

# Annual Report on Internal Financial Control

**Calendar Year 2016**

Office of the City Comptroller

March 1, 2017



## Executive Summary

This Annual Report on Internal Control is issued pursuant to City of San Diego Municipal Code (SDMC) §22.0706, adopted by the City Council in October 2004 via Ordinance 19320 to achieve a high standard of quality in and efficacy of the City of San Diego's (City's) financial reporting and disclosure practices. SDMC §22.0706 requires that management:

1. Perform an annual evaluation of the City's internal financial controls;
2. Submit a written Annual Report to the Audit Committee and the City Council on management's annual evaluation of the City's internal financial controls;
3. Submit a Certification by City Management regarding the design, maintenance, and effectiveness of the City's internal financial controls.

The objective of a system of internal controls over financial reporting is to provide reasonable assurance that the financial information produced is reliable and that it reflects the City's transactions and events for the reporting period. It is not intended to be perfect by eliminating all risk, as this would be cost prohibitive. Rather, the controls are intended to be effective in mitigating the risk of financial reporting errors to a level that is acceptable based on considerations of materiality. Materiality is the threshold above which missing or incorrect information in financial statements is considered to have an impact on the decision making of users.

Establishing effective internal controls is a continuous process. Management actively assesses risk, as financial reporting standards or requirements change and new software or technology is implemented. Risk can also increase as accounting and reporting processes change and as there is turnover in management and staff. As new risks are identified, management responds by implementing or enhancing controls to mitigate such risks.

Within the last 90 days, management evaluated the City's internal financial controls. Based on this evaluation, management concludes that the internal financial controls over financial reporting are effective. There were however, certain risks identified by the Office of the City Auditor regarding core financial system and the privileged access used to maintain it. The City Auditor's report identified three audit findings and provided five recommendations to ensure the risk that accompany these accounts are appropriately minimized where feasible. Additionally, subsequent to the date of our evaluation, there were certain risks identified by the City's external auditor related to the preparation of the MWWA Allocation of Billing Schedule. The City is currently in the process of strengthening controls over these two areas.

This report summarizes management's approach to developing an internal control system that provides reasonable assurance that financial reporting objectives are met. The City's internal controls over financial reporting improved significantly with the implementation of its Enterprise Resource Planning System (SAP). SAP, combined with hundreds of processes and controls that have been developed through the years allow for the production of reliable financial information. This report includes some of the significant enhancements that have

been achieved during the year and some of the potential risks that were identified, either by management or through the audits performed by independent auditors. It also includes the related controls that were implemented, or are in the process of being implemented, to address such risks. Other than what has been included in this report, management did not identify any significant deficiencies in the design or operation of internal controls that could adversely affect the City's ability to record, process, summarize and report financial data.

The list below identifies the most significant internal control improvements implemented by the Office of the City Comptroller (Comptroller's Office) during the assessment period.

### Internal Control Improvements – February 2016 – February 2017

- Received an unmodified (clean) audit opinion on the City's Comprehensive Annual Financial Report (CAFR). No material adjustments and no material weaknesses or significant deficiencies in internal controls over financial reporting were identified through the fiscal year 2016 CAFR independent audit.
- Received a Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association (GFOA) for the fiscal year 2015 CAFR. In order to be awarded a Certificate of Achievement, the City had to publish an easily readable and efficiently organized CAFR that satisfied both generally accepted accounting principles and applicable GFOA program requirements
- Documented 107 processes, exceeding Comptroller's Office annual goal of documenting 100 processes each year. The Comptroller's Office is on track to meet its fiscal year 2017 goal of documenting an additional 100 processes.
- Developed a more effective review method of CAFR drafts through version control and tracked changes. After a thorough review of an initial draft, tracked changes on each subsequent version was used for focused review of those sections of the CAFR that changed.
- Delivered assessments of currently documented processes to process owners to evaluate continued relevance and effectiveness. Worked with process owners to revise processes and related controls identified for changes during the fiscal year 2016 assessment.
- Developed and implemented a new accounting policy on capitalization of information technology projects and equipment. Enhanced the accounting structure to better track and capitalize expenditures related to intangible assets.
- Trained all professional Comptroller's Office staff on internal controls and process documentation in order to expand internal control work and accelerate the documentation of key processes.
- Implemented Vendor Invoice Management (VIM) in SAP. Streamlined the City's accounts payable process by eliminating the need for most data entry through electronic scanning of vendor invoices.

