
OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: March 4, 2010

IBA Report Number: 10-22

Audit Committee Docket Date: March 8, 2010

Item Number: # 3

Review of the City Comptroller's Kroll Remediation Status Report

OVERVIEW

On January 13, 2010, Audit Committee Chairman Faulconer requested that the IBA work with the Mayor's Office to provide an update on the status of Kroll Report recommendations prior to the conclusion of Independent Consultant's (Stan Keller) contract. The IBA subsequently learned that the City Comptroller was already in the process of preparing a status update for Kroll Report recommendations. The City Comptroller issued a Kroll Report Remediation Update on February 22, 2010. This report comments on the findings of the City Comptroller's Report.

Additionally, as it relates to Kroll Report recommendation #36 and addresses a policy question raised by members of the Audit Committee, this report makes a recommendation related to the timing of an independent audit of the City's internal controls.

FISCAL/POLICY DISCUSSION

Comments on the Findings of the City Comptroller's Report

When issued in August of 2006, the Kroll Report included numerous recommendations for the City. These recommendations can be found in Section XII (beginning on page 240) and Appendix M of the Report; however, they are not numbered. In analyzing and responding to the Report, the CFO initially identified 121 recommendations in 33 different categories. Further analysis of some of the recommendations yielded sub-item recommendations which the CFO determined warranted separate response. There are currently 145 identified recommendations.

The City Comptroller has reviewed these recommendations and characterized the status of each as **"Tested" (76)**, **"Remediated" (64)**, **"In Process" (4)** and **"no status" (1)**. The IBA has been informed that each status label means the following: **Tested** – the recommendation has been tested by the Office of the City Auditor and found to be remediated; **Remediated** –

management represents that the recommendation has been remediated; **In Process** – the recommendation is in progress and has been partially completed; **No Status** – the recommendation has yet to be implemented. Excepting five recommendations evaluated to be In Process or No Status, the City Comptroller concludes that the Kroll recommendations are **96.6% remediated** (140/145).

The IBA has reviewed the City Comptroller’s status review of the identified Kroll recommendations. While we might like to add clarifying/additional detail to the comment section for several of these, we generally concur with the status the Comptroller has assigned to each recommendation. We have selectively made a few additional comments below:

Recommendation

IBA Comment:

- | | |
|------------------|---|
| 4 and 4.1 | City Monitor (Independent Consultant Stan Keller) made annual and periodic reports to the City and the SEC as required in the SEC Order – not regular quarterly reports as noted. |
| 36 | This “No Status” item relates to conducting an independent audit of the City’s internal controls. The next section of this report (below) discusses implementation of this recommendation. |
| 43 | This item is related to efforts to increase efficiency and identify new sources of revenue. The City is continuing to work to identify solutions to address its structural budget deficit. The City Council recently approved a set of Guiding Principles to guide the development of an action plan to eliminate the City’s structural budget deficit. The 1st principle calls for eliminating the General Fund structural budget deficit through a balanced approach of ongoing expenditure reductions and revenue generation, including identifying new revenue sources. |
| 44.i | This item relates to the use of one-time revenues. The IBA would characterize status as “In Progress”. While addressed in the Budget Policy, the City recently utilized \$72 million in one-time revenue sources to balance a \$179 million deficit to avoid further service cuts. This policy has been reiterated in the Guiding Principles for developing an action plan to address the City’s structural budget deficit. |
| 44.v | To clarify the current reserves status, we note that in accordance with the City’s Reserve Policy the City has or will have reserves of 7% of the General Fund in FY 2010. |
| 45 | With regard to publishing budget assumptions, it was determined that this item has been remediated but not tested by the Office of the City Auditor. Status should be listed as “Remediated”. |

- 53 With respect to DPWG reporting, the DPWG reports to the Audit Committee as requested to discuss their annual report, review of CAFRs and other matters of disclosure related interest.
- 64 After discussing the listed comment regarding lengthening the 13th accounting period with the City Comptroller, it was agreed that with the implementation of the new ERP system (07/01/09), the City changed its accounting calendar from 13 periods to 16 periods. The previous 13 period model consisted of 12 four week periods, with the last period remaining open until the annual audit was completed for that fiscal year. The new model consists of 12 one month long periods and four additional periods following the fiscal year end. These four additional periods are used for tracking and monitoring adjusting entries made after fiscal year end.
- 94 With regard to elected official and City staff disclosure training, the City Council received two hours of training regarding their disclosure obligations under federal and state securities laws in April 2007 and March 2009 in accordance with the City Council financial training program they adopted in December 2006. Trainings were held in public, recorded for future viewing and are available to City staff and the public.

Recommendation Related to the Timing of an Independent Audit of Internal Controls

In making a motion for the City Council to receive and file the City's FY 2009 CAFR on February 1, 2010, Councilmembers Faulconer and DeMaio requested the IBA develop policy recommendations (consulting with the Mayor's staff) for the timing for an independent audit of the City's internal controls. Kroll Report recommendation # 36 (page 248) reads as follows:

“A reputable independent auditing firm should be retained by the City's new Audit Committee, which should, in connection with the annual audit of the financial statements of the City for the fiscal year ending June 30, 2008, conduct an audit of the City's internal controls, in accordance with the applicable auditing standards, and issue a report thereon. Such report should, among other things, identify any material weaknesses and be included as part of the City's CAFR.”

