

# ANNUAL REPORT ON INTERNAL CONTROLS 2014

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CALENDAR YEAR 2014

OFFICE OF THE CITY COMPTROLLER  
THE CITY OF SAN DIEGO | DECEMBER 30, 2014

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## EXECUTIVE SUMMARY

This *Annual Report on Internal Controls* (Report) is issued pursuant to Ordinance 19320 adopted by the City Council in October 2004 to achieve a “high standard of quality in and efficacy of the City’s financial reporting and disclosure practices.” Municipal Code §22.0708 implements this Ordinance and includes these requirements:

- Performance of an annual evaluation of the City’s internal financial controls;
- Presentation of any evaluation findings in an Annual Report to the City Council and Audit Committee;
- Certifications from City Management in respect to the design, maintenance, and effectiveness of the City’s internal financial controls.

Internal controls 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 objectives relating to operations, reporting, and compliance.

The Office of the City Comptroller (Comptroller’s Office) reviewed citywide financial activity to determine the scale and scope of the factors affecting the design and performance of internal controls over financial reporting. This review established areas of focus and further defined the strategy to continue developing and implementing process documentation and controls for all financial related activity throughout the City.

The Comptroller’s Office also conducted Risk Assessments at the entity and section activity levels that included assessments for documented processes and controls to determine levels of performance and relevancy; and a gap analyses to determine instances of undocumented process performance and external reporting activities. Results indicated that while the City has made significant progress over the last several years, a substantial amount remains to be accomplished. Controls exist on processes that can materially affect financial reporting; however, some of these controls require formal documentation as a Process Narrative.

The City maintains internal financial control over the preparation of the City’s Comprehensive Annual Financial Report (CAFR). Management continues to monitor these controls each year, as new standards are implemented, areas of attention are identified and opportunities for improved controls are recognized. Additional controls discussed in this Report were developed and implemented in calendar year 2014.

During 2014, there were reportable weaknesses related to the preparation of the Schedule of Expenditure of Federal Awards required under Office of Management and Budget (OMB) Circular A-133 and compliance findings regarding reporting requirements related to the

Equitable Sharing Agreement Program. Each weakness was examined and remediation efforts were developed and implemented to prevent a reoccurrence.

The Internal Controls Section continues to perform activities on a daily basis to develop and enhance the internal control environment within the City. Through partnership with other City departments, internal controls implemented over the past four years continue to guide and strengthen financial activities throughout the City.

Within the last 90 days, management evaluated the City's internal control environment with respect to the currently documented processes and the financial activity of the year, including the preparation of the City CAFR and other internal and external financial reporting. Based on this evaluation, there have not been any changes in the documented internal control policies, formalized procedures or financial operations that may have weakened internal controls over financial reporting. In addition, the City has strengthened existing controls and implemented new controls in areas in which significant deficiencies or material weaknesses were identified during calendar year 2014.

## BACKGROUND

This Report for 2014 is prepared and submitted to comply with the provisions in Municipal Code §22.0708. In October 2004, City Council adopted Ordinance 19320 to achieve a “high standard of quality in and efficacy of the City’s financial reporting and disclosure practices.” Municipal Code §22.0708 *Annual Report on Internal Controls*, implements a component of this ordinance and requires that an annual report on the City’s internal financial controls be presented to the City Council and Audit Committee.

### SAP Enterprise Resource Planning System

The implementation of the Enterprise Resource Planning System (SAP) was a defining event in the City’s movement towards a well-designed internal control framework. Through the configuration phase, internal controls were embedded in processes performed in the system through the use of user access rights and defined authorization pathways. Work instructions illustrating the performance of activities in SAP were created and made available to all end users to ensure consistency in the performance of transactional activities.

During the procurement of SAP, the City also acquired the SAP Governance, Risk and Compliance (GRC) module to identify and mitigate risk across system user access rights, segregation of duties and process performance. The SAP GRC module supports the five key components of the internal control framework developed by COSO. It is particularly relevant to the risk assessment and monitoring components of the framework. The implementation of SAP and the GRC module provided the City fundamental technological tools for developing and implementing its Internal Control program.

### Process Documentation

While SAP transactions were designed and implemented from a technical perspective, along with the development of work instructions at the transaction level, there was one key element that management was responsible to develop – process documentation. To address this need, the process narrative and workflow format (Process Narrative) were created to identify how the process should be performed and to provide a resource for end users. The Process Narrative not only contains the steps necessary to perform the process with reference links to the published work instructions, but it also contains information in respect to the risk and controls relating to each process. The designed formats have been very successful whether the end user is a City employee looking for guidance or an external auditor performing field work. A sample Process Narrative for a common financial transaction at the City is attached as Appendix 2.

## City of San Diego Internal Control Framework

Internal controls are a varied means used by management to achieve management objectives and to meet management responsibilities. Those responsibilities include achieving effectiveness, efficiency, compliance and accountability. Management is responsible for achieving its objectives while making optimal use of the limited resources placed under its control and in compliance with limitations placed over those resources by policy, laws or regulations. The City is accountable to San Diego residents and outside groups for the management of the City's resources and meets this responsibility by preparing financial statements for the benefit of those stakeholders and policy makers. In addition, management is responsible for developing and maintaining an accounting system that provides the information managers and elected officials need to make timely financial decisions.

The focus of this report is on internal controls over financial reporting, including the preparation of financial statements for external use as well as financial reporting for internal decision-making. While it is important to recognize that the implementation of effective internal financial controls is a continuous process, the objective is to achieve a level of risk that is acceptable. Effective internal financial controls allow for the preparation of financial statements that present fairly, in all material respects, the financial position and activity of the City.

The most authoritative guidance on internal controls over financial reporting is the integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), established in 1992. The City's internal control program is based on this framework.

The Sarbanes-Oxley (SOX) law enacted in 2002 increased reliance on the COSO framework to comply with standards set forth in the legislation. While no requirement exists for the City to comply with SOX as there is for publicly traded companies, the COSO framework is considered industry best practice for any entity that implements an internal control program. For example, the Government Finance Officers Association (GFOA) uses this framework in their guides for municipalities to establish internal control programs.