- Enhanced controls by segregating the invoicing and goods receipt roles in SAP. These changes will reduce the opportunity for fraud, create an improved audit trail, create accountability for the receipt of goods and services and decrease the possibility of paying for goods or services not received.
- Updated the SAP Governance Risk and Compliance module (GRC), that is utilized to identify and mitigate risk across system user access rights, segregation of duties and process performance. In addition, implemented a new automated process for privileged user's (firefighter) access requests, approvals, and monitoring.
- Made numerous system enhancements to the payroll time entry system in SAP which provide enhanced automation and an improved user interface for the time entry process. Citywide compliance with the Comptroller's Office time entry and approval policy improved significantly with the implementation of time card entry notifications.
- Enhanced monitoring controls with the implementation of OpenText's version tracking and audit trail feature of storing supporting transaction documents.
- Documented cost allocation process and implemented citywide training program in calendar year 2015. System enhancement allows differentiation of direct or indirect costs used by the Comptroller's Office to calculate load and overhead rates.
- Assisted City Departments to develop and issue process narratives and work instructions to detail the performance of their operations documented in Administrative Regulations and Department Instructions.
- Enhanced the SAP Grants module allowing for more efficient and accurate reporting of expenditures as required by the Federal Uniform Guidance. The Uniform Guidance is a set of authoritative rules and regulations on federal awards issued by the U.S. Office of Management and Budget.
- Completed system enhancements to the SAP Fixed Asset module, which allows for mass creation or modification of asset records and eliminates the need for Comptroller's Office staff to manually enter each asset, reducing the risk of human error and significantly improving efficiency over the process.
- Developed and implemented six new financial reporting tools for citywide use through business objects software that allow users to perform ad hoc queries and efficiently access financial data stored in SAP.

## Background

The City is accountable to San Diego residents and outside stakeholders for the management of the City's financial and economic resources. It meets this responsibility in large part by preparing a CAFR each year. The CAFR is the most significant financial report produced by the City for external users. It is available on the City's website and the investor information webpage and can be accessed by residents, investors, rating agencies and other interested parties. The CAFR is a comprehensive financial document that includes the balances and activity of all funds and component units of the City and related disclosures. The report typically takes five months to prepare and involves the work of more than 69 accountants in the Comptroller's Office, as well as key department staff who provide necessary information for required disclosures. The CAFR is prepared in accordance with Generally Accepted Accounting Principles (GAAP), which are established by the Governmental Accounting Standards Board (GASB). The CAFR is audited annually by an independent auditing firm who expresses an opinion on whether or not the basic financial statements are fairly presented in all material respects in accordance with GAAP.

The City also produces other financial reports for external use such as the Schedule of Expenditures of Federal Awards, which summarizes all expenditures of federal awards for the fiscal year and is subject to a single audit by an external independent auditor (Single Audit). Annually, the City's external independent auditor also conducts an audit of the schedule of costs related to the Metropolitan Wastewater System and the City's allocation of such costs to Participating Agencies (MWWD Allocation of Billing Schedule).

Internal control over financial reporting is defined as a process established by an entity's governing body, management and other personnel, which has been designed and implemented to provide reasonable assurance regarding the achievement of financial reporting objectives. The main internal control objective in preparing external financial reports is that the information included in the report is reliable and that it reflects the City's transactions and events for the reporting period in accordance with GAAP or other reporting requirements.

The most authoritative guidance on internal control over financial reporting is the integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The City's internal control program is based on this framework. The framework put forth by COSO is comprised of five fundamental components which, when present and functioning together, work towards the goals of reducing risk to an acceptable level, and achieving objectives for reliable financial reporting. These five fundamental components include (1) Control Environment, (2) Risk Assessment, (3) Control Activities, (4) Monitoring, and (5) Information and Communication. Our assessment of internal control over financial reporting focused on an evaluation of each of these five components.

## Control Environment

The Control Environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The Control Environment sets the tone of the organization and represents what is commonly referred to in the private sector as an entity's "corporate culture." It encompasses the City's integrity and ethical values; the City Council and Mayor's oversight, responsibilities, and delegation of authority; the process for attracting, developing and retaining employees; and the measures, incentives and rewards used to manage accountability and performance.

