers to SAP, and assists in the development of Process Narratives and Work Instructions.

Control Activities deployed through Policies and Procedures

Management incorporates controls into financial reporting activities by establishing clear accounting policies and developing and implementing accounting procedures. Policies reflect management's statements of what should be done, guiding the actions of staff. Procedures consist of actions that implement a policy. Having policies, procedures and controls is key to preventing and detecting material errors and fraud. It is essential that policies are current, formally documented, and easily accessible to all employees.

In 2016, the Human Resources department initiated the Citywide efforts of updating existing A.R.s and Department Instructions (D.I.)'s as an additional method to strengthen the control environment. The A.R.s and D.I.s direct administrative policies and procedures of a continuing nature. It is important that our policies as documented reflect the actual processes. The City's effort to update all A.R.s began with the revision of A.R. 1.00 Administrative Regulation and Department Instruction Preparation Procedures which added the involvement of the Internal

Controls Section with all future revisions of A.R.s or D.I.s. To date the City of San Diego has over one hundred documented A.R.s, of which 56 were updated or newly added between 2016 and 2018. The Human Resource department is currently working on completing new A.R.s and updating 33 A.R.s during calendar year 2018.

The Internal Controls Section reviews and approves policies and procedures included in the A.R.s to ensure internal controls exist to mitigate risks and improve efficiency. In 2018 during a review of an Administrative Regulation, the Internal Controls Section identified improvements in the current monitoring review of Tuition Reimbursements. This leads to enhancing the current process to ensure compliance with the City's policies and procedures.

The DoF continues to focus on formally documenting policies and procedures related to accounting and financial reporting. Most of these policies and procedures have been long-standing practice and consistently applied each fiscal year. This allows the City to have a formal inventory of procedures and related controls that can be systematically monitored for effectiveness and continued relevance. The DoF has identified approximately 827 processes that require documentation of which 592 have been formally documented. The DoF has prioritized documenting those processes that have a material impact on the preparation of the CAFR. Of the 827 processes identified, approximately 642 relate to the CAFR, all of which 468 have been documented. The total number of processes to document changes annually as new processes are identified, new accounting standards are issued, and new software or technology is implemented, as accounting and reporting processes change (i.e. automation) and as new risks are identified by management. In Fiscal Year 2018, the DoF documented 103 processes and will continue efforts in the current year

Information and Communication

The Information and Communication component of the COSO framework supports the functioning of all components of internal control. COSO defines communication as the continual iterative process of providing, sharing and obtaining necessary information. In an organization as large as the City, it is critical that management establishes effective communication procedures to meet accounting and disclosure requirements under governmental accounting standards and under state and federal securities laws.

Formal Communication Processes

The City has formal communication processes to ensure relevant information is communicated effectively to those responsible for preparing the CAFR. The DPWG includes individuals in key City positions within the City and external counsel that can review disclosures, communicate known facts and other relevant information and ensure consistency throughout the City's financial disclosure documents. The DPWG has formal disclosure controls and procedures that define roles and responsibilities over the development and review of financial disclosures. These controls and procedures require that the City's Chief Financial Officer certify to the City Council that the City's financial statements included in the CAFR are

fairly presented and that disclosures are true and complete. Similarly, department directors are required to also certify that contributions made by their staff have been reviewed by the director and that the information is accurate and complete.

While the DPWG is responsible for ensuring that disclosures comply with federal and state securities laws, the DoF is responsible for ensuring financial statements and related disclosures are prepared in accordance with GAAP. The DoF relies on a formal distribution of work document that clearly communicates specific responsibilities for development of the CAFR, including who is responsible for preparing and reviewing the relevant sections of the CAFR. During the preparation of the 2018 CAFR, the DPWG participated in the review of the CAFR drafts. The DPWG reviewed and signed off on the disclosures included in the CAFR, including the Letter of Transmittal, Management's Discussion and Analysis, Notes to the Basic Financial Statements and the Fund Descriptions.

During the audits of the CAFR and other financial reports, the independent auditor requests a broad range of supporting documents. The multiple items requested are managed through a master pending list. This allows for effective communication with the independent auditor, as items are clearly assigned to relevant staff and tracked by management throughout the audit process.

The Finance staff in the DoF utilize an internally generated Financial Statement checklist when preparing the fund level financial statements. This helps to communicate expectations and ensures that statements are complete and accurate. The Supervisor can then review staff work against a standard set of expectations. In addition, the DoF relies on a comprehensive accounting and disclosure checklist developed by GFOA. Each question in the checklist is assigned to a staff member within the DoF based on area of responsibility. This allows for a clear and objective way to ensure compliance with existing governmental accounting standards.

Financial Reporting Tools

The DoF continues to work with DoIT to develop and implement new financial reporting tools for citywide use through business objects software that allow users to perform ad hoc queries and efficiently access financial data stored in SAP. Information is useful when it is timely, accurate, and appropriate to the user. The following reporting tools were developed and published by DoIT and finance branch departments in calendar year 2018:

- o The Availability Control Report (AVC) provides the amount of available budget before AVC prevents spending. This allows departments to continuously check their available budget and validate if an AVC error they're receiving at the moment is valid.
- o The Budgeting Workbench (FMBB) Review Report assists departments with the review of FMBB's.
- o The Overtime Dashboard provides an overview of overtime budget, labor costs and hours in the organization by fiscal year.

   o   The Fund Listing Report provides all transactional data and master data with balances for all funds.

   o   The Accounts Payable Dashboard in Business Objects was published in October 2018. This dashboard provides a variety of valuable Accounts Payable information including: historical statistics on invoices, list of outstanding invoices, goods receipts and goods returns to help track and improve a departments' vendor invoice payment timeliness and charts and graphs that provide a quick glance of high level information for management to obtain details on their AP processes.

Many SAP related initiatives were completed by DoIT in calendar year 2018 which includes 47 SAP training videos, 5 ERP eLearning courses with imbedded simulations and over 17,000 SAP training instances including classroom and online courses.

Financial Training

The DoF has implemented a Citywide Training – Finance Academy. The next generation of financial leaders graduated from the City of San Diego's first Finance Academy on April 12, 2018. Subject matter experts representing various departments collaborated in a 7-day accelerated learning program to strengthen core financial competencies of key individuals through a variety of lessons. Each topic focused on the latest government practices and processes in place to strengthen internal controls and improve financial reporting for the City. The next Academy is scheduled for March 2019. Additionally, the DoF provides year-end training to other City departments on disbursements, cost allocation processes, and business object financial reports. This training helps ensure that transactions are accurately posted, and it conveys to City departments how their decisions impact financial reporting.

Monitoring Activities

An effective internal control program requires continuous evaluation of each of the five COSO components to ensure that they are functioning effectively. This includes assessing whether risks are being identified timely and if control activities address identified risks. Management should evaluate whether controls are being performed completely, accurately and in accordance with policy. It also includes assessing whether information is being communicated effectively to ensure disclosures are accurate and complete and that accounting policies and procedures are clearly understood by relevant staff.

Budget Monitoring

The DoF monitors fund balances, as well as revenue and expenditure projections, throughout the Fiscal Year. The DoF prepares monthly and periodic reports that serve as a summary of the year-to-date financial activity of the General Fund and certain other budgeted funds. These reports are presented to City Management and to the Mayor and Council. The DoF prepares an analysis of actual and projected financial activity for the entire fiscal year on a quarterly basis by issuing four budget monitoring reports during the year (First Quarter, Mid-

