

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Subject: Internal Auditor Recruitment

OVERVIEW

At the Audit Committee meeting on March 19, 2007, the CFO presented a memorandum describing the reduction in internal audit staffing and presenting an expected timeline for filling the internal auditor position. The Audit Committee adopted a motion directing the IBA, the Independent Consultant and the City Attorney to review and comment on the CFO's memorandum. On March 21, 2007, the IBA received a memorandum from the Independent Consultant regarding the appointment of an internal auditor and the creation of an effective internal audit function. Having reviewed the memorandums of both the CFO and the Independent Consultant, this report provides comments, raises questions and makes recommendations related to the process for selecting an internal auditor.

FISCAL/POLICY DISCUSSION

Initiating Internal Auditor Recruitment

Upon learning of the City's significant reduction in internal audit staffing/activity, the City Council has increasingly expressed concern that the City currently does not have an internal auditor. Although the City Council, the Mayor's staff and the Kroll Report have publicly represented the need for an independent internal auditor, the City Attorney has opined that City Charter sections 39 and 265 limit the City's ability to establish an independent internal auditor position. The City Attorney has indicated that an affirmative public vote will be necessary to explicitly amend the City Charter to provide for real auditor independence. It is expected that this issue will be placed on the ballot in either February or June of 2008.

The City Council, Mayor, City Attorney, IBA and Independent Consultant have been meeting for two months to fashion a workable plan to create an independent internal audit function during the interim period prior to the June 2008 election. One of the primary

objectives of these meetings was to cooperatively develop a means to best achieve the goal of auditor independence despite the limiting City Charter language. Following these meetings, the Mayor issued a Statement of Operating Principles to, in part, frame an independent working relationship between the internal auditor and City's new Audit Committee. Regarding the selection of an internal auditor, operating principle # 5 indicates that "the Mayor shall select as the Auditor, with the participation of the Audit Committee, a person with professional qualifications as an internal auditor."

Recommendation for Internal Auditor Appointment through June 2007

City Charter section 265 (10) gives the Mayor "sole authority to appoint the City Auditor and Comptroller, subject to City Council confirmation". In the short term, it has been suggested that the Mayor would appoint his CFO to serve as City Auditor and Comptroller (currently vacant), subject to requisite City Council confirmation, and that the Mayor would then separately appoint an internal auditor of his choice. If this happens and in order to best achieve the shared goal of auditor independence until an internal auditor can be recruited (perhaps by June 2007), the IBA recommends that the Mayor appoint someone other than the CFO/Auditor and Comptroller to serve as internal auditor for the next few months and that, in good faith, that individual be accorded the highest practical level of auditor independence and be allowed to interact as may be necessary with the Audit Committee.

With respect to the internal audit function, the Independent Consultant recommends that "the objective should be to have a highly qualified internal auditor that can function effectively and with the requisite independence across the full range of internal auditing functions." The Independent Consultant goes on to state "In my judgment, this is best accomplished using the dual reporting model under which the internal auditor is part of management for administrative purposes but has a direct communication line to the Audit Committee." The IBA agrees with these recommendations for the interim period and until the public can vote on City Charter amendments that are necessary to create the kind of auditor independence supported by all government finance best practices. The IBA would ask the Independent Consultant for any specific suggestions that he might have as to how the "dual reporting model" can be effectively implemented during this interim period.

Internal Auditor Recruitment Process

In their recommendation for an independent Auditor General (now referred to as an internal auditor), Kröll 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 IBA believes that if the City is to

best achieve internal auditor independence during the important interim period prior to June of 2008, it is imperative that the Audit Committee, on behalf of the City Council, be allowed to actively participate in all aspects of the internal auditor recruitment process. We would recommend that active participation for the Audit Committee include the following:

- Interaction with the outside recruiter who will assist the City in reaching out to highly qualified candidates. The Audit Committee should be able to share their aspirations for a candidate who will be working closely with them in the interim and who may ultimately report directly to them.
- For the same reason cited above, a comprehensive job description should be developed that conveys the expectations and responsibilities for the position to qualified candidates including financial auditing and performance auditing.
- An opportunity to independently interview all qualified candidates (with support from the IBA if desired) in order to make an informed recommendation to the Mayor for consideration.
- The ability to communicate with and provide feedback to the selected outside recruiter regarding the qualifications or caliber of identified applicants.
- Cooperative and collaborative participation with the Mayor's assigned staff throughout the entire recruitment process to achieve a common goal of finding the best candidate for the City's internal auditor position.

The IBA was initially concerned that the CFO's memorandum indicated that a Request for Qualifications (RFQ) had already been developed and mailed to a limited number of outside recruiters (5) without any City Council involvement; however, the Mayor's Assistant Chief Operating Officer (ACOO) has agreed to make a few amendments to the original RFQ for the outside recruiter. We have recommended that the RFQ be amended and reissued to request that the outside recruiter solicit feedback from members of the Audit Committee regarding the scope and responsibilities of the internal auditor position and to solicit feedback from the Audit Committee during other stages of the process. For example, if the Audit Committee concurs with our recommendation to independently interview the candidates, the outside recruiter would meet with the Audit Committee after completing the interviews to receive their feedback on the candidates.