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) Risk Assessment, (2) Control Environment, (3) Control Activities, (4) Monitoring, and (5) Information and Communication. These five components are supported by 20 principles which help to prevent or detect material misstatements of financial reports. The COSO components support the core principals of City management: effectiveness, efficiency, regulatory compliance and accountability through accuracy in financial reporting. The table below provides a summary of the five fundamental components under the COSO framework:

## The Five Fundamental Components under the COSO Framework

<b>Control Environment</b>	The control environment is generally regarded as the most important of the five components and the basis upon which the remaining components rely. In effect, it is responsible for setting the tone of an organization and the parameters by which the organization operates. It is management's role and responsibility to establish an internal controls environment across all City operations and other areas that have a financial impact on the financial reports issued by the City.
<b>Risk Assessment</b>	Risk assessment is the process through which risks to the achievement of reliable financial reporting objectives are identified by management. This assessment provides the foundation for how the risks identified should be managed.
<b>Control Activities</b>	Control activities are the next logical step in response to risks identified through the risk assessment component. Essentially, they are the policies and procedures that management develops and implements, to ensure that risks to reliable financial reporting are addressed. To be effective, these control activities will occur at all levels of the organization and be functional in nature.
<b>Monitoring</b>	Monitoring is performed to determine the health of the internal control system that has been put in place. It gauges the performance of, and compliance to, control activities that have been implemented to address identified risks. Also, a key function of monitoring is to ensure that the internal control system remains relevant and capable of mitigating new risks.
<b>Information and Communication</b>	This component addresses the need to identify, capture and communicate information in a timely manner that is accurate, relevant and supports the execution of assigned responsibilities. Information that is communicated needs to be able to permeate through the organization from every direction conceivable.



## SCOPE OF THE INTERNAL CONTROLS PROGRAM

To ensure that internal controls are designed effectively and applied at the point of risk, it is first necessary to define the scope of the internal controls program. In a typical month, there are in excess of 16 million user interactions within the City's financial system, SAP. The majority of these interactions occur in various departments as they perform their core responsibilities. These interactions make their way into the financial system either through direct input or through some type of interface application. The financial activity is consolidated with similar types of activities and is eventually presented in the financial statements that are prepared by the Comptroller's Office.

In developing the City's internal control system, the Comptroller's Office implemented a top down, risk-based approach in line with industry best practices as outlined by the Public Company Accounting Oversight Board (PCAOB) to address audits of internal controls. This top-down approach begins at the financial statement level and identifies the various inputs and processes that occur, from the initial activity through aggregation and classification of transactions and account balances in the financial statements. The approach should consider various factors including the control environment, risk awareness, and functioning and effectiveness of controls at the entity, activity and transaction levels.

The Internal Controls Section has identified three main areas of focus in respect to the continued development and maintenance of a robust internal control system within the City:

1. Accounting and Reporting Processes within the Comptroller's Office
2. Financial Transactions generated through department operations
3. Legislative and Regulatory Actions

### Accounting and Reporting Processes within the Comptroller's Office

The Comptroller's Office is responsible for the general accounting and financial reporting function for the City. It is also responsible for payment services, including payroll processing for the City's approximately 10,000 employees and centralized processing for all vendor payments. In addition to internal financial reporting within the organization, the Comptroller's Office prepares the City's Comprehensive Annual Financial Report (CAFR) and the Schedule of Expenditures of Federal Awards (SEFA), included as part of the Single Audit required under OMB Circular A-133.

Because of its central financial role within the City, strong controls over processes in the Comptroller's Office are fundamental to achieve proper financial reporting. The Comptroller's Office developed a framework utilizing a top down approach to implement an internal control system over financial reporting. The foundation for this system was the development of process

documentation (Process Narratives) for all types of financial transactions and activities that take place within the City.

### Transactions Generated through Department Operations

While the Comptroller's Office is responsible for preparation of financial statements, the financial work performed in the Comptroller's Office is heavily dependent on the financial transactions performed by other City departments. In many instances, these transactions are performed in systems where data is entered and then transported through an interface or is directly entered manually into the SAP financial system. Failure to have internal controls in place at the initial transaction generation point increases the risk of financial misstatements.

Where transactions in the departments are performed by system users, a comprehensive control framework needs to exist. This framework should encompass key activities including documenting the process, ensuring personnel are adequately trained in the performance of tasks and recording of transactions, as well as monitoring for exceptions in the process. All material financial transactions recorded and reported in the financial system need to be documented. Once the documentation process has started, controls of either a preventative or detective nature can be developed and implemented. These activities are the key to ensuring that transactions are recorded accurately and timely.

System interfaces play a critical role in ensuring that transactional data is transported from external systems into SAP. It was recently determined that in excess of three hundred and fifty jobs are processed through interfaces on a daily or weekly basis between the external systems and SAP. Interfaces are another point where controls play a vital function. It is critical that data is mapped correctly and any changes to that mapping or to the configuration of the interface are authorized, documented and tested. In addition, access to the interface should be restricted to appropriate personnel with periodic reviews performed.

### Legislative and Regulatory Actions

The City operates within an environment that is consistently changing. Actions affecting legislation, regulation and oversight at the federal, state and local level have an effect on the City's internal control program. A recent change to the City's Municipal Code on purchasing thresholds is a clear example of changes that require risk assessment and additional control efforts in order to successfully implement new regulations. Also, changes to external reporting requirements for governments, including changes to *Governmental Accounting Standards*, as well as external reporting requirements for federal awards, require a consistent assessment of risk to ensure controls are in place to achieve compliance.

## CONTROL ENVIRONMENT

The Control Environment is the most important component of the COSO framework. The Control Environment sets the tone of the organization and represents what is commonly referred 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 and responsibilities, delegation of authority and responsibilities, the process for attracting, developing and retaining employees, and the measures, incentives and rewards used to manage accountability and performance.

The Government Finance Officers Association publication titled *Evaluating Internal Controls*<sup>1</sup>, states that "when management believes that internal controls are important to achieving its goals and communicates that view to employees at all levels, internal controls are likely to be effective. Conversely, if management views internal controls as unrelated to achieving its objectives, or even as an obstacle, it is all but certain that this attitude will be communicated to staff at all levels despite official statements or policies to the contrary. In such an environment, employees readily come to see internal controls as 'red tape' that they can 'cut through', as needed, to 'get the job done.'"

City management meets the GFOA standard for elevating the importance of internal controls in addition to the policies and practices that provide for a strong control environment. The City has established an Independent Audit Committee with public members possessing audit expertise. Independent departments assist the City Council in establishing checks and balances over the executive branch, including the Independent Budget Analyst and the Office of the City Auditor. The City has established the Disclosures Practices Working Group, with objectives to ensure compliance by the City with federal and state securities laws, and to promote the highest standards of accuracy in disclosures relating to securities issued by the City or by its related entities. In addition, the City has established mandatory financial disclosure training for management and City Council, the Employee Code of Conduct, the Fraud, Waste and Abuse Hotline, and the Annual Report on Internal Controls. The Ethics Commission is also supported by the City to provide guidance and enforcement of local government ethics laws.