Citing the need to have a new internal controls system up and running for a year prior to testing, the City Comptroller recommends that an independent audit of internal controls be performed in conjunction with the FY 2012 CAFR audit which will begin in the latter part of FY 2012. The City Comptroller has informed the IBA that additional time allows for the new system to be tested and adjusted as necessary to be most effective prior to an audit. Additionally, the Comptroller believes an independent auditor will want a year's worth of data to test in the course of an audit.

In his Third Annual and Final Report, the City's Independent Consultant recommends that the City continue with its current commitment to implement its Internal Controls Over Financial

Reporting (ICOFR) remediation so as to permit an external audit in connection with the audit of the FY 2011 CAFR. Specifically, the Independent Consultant states the following:

"I believe that extending the schedule for an external audit of the City's ICOFR at this time is unfortunate because it will relieve the pressure to complete the process that should have already been further along than it is and will represent acceptance of the City's failure to commit the internal and external resources necessary to successfully complete the ICOFR process. The result would be to increase the likelihood of further delay. Instead, I believe that the City should continue with its commitment to implement its ICOFR remediation so as to permit an external audit in connection with the audit of the FY 2011 CAFR. Even if this proves not to be feasible after the City's best efforts, the City is likely to have made more progress with its ICOFR remediation, which can then be tested as part of the fiscal 2011 CAFR audit. The appropriate schedule for a full external assessment of the City's ICOFR remediation could be reevaluated at that time."

With respect to the City's current ICOFR process, the City Comptroller has a schedule for completing approximately 264 process narratives (which explain appropriate procedures for relevant City processes and discuss how "control" is achieved). Many of these processes have been identified within a scoping document that has been jointly developed by the City Comptroller and an independent auditing firm (McGladrey & Pullen) retained by the City's Independent Consultant to assist in assessing the City's ICOFR remediation effort. The City Comptroller's current schedule calls for 263 of 264 process narratives to be completed by December 2010.

The IBA has discussed the timing and cost of an internal controls audit with more than one independent auditing firm. Timing and cost factors will be influenced by the desired scope of the audit. Feedback from independent audit firms suggest that an effective internal controls audit could be limited to 15 to 20 major City processes as opposed to comprehensively evaluating all of the City's internal controls or all of the 264 ICOFR process narratives. In so doing, the cost (roughly estimated to be approximately \$200,000) and time required to perform the audit (approximately four to six months) becomes more manageable. Independent auditing firms have also suggested that an effective audit can be performed with as little as six months of data to test (as opposed to having a full year of data).

Based on this feedback and depending on the desired scope of the internal controls audit, an internal controls audit could be performed in conjunction with the FY 2011 CAFR audit as suggested by the Independent Consultant. The internal controls audit would be a standalone audit that could be included in the CAFR or not, depending on whether the City elects to utilize its financial statement auditor to also perform the internal controls audit. If the City decides to competitively bid the internal control audit work, the selection process should begin no later than July 2010. If the internal controls audit is to be performed in FY 2011, the City should immediately plan to budget for this work.

Considering the City Comptroller's current schedule for completing ICOFR process narratives, a reasonable timeframe for internal testing of implemented ICOFR processes, and time requirements for an independent audit of internal controls, the IBA recommends

that the independent audit of the City's major internal control processes be conducted over the course of a year beginning in January 2011. As over half of the 264 identified ICOFR processes are currently scheduled to be completed before June 2010, this will allow City Comptroller staff at least six months to initially test and adjust new control processes before the internal control audit begins. Completed components of the internal controls audit could be reported in June 2011 and considered (or incorporated) in the audit of the City's FY 2011 CAFR. The remainder of the internal controls audit findings would be reported later in calendar 2011 and considered in the City's FY 2012 CAFR audit.

We believe this approach is feasible and will satisfy Kroll recommendation #36. It allows a reasonable amount of time to develop a thoughtful scope of work, retain an independent auditor and perform a large scale audit. Importantly, it balances the Independent Consultant's recommendation that the City's ICOFR remediation process remain a high priority with the City Comptroller's desire to initially test/adjust newly implemented internal controls as needed.

CONCLUSION

The IBA has reviewed the City Comptroller's status review of the identified Kroll recommendations. We generally concur with the status the Comptroller has assigned to each recommendation and have made a few additional comments for some of the recommendations.

This report also provides a recommendation in response to direction received from the Audit Committee and the City Council regarding the timing for an independent audit of the City's internal controls. **Considering the City Comptroller's current schedule for completing ICOFR process narratives, a reasonable timeframe for internal testing of implemented ICOFR processes, and time requirements for an independent audit of internal controls, the IBA recommends that the independent audit of the City's major internal control processes be conducted over the course of a year beginning in January 2011.**

[SIGNED]

Jeff Kawar
Fiscal & Policy Analyst

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst