

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: November 8, 2006

IBA Report Number: 06-53

City Council Agenda Date: November 13, 2006

Item Number: 601

Subject: Kroll Remediation Status and Related Actions.

OVERVIEW

At this special meeting of the City Council, the Mayor and City Attorney will provide a variety of status updates and action items on the Kroll remediations for the City Council's consideration. As documented in the Mayor's memo of October 30, 2006, a number of the identified remediations have been completed or are in process and details as to those processes are provided. In addition, the City Attorney has provided an ordinance for Council action on Improper Influence.

FISCAL/POLICY DISCUSSION

The progress reported for this remediation status update is significant and actions taken are thoughtfully executed and documented. Several more administrative remedies have already been instituted and recommended budgeting practices are being addressed. We note that the Office of Ethics and Integrity has established policies and procedures for the employee hotline to protect whistleblowers, as recommended by Kroll. These procedures also address a concern raised by this office in IBA Report 06-35 in that they require that the Auditor-General receives a copy of every hotline call in order to ensure the opportunity for proper investigation into every complaint. The IBA supports efforts executed and underway as reported here.

Audit Committee

As we discussed in our initial report on this topic, we do have concerns with the implementation of Kroll's Audit Committee recommendation. The Mayor's plan

proposes the continuation of those components, so we refer back to IBA Report 06-35 and restate each of the concerns raised at that time.

With respect to the long term plan for the establishment of an Audit Committee, we concur with the Mayor's assessment, as well as with the City Attorney's assessment in his September 1, 2006 report, that a Charter change will be required to fully implement the Audit Committee provisions as envisioned in the Kroll report. We again agree that the City Council should direct the City Attorney to prepare the necessary ordinances to place such a measure on the ballot. It is preferable to place this measure before the voters at the earliest opportunity, yet we do not recommend a special election for this purpose given that the cost of such a special election may approach \$3 million. While this new Audit Committee function should be a valuable addition to the City's processes, we believe that it is incumbent upon the City to pursue a more economical interim option. Therefore we concur with the Mayor that this item, modified as discussed in our original report to require committee appointments to be made by the legislative body, should be prepared for the June 2008 ballot.

Consequently, the Mayor also presents a short term plan for the Audit Committee, which would put a committee in place subject to limitations in our current City Charter. This is proposed to be accomplished by amending the Municipal Code section added in October 2004 that establishes the Financial Reporting Oversight Board (FROB) using language from the Kroll report, modified to prevent conflict with the City Charter.

However, the FROB structure does not provide the necessary authorities and attributes for the committee and therefore the IBA does not support the Mayor's recommendation for the short term plan that utilizes the FROB structure. As pointed out by the City Attorney in his report of September 1, 2006, the current Charter requirements do not allow the Audit Committee the authority to set the budget or salaries of the Auditor-General and his/her office or the authority for the committee to direct the activities of any department, including the Auditor-General. Consequently, the Auditor-General must continue to report to the Mayor until and unless the City Charter is changed, reducing his/her independence. This model diminishes the effectiveness of the audit organization as a whole.

Secondly, the current Charter does not allow anyone but the Mayor to appoint members of advisory boards (Charter section 43(a)). As discussed in IBA Report 06-35, it is absolutely contrary to the recommendations of reputable advisory organizations and best practices across the country to have management appoint members that will audit the work of the management. Since the publication of our report, the Government Finance Officers Association (GFOA) has released an entire handbook on Audit Committees, "An Elected Official's Guide: Audit Committees". This guide not only emphasizes ever more strongly that management influence on the committee is verboten, but that the committee

members should *all* be members of the governing body. They provide two reasons for this:

“First, one of the core responsibilities of the legislative branch of government is to oversee the executive branch (including its financial management). As a rule, a core responsibility *cannot* be delegated. Second, the credibility of the audit committee (and hence its effectiveness) inevitably will depend on both its *real* and *perceived* authority. The process of delegation inherently weakens both by opening a gap between the audit committee and actual decision makers.” (p. 19)

This echoes concerns raised to this office in discussions with the City Attorney’s office. While the GFOA finds this delegation unacceptable for financial policy, the City Attorney has stated that this delegation is in fact unacceptable under our current City Charter. For these reasons, we suggest that the Mayor, City Council and City Attorney have a discussion that will outline in clear terms the intended duties of the “Interim” Audit Committee, and how those duties can be fulfilled under the limitations of our current City Charter.