The City has established policies and practices that provide for a strong control environment. The City's auditing function is overseen by an independent audit committee, which includes members from the public who possess the appropriate technical expertise. In addition, independent departments assist the City Council in establishing checks and balances over the executive branch, including the Independent Budget Analyst and the Office of the City Auditor. The Office of the City Auditor manages the contract of the independent auditing firm that is responsible for auditing the City's CAFR.

The City has established the Disclosures Practices Working Group (DPWG), a group responsible for ensuring compliance by the City with federal and state securities laws, and for promoting the highest standards of accuracy in disclosures relating to securities issued by the City or by its related entities. The City of San Diego Municipal Code (SDMC) requires that an evaluation and report be prepared by the DPWG on a yearly basis. In addition, the City has established mandatory securities law training for members of management, relevant City staff and elected officials.

The City has implemented a comprehensive financial training program adopted on December 6, 2006 by Resolution R-302243. Financial Statement Overview training is one component of the program for elected officials providing them a general understanding of the City's financial statements. The City Council last received training on the Financial Statement Overview subject, Role of Governance over the Audit and Financial Statements on February 7, 2017.

The Ethics Commission contributes towards a strong control environment for the City. As an independent department, the Ethics Commission monitors, administers and enforces the City's governmental ethics laws, conducts investigations, refers violations to appropriate enforcement agencies, reviews disclosure statements and advises and educates City officials, candidates, political committees, and lobbyists about governmental ethics laws.

Continuing education for professional staff who have financial responsibilities is critical for delivering comprehensive and accurate financial information to the City's stakeholders. The City's Chief Financial Officer requires financial professionals to grow and maintain their professional competencies in all areas of accounting, reporting, compliance, grant analysis, debt management, ethics, and any other finance related field. This is accomplished through training policies that have been tailored for each department to promote competencies in each

department's respective area. The Comptroller's Office training policy requires that staff engaged in accounting, financial reporting, and payroll functions participate in a minimum of 40 hours of formal subject matter training per year. This ensures that accounting staff responsible for preparation of the CAFR are knowledgeable of the accounting standards relevant to their area of responsibility.

In the next few months, Principal Accountants and Supervising Accountants in the Comptroller's Office will receive COSO training in order to earn the COSO Internal Control Certificate. Accountants will receive training in designing, implementing, and conducting an internal control system. Accountants at the management and supervisory level will learn to understand COSO's principle-based approach, identify and analyze risk, and enhance the internal control system.

Other practices and policies contributing to a strong control environment for the City include the adoption of an Employee Code of Conduct, the Fraud, Waste and Abuse Hotline, and the Annual Report on Internal Financial Controls.

## **Risk Assessment**

A continuous and effective assessment of risk is a critical component of the internal control framework because it allows management to form a basis for determining how risk should be managed and mitigated. It allows management to identify the need for control and monitoring activities, improvements to the flow of information and communication or the need for changes to the control environment.

COSO defines "risk" as the possibility that an event will occur and adversely affect the achievement of objectives. As noted earlier, the main objective in preparing the CAFR is that the information included in the report is reliable and that it reflects the City's transactions and events for the reporting period in accordance with GAAP or other reporting requirements. The policies and procedures established for financial reporting include controls that have resulted from management's risk assessment and its efforts to mitigate such risks.

At the beginning of each CAFR preparation cycle, management communicates areas of potential risk to the City's independent auditor based on management's risk assessment and ongoing monitoring activities, including management's response to such risks through development and implementation of additional controls. For the fiscal year 2016 reporting cycle, the Comptroller's Office identified the following risks and applied related controls during the reporting cycle:

Risk		Control Activities
1	Risk related to version control in the preparation of the CAFR which results in a financial reporting misstatement.	Developed a more effective review method of CAFR drafts through version control and tracked changes allowing for focused review of those sections of the CAFR that changed after each draft.
2	Risk that an accountant misclassifies fund balance within fund balance categories when preparing financial statements. Fund balance classification is a manual process that relies on the judgement and technical knowledge of the accountant preparing the financial statement.	Supervisory and Management review; year-over-year variance analysis; development of clear classification policies; development of decision tools consistently used by staff to apply categorization policy.
3	Risk that a City department may misclassify a fixed asset or may not timely communicate the addition of donated assets or disposition of fixed assets.	Biennial department inventories; asset account monitoring; documented fixed asset process narratives; formalized capitalization and project close out procedures requiring formal communication; regular routine inquiries by the Comptroller's Office.
4	Risk of not properly accounting for intangible assets.	Developed a capitalization policy for intangible assets. Enhanced the accounting structure to better track and capitalize expenditures related to intangible assets.
5	Risk of potential financial misstatements or inadequate disclosures due to high volume of long-term debt activity (new issuances and refunding) when there is management turnover in the debt section of the Comptroller's Office.	Established strong communication between the new and former debt Principal Accountant to ensure adequate training and transfer of knowledge. Strong collaboration with Debt Management department including review of relevant disclosures. Additional supervisory resources were provided to the section to perform review functions. Strong reliance on process narratives and work instructions for the preparation of note disclosures and related schedules.

