

## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

**Date Issued:** April 5, 2007

**IBA Report Number:** 07-40

**City Council Agenda Date:** April 9, 2007, Special 9:00 a.m. Council Meeting

**Item Number:** 603

**Item:** Discussion and Proposed Adoption of: 1) the Permanent Rules of Council to Establish an Audit Committee, 2) an Audit Committee Charter, and 3) a Statement of Operating Principles with the Mayor

### Background

On January 9<sup>th</sup>, the City organization and this Council achieved a major milestone when it created the City's first independent Audit Committee made up of members of the legislative body as recommended by GFOA and numerous other professional organizations. The Audit Committee has already held five meetings and taken quick action holding the first public discussions with officers of KPMG to successfully accelerate completion of the City's 2003 financial audits.

At their meeting of February 26<sup>th</sup>, the Audit Committee reviewed and approved, to forward to City Council, its Permanent Rules and Charter. Stan Keller, the City's Independent Consultant took the lead in working with the Audit Committee Chair, the City Attorney, the Mayor's Office, the CFO and the IBA to develop these guidelines for the new Audit Committee.

The Independent Consultant also worked with the Mayor and others noted above to develop a Statement of Operating Principles to direct City Auditor activities with the Audit Committee, in accordance with the City Charter, during the interim period until the Charter can be revised. Article XV, Section 265(b)(10) of the existing Charter provides the Mayor with "sole authority to appoint the City Auditor and Controller, subject to Council confirmation." According to the City Attorney, this appointment authority infers a reporting relationship of the Auditor to the Mayor. It is important to note that this reporting relationship, while required by Charter, does not meet the test of Auditor independence from management who is responsible for the City's day-to-day financial operations.

Throughout discussions and meetings over the last several months relative to both the Audit Committee and the role of the Auditor, the IBA has strongly advocated for independence from management of both of these important entities which form the City's

“Audit Organization.” In the strong mayor form of government, the Mayor and his team are management. This independence from management is recommended by numerous reputable advisory organizations, including the Government Finance Officers Association, the Association of Local Government Auditors and the American Institute of Certified Public Accountants, as well as the State of California Government Code, the SEC and the General Accounting Office. As indicated earlier, an independent Audit Committee, made up of three members of the legislative branch, was established by Council Resolutions R-302279, R-302280, and R-302281 on January 9, 2007 and has been successfully implemented.

However, to achieve increased independence of the Auditor, the City Attorney has opined that City Charter revisions are necessary to change the existing appointment and reporting structure which currently resides with the Mayor. The earliest that amendments to the City Charter can be considered is February or June of 2008.

#### Proposed Dual Reporting Model for Interim Period

Until the necessary Charter changes can be achieved, the proposed Mayor’s Statement of Operating Principles is intended to provide interim guidelines for the Auditor’s activities and reporting responsibilities that comply with the Charter. The Independent Consultant has represented to the Audit Committee that the Mayor’s Statement of Operating Principles (SOP) is intended to provide for a dual reporting model. In a March 29 memorandum to the Audit Committee, Mr. Keller defined this model as follows: “The Internal Auditor is part of management for administrative purposes, but has a direct communication line to the Audit Committee.”

While, this “dual reporting model” is not spelled out as such in the Statement of Operating Principles or the Charter, Mr. Keller has indicated that the following language in Section 1 of the SOP accomplishes this: “The Auditor . . . is directed periodically and more frequently as necessary to communicate directly to and consult with the Audit Committee and to be responsive to its requests for information consistent with the Audit Committee’s oversight responsibilities.”

This dual reporting model is critical for the City, the Auditor and the Audit Committee, during the interim period in order to provide a minimal level of independence from management. How this reporting model is put into practice will determine its effectiveness.

### Proposed Independence Protections for Interim Period

Key language in the proposed documents, that helps to facilitate a working relationship between the Auditor and the Audit Committee and provides a minimal level of independence for the Auditor during the interim period, includes the following:

“The Auditor shall have the responsibility to inform the Audit Committee if he believes his independence is being compromised.” (Mayor’s SOP, Item 1)

Both the Mayor and the Audit Committee will provide input to the Auditor’s Annual Audit Work Plan. “The Auditor shall resolve any differences through the exercise of his independent professional judgment.” (Mayor’s SOP, Item 3)

“The Mayor shall select as the Auditor, with participation of the Audit Committee, a person with professional qualifications as an internal auditor.” (Mayor’s SOP, Item 5) (However, “participation” is not defined.)