Year, Year-End Budget Monitoring Reports and the Year-End Performance Report). The First Quarter Budget Monitoring Report provides an update of major General Fund revenues, overtime expenditure projections, updates on selected programs and/or initiatives, updates on General Fund balance and reserve estimates, and non-General Fund Risk Management reserves. The Mid-Year Budget Monitoring Report projects revenues and expenditures through the end of the fiscal year, incorporating five months of actual revenues and expenditures. In accordance with Municipal Code Section 22.0229, the Mayor recommends to the City Council mid-year budget appropriation adjustments for any projected deficit or surplus. The Year-End Budget Monitoring Report is prepared incorporating nine months of actual results and includes projections through fiscal year-end. The Year-End Budget Monitoring Report is typically released at the same time as the City Council's first public hearing on final budget decisions for the upcoming fiscal year. This allows the City Council to have the most current budget information available for the current fiscal year prior to making decisions on the budget for the upcoming fiscal year. The Year-End Performance Report provides a detailed comparison and variance analysis of the year-end projections for General Fund revenues and expenditures found in the Year-End Budget Monitoring Report to the un-audited actual results to date. The Year-End Performance Report also includes financial schedules prepared by the DoF in accordance with Charter Section 39.

Review of Independent Audits

As part of its monitoring activities, the DoF reviews the results of independent audits to identify potential areas of risk or areas for which controls need to be strengthened. Independent auditors are required by auditing standards to communicate to the appropriate governing body any material adjustments identified through the audit of the City's financial statements. For the audit of the fiscal year 2018 CAFR, there were no material adjustments identified by the independent auditors. In addition, no material weaknesses or significant deficiencies in internal control over financial reporting were identified in the *Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards*, dated December 7, 2018 (See Attachment 2). The audit of the financial statements is not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. However, the audit process does require significant interaction between the audit team and management with a sustained communication effort throughout the process that allows for effective monitoring of controls over accounting and financial reporting.

The DoF also conducts an internal review of the preparation and completion of the CAFR to identify entries that occurred after the draft was submitted to the independent auditors. This allows the DoF to identify potential areas of risk and implement controls to continuously improve the CAFR preparation process.

The Internal Controls Section reviews and monitors the results of audits performed by the City Auditor that directly or indirectly impact the financial reporting functionality of the City. The

Internal Controls Section monitors recommendations that impact internal controls and works closely with departments to modify processes, establish new controls or strengthen existing controls. The audits are tracked to ensure controls remain effective or are reevaluated and that existing processes are updated.

Monitoring through GFOA Certificate Process

The City received the Certificate of Achievement for Excellence in Financial Reporting awarded to the City by GFOA for the fiscal year 2017 CAFR. To receive this award, the City must comply with a comprehensive checklist that incorporates accounting and disclosure requirements in accordance with GAAP. Comments received from GFOA on the submittal of the CAFR also serve as a monitoring tool to ensure controls are effective. If GFOA identifies significant deficiencies in the CAFR, they disqualify a CAFR from being awarded the Certificate of Achievement for Excellence in Financial Reporting. The review of the fiscal year 2017 CAFR resulted in three suggestions for improvements on presentation, all of which were incorporated into the fiscal year 2018 CAFR. We anticipate receiving the award for the fiscal year 2018 CAFR.

Segregation of Duties Monitoring

The DoF continues to monitor for segregation of duties violations to ensure that no one individual has control over an entire process or multiple components of a process, which if abused, could cause harm to the City or result in misstatements in the financial statements. Due to the importance of maintaining controls around segregation of duties violations, continuous monitoring is performed. The Internal Controls Section also facilitates monitoring activities performed at the transactional level. Automated testing is developed within the SAP GRC Module, the City's ERP module used to request and provision security access, and the results are sent to the process owner for review and remediation where necessary.

The GRC Module was upgraded to HANA 2.0, which provides additional enhancements and stability to the monitoring and management of system-wide access including performance gains. DoIT automated an annual review of users' security access in the ERP system to prevent users from having unauthorized access. This process known as User Access Review or UAR provides a workflow-based review and approval for an existing SAP user's access. The review takes in to account roles assigned to users and the frequency of use for that role by the user.

DoIT also implemented the Business Role Management (BRM) concept to some business processes within SAP GRC access requests. The BRM concept is a grouping of roles based on role type and role/profile name and provide easement to users when requesting for role(s) access. The Internal Controls Section also provides independent monitoring of privileged user activities to assess whether these accounts are sufficiently controlled and comply with DoIT's policies and procedures. The next enhancement will be the expansion of BRM concept for all production systems and automation of training within the SAP GRC Access Request tool.