### Risks Identified by Independent Auditors

Annually, the City's independent auditor conducts an audit of the MWWA Allocation of Billing Schedule, which summarizes costs related to the Metropolitan Wastewater System and the City's allocation of such costs to Participating Agencies. The June 30, 2015 audit of the MWWA Allocation of Billing Schedule, identified an overstated entry, which resulted in erroneous charges to participating agencies. The independent auditors recommended that the City



improve the established review of procedures of all financial schedules, re-evaluate procedures and processes to determine whether changes are necessary to provide greater assurance to prevent, detect, and correct errors, improve communication between the Comptroller's Office and the Public Utilities Department and implement high-level analytical review by responsible management. The City is in the process of implementing the independent auditor's recommendations and anticipates documenting all related processes and controls by the end of calendar year 2017.

## **Control Activities**

Control activities are the next logical step in response to risks identified through management's risk assessment. COSO defines *control activities* as the actions established through policies and procedures that help ensure that management's directives to mitigate risks are carried out. In the preparation of financial reports for external use, these are the policies and procedures, with embedded controls, that management develops and implements to mitigate risks of errors and omissions that could affect the reliability of the information presented in the reports.

### **Transaction Control Activities**

The implementation of SAP was a defining event in the City's progress towards a well-designed internal control framework. SAP allows internal controls to be embedded in the system through restricted access, segregation of duties and authorization workflows. These controls allow for review, validation and approval of transactions, not only mitigating the risk of fraud but also preventing transaction errors or instances of non-compliance with laws and regulations.

The majority of user interactions within SAP occur in various departments as they perform their core responsibilities. Often transaction workflows cross departments in order to properly segregate duties and mitigate the risk of fraud. For example, the Comptroller's Office processes employee payroll, but only the Personnel Department can change an employee's hourly rate in SAP. Other transactions include vendor payments, generation of City invoices, cash deposits, payroll transactions, journal entries, most of which segregate the creator of the transaction from the approver. These interactions make their way into the financial system either through direct input or through some type of interface application. The City's financial activity is consolidated with similar types of activities and is eventually presented in the CAFR and other financial reports.

Over the years, the City has implemented a variety of control activities over financial transactions. Where automated controls are not available, manual controls are used. These control activities ensure that the financial information is complete, accurate and valid. Below are some of the control activities embedded in the City's multiple accounting and financial reporting processes:

- Authorizations and approvals that affirm that a transaction is valid, such as the approval of a journal entry or an invoice payment;
- Verifications- comparing two or more items with each other, such as comparing goods received against a purchase order;
- Physical controls, such as comparing fixed asset inventories against control records;
- Reconciliations – comparing two data elements and taking action when differences are identified to bring the data into agreement, such as reconciling bank accounts to the general ledger; and
- Supervisory controls that assess whether other transaction control activities are being performed completely, accurately and in accordance with policy.

In addition, the Internal Controls section of the Office of the City Comptroller (Internal Controls Section), promotes a strong control environment through involvement in various projects and activities. The Internal Controls Section is involved with the implementation or monitoring of the following new software modules, VIM, IAM San Diego, ARIBA, P2P Overhaul, OpenText, OnBase, Crywolf and NextRequest. The Internal Controls Section reviews the projects for process gaps, control weaknesses, segregation of duties, system access, how data transfers to SAP, and assists in the development of process narratives and work instructions.

### **Control Activities deployed through Policies and Procedures**

Management incorporates controls into financial reporting activities by establishing clear accounting policies and developing and implementing accounting procedures. Policies reflect management's statements of what should be done, guiding the actions of staff. Procedures consist of actions that implement a policy. For example, the Comptroller's Office sets an accounting policy limiting capitalization of expenditures to only those capital asset purchases with a cost exceeding \$5,000. The procedure identifies the steps needed to record the transaction, which include controls that ensure that all expenditures related to the purchase of capital assets are identified, that they are properly classified, that the city has rights to the assets and that the capitalization threshold is consistently applied.

During fiscal year 2016, the Comptroller's Office developed a capitalization policy for the IT intangible asset projects. This policy sets criteria for IT expenses that can be capitalized. The Comptroller's Office created a decision tree to assist the Department of Information Technology in determining which projects should be capitalized. A new CIP project type was created in SAP for these capitalized projects to provide enhanced visibility, tracking and accountability on IT projects.

Much of the recent work performed by the Comptroller's Office, as it relates to internal controls, has focused on formally documenting policies and procedures related to accounting and financial reporting. Most of these policies and procedures have been long-standing practice and consistently applied each fiscal year. This allows the City to have a formal inventory of procedures and related controls that can be systematically monitored for effectiveness and continued relevance. The Comptroller's Office has identified approximately 760 processes that require documentation of which 426 have been formally documented. The

total number of processes to document changes annually as new processes are identified, new accounting standards are issued, new software or technology is implemented, as accounting and reporting processes change (i.e. automation) and as new risks are identified by management. In fiscal year 2016, the Comptroller's Office documented 107 processes, exceeding its annual goal of documenting 100 processes each year. The Comptroller's Office is on track to meet its fiscal year 2017 goal of documenting an additional 100 processes.

The Comptroller's Office is currently reviewing all identified processes and exploring new approaches that may help expedite documentation of significant processes and controls. Our current focus is on prioritizing those processes and controls that relate to external reporting including the preparation of the CAFR, the Single Audit of federal awards and the MWWD Allocation of Billing Schedule. We anticipate having fully documented all significant financial processes related to external financial reporting, for the office within the next two fiscal years.

In fiscal year 2016, the Internal Controls Section became involved in the preliminary review of Administrative Regulations (A.R.) and Department Instructions (D.I.). Administrative Regulations and Department Instructions direct administrative policies and procedures of a continuing nature. Departments involved in complicated, lengthy, or detailed operations, as detailed in the A.R. or D.I., are required to work with the Internal Controls section to develop and issue Process Narratives and Work Instructions to detail the performance of these operations.

## **Information and Communication**

The Information and Communication component of the COSO framework supports the functioning of all components of internal control. COSO defines communication as the continual iterative process of providing, sharing and obtaining necessary information. In an organization as large as the City, it is critical that management establishes effective communication procedures to meet accounting and disclosure requirements under governmental accounting standards and under state and federal securities laws.

Pursuant to SDMC §22.4101 and § 22.4103, a Disclosure Practices Working Group (DPWG) was established by the City, responsible for reviewing financial disclosures for compliance with federal and state securities laws and promoting disclosure best practices. The DPWG includes individuals in key City positions within the City and external counsel that can review disclosures, communicate known facts and other relevant information and ensure consistency throughout the City's financial disclosure documents.

The DPWG has formal disclosure controls and procedures that define roles and responsibilities over the development and review of financial disclosures. These controls and procedures require that the City's Chief Financial Officer certify to the City Council that the City's financial statements included in the CAFR are fairly presented and that disclosures are true and complete. Similarly, department directors are required to also certify that contributions made

by their staff have been reviewed by the director and that the information is accurate and complete.

While the DPWG is responsible for ensuring that disclosures comply with federal and state securities laws, the Comptroller's Office is responsible for ensuring financial statements and related disclosures are prepared in accordance with GAAP. The Comptroller's Office relies on a formal distribution of work document that clearly communicates specific responsibilities for development of the CAFR, including who is responsible for preparing and reviewing the relevant sections of the CAFR.

During the audits of the CAFR and other reports, the independent auditor requests a broad range of supporting documents. The multiple items requested are managed through a master pending list. This allows for effective communication with the independent auditor, as items are clearly assigned to relevant staff and tracked by management throughout the audit process.

The Comptroller's Office relies on a comprehensive accounting and disclosure checklist developed by GFOA. Each question in the checklist is assigned to a staff member within the Comptroller's Office based on area of responsibility. This allows for a clear and objective way to ensure compliance with existing governmental accounting standards.

## **Monitoring Activities**

An effective internal control program requires continuous evaluation of each of the five COSO components to ensure that they are functioning effectively. This includes assessing whether risks are being identified timely and if control activities address identified risks. Management should evaluate whether controls are being performed completely, accurately and in accordance with policy. It also includes assessing whether information is being communicated effectively to ensure disclosures are accurate and complete and that accounting policies and procedures are clearly understood by relevant staff.

As part of its monitoring activities, the Comptroller's Office reviews the results of independent audits to identify potential areas of risk or areas for which controls need to be strengthened. Independent auditors are required by auditing standards to communicate to the appropriate governing body any material adjustments identified through the audit of the City's financial statements. For the audit of the fiscal year 2016 CAFR, there were no material adjustments identified by the independent auditors. In addition, no material weaknesses or significant deficiencies in internal control over financial reporting were identified in the *Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards*, dated December 6, 2016. The audit of the financial statements is not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. However, the audit process does require significant interaction between the audit team and management and a sustained communication effort throughout the process that allows for effective monitoring of controls over accounting and financial reporting. The audit

of the MWWWD Allocation of Billing Schedule for fiscal year 2015 identified an overstated entry, which resulted in erroneous charges to participating agencies (see Risk Assessment). The City is in the process of implementing the independent auditor's recommendations and anticipates documenting all related processes and controls by the end of calendar year 2017.

The Comptroller's Office also conducts an internal review of the preparation and completion of the CAFR to identify entries that occurred after the draft was submitted to the independent auditors. This allows the Comptroller's Office to identify potential areas of risk and implement controls to continuously improve the CAFR preparation process.

The City received the Certificate of Achievement for Excellence in Financial Reporting awarded to the City by GFOA for the fiscal year 2015 CAFR. To receive this award, the City must comply with a comprehensive checklist that incorporates accounting and disclosure requirements in accordance with GAAP. Comments received from GFOA on the submittal of the CAFR also serve as a monitoring tool to ensure controls are effective. If GFOA identifies significant deficiencies in the CAFR, they disqualify a CAFR from being awarded the Certificate of Achievement for Excellence in Financial Reporting. The review of the fiscal year 2015 CAFR resulted in six suggestions for improvements, all of which were incorporated into the fiscal year 2016 CAFR. We anticipate receiving the award for the fiscal year 2016 CAFR.

### **Segregation of Duty Monitoring**

The Comptroller's Office continues to monitor for segregation of duty violations to ensure that no one individual has control over an entire process or multiple components of a process, which if abused, could cause harm to the City or to the financial statements. Due to the importance of maintaining controls around segregation of duty violations, continuous monitoring is performed. This monitoring covers in excess of 11,900 users and is performed several times a week to ensure that no violations exist. The Internal Controls Section also facilitates monitoring activities performed at the transactional level. Automated testing is developed within the SAP Governance Risk and Compliance module (GRC) Module and the results are sent to the process owner for review and remediation where necessary.

As mentioned earlier, GRC upgraded to version 10.1, which provides additional enhancements to the monitoring and management of system-wide access. Department of Information Technology is in the process of implementing additional capabilities within SAP GRC Access Control. SAP GRC Access Control is a tool to monitor and prevent unauthorized access to SAP, to review and mitigate cross-departmental authorization requests and to prevent conflicts within roles and identify segregation of duty risks. The enhancements will automate and expedite access requests and review of roles.

In January 2017, the Office of the City Auditor audited the City's core financial system and the privileged access used to maintain it to ensure the risk that accompany these accounts are appropriately minimized where feasible. The confidential report identified three audit findings and five recommendations to address these findings. The Department of Information

Technology and the Comptroller's Office are in the process of implementing the recommended changes.

### **Assessment of Documented Processes and Controls**

A key part of maintaining a strong internal control system is the periodic evaluation and monitoring of processes and their embedded controls. Process design assessments have been developed in the SAP GRC Module with the objective of testing the validity, accuracy and performance of the process as documented. Control design assessments have also been developed to test the presence and performance of controls that have been identified in the process.

For fiscal year 2016, process design assessments and control design assessments were delivered to the respective process owners in City Departments. The assessments identified processes that required changes to the process and to the related controls. During calendar year 2016, the Comptroller's Office worked with the respective process owners to resolve the issues identified during the assessment resulting in revisions to the processes.

## **Conclusion**

The City has established a high bar for the development of a comprehensive internal control program for a municipal government. Based on management's evaluation we believe that internal controls over financial reporting are effective. The City's internal controls over financial reporting improved significantly with the implementation of SAP which, combined with hundreds of processes and controls that are currently in place allow for the production of reliable financial information.

