



## THE CITY OF SAN DIEGO

DATE: June 10, 2010

TO: Honorable Members of the Audit Committee

FROM: Eduardo Luna, City Auditor

SUBJECT: Revenue Audit Integration into City Auditor's Office

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We are issuing this memorandum in response to a request by Audit Committee Member Carl DeMaio. On May 10, 2010, Councilmember DeMaio requested the City Auditor's Office provide a written proposal addressing the following five areas for integrating the Revenue Audit Division into the City Auditor's Office starting January 2011:

- How the City Auditor would assume the Revenue Audit function,
- Whether and where there would be additional cost efficiencies,
- How revenues would be enhanced,
- How position salary increases would be addressed, and
- How to achieve coverage enhancement.

In March 2010, the City Auditor issued a Citywide Revenue Audit memorandum with a preliminary evaluation of the proposal to move the Revenue Audit & Appeals Division to the Office of the City Auditor. We did not make a recommendation regarding this matter because it is a decision to be made by the Mayor and City Council, and we do not make one in this memorandum either.

### **Background**

Under City Charter Section 39.2, the Office of the City Auditor is empowered to conduct audits in accordance with Government Auditing Standards (Standards), which provide a professional framework for performing high-quality audit work with competence, integrity, objectivity, and quality throughout the audit process.

On May 7, 2010, the Office of the City Auditor released a memorandum evaluating a proposal to consolidate the Revenue Audit positions from the City Treasurer's Office into the Office of the City Auditor. If the City Auditor's Office is requested to absorb the Revenue Audit positions and is tasked with performing revenue audits, we would continue to adhere to the high benchmarks outlined in the Standards.

We believe that the considerable audit expertise, training, and resources available at the Office of the City Auditor will enhance the revenue audit process.

### **Integration of Revenue Function**

If requested, the Office of the City Auditor is prepared and able to integrate new staff into our office quickly. We would assess the education, experience, and training of new staff members and insure that each staff member is equipped with the tools needed to conduct effective performance audits. In the Office of the City Auditor, new staff would be overseen by a leadership and management team with a combined 50 years of audit experience and certifications in Internal Auditing, Public Accounting, and Fraud Examination. Revenue auditors would have the opportunity to work side-by-side or consult with experienced auditors trained by leading audit organizations such as the California Bureau of State Audits and the US Government Accountability Office. New auditors can leverage considerable expertise in areas of accounting, business, and information technology, and access a wealth of experience and training resources.

The City Auditor emphasizes continuous training and development for all auditors, and can adjust annual training plans to focus on enhancing any skills beneficial to revenue audits. New staff would be encouraged to pursue professional certifications in auditing and attend professional development conferences to learn auditing best practices.

The City Auditor already maintains written policies and procedures which address the audit process. These policies and procedures can be utilized with little to no additional changes of the audit process to accommodate revenue audits.

The Revenue Audit Division consists of principal accountant and accountant II and III classifications, while the City Auditor's Office is primarily comprised of unclassified principal auditors. The current salaries of the principal accountant and accountants II and III fall within the salary range of the principal auditor classification. Since we do not contemplate giving pay raises, no position salary<sup>1</sup> increases would be necessary.

### **Cost Efficiencies, Revenue and Coverage Enhancements**

The Office of the City Auditor maintains a three person management team with 14 auditors. The City Auditor can integrate six additional auditors without expanding management capacity, and can reassign hours currently used for supervision within the Revenue Audit Division to conducting revenue audits. Further, the integration of six new

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<sup>1</sup> We should note that accountants II and III are classified employees represented by a bargaining unit while principal auditors are unclassified and unrepresented. Benefit options vary for classified and unclassified employees. As a result, there may be some benefit cost differences for certain employees. Since we do not know the medical coverage requirements for each employee, we cannot ascertain any costs due to benefit changes.

positions into the pool of performance auditors and the narrow focus of revenue audits allows the City Auditor to increase the annual number of hours available for revenue audits at no additional cost.

The City Auditor can leverage the considerable audit expertise, training, and methodologies of the office to enhance revenue audit coverage. We would implement a risk-based methodology and analytical techniques to enhance the audit process and to emphasize testing areas that are more likely to yield value to the City. We believe these proven methods would increase the current audit coverage to beyond Transient Occupancy Tax, Franchise Agreement, and Lease revenue audits, and allow the Office of the City Auditor's Office to audit additional revenue sources and identify other revenues owed to the City. Although an exact estimate of the revenue enhancements is difficult to provide, we will maintain our target of four dollars of enhancement for every one dollar spent.

### **Independence and Auditing Experience Can Enhance Revenue Audits**

The Office of the City Auditor has advantages over the Revenue Audit Division regarding independence and performance audit experiences that can enhance revenue audits. The Office of the City Auditor retains broad authority to conduct audits and performs audits in accordance with Government Auditing Standards. These represent the gold standard in auditing, and their use is mandated by the federal government and many state and local audit organizations. Organizations that conduct audits without following these guidelines lose the significant benefits and quality assurance conferred by them.

Independence is a central tenet of the Office of the City Auditor. Independence requires an audit organization and individual auditors to be free from personal, external, and organizational impairments. The Office of the City Auditor utilizes stringent criteria to assess auditors and ensure no impairments exist before making audit assignments. As a result, auditors do not have hindrances which would limit their inquiries, affect their objectivity, restrict disclosures, or weaken or slant audit findings.

The Office of the City Auditor is free from external impairments allowing auditors to be free from pressures, actual or perceived, from management. These impairments include, but are not limited to:

- External interference or influence that could improperly limit or modify the scope of an audit;
- Externally imposed restriction on access to records, government officials, or other individuals needed to conduct the audit;
- External interference over the assignment, appointment, compensation, and promotion of audit personnel; and
- Authority to overrule or to inappropriately influence the auditors' judgment as to the appropriate content of the report.