During fiscal year 2014, the City restructured senior management and reduced the Chief Operating Officer's span of control by creating Deputy Chief Operating Officer positions to provide more oversight and accountability for City operations. This structure ensures that policy decisions are made more efficiently, allows for greater professional growth and enhances internal communications. This operations restructure also re-established the training and professional development curriculum offered through Management and Leadership Academies.

## RISK ASSESSMENT

### Internal Controls over Financial Reporting – Comptroller’s Office

One of the primary objectives of the Comptroller’s Office is developing and maintaining internal financial controls over accounting and financial reporting. In calendar year 2014, the Comptroller’s Office focused on defining the department’s scope of work as it relates to the internal control program, identifying all processes performed by the department and all financial reports issued by the City. A complete inventory of financial processes and reports is an important step to prioritize resources and focus those resources on areas of higher risk and materiality.

#### *Process Study*

As part of a self-assessment performed earlier this year, the Internal Controls Section performed a review of the processes documented to date (Process Study). To ensure that an awareness of all financial processes performed by the department existed, a process questionnaire template was sent to each employee within the Comptroller’s Office requesting staff to list the various processes that are performed during the fiscal year. This effort resulted in the identification of 1,186 processes or tasks, of which approximately 239 were documented in the Process Narrative format. While the primary objective was to identify processes performed within the department, the template also sought to capture critical aspects regarding performance of the process including frequency of performance, risk profile, documentation format and purpose of the process. Information obtained from this activity is being used to identify additional processes that need to be documented, and to ensure that risks associated with each of the processes are understood and cataloged. As probability and impact associated with each of these risks are analyzed, mitigating controls are developed and applied to reduce or eliminate the element of risk.

The Internal Controls Section has analyzed the 239 processes that have been documented in the Process Narrative format, identified instances where control gaps or weaknesses exist, and applied mitigating controls. Also, processes and tasks have been streamlined resulting in increased efficiency or effectiveness over operations. The documented process forms one of the key cornerstones for ensuring the integrity of the financial statements.

Of the remaining 947 processes identified through the Process Study, 510 were documented in an alternative format and 437 were not formally documented. This does not necessarily mean that 947 Process Narratives need to be developed. Some of these processes could be grouped and documented as one single process, while others might be simple enough to document through work instructions. In early 2015, the Comptroller’s Office will complete its assessment of the list of processes identified through the process questionnaire in order to prioritize process documentation based on materiality and risk. It is important to note that controls currently exist

on processes that can materially affect financial reporting. Some of these controls, however, have not been formally documented and may rely upon the institutional knowledge of professional staff within the Comptroller's Office. The Process Study highlighted the need to continue documenting processes performed within the department in order to ensure that institutional knowledge is documented and risks related to staff turnover is mitigated.

Currently, all Process Narratives are reviewed by the staff of the Internal Controls Section. As part of the 2015 calendar year program, additional professional staff within the Comptroller's Office will be trained to perform Process Narrative review functions in order to expand work capacity and expedite process documentation work.

### ***Risk Assessment of Comptroller's Office Internal Controls***

Risk Assessment is another main component of the COSO framework. A risk assessment was performed by the Comptroller's Office. This assessment was broken out into two separate evaluations (entity and section level) with different objectives for each assessment. The entity level assessment was delivered to all employees of the Office, with the exception of the authors, and was primarily designed to determine the health of the control environment and communication channels. The section level assessment was delivered to each section manager and was designed to identify the risk associated with each of the processes performed within the section. The objectives of the assessments were to identify areas of weakness that reside outside of documented processes and to examine the functioning of controls at the entity level. The assessments will be useful in prioritizing process documentation work for the calendar year 2015 internal controls work program.

Responses to the risk assessments indicated the need to increase training for financial professionals within the Comptroller's Office, develop reporting tools to facilitate the timely and accurate preparation of financial reports and the need for an increased understanding of risk and the impact on financial statement reporting.

The Comptroller's Office is working to address these issues:

- Training on recent changes to governmental accounting standards and training on Microsoft Excel, levels I-III was provided to accounting staff in the fall of 2015. The training program will continue in calendar year 2015 to include foundational governmental accounting training, work paper documentation and documentation of processes. In addition, the Office has implemented the use of the GFOA disclosure checklist, which provides technical guidance in the preparation of CAFR financial statements and note disclosures.
- The Comptroller's Office, in partnership with the Department of Information Technology, has launched a financial reporting initiative to more easily and effectively

use SAP financial data. Through the use of Business Objects software, four reports have been completed, including (1) Project-to-date Budget and Expenditures for Capital Improvement Projects (CIP), (2) Personnel and Fringe Expenditure Detail for CIP and Grants, (3) General Ledger Summary and Transaction Detail, and (4) the Accounts Payable Transactions Listing. Development of additional reports will continue in calendar year 2015.

- A materiality policy will be developed and implemented in calendar year 2015 to provide clear guidance to Comptroller's Office supervisors and managers for assessing risk and financial statement impact on processes and transactions they oversee. This will be useful in prioritizing process documentation and will allow for better prioritization and focus of work review.

### ***External Financial Reporting***

During 2014, the Comptroller's Office focused its attention on financial reporting activities to external agencies and parties by City departments. Of particular concern was the issuance of reports by departments which contained financial data that had not been reviewed by the Comptroller's Office prior to distribution. An example of inaccurate reporting due to inadequate review processes was the recent reporting issues related to the Equitable Sharing Agreement Program, also known as the Seized Assets Sharing Program, which are described in *Internal Control Weaknesses and Remediation related to Single Audit* section of this report. To identify instances where external financial reporting was occurring, each department was asked to complete a questionnaire identifying the requirements and respective recipients for each report. The questionnaire also attempted to capture information to allow the Internal Controls Section to understand the risks associated with each reporting activity and to identify instances where processes needed to be documented and control weaknesses addressed. Through this effort, the Comptroller's Office identified processes performed outside of the department which need to be documented with specific oversight requirements performed prior to distribution of reports to external parties. As part of its calendar year 2015 internal controls work program, the Comptroller's Office will prioritize external reporting process documentation based on materiality and risk and will work with City departments to document these processes, including a review component by the Comptroller's Office.

### **Internal Control Weaknesses and Remediation related to Single Audit**

#### ***Reportable Condition***

While conducting the fiscal year 2013 audit and testing of the City's preparation of the Schedule of Expenditures of Federal Awards (SEFA), the City's independent auditors noted several discrepancies in financial reporting. The auditor's report stated that the City had not established a comprehensive process for adequately identifying and capturing complete and accurate information from City departments for the compilation and preparation of the SEFA.

Furthermore, there was not a formal review process whereby someone independent of the SEFA preparation completed a review for completeness, accuracy, and compliance with the reporting requirements of OMB Circular A-133.

The Single Audit also reported that the City's completion and submission of the annual Equitable Sharing Agreement and Certification Form (Certification Form) for fiscal years 2009 through 2013, were not submitted within 60 days from the City's fiscal year end. Also, the required accounting information reported in the Certification Forms prepared by the San Diego Police Department, for fiscal years 2009 through 2013, was inaccurately reported to the U.S. Department of Justice. The Certification Forms were prepared and submitted by the San Diego Police Department without the prior review and approval by the Comptroller's Office.

### ***Remediation***

In calendar year 2014, the Comptroller's Office, in collaboration with the San Diego Police Department, developed and documented processes, which included additional or revised controls to remediate these findings and prevent reoccurrence.

The Comptroller's Office established a standard process for the submittal of information by City departments to the Comptroller's Office for compilation and preparation of the SEFA. The process includes submittal of appropriate documentation by City departments and a review of the information and documentation by the Comptroller's Office. In addition, the Comptroller's Office performs a reconciliation between federal expenditures and federal revenue or cash received during the fiscal year and performs an independent supervisory review of the SEFA. These actions are performed prior to submission of the SEFA to the City's external auditors. In order to ensure all federal programs have been considered for inclusion in the SEFA, a yearly citywide process has been implemented requiring that directors certify that all federal programs for which their respective departments have received federal revenue have been included in the SEFA.

In regard to the Equitable Sharing Program findings, the City revised existing accounting and reporting processes related to the Equitable Sharing Program and documented these changes in the form of Process Narratives. These changes ensure that the annual Certification Forms are prepared accurately and submitted timely in accordance with program requirements. The revised process ensures that the City maintain revenues, expenditures and interest properly segregated between funds. In addition, the process establishes controls over cash deposits, approval of expenditures and completion of the Certification Reports, including an independent reconciliation and review process performed by the Comptroller's Office. Moreover, the process requires the reconciliation of the City's accounting records to a revenue transaction listing provided by the U.S. Department of Justice and the U.S. Department of the Treasury to ensure all revenue related to the program has been correctly deposited into the appropriate funds.



In August 2014, the San Diego Police Department, working in collaboration with the Comptroller's Office, updated and corrected the Certification Forms previously submitted for fiscal years 2009 through 2013, and submitted the revised Certification Forms to the U.S. Department of Justice. In addition, the Comptroller's Office compiled a list of external financial reporting prepared by City departments in order to ensure processes are documented and a review component by the Comptroller's Office is performed (see *External Financial Reporting* above).



## CONTROL ACTIVITIES

### Partnership with Departments

Calendar year 2014 presented significant opportunities for the Internal Control Section to enhance the internal controls culture within the City. The Internal Control Section partnered with various City Departments throughout the year to establish and monitor controls over financial reporting and operations. The most significant activities are listed below:

#### ***Purchasing and Contracting Department***

The Internal Control Section participated in two separate initiatives with Purchasing and Contracting Department (P&C). The first initiative, which began in March 2014, related to the design of the procure-to-pay module in SAP. During prior enhancement testing, control failures were identified which needed to be addressed. P&C management supported the goal of conducting a deep dive into the SAP module to identify issues and activities where a strong internal control focus was not evident. Teams were formed from various City departments and processes were performed and evaluated from end to end. Changes to the module design, workflow and associated roles were made resulting in the strengthening of controls within the module.

The second initiative resulted from the Municipal Code changes that Purchasing and Contracting brought before the City Council in April 2014. After receiving City Council approval, process changes were identified and controls were developed to mitigate risk. These controls, surrounding transaction monitoring, have been automated in the GRC application and are delivered to the Control Owner on a monthly basis. In addition, new Process Narratives were developed and published to support the new processes, and existing processes narratives were reviewed for accuracy and validity.

#### ***Public Utilities Department– Customer Care Solution***

The Internal Control Section has continued to provide support and guidance to Public Utilities Department in respect to role design and segregation of duty violations for their SAP Customer Care Solution, the Public Utilities Department's customer billing system. This has resulted in a significant reduction in the amount of roles as well as the removal of unnecessary transactional ability to conform to the information security principle of least privilege. As a result of these changes, the number of segregation of duty violations has been reduced considerably requiring the development of far fewer mitigating controls.

#### ***Department of Information Technology***

Through partnership with the Security and Enterprise Resource Planning (ERP) Support teams, several initiatives are underway which will further integrate and strengthen internal controls. From a security perspective, a user access review has been conducted to ensure that users who

access SAP only have the necessary rights to conduct transactions to perform their assigned responsibilities. Also, expansion of the use of the SAP GRC module is also underway to achieve the key objectives of automating super user privilege access and regular user system access requests. The Internal Controls Section is also contributing to the work being performed by the ERP Support team in the development of a comprehensive training platform where Process Narratives, process workflows and work instructions will be integrated with training media developed by the ERP Support Team.

### Comprehensive Annual Financial Report

The Comprehensive Annual Financial Report (CAFR) is the most significant external report produced by the Comptroller's Office. The CAFR is available on the City's investor information webpage and can be accessed by residents, investors, rating agencies and other interested parties. As the name implies, it is a comprehensive financial document, which 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 more than 50 accountants in the Comptroller's Office as well as key departments who provide necessary information for disclosures within the CAFR. The CAFR is prepared in accordance with Generally Accepted Accounting Principles and with standards established by the Governmental Accounting Standards Board.

The City has established internal financial control over the preparation of the CAFR. The CAFR is audited annually by the City's independent auditors. In planning and performing their audit, the auditors consider the City's internal control over financial reporting as a basis for designing their auditing procedures for the purpose of expressing their opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Any findings regarding deficiencies in internal controls are documented in the Independent Auditor Report, also known as the Yellow Book Report. The audits of the CAFR for the last three fiscal years (FY2011 – FY2013) did not identify any deficiencies in internal controls, considered to be material weaknesses, related to the preparation of the CAFR. The Independent Auditor Report for fiscal year 2014 had not been issued as of the completion of this Report. However, the City's Independent Auditors confirmed that no material weaknesses on internal controls were identified through the fiscal year 2014 CAFR audit.

Management continues to monitor financial controls over the preparation of the CAFR and makes internal control additions or changes as new standards are implemented, areas of attention are identified and opportunities for improved controls are recognized. Several controls were developed and implemented in calendar year 2014:

- Director Certification was obtained for those departments who significantly contributed to CAFR disclosures. This control will be a recurring annual control.

- Established an Interim Financial Statements preparation process for period 10 (April). The objective of this process is to shift as much preliminary work as possible prior to fiscal-year-end, allowing for more analytical and review work after fiscal-year-end. This work typically includes classification of new accounts and funds, analysis of new standards, and variance analysis.
- Established the use of a Government Finance Officers Association disclosure checklist for preparation of the notes to the financial statements and required supplementary information.
- Established controls over the automated accrual process generated by entering a goods receipt transaction in SAP. Departments can enter goods receipts against existing purchase orders, generating an expenditure accrual transaction for the fiscal year. If a department overestimates the amount of the accrual, there is a risk of financial statement misstatement (overestimating expenditures). A review process was established in fiscal year 2014 to identify and reverse accrual transactions generated from goods receipts that did not materialize after the end of the fiscal year.

## MONITORING ACTIVITIES

### SAP Governance Risk and Compliance Module

Monitoring control-related policies and procedures on an ongoing basis is needed to ensure that they are continuing to function properly and that they continue to be relevant. Using the SAP GRC module, the Internal Controls Section has developed hierarchies which align with the City's organizational structure and the process documentation formats. Ownership of processes, risks and controls have been assigned at both the department and employee level. These hierarchies allow the performance of assessments at the risk, process and control levels in addition to supporting ongoing monitoring through the use of automated transactional testing, effectiveness tests and continuous segregation of duties monitoring.

As processes are developed and published, they are uploaded into the SAP GRC module, process and control design questions and surveys are developed and where appropriate, transactional testing initiatives are put in place. Testing and monitoring activities are then scheduled in accordance with the needs of the organization. It is critical to note that this is a continuous process. Due to constant changes in the organization, accounting standards and laws and regulations, the internal control process continues indefinitely.

To effectively manage risk and promote a strong internal control framework, it is vital that processes are documented and communicated, risks are identified and mitigated, and continuous oversight exists to detect deviations from the process, which are then remediated. In essence, it is a continuous improvement model to support the achievement of management objectives throughout the City.

### Segregation of Duty Monitoring

The Internal Controls Section continues to monitor for segregation of duty 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 to the financial statements. Due to the importance of maintaining controls around segregation of duty violations, continuous monitoring is performed. This monitoring covers in excess of 10,000 users and is performed several times a week to ensure that no violations exist. The section also facilitates monitoring activities performed at the transactional level. Automated testing is developed within the SAP GRC module and the results are sent to the process owner for review and remediation where necessary.

### 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. While this evaluation supports the risk

assessment activities detailed above, the Internal Controls Section determined that the processes and controls documented within the Process Narratives should be assessed and monitored. Process design assessments had 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 had also been developed to test the presence and performance of controls which had been identified in the process. In October and November of 2014, 290 process design assessments and 275 control design assessments were delivered to the respective owners for documented processes in the following departments; Offices of the City Comptroller and City Treasurer, Purchasing and Contracting, Financial Management, Debt Management, Risk Management, Department of Information Technology and Public Utilities.

## INFORMATION AND COMMUNICATION

The basic function of internal controls is to meet management's objectives including effectiveness, efficiency, regulatory compliance and accountability through accuracy in financial reporting. The Information and Communication component of the COSO framework is essential to meet all of these objectives. City employees at all levels should be able to access information that is timely and accurate, but not be overwhelmed by too much information that obscures what they critically need to know to effectively perform their jobs. A clear understanding of the City's priorities and goals, communicated by management, is fundamental for City employees to strive to achieve these goals and to better prioritize the use of limited resources. Similarly, understanding changes to the regulatory environment and timely communicating such changes to relevant staff helps employees plan and prioritize work in order to achieve compliance with such requirements.

Accountability through accurate and timely financial reporting, in essence, represents an information and communication effort. Through timely and accurate accounting of the City's financial resources, the City's financial branch organizes data into meaningful reports that assess the City's financial position, how such financial position has changed during a specific period of time and how future trends will affect the City's financial position. This information is communicated to internal and external parties through the CAFR and through internal reports such as the monthly Charter 39 Financial Reports and the quarterly Budget Monitoring Reports.

The Information and Communication component of the COSO framework overlaps and has a direct effect on the Control Environment. Communication from top management regarding the importance of internal controls and the alignment of such controls with management objectives is necessary to have effective internal controls. The City's restructure of senior management in 2014 enhanced internal communications by providing clear lines of communication throughout the organization.

Information and Communication is essential for accuracy in financial disclosures. In an organization as large as the City, it is critical that effective communication channels are established to meet disclosure requirements by Governmental Accounting Standards and by state and federal securities laws. The creation of the Disclosure Practices Working Group brings together individuals within the City that can communicate critical information to ensure accuracy and completeness in the preparation of financial disclosure documents.

Management has established an open door policy at all levels to ensure issues are communicated timely. As a control measure, a means must be provided for staff at lower levels to communicate around management that may be involved in improper conduct. The creation of the Fraud, Waste and Abuse Hotline provides such a vehicle and has proven effective in addressing concerns from City staff and residents.

## INTERNAL CONTROL WORK PLAN – CALENDAR YEAR 2015

### Process Documentation

While focus has remained on the documentation and publication of Process Narratives, the need to revise numerous documents was identified due to changes in regulatory requirements, process streamlining activities and changes in ownership. It is anticipated that through the Process Study described above and the development of the training platform by the ERP Support team, a greater number of processes will be identified which will require documentation. In an effort to speed up completion and development of process documentation, new approaches are being reviewed to make more resources available. This includes training additional staff within the Comptroller's Office to perform some of the functions currently being performed by the Internal Controls Section and expand the capacity for more expedient process documentation. This process documentation activity will also encompass the documentation of external reporting requirements.

### Compliance Requirements

There were several changes across the compliance and guidance landscapes put forward by the federal government, State of California and COSO during 2014. The Internal Controls Section is working with the various stakeholders to understand the impact of the changes and to develop methodologies, which when implemented, will ensure that the City achieve compliance with all regulatory requirements and operates with best practices in mind.

#### ***Federal Government***

In May 2014, the White House Office of Management and Budget issued the 2014 Compliance Supplement and Uniform Guidance with an implementation date of December 26, 2014. This single document is a compilation of numerous circulars with the key objective of providing a government wide framework for grants management. The primary areas of focus within the Uniform Guidance address the categories of administrative requirements, cost principles and audit requirements. It is expected that through the adoption of this Uniform Guidance, an increased focus on internal controls over compliance with federal program rules will occur. This increased focus will encompass federal award subrecipients resulting in the performance of additional monitoring activities.