Assessment of Documented Processes and Controls

A key part of maintaining a strong internal control system is the periodic evaluation and monitoring of processes and their embedded controls. Process design assessments have been developed in the SAP GRC Module with the objective of testing the validity, accuracy and performance of the process as documented. Control design assessments have also been developed to test the presence and performance of controls that have been identified in the process.

The DoF evaluates the effectiveness of controls of transactional activities that are deemed significant by management monthly or periodically. For example, a monthly sampling of vendor invoices is performed to review compliance with policies and procedures. Monitoring of controls also includes considering whether the controls are operating as intended and that they are revised as appropriate for changes in the organization.

For calendar year 2018, process design assessments and control design assessments were delivered to the respective process owners of significant processes with financial reporting impacts. The assessments identified processes that required changes to the process itself or to the related controls. During fiscal year 2018, the DoF worked with the respective process owners to resolve the issues identified during the assessment resulting in revisions to the processes.

Ongoing Monitoring

Several post-processing transactional monitoring activities have been established over the past few years. Examples of some are as follows:

Procurement Card Program (Pcard)
The Internal Controls Section developed a formal methodology for selecting departments, Pcard holders, and transactions to review. At the beginning of each fiscal year, a review test cycle is created based on established criteria, to ensure that all departments are reviewed at least once a year. On a monthly basis, the Internal Controls Section randomly selects transactions to review and schedules a manual test in SAP GRC module. Departments that are considered high-risk are reviewed more than once in a year. Under the supervision of the Pcard Administrator, the Assistant Pcard Administrator reviews these transactions for proper authorization, completeness, accuracy, validity, and compliance to ensure that the Pcard holders adhere to the City's policies and procedures. The Internal Controls Section ensures that the review is completed within the allotted time and records the findings in a summary log, which is provided to the Pcard Administrator monthly. Corrective actions are taken when findings are identified.

Tuition and Travel Reimbursements
In 2018, the Internal Controls Section identified improvements in the current monthly monitoring review of travel and tuition expenses. This includes refining sampling techniques

and test questions. The Internal Controls Section is responsible for a random selection of reimbursement requests based on a formal methodology. A tracking log is created in conjunction to ensure majority of Personnel Areas are tested at least once within the calendar year. The selection is forwarded to the Payroll Section to perform a review for accuracy, completeness, proper authorization, validity, and cutoff. The monitoring review provides assurance that reimbursements comply and adhere to City's policies and procedures. The Internal Controls Section ensures that the review is completed within the allotted time. Corrective actions are taken when findings are identified.

Accounts Payable and Disbursements

The Department has developed a daily monitoring review of invoices passing through the Vendor Invoice Management (VIM) system to ensure accuracy and compliance with the City's policies and procedures. The Internal Controls Section is responsible for obtaining a list of Purchase Order invoices that were posted daily in VIM and randomly select invoices for review using a risk-based sampling methodology. The selections are forwarded to the Disbursement Section to conduct the review. The Internal Controls Section ensures that the review is completed within the allotted time and records the findings in an analytics log, which is provided to the Disbursement Manager quarterly. Corrective actions are taken when findings are identified.

Purchasing & Contracting (P&C)

The Internal Controls Section has assisted P&C in developing semi-automated monitoring tests in SAP GRC Module with the objective of improving monitoring, compliance and contract surveillance of citywide contracts. On a monthly and quarterly basis, the Internal Controls Section is responsible for scheduling monitoring reviews for P&C to conduct the review, based on a formal methodology and control focus. The purpose of these monitoring reviews are to (1) ensure threshold limits are not bypassed by the splitting of purchase orders; (2) check for expired insurance policies linked to current vendors; (3) detect purchases that have been made without utilization of existing contracts or agreements; and (4) ensure that engaged vendors are licensed to perform business within the City. SAP is utilized to pull data, and if applicable, deficiencies are flagged for review. The Internal Controls Section ensures that the review is completed within the allotted time. Corrective actions are taken when findings are identified.