The City Auditor is sufficiently insulated from political pressures, and is able to conduct audits and report findings, opinions, and conclusions objectively without fear of reprisal.

The City Auditor's organizational structure does not negatively affect the organization's independence. This generally necessitates the placement of an audit organization outside the reporting line of the entities it reports on, as well as disallowing it from performing audits of any operations it is responsible for. The City Charter places the Office of the City Auditor outside the reporting line of the City, the entity under audit, and the City Auditor has no responsibility for City operations. The Office of the City Auditor reports to an Audit Committee made up of two City Council members and three public members. The City Council, the governing body of the City, retains the final authority over the Office of the City Auditor. The Standards classify this structure as an external audit organization free from impairment to independence.

The same cannot be said of the structure of the Revenue Audit Division and its staff. As an internal audit function, the Revenue Audit Division would be free from organizational impairments only if it

- Is accountable to and has access to the governing body,
- Reports the results of work publically, and
- Is located organizationally outside the staff or line-management function of the Treasury Department.

To the extent that the Revenue Audit Division audits revenues received to determine compliance with any municipal codes and reviews applicable regulations or contract agreements, such work is considered a performance audit. Since the Revenue Audit Division cannot and is not required to follow the Standards, the lack of independence increases the risk that impairments could limit the breadth and depth of revenue audit work

### **Conducting Performance Audits**

Most work currently performed by the Office of the City Auditor involves complex performance audits whose objectives include assessments of program effectiveness, economy and efficiency. The City Auditor may also conduct more focused audits to ensure that revenues are received in compliance with the municipal code, regulations, or contract agreements. Generally, revenue audits require significantly less staff resources than complex performance audits. If requested, we would increase these types of performance audits.

The City Auditor submits an annual workplan to the Audit Committee identifying the performance audits scheduled for review during the upcoming fiscal year. The workplan targets audit areas which pose a higher risk to the City, and considers prior audit findings.

If requested, we would add revenue audits to the FY2011 workplan and dedicate sufficient resources to provide adequate audit coverage.

The current structure of the office allows for the integration of additional auditors without hiring additional management. The focused nature of individual revenue audits allows the City Auditor to assign audits strategically and optimize the value of additional staff members. Between FY 2006 and FY 2009, the Revenue audit Division averaged 7,775 audit hours annually. We estimate that the Office of the City Auditor can comfortably raise this average to over 8,500 hours. The existing management capacity can accommodate the additional staff, and a more balanced assignment of revenue audits across all staff would reduce the impact that training, vacations, and staff leaves have on available audit hours.

Performance audits conducted in compliance with Standards provide reasonable assurance that the auditors have obtained sufficient, appropriate evidence to support the conclusions reached. Each audit is overseen by an audit manager to ensure appropriate supervision. The City Auditor, in collaboration with the audit managers, assigns auditors with the requisite expertise to perform the audits. Audit managers review and approve audit work and coordinate office-wide activities.

Auditors carefully plan each audit and take into account audit risk and significance when designing their tests. After obtaining appropriate background information, auditors conduct fieldwork testing steps which may include interviews, document reviews, observations, and analytical procedures. Auditors then draft a report of their findings for each audit. The City Auditor reviews the audit report with the responsible manager, subjects the audit to a rigorous quality control review, and subsequently issues a public report. Since revenue audits are recurring, their audit process is streamlined and focused on fieldwork testing.

The City Auditor presents each audit report to the Audit Committee. Under the City Charter, the Audit Committee has oversight responsibility for the City's auditing, internal controls, and any other financial or business practices specified in the City Charter. The Audit Committee publically reviews, discusses, and accepts each report. The Revenue Audit Division performs audits as defined under the Standards. Although the Revenue Audit Division is not required to comply with the Standards, all audit activity performed by management should report to the Audit Committee. Consequently, over \$150 million in annual revenues are being audited by management without the independent oversight of the Audit Committee and without regularly issuing public reports.

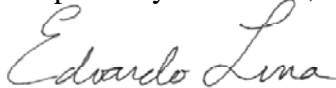
### **Issues to Consider**

There are some issues which require consideration. The City Auditor remains the appointing authority and is required to be free from any impairment to independence. Specifically, the City Auditor must be free from external interference over the assignment, appointment, compensation, and promotion of audit personnel. If the Office of the City Auditor is requested to absorb existing City staff, the City Auditor would need to retain the authority to provide unencumbered assignment, appointment, compensation, and promotion authority of all new audit staff. Further, the City Auditor's right to audit must remain clear and not limited. To the extent that audit authority remains unclear, the Audit Committee should recommend actions to clearly articulate the City Auditor's authority.

The Revenue Audit Division performs a function defined as auditing under the Government Auditing Standards without reporting to the Audit Committee, and its work does not comply with Standards. Consequently, its impairment of independence, susceptibility to management influence, and lack of public reporting as required by Standards constitute a defect in maintaining an audit-type activity outside the purview of the Audit Committee. If the Revenue Audit Division remains in the Treasurer's Office, the Audit Committee may want to identify mechanisms to reduce impairments to the Revenue Audit Division.

We note that we compiled this information from current available data sources and did not audit the information or conduct a performance audit of the City Treasurer's Revenue Audit Division.

Respectfully Submitted,



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Eduardo Luna  
City Auditor

cc: Honorable Mayor Jerry Sanders  
Honorable City Council Members  
Jay M. Goldstone, Chief Operating Officer  
Mary Lewis, Chief Financial Officer  
Gail Granewich, City Treasurer  
Jan Goldsmith, City Attorney  
Andrea Tevlin, Independent Budget Analyst