Establishing effective internal controls is a continuous process. Management actively assesses risk as the organization changes and as new reporting requirements are issued. As with any effective system of internal controls over financial reporting, management responds to new risks identified by implementing or enhancing controls to mitigate such risks, including those that have been identified in this report.

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### **Sources**

1. Gauthier, Stephen J. *Evaluating Internal Controls*. Chicago IL: Government Finance Officers Association of the United States and Canada, 2013. Print
2. Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework, Framework and Appendices, 2013*
3. Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework, Internal Control over External Financial Reporting: A compendium of Approaches and Examples, 2013*

**RECOMMENDATIONS:** N/A

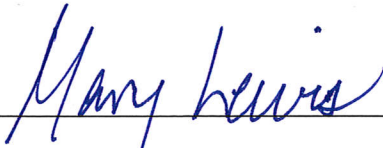
**FISCAL CONSIDERATIONS:** N/A

**COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:** N/A

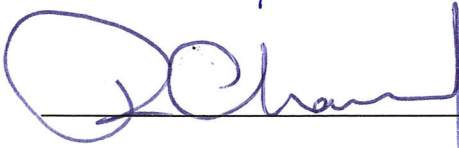
**KEY STAKEHOLDERS AND PROJECTED IMPACTS:** N/A

Attachments:

1. Certification by the Chief Operating Officer, Chief Financial Officer and City Comptroller
2. Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards
3. Report from Macias Gini & O'Connell to those charged with Governance – Fiscal Year 2016 CAFR



Mary Lewis, Chief Financial Officer



Rolando Charvel, City Comptroller

**CERTIFICATION BY MAYOR AND CHIEF FINANCIAL OFFICER**

In accordance with the requirements of §22.0706 of the San Diego Municipal Code, the Mayor's designee, the Chief Operating Officer and the Chief Financial Officer hereby certify that they:

1. are responsible for establishing and maintaining the City's internal financial controls;
2. have identified the need to design such internal financial controls to ensure that material information relating to the City and its departments, offices, agencies, and affiliated "related entities" as defined in San Diego Municipal Code section 22.4102, is made known to the Mayor and/or the Chief Financial Officer by others within the City and its departments, offices, agencies, and affiliated "related entities," particularly during the period in which the Annual Report required by this section is being prepared;
3. have evaluated the effectiveness of the City's internal financial controls as of a date within 90 days prior to the Annual Report;
4. have presented in the Annual Report their conclusions about the effectiveness of their internal controls based on such evaluation as of that date;
5. have disclosed to the City's independent auditors and the Audit Committee all significant deficiencies in the design or operation of internal controls that could adversely affect the City's ability to record, process, summarize, and report financial data;
6. have identified for the City's independent auditors any material weaknesses in internal controls and any fraud, whether or not material, that involves management or other employees who have a significant role in the City's internal controls; and
7. have indicated in the Annual Report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Signed:  \_\_\_\_\_

Date: 27 FEB 17

Scott Chadwick, Chief Operating Officer

Signed:  \_\_\_\_\_

Date: 2/27/17

Mary Lewis, Chief Financial Officer

Signed:  \_\_\_\_\_

Date: 3/1/17

Rolando Charvel, City Comptroller





**Independent Auditor’s Report on Internal Control Over Financial Reporting and on  
Compliance and Other Matters Based on an Audit of Financial Statements  
Performed in Accordance With *Government Auditing Standards***

To the Honorable Mayor and Members of the  
City Council of the City of San Diego, California

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of San Diego, California (City), as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise the City’s basic financial statements and have issued our report thereon dated December 6, 2016. Our report includes an emphasis of a matter related to the City’s adoption of Governmental Accounting Standards Board (GASB) Statement No. 72, *Fair Value Measurement and Application*. Our report also includes a reference to other auditors who audited the financial statements of the San Diego Housing Commission, a discretely presented component unit, as described in our report on the City’s financial statements. This report does not include the results of the other auditors’ testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered the City’s internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City’s internal control. Accordingly, we do not express an opinion on the effectiveness of the City’s internal control.

*A deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

## **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

## **Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

*Macias Gini & O'Connell LLP*

San Diego, California  
December 6, 2016



January 25, 2017

To the Audit Committee and City Council  
of the City of San Diego

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of San Diego (City) for the year ended June 30, 2016. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards (and, if applicable, *Government Auditing Standards* and the Uniform Guidance), as well as certain information related to the planned scope and timing of our audit. Professional standards also require that we communicate to you the following information related to our audit.