#### ***State of California***

The State of California has added a section (12422.5) to the Government Code focusing on the role that internal controls play in maintaining the integrity of financial reporting. Section 12422.5 requires the State Controller to “develop internal control guidelines applicable to each local agency to prevent and detect financial errors and fraud.” The Government Code also requires the State Controller to publish these guidelines on their website on or before January 1, 2015. Once

published, the City will evaluate and make any necessary changes to comply with these guidelines.

***Committee of Sponsoring Organizations of the Treadway Commission (COSO)***

As outlined in the introduction, this report is based on the five major components described in the Integrated Framework put forward by COSO in 1992. In response to the rapidly changing business environment and considering the numerous high profile governance and internal control breakdowns over the last decade, COSO determined that an update to the framework was required. The 2013 framework came into full effect on December 16, 2014. While there are many similarities between both versions, the 2013 framework explicitly identifies and speaks to the 17 principles which represent the core concepts associated with each of the five internal control components. While the COSO frameworks are the preferred internal control framework for publicly traded companies that are subject to Sarbanes-Oxley (SOX), it is good business practice to adopt the framework even though no such compliance requirement exists for the City.



## LONG-TERM STRATEGY

The importance of having processes designed effectively and efficiently, performed accurately and documented appropriately, cannot be understated. These processes are an integral requirement for an effective system of internal control. Scoping activities and risk assessments performed by the Comptroller's Office indicate that a substantial amount of processes remain undocumented. Process documentation has been, and continues to be, the largest challenge facing the City due to the considerable amount of time and resources that this effort requires.

The primary objective of the Internal Controls Section is to facilitate the documentation of all of the processes performed by the Comptroller's Office. As identified as one of the main focus points through the scope analysis, documenting processes performed will allow the Office to establish effective and efficient mechanisms to ensure that transactional data that is relied upon for the preparation of the financial statements is accurate, authorized and complete. To address the resource constraints, several innovative approaches have been developed and are currently being implemented to increase productivity on publication of outstanding process documents.

The secondary objective is to extend the process documentation initiative to the second area of focus, the transactions generated through department operations. This will entail the identification of processes, which have a financial component that are performed at the department level. This identification should also encompass transactions and financial activity that is conducted both within the City's financial SAP system and in systems external to SAP, where activity is transferred through electronic interfaces.

A key aspect of the documentation related to the objectives described above is the identification of controls, both preventative and detective, to ensure the integrity of the transactional activity is maintained for financial reporting purposes. With the constantly evolving business environment, it is critical that the processes and related controls are assessed on a periodic basis to ensure relevance and applicability. As the amount of processes and controls will continue to increase in the future, the amount of monitoring will also increase. To accomplish this increasing amount of oversight activity, the use of assessments, manual tests and automated testing within the SAP GRC module will become more prevalent through the organization.

It is expected that once the objectives described above have been accomplished, resources can be more effectively allocated to the remaining area of focus identified in the scope of work. The strategies described above will also help the City adopt a proactive approach that prevents financial reporting errors by establishing a strong internal control framework.

As we continue to develop and strengthen the internal control framework within the City, specific emphasis will be placed on implementing the regulatory compliance requirements contained in California Government Code Section 12422.5 as well as those contained within the

2014 Compliance Supplement and Uniform Guidance issued by the Office of Management and Budget. These requirements will be analyzed and implemented using the New Framework issued by COSO in 2013.

While the Internal Controls Section will be focused on the accomplishment of the objectives above, the day-to-day activities including monitoring for segregation of duty violations, developing and facilitating automated testing, identification of control weaknesses and mitigating controls will continue. During 2014, the use of the SAP GRC module has expanded and it is expected that this trend will continue. This powerful tool has additional capabilities that can be deployed to increase efficiency and oversight within the SAP Security and Internal Control arenas.

## CONCLUSION

The City has established a high bar for the development of a comprehensive internal controls program for a municipal government, and while there is more to do, much has been accomplished over the past several years.

The development and implementation of an internal control system across the City is a complex and resource intensive activity that is continuous in nature. In this reporting cycle, calendar year 2014, numerous activities have been performed to gain a deeper understanding of the current internal control landscape and to identify the scale and scope of work that remains. Even though much has already been achieved, much remains to be completed. The City needs to continue to document financial processes by prioritizing resources on those areas of higher materiality and risk. While internal controls are usually understood to relate to financial reporting, they are much more. Internal controls are a varied means used by management to achieve management objectives and to meet management responsibilities. Internal controls are being ingrained into the culture of the City and are being recognized as a means to support the achievement of the City's objectives. "Internal controls" has become part of the City's vocabulary.

A key purpose of this report is to evaluate the City's Internal Control Program and communicate the results of such evaluation to the City Council, Audit Committee and residents of San Diego. This evaluation includes identifying any areas of material weakness and material changes to the Internal Control Program over the course of the year. As described in this Report, management has evaluated the City's Internal Control Program in respect to the processes currently documented as well as the financial activity of the year, including the preparation of the City's CAFR and other internal and external financial reporting. Based on this evaluation, there have not been any changes in the documented internal control policies, formalized procedures or financial operations that may have weakened internal controls over financial reporting. In addition, the City has strengthened existing controls and implemented new controls in areas in which significant deficiencies or material weaknesses were identified during calendar year 2014.

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### **Sources**

1 Gauthier, Stephen J. *Evaluating Internal Controls*. Chicago IL: Government Finance Officers Association of the United States and Canada, 2013. Print

**RECOMMENDATIONS:** N/A

**FISCAL CONSIDERATIONS:** N/A

**COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:** N/A

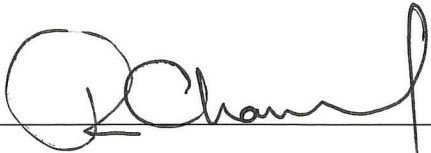
**KEY STAKEHOLDERS AND PROJECTED IMPACTS:** N/A

- Attachments:
1. Certification by the Chief Operating Officer, Chief Financial Officer and City Comptroller
  2. Process Narrative and Workflow Sample



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Mary Lewis, Chief Financial Officer



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Rolando Charvel, City Comptroller

**CERTIFICATION BY MAYOR AND CHIEF FINANCIAL OFFICER**

In accordance with the requirements of §22.0708 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 or not 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:   
 Scott Chadwick, Chief Operating Officer


Date: 30 DEC 14

Signed:   
 Mary Lewis, Chief Financial Officer

Date: 12/24/14

Signed:   
 Rolando Charvel, City Comptroller

Date: 12/24/14

	THE CITY OF SAN DIEGO		<i>Status</i>	<i>Doc #</i>	<i>Rev Date</i>
	Process Narrative		Approved	PN-0011	11/05/2014
<i>Document Name:</i>	Procurement Card (P-card) Invoice Payment Process			<i>Page:</i>	1 of 6
<i>Owner Name:</i>	Dianne Owalla	<i>Internal Controls</i>	Coleen Maddox		

**PURPOSE:**

How to process Bank of America's monthly Procurement Card (P-Card) Invoice Payments within the City of San Diego.

**SCOPE:**

This process is applicable to the Office of the City Comptroller.

**DEFINITION(S):**

**ACH:** Automatic Clearing House/Electronic Payments.

**Activity Detail:** Monthly detail of procurement card transactions for each Cardholder provided by Bank of America.

**Appointing Authority:** The person signing must be on the Appointing Authority listing maintained by the Office of the Comptroller.

**Group:** Participants identified by Division or Department in the P-Card Program, WORKS®

**Invoice Payment (IP):** A document submitted by the Vendor requesting payment for goods or services supplied to the City of San Diego.

**Journal Entry Document (JE):** A document used to manually record SAP general ledger activity such as accruals, adjustments, allocations, corrections, re-postings, transfers and other revenue or expense postings for assets, liabilities, equity, revenues and expenses.


**Non-PO Invoice Payments (KR):** Invoices submitted by the department to make a payment for goods or services received without a Purchase Order.

**Payment Center:** Bank of America's password protected, secure Internet website for viewing and printing monthly statements.

**Procurement Card Program Administrators:** Office of City Comptroller employees designated by the Comptroller to manage and maintain citywide operation of the Procurement Card Program. This includes user access, set up and termination of new cards, monitoring of credit limits and spending activity, reporting and related invoicing/billing.

**SAP:** An Enterprise Resource Planning platform for the City's core Financial, Procurement, Human Resources, and Payroll processes in a single integrated environment.

**SAP T-Code:** A code executed in SAP to perform a desired function.

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**Statement:** Monthly summary of procurement card transactions for each Cardholder provided by Bank of America.

**WORKS®:** Bank of America’s password protected, secure Internet website for managing the City’s Procurement Card Program. WORKS® allows Cardholders to manage all transactions by assigning funds, cost centers, general ledger expense accounts, internal orders and descriptions. WORKS® also allows Approvers to sign off on all transactions electronically.

**ZGLPARK:** A SAP T-code executed to upload an invoice payment document in SAP.

**RESOURCE REQUIREMENTS:**

Access to Payment Center

Access to SAP

Access to WORKS®

AP Invoice Administrator – Users mapped (assigned) to this role within a department will be designated with access to initiate an Invoice Payment in SAP.

AP Invoice Approver – Users mapped (assigned) to this role within a department will be designated with access to post a completed Invoice Payment in SAP.

GL Journal Entry Administrator – Users mapped (assigned) to this role within a department will be designated with access to create, modify and deleted an unposted journal entry document in SAP.


GL Journal Entry Approver – Users mapped (assigned) to this role within a department will be designated with access to post a completed journal entry document in SAP.

Journal Entry Upload Template

**PROCESS:**

**Invoice Payment**

- The Procurement Card Program Administrator accesses the Bank of America Payment Center website to download the monthly Statement generated by the bank on the 22nd of each month.**S1**
- The Procurement Card Program Administrator accesses the Bank of America WORKS® website to download the monthly Activity Detail.**S2**


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- The Procurement Card Program Administrator reconciles the Bank of America Payment Center monthly Statement to the WORKS<sup>®</sup> monthly Activity Detail.**M1**
- If differences exist, the Procurement Card Program Administrator researches and resolves the difference.
- Using the monthly Activity Detail downloaded from WORKS<sup>®</sup>, the Procurement Card Program Administrator prepares and uploads the Invoice Payment (Document Type KR) to SAP by executing SAP T-code ZGLPARK. Expenses are summarized by Group and posted to General Ledger Account 516046 (P-Card Unallocated Expense) using each Group's assigned Cost Center and Fund identified annually by the department budget analyst (See How to Process Non-Purchase Order Invoices, [PN-0010](#)).**S3**
- The Procurement Card Program Administrator attaches the monthly Statement to the Invoice Payment in SAP by executing SAP T-code FB03.**S3**
- The Comptroller Invoice Approver reviews and posts the Invoice Payment in SAP by executing SAP T-code FBV0.**M2,S3**
- For Invoice Payments which fail this review, the Procurement Card Program Administrator is contacted to revise the Invoice Payment.
- The Invoice Payment is paid via ACH upon reaching agreed upon payment terms.

#### Journal Entry Document

- Once City departments have allocated and approved all Procurement Card transactions within WORKS<sup>®</sup>, as detailed in the WORKS<sup>®</sup> Quick Reference Guide, the Procurement Card Program Administrator accesses the Bank of America WORKS<sup>®</sup> website to download the allocated monthly Activity Detail.**S2**
- Using the allocated monthly Activity Detail downloaded from WORKS<sup>®</sup>, the Procurement Card Program Administrator prepares a journal entry crediting General Ledger Account 516046 (P-Card Unallocated Expense) and debiting the General Ledger Account indicated by the Cardholder in WORKS<sup>®</sup>.
- The Procurement Card Program Administrator parks (saves) the journal entry document (Document Type SA) in SAP by executing SAP T-code ZGLPARK (See How to Process a Journal Entry Document in SAP, [PN-0064](#)).**S3**
- The Procurement Card Program Administrator attaches the allocated monthly Activity Detail to the Journal Entry Document in SAP by executing SAP T-code FB03.**S3**



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- The Comptroller Journal Entry Approver reviews and posts the journal entry document in SAP in the same period the Invoice Payment was posted by executing SAP T-code FBV0.M3,S3
- For journal entries which fail this review, the Procurement Card Program Administrator is contacted to revise the journal entry document.

### **POST PROCESS REVIEW:**

Monthly, the Procurement Card Program Administrator executes SAP T-code FBL3N to validate that the balance in General Ledger Account 516046 is zero.

### **ATTACHMENTS:**

[Payment Center](#)

The Process Workflow Diagram can be retrieved from ([PF-0011](#))

Work Instructions for the T-codes listed throughout this process can be accessed by clicking on the T-code links below:

Attach/Review Scanned Documents ([FB03](#))

Post Invoice (Non-PO Related) ([FBV0](#))

Post Journal Entry ([FBV0](#))

Upload and Park Journal Entry via Spreadsheet ([ZGLPARK](#))

[WORKS®](#)


[WORKS® Quick Reference Guide](#)

## **FOR INTERNAL CONTROLS USE ONLY**

### **RISKS ASSOCIATED WITH THIS PROCESS:**

Invoices do not represent the goods and services received resulting in financial misstatements and potential inventory errors.

A payment is made for goods or services not ordered or rendered and received resulting in financial error and potential fraudulent activity.

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**INTERNAL CONTROL POINTS:**

**Control Legend:**

Control Category	P D	Preventive Detective
Control Method	M A	Manual Automated
Control Type	C A V R	Completeness Accuracy Validity Restricted Access

**Manual Key Controls:**

**M1** The Procurement Card Program Administrator reconciles the Bank of America Payment Center monthly Statement to the WORKS<sup>®</sup> monthly Activity Detail.(P,M,C,A)

**M2** The Comptroller Invoice Approver reviews and approves all Invoice Payments.(P,M,C,A)

**M3** The Comptroller Journal Entry Approver reviews and approves all Journal Entry Documents.(P,M,C,A)

**System Key Controls:**


**S1** Access to the Bank of America Payment Center website is restricted to authorized personnel and password protected.(P,A,R)

**S2** Access to the Bank of America WORKS<sup>®</sup> website is restricted to authorized personnel and password protected.(P,A,R)

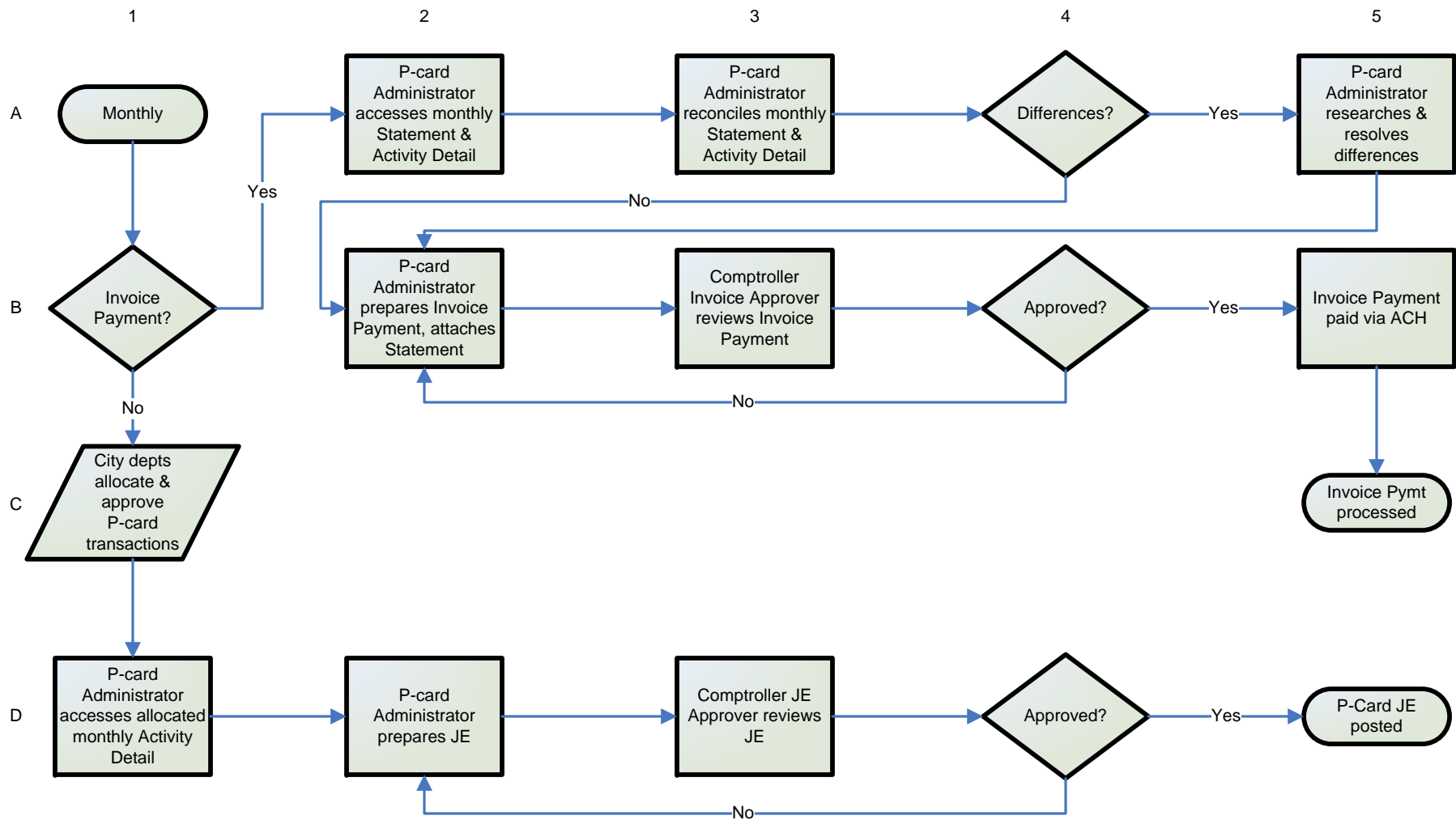
**S3** Access to SAP is restricted to authorized personnel.(P,A,R)

**FINANCIAL STATEMENT ASSERTIONS:**

1. Existence or Occurrence: Recorded liability and expense represents goods or services received in the respective period.
2. Completeness: A liability and expense have been recorded for all goods and services in the respective period.
3. Valuation and Allocation: Invoices and expenses are entered at the correct amount.

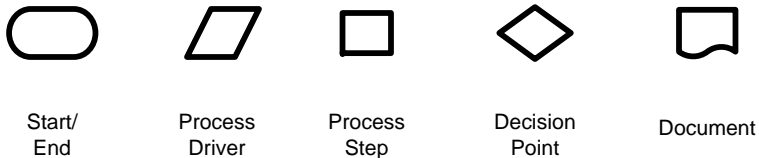
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4. Rights and Obligations: All invoices and expenses paid and accrued represent valid expenditures.
5. Presentation and Disclosure: Expenditures are correctly coded to the appropriate expense classification.



**Process Notes:**  
Please read in conjunction with PN-0011.

**LEGEND:**



**CITY OF SAN DIEGO PROCESS WORKFLOW**  
**Title: Procurement Card (P-Card) Invoice Payment Process**  
**Doc #: PF-0011**  
**Process Narrative Ref #: PN-0011**  
**Owner: Dianne Owalla**  
**Status: Approved**  
**Rev Date: 11/05/2014**