

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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To: Charter Review Committee Members

From: Andrea Tevlin, Independent Budget Analyst

Subject: Auditor Independence and Audit Committee Issues

OVERVIEW

On November 2, 2004, the voters of the City of San Diego passed Proposition F, which amended the City Charter to add Article XV to “test implementation of a new form of governance commonly known as a Strong Mayor form of government”. In considering Charter Sections 39 and 265 as they relate to the City Auditor & Comptroller, the City Attorney opined in a memorandum dated January 23, 2006 (attached) that the Office of the City Auditor and Comptroller is now under the Mayor’s direct supervision; however, the “Mayor may not limit or impede the authority or duties given to, or required of, this public office by City Charter or ordinance, federal or state law.” Given concerns about auditor independence and the oversight role of the City’s new Audit Committee, the IBA has prepared a binder of Auditor and Audit Committee documents for the Charter Review Committee. Drawing from the contents of the binder, this report attempts to highlight some of major issues related to auditor independence and the City’s Audit Committee to better facilitate Charter Review Committee discussion prior to a public vote to possibly amend the City Charter.

FISCAL/POLICY DISCUSSION

Auditor Independence

The IBA has issued several reports expressing our concern about the City’s lack of auditor independence under the new form of government. As stated in IBA Report Number 06-35, we believe that an audit organization’s independence will and should be its most distinguishing attribute. In an effort to initiate Charter Review Committee discussion related to auditor independence, the IBA has extracted the following bullet points for your consideration:

- The United States Government Accountability Office (GAO) defines *independence*, in their Generally Accepted Government Audit Standards (GAGAS), as independence from management. In the City’s new form of government, the Mayor controls organizational management.

- The GAO further 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.”
- The IBA believes that the greatest risk of impairment or undue influence to City’s audit organization is the current structure whereby the auditor reports to management whose activities he is charged with auditing.
- In their recommendation for an independent Auditor General (now referred to as an internal auditor), Kroll makes the following statement: “Currently, the functions of accounting and financial reporting are combined with the function of internal auditing in the Office of the City Auditor and Comptroller; in substance, the auditor audits his own work. Such a structure lacks the requisite level of independence widely viewed as essential for a sound financial reporting system.”
- The City’s first Annual Report on Internal Controls, prepared by the former City Auditor and Comptroller and dated January 1, 2006, provided the following about auditor independence: “An auditor’s ‘stock-in-trade’ is her or his opinion. The value of the auditor’s opinion is rooted in the auditor’s *objectivity*. The auditor’s objectivity is rooted in the auditor’s *independence* within the organization. To the extent that an auditor’s opinion is less than objective, the value (and reliability) of that opinion is diminished.”
- The California legislature has codified the necessity for audit independence with Section 1236 of the California Government Code that requires all city and county audit activities and auditors follow the Institute of Internal Auditors (IIA) Professional Practice Standards. The IIA’s Statement of Responsibilities speaks to auditor independence as “essential to the effectiveness of internal auditing.”
- The IIA’s Statement of Responsibilities further specifies that “objectivity is essential to the audit function. Therefore, an internal auditor should not develop and install procedures, prepare records, or engage in any other activity which he would normally review and appraise and which could reasonably be construed to compromise his independence.”
- In a private sector parallel, the Sarbanes-Oxley Act of 2002 addresses auditor independence by adding a “Prohibited Activities” section to the Securities Exchange Act of 1934 that makes it unlawful for an auditing firm providing an audit for a client to contemporaneously provide any non-audit service (i.e., bookkeeping or other services related to the accounting records or financial statements of the audit client) for that same client.

Audit Committee Issues

In the Report of the Audit Committee of the City of San Diego dated August 8, 2006 (“Kroll”), there was a financial remediation recommendation to establish a three-member Audit Committee, with two members from the public and one member from the City Council. Kroll further suggested that the two public members be appointed by the Mayor and confirmed by the City Council. Citing professional best practices in IBA Report Number 06-35, the IBA recommended that the City Council appoint the two public members. After considerable discussion about the appropriate process and composition of the recommended committee, the City Council acted to establish an Audit Committee with the adoption of Resolution R-302279 on January 9, 2007. The City’s Audit Committee is comprised of three members of the City Council.

The City Council adopted Ordinance O-19612 on April 24, 2007 to codify the Audit Committee Charter into the City’s Municipal Code. The Municipal Code now specifies that the Audit Committee shall provide independent, legislative oversight for the audit work performed by and for the City. The Audit Committee Charter and the City’s Municipal Code state that this oversight “shall extend to the City’s internal controls over financial reporting; the City’s financial disclosures; internal financial audits; and the selection, with appropriate consultation with the Mayor, and monitoring of independent audit firms.”

The following bullet points provide information contained within the binder related to some of the issues faced in establishing and defining the role of the City’s Audit Committee:

- In their Recommended Practice for 2006, the Government Finance Officers Association (GFOA) states “An audit committee also provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns. By effectively carrying out its functions and responsibilities, an audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management’s practices, and that the independent auditors, through their own review, objectively assess the government’s financial reporting practices.”
- With respect to audit committee establishment, the GFOA further provides “The governing body (4) of every state and local government should establish an audit committee or its equivalent ...” (4) footnote: “For the purposes of this recommended practice, the term ‘governing body’ should be understood to include any other elected officials (e.g., county auditor, city controller) with legal responsibility for overseeing financial reporting, internal control and auditing, provided they do not exercise managerial responsibilities within the scope of the audit.”
- The Association of Local Government Auditors (ALGA) has developed model code or ordinance language for establishing a local government auditor and/or audit committee. That language specifies that “Audit committee members shall be appointed by the

legislative body and all appointees shall be independent of the local government's management and administrative service.”

- The American Institute of Certified Public Accountants (AICPA) states “The creation of an effective audit committee function can help a government establish accountability because it can focus specifically on issues related to fiscal accountability. Furthermore, a government audit committee can devote more time to fiscal accountability matters, resulting in greater benefits. For example, government audit committees can improve financial practices and reporting, enhance the internal audit function and enhance the external audit function.”
- The National Office of Audit and Accounting (NOAA) issued an Audit Committee Guide for Public Sector Entities which contrasts the role of management with that of the audit committee as follows: “Management has the responsibility to ensure the accuracy of the financial statements and compliance with laws, regulations and agreements. It is the audit committee’s function to carry out due diligence by evaluating information from the chief financial officer, program administrator, the internal auditor, and the external auditors to form conclusions.”

CONCLUSION

The information provided within this binder is provided as a resource for members of the Charter Review Committee to utilize in discussing the City Charter as it relates to the issue of auditor independence, which is linked to the new role of the City’s Audit Committee. The binder is largely comprised of best practices and recommendations from professional auditing, accounting and government associations. In an effort to provide additional perspective, we have included related IBA reports and selected pages from the Kroll consultant report to the City.

The IBA is pleased to be an ex-officio member of the Charter Review Committee. We are interested in the work of the Committee and would be glad to provide you with additional information to support your review. My staff and I stand prepared to assist the Committee, and its Subcommittees, as may be needed. Please feel free to discuss anything of interest with me or a member of my staff in the course of your review.

[SIGNED]

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