“The Auditor may be dismissed by the Mayor subject only to a right to appeal to the Audit Committee to overturn the Mayor’s decision.” (However, it is not clear how this would work in practice.) (Mayor’s SOP, Item 6)

The Mayor shall consult with the Audit Committee regarding Auditor compensation, performance and budget. (Mayor’s SOP, Item 7)

The Committee “may meet with the internal auditor outside the presence of the Mayor to discuss the internal financial audit.” (Charter, p.3)

### Discussion of Audit Committee Oversight Responsibilities During Interim Period

Relative to the definition in the documents of the oversight role of the Audit Committee, and the focus of the Auditor’s work for the interim period, you will note frequent references to “financial audits” and “financial reporting” throughout the Rules, Charter and SOP. This language, which does not specifically spell out performance audits, compliance audits or internal auditing in general, is language recommended by the Independent Consultant, to recognize financial audits/reporting as a top priority, for the interim period prior to a February or June 2008 election.

The IBA has strongly advocated for the Audit Committee to have oversight responsibility for internal auditing and for reestablishment of the City’s internal auditing function. We identified the latter as an issue of concern in IBA Report No. 07-18, entitled “Second Annual Report on Internal Controls,” dated January 25, 2007. This concern was reiterated in IBA Reports No. 07-35, “Internal Audit Division” and No. 07-37, “Internal

Auditor Recruitment.” Financial auditing and performance auditing are both critical, and should not be seen as mutually exclusive. That being said, all audit work - including compliance; performance; procurement; and internal auditing; or auditing for fraud, waste and abuse-potentially impacts the City’s financial condition. The Audit Committee should not feel limited with respect to their oversight responsibilities to only financial audits and financial reporting. In fact, it is the Committee’s fiduciary duty to inquire into any such matters that could put the City in a position of risk.

While the financial audits are clearly a top priority, there will be circumstances where the Committee will provide an important role in the oversight of performance auditing as well during this time. For instance, the CFO recently announced the appointment of Kyle Elser as Acting Internal Auditor. Mr. Elser’s first task, according to the CFO, will be to undertake a risk assessment for the City and prioritize and determine those areas that require immediate attention. These resulting audit priorities, whether financial or performance audits, should be brought to the attention of the Audit Committee as discussed at their March 26th meeting. The Mayor has also charged the new Independent Rate Oversight Committee (IROC) with reviewing “independent performance audits on Water and Wastewater systems.” This work should also be coordinated with the Audit Committee and the results of these performance audits should be presented to the Committee per the Council’s motion to this effect on March 20<sup>th</sup> when they approved the formation of IROC.

### Recommendation

The independent consultant has recommended adoption of the language proposed in the draft SOP, Charter and Permanent Rules for the interim period. Based on this recommendation, on February 26<sup>th</sup> the Audit Committee acted to forward these documents to the full Council without changes. At this Committee meeting, the IBA verbally expressed two concerns with the proposed language as outlined in this report:

- The lack of specificity regarding the dual reporting model, which provides for the Auditor to report to the Mayor as required by the Charter, and to report to the Audit Committee as well, and the lack of clarity as to how this will function on a day-to-day basis. This is likely difficult to define and will need to be addressed on a practical level.
- Potential for the language to be perceived as or interpreted as limiting the Audit Committee’s oversight responsibilities to financial audits and financial reporting, rather than all internal auditing. As discussed earlier, the Committee has a fiduciary responsibility to inquire into any such matters that could put the City at risk. The Audit Committee will provide an important oversight role over the next several months for audits identified as a priority in the new Internal

Auditor's risk assessment and workplan; the performance audits reviewed by the Independent Rates Oversight Committee; audits completed by Myer Hoffman and McCann (MHM), such as for park and recreation sites.

The IBA recognizes the progress that has been made in the past two months and the importance of putting guidelines into place so that the Audit Committee can move forward with the full breadth of its legislative responsibilities, including the development of appropriate revisions to the City Charter for the 2008 ballot. As such, these documents are adequate for the interim period only. Our office looks forward to working with the Mayor's Charter Commission and the Audit Committee on developing Charter revisions that achieve Auditor independence from management for the long term.

The IBA recommends Council **adoption** of the proposed ordinance, which codifies the **Audit Committee's Charter and Permanent Rules**. We recommend **acceptance only** of the **Statement of Operating Principles with the Mayor**, rather than its adoption by ordinance. The SOP is a statement of intent that establishes a protocol for the working relationships of the Mayor, the City Council, the Audit Committee and the Internal Auditor, that is adequate for the interim period, but should not be codified in municipal law.

**[SIGNED]**

---

Andrea Tevlin  
Independent Budget Analyst