INTERNAL AUDITOR INDEPENDENCE

Background

The creation of the Audit Committee and the Auditor General position (i.e. Internal Auditor) are two of the most significant and fundamental remediations recommended in the Kroll report. Together the two new entities will create an "audit organization," which will effectively become a new arm to City government. The central role of this arm will be to provide independent oversight and auditing for the accounting and financial reporting functions of City management. The audit organization's independence from management will and should be its most distinguishing attribute.

KROLL RECOMMENDATIONS

The City's Auditor General would be nominated by the Mayor and appointed by a majority vote of the City Council.

The Auditor General should report to the Audit Committee no less than on a quarterly basis and periodically to the City Council.

The Audit Committee should approve the annual compensation of the Auditor General and the annual budget for the Auditor General's staff.

The Auditor General should serve a term of 10 years and could be removed from office for cause by the Audit Committee or upon an affirmative vote of three-quarters of the City Council.

Summary of Best Practices

The United States Government Accountability office (GAO) states that "the audit organization and the individual auditor, whether government or public, should be free both in fact and appearance from organizational impairments to independence."

GAO also states that a government audit organization may be free from organization impairments for external reporting if the organization's head meets any of the following criteria:

a. is directly elected by voters of the jurisdiction being audited;
b. is elected or appointed by a legislative body subject to removal by a legislative body and reports the results of audits to and is accountable to a legislative body;
c. is appointed by someone other than a legislative body so long as the appointment is confirmed by a legislative body and reports the results of audits to and is accountable to a legislative body; or

d. is appointed by, accountable to, reports to, and can only be removed by a statutorily created government body the majority of whose members are independently elected or appointed and come from outside the organization being audited.

The Institute of Internal Auditors (IIA) defines independence as "the freedom from conditions that threaten objectivity or the appearance of objectivity."

Generally Accepted Government Audit Standards (GAGAS) defines independence as independence from management.

Government Finance Officer's Association (GFOA) best practice states "it is recommended that internal auditors of state and local governments conduct their work in accordance with the professional standards relevant to internal auditing contained in the U.S. General Accounting Office's publication *Government Auditing Standards* including those applicable to the independence of internal auditors."

Summary of City Attorney's Position (Excerpted from January 23, 2006 City Attorney Memorandum of Law

The City Attorney has opined that the current Charter does not allow for the changes that are necessary to address key issues relative to increased independence of the Auditor. Specifically, Charter Section 265 (b)(10)(11) transferred the authority to appoint the Auditor from the City Council to the Mayor subject to Council confirmation, and provides that the Mayor may remove the Auditor subject to appeal to the City Council. Charter Section 29 also gives the Mayor the power to appoint and remove "all City officers and employees in the administrative service of the City under his control . . . ."

Also, the Mayor's Charter responsibilities with respect to the City's finances and budget under Charter Section 28 require that he exercise supervisory authority over the Auditor. Supervisory authority is inherently inconclusive of reporting structure and establishment of the Auditor's budget and compensation.

The current City Auditor and Comptroller also remains the "chief fiscal officer" under Charter Section 39 which precludes establishing a separate independent audit function without changes to the Charter.

Current Structure

The acting Internal Auditor, Kyle Elser, was appointed by the Mayor in April 2007 and reports directly to the CFO. The City is currently in the process of recruiting for a permanent Internal Auditor. For the interim, until Charter changes can be submitted to the voters that would allow for increased independence of the Internal Auditor, the Mayor and City Council have developed a Statement of Operating Principles for this position setting forth communication protocols and working relationships between the Internal

Auditor, the Mayor and the Audit Committee. This Statement also addresses a cooperative and participatory process between the Mayor and the Audit Committee relative to the recruitment and appointment of the permanent Internal Auditor.

IBA Recommendation

Mayoral nomination/appointment of the Internal Auditor with Council confirmation is acceptable provided other protections are in place that would ensure the position's independence as well as Audit Committee independence. These protections include the following:

a. Once appointed, the Auditor would report to and be accountable to the Audit Committee rather than to management.

b. The Audit Committee/Council would set the compensation, staffing and budget for the Internal Auditor .

c. The Council would be responsible for making the determination regarding removal for cause.

d. Audit Committee independence has been ensured through committee composition as recommended.

Additional protections for consideration as recommended by Kroll are a long term contract for the Internal Auditor and a requirement of a three-quarters vote by Council for removal.

Increased independence could be achieved with appointment of the Internal Auditor by the legislative body rather than the Mayor.

CHARTER IMPLICATIONS

Possible changes necessary to Sections 28, 29, 39 and 265 to achieve desirable level of Internal Auditor independence.