### Significant Audit Findings

#### *Qualitative Aspects of Accounting Practices*

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 to the financial statements. As described in Note 1(v) to the financial statements, effective July 1, 2015, the City adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 72, *Fair Value Measurement and Application*. Accordingly, the City has disclosed its investments in accordance with the fair value hierarchy. We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the City's financial statements were:

- Management's estimate of the useful lives for depreciable assets is based on the nature of related capital assets.
- Management's estimate of the workers' compensation, public liabilities, and long-term disability liabilities are based on actuarial valuations using historical loss, employee and other data.
- The net pension liability (NPL), deferred outflows of resources, deferred inflows of resources, and pension expense is based upon the actuarial valuation of the total pension liability and net position of the City's defined benefit pension plan.
- Management's estimate of the City's Annual Required Contribution (ARC) for the Other Postretirement Benefit (OPEB) plan are based on annual actuarial valuation using accepted actuarial methods and various actuarial assumptions. The Net OPEB Obligation (NOPEBO) is a function of the ARC and is estimated by comparing the ARC with the actual funding during the current year and applying an interest rate factor and amortization adjustment factor to the prior year's NOPEBO.

- Management’s estimate of its claims liability and contingencies is based on the development of accounts from actuarial valuations and advice from legal counsel about the ultimate outcome of the claim.
- Management’s estimate of the fair value of investments, except real estate, private equity, infrastructure, equity and fixed income commingled funds, money market mutual funds, and the Local Agency Investment Fund (LAIF), are based on quoted market prices, bid evaluation, or matrix pricing techniques. Directly held real estate investments are reported at appraised values as determined by the San Diego City Employees’ Retirement System’s (SDCERS) real estate managers and third-party appraisal firms. Private equity and infrastructure assets are measured at fair value using the net asset value (NAV) per share or its equivalent by their respective investment managers, giving consideration to the financial condition and operating results of the portfolio companies, and other factors deemed relevant. Equity and fixed income commingled funds are reported using the NAV per share. Money market mutual funds are valued at NAV based on amortized cost. The City’s investment in LAIF is reported based upon the application of a fair value factor to each one dollar share invested.

We evaluated the key factors and assumptions used to develop these estimates in determining that they are reasonable in relation to the financial statements taken as a whole.

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements are:

- The City’s NPL and sensitivity of the NPL to changes in the discount rate disclosed in Note 11 to the financial statements.
- The funded status of the City’s OPEB plan and the City’s NOPEBO disclosed in Note 12 to the financial statements.
- The commitment disclosure related to the City’s future estimated operating and capital costs to comply with the California Regional Water Quality Board’s administrative proceeding concerning the City’s municipal storm water permit as disclosed in Note 16.
- The disclosure of related to contingencies affecting the City as described in Note 17 to the financial statements.

The financial statement disclosures are neutral, consistent, and clear.

*Difficulties Encountered in Performing the Audit*

We encountered no significant difficulties in dealing with management in performing and completing our audit.

*Corrected and Uncorrected Misstatements*

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are clearly trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to each opinion unit’s financial statements taken as a whole.

### *Disagreements with Management*

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

### *Management Representations*

We have requested certain representations from management that are included in the management representation letter dated December 6, 2016.

### *Management Consultations with Other Independent Accountants*

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

### *Other Audit Findings or Issues*

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

### Other Matters

We applied certain limited procedures to the management's discussion and analysis, the Preservation of Benefits Plan schedule of funding progress, the schedule of changes in net pension liability and related ratios, the schedule of employer contributions, the OPEB trust fund schedule of funding progress, the OPEB trust fund schedule of employer contributions, and the General Fund schedule of revenues, expenditures and changes in fund balance – budget and actual (budgetary basis) and related notes, which are required supplementary information (RSI) that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

We were engaged to report on the combining and individual fund financial statements and schedules, which accompany the financial statements but are not RSI. With respect to this supplementary information, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

We were not engaged to report on the introductory section and statistical section, which accompany the financial statements but are not RSI. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Restriction on Use

This information is intended solely for the information and use of the Audit Committee and City Council, and management of the City of San Diego and is not intended to be, and should not be, used by anyone other than these specified parties.