Certainly, the City Council could form a subcommittee for this purpose, as suggested by GFOA. Although concerns could be raised regarding the level of expertise available amongst elected officials, the GFOA notes this concern and responds:

“Members of governing bodies are not necessarily elected or appointed for their specialized expertise in accounting, auditing, financial reporting, and internal control. Therefore, it is quite possible that no member of a given governing body will possess the required level of expertise in any or all of these topics to qualify as a *financial expert*.....Consequently, it is not possible in the public sector to mandate that the financial expert be a member of the audit committee without at the same time relaxing the more fundamental requirement that all members of the audit committee also be members of the governing body. Rather than do that, the GFOA recommends that governments resolve this potential dilemma by authorizing the audit committee to obtain the services of an *outside* financial expert to assist in the conduct of its work.” (pp. 22-23)

This option would allow the City to implement the Audit Committee format more fully as envisioned by Kroll, and would resolve the conflict of interest issue in having management involvement on the Committee.

As suggested above, we recommend that the Mayor, City Council and City Attorney discuss the duties of an Audit Committee and what models could execute those duties best, whether it be a City Council subcommittee or some other committee pursuant to the City Charter that can be established by appointment of the legislative body.

In addition to the above, we are disappointed that the discussion of the Auditor-General position was not brought forward to this meeting in conjunction with the Audit Committee. As reflected in IBA Report 06-35, we believe these two items should be discussed together in the context of the audit organization as a whole, in order to ensure that this new arm of government is empowered with all the tools necessary to fulfill its mission. We strongly recommend that the discussion of the Auditor-General position be brought forward at the next opportunity.

Oversight Monitor

Regarding the Oversight Monitor, the IBA concurs with the Mayor's plan to make the final recommendation consistent with the Kroll recommendation *and* any SEC order, if applicable. As noted in the memo, the City Council has final approval on this item, since the contract will have to be approved by Council. However, we would encourage the City Council and Mayor to clarify the process for the Oversight Monitor retention. We strongly recommend that, to the extent possible, the scope of duties, term of retention and desired qualifications be brought forward for discussion in a public forum *prior* to any proposal for the engagement of a specific contractor. It is critical that the City Council and the public have a better understanding of the expectations and costs for this remediation in order to be able to evaluate a specific contractor against those requirements. We recommend that the City Council communicate that expectation now and that the details of the Oversight Monitor remediation be docketed for at least one discussion prior to a proposal for a contract, if staff is not prepared to enter into that discussion at this time.

Given the status update on these remediation items, the IBA will produce a second iteration of our itemized matrix of Kroll recommendations (refer to IBA Report 06-42) for the City Council by Monday, November 20.

CONCLUSION

The Mayor, the City Attorney and all staff are to be commended for the progress realized thus far in implementing these remediations. The IBA supports the vast majority of remediations implemented or in progress. As described above, the IBA recommends that the City Council require the following modifications to the recommendations:

1. Audit Committee - Long term: Direct the City Attorney to prepare a measure for the June 2008 ballot that will allow for the full implementation of the Audit Committee as envisioned by Kroll and that requires committee appointments to be made by the legislative body.
2. Audit Committee - Short term: More clearly define the duties of the interim Audit Committee and consider a model for the committee that fulfills those

duties, is operable under the current City Charter, and requires committee appointments to be made by the legislative body.

3. Clarify the Oversight Monitor selection process to ensure that the details of the work of the Oversight Monitor will be brought forward to a public hearing prior to the request for City Council approval of a specific contractor.

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