

## **OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT**

**Date Issued:** January 25, 2007

**IBA Report Number:** 07-18

**City Council Docket Date:** January 29, 2007

**Item Number:** 201

**Subject:** Second Annual Report on Internal Controls

### **OVERVIEW**

On January 29, 2007, the City Auditor & Comptroller's Office will present their Second Annual Report on Internal Controls (Report) to the City Council. The Report complies with a requirement in Ordinance 19320 that was adopted on October 11, 2004. This ordinance requires the City Auditor to conduct a "thorough review of the efficacy of the City's internal financial controls and their operation" and "submit a written Annual Report of their findings to the City Council ... on or before January 1 of every year, beginning with January 1, 2006."

The IBA has reviewed the City Auditor's Report and compared it to the findings of the first Annual Report on Internal Controls dated January 1, 2006. This report summarizes major findings within the City Auditor's Report, discusses related considerations and comments on budgetary / fiscal policy considerations.

### **FISCAL/POLICY DISCUSSION**

#### **Internal Controls Discussed in the Report**

The City Auditor's Report focuses on internal financial controls and does not endeavor to review disclosure procedures/controls which are separately addressed in Ordinance 19320. Internal Controls are defined to be "a coordinated set of policies and procedures designed to provide reasonable assurance of achieving management's objectives. These objectives include the effectiveness and efficacy of operations as well as the reliability of financial reporting."

The Report distinguishes between internal controls designated as ‘administrative controls’ and those designated as ‘financial controls’. Administrative controls being those designed and implemented to assure or enhance the efficiency and effectiveness of operations. Financial controls are those designed and implemented to assure accuracy and timeliness of financial reporting. The City Auditor indicates that this second Report, like the first, is limited to only address financial controls. The City Auditor further states that “as the internal review process evolves, future reviews will opine on the adequacy of administrative controls – the controls that are or should be in place to assure the delivery of high quality services at the lowest cost in all phases of the City’s operations.”

The IBA understands that the City Auditor has had limited resources and a mandate to focus on critical financial reporting matters. There are significant costs to the City associated with four years of delayed financial statements and an inability to access the public capital markets. Irrespective of these and other valid circumstances driving the City Auditor’s focus to financial controls, the IBA is concerned that administrative controls have received diminished attention and are not being discussed in the Annual Report. With insufficient resources and without sacrificing other auditing priorities, the City Auditor has not been able to perform many routine administrative controls that should be performed in every public agency. The IBA recommends that this issue be discussed further at a future meeting of the City’s Audit Committee.

The IBA believes that administrative controls are a big part of the larger internal control framework and should be reviewed / covered in the City’s annual internal control report. Administrative controls focus on the effectiveness of the City’s operational policies and procedures. Examples of administrative controls include timecard processing audits, invoice processing reviews, organization audits or procurement process reviews. Administrative controls are important in that they provide a necessary check on operational practices and catch processes that need to be improved.

#### Importance of the Control Environment and Internal Auditor Independence

The overarching point made throughout the City Auditor’s Report in 2007 as well as 2006 is the importance of the ‘control environment’ to the effectiveness of internal control policies or procedures. The Report defines ‘control environment’ as a term used to describe what is commonly referred to as ‘tone-at-the-top’, or more broadly as the ‘corporate culture’. The Report emphasizes that “the best control policies and procedures, however, will only be as effective as management will allow them to be.”

The IBA believes the concept of the control environment is particularly important when discussing the independence of the internal auditor, another subject that is addressed within the Report. Professional government, financial and accounting organizations recommend against having an internal auditor function that reports to management as it is difficult, if not impossible, to independently investigate and comment on financial processes that will often be critical of functions controlled by management. The Report states that “the Internal Auditor should not report to the entity’s CEO under any

circumstances. This concept is recognized in the California Government Code Section 1236, the Recommended Practices of the Government Finance Officers Association, and the internal auditing standards promulgated by the Institute of Internal Auditors.”

The IBA commends the Mayor and his management team for initiating several actions designed to improve the City’s control environment. Mandatory values-based ethics training for all management personnel, establishment of an Office of Ethics and Integrity (OEI), mayoral communications to employees, an employee ethics survey and an Employee Hotline are all positive efforts by the Mayor to improve the control environment. However, the IBA believes that it is imperative for the City to establish independent internal audit functions to objectively report on internal controls and effectively review the fiscal operations controlled by management.