Conclusion

The City has established a high bar for the development of a comprehensive internal control program for a municipal government. Based on management's evaluation we believe that internal controls over financial reporting are effective. The City's internal controls over financial reporting improved significantly with the implementation of SAP which, combined with hundreds of processes and controls that are currently in place, allow for the production of reliable financial information. More recently, significant efforts have been focused on

formally documenting such processes and controls, prioritizing those that are material to the CAFR preparation process.

Establishing effective internal controls is a continuous process. The implementation of effective internal controls reduces the exposure to error, fraud, and theft. It is Management's responsibility to design, implement, and maintain internal controls and consider the areas of risk. Implementation of effective policies and procedures can prevent, detect, and correct errors and fraud before they affect the financial statements. The Department of Finance continues to develop written policies to document and confirm existing internal financial controls and continues to work with City departments in documenting processes and new system implementations. The DoF also identifies opportunities for improvement and develops new policies and processes. Management actively assesses risk as the organization changes and as new reporting requirements are issued. As with any effective system of internal controls over financial reporting, management responds to new risks identified by implementing or enhancing controls to mitigate such risks, including those that have been identified in this report.

Sources

1. Gauthier, Stephen J. *Evaluating Internal Controls.* Chicago IL: Government Finance Officers Association of the United States and Canada, 2013. Print
2. Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework, Framework and Appendices, 2013*
3. Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework, Internal Control over External Financial Reporting: A compendium of Approaches and Examples, 2013*

Attachments:
1. Certification by the Chief Operating Officer, Chief Financial Officer and Assistant Director
2. Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

_____

Rolando Charvel, Chief Financial Officer

_____

Scott Clark, Assistant Director, Department of Finance
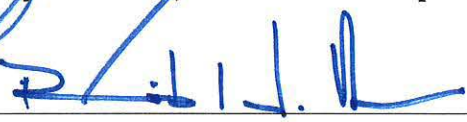
CERTIFICATION BY MAYOR AND CHIEF FINANCIAL OFFICER

In accordance with the requirements of §22.0706 of the San Diego Municipal Code, the Mayor's designee, the Chief Operating Officer and the Chief Financial Officer hereby certify that they:

1. are responsible for establishing and maintaining the City's internal financial controls;
2. have identified the need to design such internal financial controls to ensure that material information relating to the City and its departments, offices, agencies, and affiliated "related entities" as defined in San Diego Municipal Code section 22.4102, is made known to the Mayor and/or the Chief Financial Officer by others within the City and its departments, offices, agencies, and affiliated "related entities," particularly during the period in which the Annual Report required by this section is being prepared;
3. have evaluated the effectiveness of the City's internal financial controls as of a date within 90 days prior to the Annual Report;
4. have presented in the Annual Report their conclusions about the effectiveness of their internal controls based on such evaluation as of that date;
5. have disclosed to the City's independent auditors and the Audit Committee 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;
6. have identified for the City's independent auditors 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
7. have indicated in the Annual Report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Signed: _____ Date: 2/28/19
Kris Michell, Chief Operating Officer

Signed: _____ Date: 2-27-19
Stacey LoMedico, Assistant Chief Operating Officer

Signed: _____ Date: 2.27.2019
Ronald H. Villa, Assistant Chief Operating Officer

Signed: _____ Date: 2/26/19
Rolando Charvel, Chief Financial Officer

Signed: _____ Date: 2/26/19
Scott Clark, Assistant Director, Department of Finance

mgo Certified
Public
Accountants

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

To the Honorable Mayor and Members of the
City Council of the City of San Diego, California

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of the City of San Diego, California (City), as of and for the fiscal year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the City's basic financial statements, and have issued our report thereon dated December 7, 2018. Our report includes an emphasis of a matter related to the City's adoption of Governmental Accounting Standards Board Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*. Our report also includes a reference to other auditors who audited the financial statements of the San Diego Housing Commission, a discretely presented component unit, as described in our report on the City's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the City's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

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Compliance and Other Matters

As part of obtaining reasonable assurance about whether the City's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Macias Gini & O'Connell LLP

San Diego, California
December 7, 2018