Internal Auditor Job Description

Upon opening the existing web page for the San Diego City Auditor, there is a prominent two-sentence message from the City Auditor & Comptroller. The first sentence references fiscal management through the City's Comprehensive Financial Report (financial statements) and the second sentence states "We also assist management of the City in carrying out their responsibilities by providing professional audit services such as: attestation services, internal control reviews, performance reviews, fraud/loss, investigations and special projects." In reviewing the auditor job descriptions of other comparable cities, we find these types of internal audit functions to be commonly referenced. IBA Report 07-35 indicates that the Internal Audit Divisions of twelve large cities spend approximately 69% of their staff time, on average, performing internal audit functions other than financial reporting and internal controls related to financial reporting.

The IBA believes that the class specification for the internal auditor attached to the CFO's memorandum is too narrowly defined to accurately convey important job expectations to prospective candidates and the selected outside recruiter. Understanding that the selected candidate could serve the City for several years, we would suggest that prospective candidates be informed that the City is going through a transitional period and that they will be expected to perform in a dual reporting environment for the first year with the possibility of shifting to an Audit Committee reporting relationship thereafter. Particularly given the absence of several routine City internal control functions for more than a year, we recommend adding the following description to the major functions list in the class specification attached to the CFO's memorandum:

- Independently perform administrative internal controls to assure or enhance the efficiency and effectiveness of City operations. Administrative internal controls include, but are not limited to: performance audits, compliance audits, operational audits, contract audits, revenue audits, fraud/loss, investigations, computer audits, audits of organizations receiving funds from the City, and other economy and efficiency audits.

Citing the City's current priority to complete prior year financial reports and the Mayor's Statement of Operating Principles, the Independent Consultant's memorandum embraces an auditing focus on financial matters during the interim period prior to the next election. Members of the Audit Committee, however, have expressed a willingness to judiciously find and appropriate funds, if necessary, to simultaneously perform important administrative internal controls as soon as possible. Acknowledging limited auditing staff resources, the IBA supports finding existing vacant staff positions or additional funds if necessary to immediately address neglected internal controls.

The City is striving to complete its outstanding financial statements and ultimately restore its standing/credit ratings in the capital markets. The IBA suspects that the credit rating agencies will also have concerns with a public agency that has an understaffed auditing function and/or has significantly deferred routine internal control activity for an extended period of time. Per the Statement of Operating Principles, the priority for the coming months resides with the City's financial statements and financial reporting, however, this should not be at the exclusion of other important internal controls.

The CFO's memorandum also describes retaining the independent auditing firm of Myer Hoffman & McCann (MHM) to perform certain internal audit procedures, notably a review of water and wastewater funds and the handling of money at Park and Recreation sites. The IBA believes these internal audit functions could be performed with additional City auditing staff and would ask if this results in greater or lesser expense for the City. Irrespective of the answer to that question, we recommend that these internal auditing functions be overseen by the City's internal auditor with additional oversight from the Audit Committee. This oversight responsibility should also be referenced in the job description for the internal auditor.

CONCLUSION

With auditor independence being a shared goal of the Mayor and City Council that is only hindered by dated City Charter language, it makes perfect sense for the two branches of local government to collaborate in selecting the City's internal auditor. Nothing in the City Charter prohibits such collaboration. Active City Council participation in the internal auditor selection process, as defined above, conveys a good faith effort to achieve the highest practical level of independence during the interim period prior to the next election. It will signify to the public that the City understands the problems inherent with an audit operation that reports to the management team it is has been charged to audit, and is making every effort to overcome City Charter limitations.

In addition to the Mayor's interview process, the IBA suggests that the Audit Committee consider the possibility of interviewing each of the best candidates responding to the job announcement. A screening panel consisting of the Mayor's assigned staff, the selected outside recruiter and the IBA could identify the best candidates for further consideration. At the conclusion of the interview process, the Audit Committee would collectively provide their candidate recommendation and associated rationale to the Mayor and the outside recruiter for consideration in the final selection. Ideally, the Audit Committee's recommendation will match with the Mayor's decision. If not, there is an opportunity for the Mayor to share his rationale for selecting a different candidate with the Audit Committee. The Audit Committee benefits from having been actively involved in the process to select this important position.

The importance of auditor independence cannot be overstated and is recommended by Kroll, the Independent Consultant and all government finance/audit professional associations. An effective internal auditor operation must be free of management influence and have the freedom to independently assess risk, conduct investigations and perform audits wherever they are needed in the organization. Finally, the City will need to adequately fund and staff the internal audit operation that ultimately will also provide staff support and audit reports to the Audit Committee.

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