The following IBA document review experience helps to illuminate the aforementioned concern. The City Auditor’s Office recently provided the IBA with a substantially complete version of the Internal Controls Report to review. In reviewing this version against the final version, we noticed the wording of a critical conclusion in the Executive Summary had been substantively modified. Specifically, the first paragraph under the heading Conclusions in the Executive Summary of the substantially complete Report reads as follows:

“Although much remains to be accomplished, based upon progress to date in implementing remedial actions, we conclude that the City’s internal controls over financial reporting, as of this report date, are minimally adequate to assure timely and accurate preparation of the City’s annual financial statements.”

The same paragraph under the heading Conclusions in the Executive Summary of the final Report was modified to read as follows:

“Although much remains to be accomplished, progress was made in calendar year 2006 in implementing remedial actions. The City’s internal controls over financial reporting, as of this report date, have improved to permit timely and accurate preparation of the City’s annual financial statements.”

As there were few, if any, other substantive changes between the two versions of the Report, it was unclear as to why this language would have been amended. The IBA contacted the former City Auditor who authored the Report to inquire about the reasons for the change. The former City Auditor indicated that upon their review of the Report, the Mayor’s management team requested the change, and that the earlier version more accurately reflected his position. The nature of this type of change concerns the IBA as it is likely that many readers of the Report will focus and rely upon this paragraph.

The organizational and reporting relationships, as currently structured, allow the Mayor and his management the opportunity to review and edit audit reports. We continue to support changing this structure to provide greater independence from management for the Internal Audit function. This recommendation is supported by industry standards and best management practices.

The City Council and the Mayor are currently working together with the City Attorney to evaluate permissible organizational options, given current City Charter language, to provide for Internal Auditor independence with oversight from an independent Audit Committee. This organizational structure will set the stage for positive and longstanding fiscal reform. Every financial authority contacted by the IBA recommends independent Auditor and Audit Committee operations that are not subject to real or perceived management influence.

#### Update on Internal Control Measures Recommended in Last Year's Annual Report

Much of the City Auditor's Report describes the current implementation status for recommendations related to internal control weaknesses identified in the January 2006 Internal Control Report. In the Conclusions section of the Executive Summary, the 2006 Report stated, "we are unable to conclude that the City's internal controls over financial reporting are adequate to assure timely and accurate financial reporting." The 2006 Report identified and classified internal control deficiencies into the following four categories: Control Environment, Organizational Issues, Business Practices and Other Issues.

With respect to City Auditor's status update for each of the four categories, the IBA offers the followings comments:

##### 1. Control Environment Issues

The Report mentions the ethics survey used by OEI during Fall 2006 to gauge and confirm attitudes towards the City's control environment as perceived by City staff and management. The survey results showed that "most City employees remain unsure about the City's ethical standards and about the process for reporting lapses and violations of the City's ethics policies and procedures." Given that the control environment remains a concern for many City employees, the IBA recommends that administration of the employee hotline be transferred from OEI to an independent City Auditor with Audit Committee oversight and mayoral staff support as needed. The IBA believes that employees will be more inclined to utilize an employee hotline that is independently administered.

##### 2. Organizational Issues

The IBA believes that the realignment of staff along functional lines and empowering managers makes sense given the organizational issues presented in the 2006 Report.

### 3. Business Processes

Noting limited staff resources, the IBA commends the City Auditor for the work of the CAFR preparation team, financial reporting system improvements and new efficiencies in the areas of Accounts Payable processing. We have concerns that many City Auditor processes remain manually intensive and that the department has approximately 13 staff vacancies despite the critical workload cited in the Report.

### 4. Other Issues

Of the various findings discussed, the IBA would strongly reiterate our position (presented above) with respect to the importance of Internal Auditor independence. The IBA also supports the Mayor's decision to engage a CPA to oversee the timely and successful implementation of those remedial actions identified to address internal control deficiencies.

## **CONCLUSION**

The City Auditor's Report indicates that the City is making progress in addressing significant internal control deficiencies, particularly with respect to financial reporting. The IBA applauds this progress; however, we believe that more attention and resources should be allocated to administrative controls going forward. We recommend that administrative controls be addressed at a future meeting of the City's Audit Committee and that they be discussed in future annual reports on internal controls.

A strong and recurring statement is made throughout the Report regarding the importance of the control environment to internal controls. The Report specifies that the control environment is viewed as the most important of all internal controls, because the effectiveness of all the other controls depends upon it. In order to avoid the possibility of what the Report calls 'management override', the IBA strongly endorses expedient organizational change that will provide the City with Internal Auditor independence with oversight from an independent Audit Committee.

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Jeff Kavar  
Fiscal & Policy Analyst

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APPROVED: Andrea Tevlin  
Independent Budget Analyst