



*City of San Diego*

**ANNUAL REPORT ON  
INTERNAL CONTROLS**

*January 1, 2006*

**Issued by:**

**The Office of the Auditor & Comptroller  
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## *EXECUTIVE SUMMARY*

City Ordinance 19320 was adopted by the City Council in October 2004, to achieve “a high standard of quality in and efficacy of the City’s financial and disclosure practices”, and requires the City Auditor & Comptroller (City Auditor) to perform an annual evaluation of the City’s internal financial controls.

An entity’s internal control structure is designed to provide reasonable assurance regarding the achievement of management’s objectives, including the reliability of financial reporting. *That structure is comprised of an organization’s various control policies and procedures and the management environment within which those policies and procedures operate.*

This first annual evaluation focused on controls posing the greatest risk of materially adverse impacts on the accurate and timely preparation of the City’s annual financial statements. Accordingly, although our review included evaluation of financial controls in place throughout the organization, major emphasis was placed on reviewing the organization and business processes within the Auditor & Comptroller’s office as they affected the City’s annual financial statements. Additionally, significant effort was also placed on evaluating the City’s control environment, considered throughout the authoritative literature as the most important element of an entity’s internal control structure and *the foundation for all other controls.*

### **Conclusions**

**As of our report date, we are unable to conclude that the City’s internal controls over financial reporting are adequate to assure timely and accurate financial reporting.**

**Organizational Issues** - We determined that the current organizational structure of the Auditor’s office did not serve to promote accurate and efficient preparation of the City’s annual financial statements. Span of control issues and allocation of duties inhibited efficiency of operations and accountability for work performed.

**Business Processes** - We found that significant impediments to the accessibility of data, and a lack of automated processes resulted in many manually intensive processes prone to error.

**Other Issues** - Issues such as a lack of adequate training in the Auditor’s office and throughout the organization, over-centralization of the accounting function, and potential audit independence issues were also identified as areas in need of remedial action.

**Control Environment** - We believe there is a critical need for the City to work towards the creation and maintenance of a climate of honesty and openness that allows people to feel safe enough to discuss difficult issues.

**Remediation Measures** - Various remediation measures have been initiated or already implemented to strengthen financial reporting controls, including reorganization of the Auditor’s office, implementation of an employee hotline, and initiation of a new automated financial reporting system. Additional measures (e.g. mandatory value-based ethics training) must also be implemented to achieve an effective internal control structure.

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# ANNUAL REPORT ON INTERNAL CONTROLS

## Background

City Ordinance 19320 (the Ordinance) was adopted by the San Diego City Council on October 11, 2004 to address deficiencies in the processes utilized by the City to disclose information to the financial markets. These disclosures include the Comprehensive Annual Financial Report (CAFR), Proforma and Interim Analysis. According to the language of the Ordinance, the primary purpose and intent of the City Council in its enactment was to achieve “a high standard of quality in and efficacy of the City’s financial reporting and disclosure practices.”

To achieve the Council’s purpose, the Ordinance differentiates between “disclosure procedures and controls” and “internal financial controls” and requires *separate* annual evaluations and reports be conducted for each of these control types.

This report pertains to the evaluation required by paragraph 22.0708 of the Ordinance – the *internal financial controls* established and maintained primarily by the City Manager and the City Auditor & Comptroller (the Auditor). Reporting on *disclosure procedures and controls* is within the purview of the Disclosure Practices Working Group. Accordingly, disclosure controls are not directly addressed in this report, although numerous remediation measures presented in this report will serve to strengthen the integrity of the City’s financial disclosures.

## The Nature of Internal Controls

Internal Control, in both the government and private sectors is defined as a process, effected by an entity’s governing board, management and other personnel, designed to provide reasonable assurance regarding the achievement of management’s objectives including the effectiveness and efficiency of operations and the reliability of financial reporting.

***Internal Control ...is a process...designed to provide reasonable assurance regarding the achievement of management’s objectives...***

It is to achieve these objectives and meet its responsibilities that management establishes a framework of internal controls consisting of the following five elements, (a) Control Environment, (b) Risk Assessment,

(c) Control Activities, (d) Information and Communication, and (e) Monitoring.

In this first phase, our review was limited to an evaluation of those internal controls impacting the reliability of the City's financial reporting. Our review and our report is based upon an examination and evaluation of each of the five control elements mentioned above.

### The Five Control Elements

- ***Control Environment*** - The control environment is used to describe what is commonly referred to as the 'tone-at-the-top', or more broadly as the 'corporate culture'. The key element in a favorable control environment is management's attitude, as demonstrated through its actions and example. The City's management team includes elected officials, appointed officers, and senior executives. The control environment is viewed as the most important of the five elements, because the effectiveness of the other four elements will depend upon it.

*The control environment is viewed as the most important of the five elements, because the effectiveness of the other four elements will depend upon it.*

- ***Risk Assessment*** - Effective identification and assessment of risks (potential obstacles to achieving management's objectives) must be an ongoing process at all levels of the organization so that such risks may be dealt with on a timely basis.
- ***Control Activities*** - Control policies and procedures are established to mitigate the various risks identified by management. Purchasing policies, written authorizations and supervisory approvals for certain actions, security over assets and records, an effective internal audit function, and timely preparation of financial statements are some examples of control policies and procedures.
- ***Information and Communication*** - Information and communication are pervasive characteristics that affect all aspects of the internal control framework. It is therefore essential that current, accurate and appropriate information be made available on a timely basis to those

who need it. This communication should be multi-directional within the organization.

- **Monitoring** - Monitoring is the ongoing evaluation process by which management ensures that established control related policies and procedures are continuing to function properly, as designed.

## Analysis

### *Project Scope*

In performing our review of internal controls, we utilized a ‘top-down, risk-based approach’ as recommended by the Securities and Exchange Commission. In order to optimize limited internal resources available for this project, we focused on those areas posing the greatest risk of having materially adverse impacts on the accurate and timely preparation of the City’s CAFR.

Initial discussions among project team members and other financial staff disclosed early in the process the need for our evaluation to focus on several of the most obvious issues which appeared to present the most significant impediments to accurate and timely financial statements preparation. Accordingly, major emphasis was placed on reviewing the organization and business processes within the Auditor & Comptroller’s office as they affected preparation of the City’s CAFR.

***Initial discussions disclosed the need to focus on the issues which appeared to present the most significant impediments to accurate and timely financial statement preparation.***

Detailed testing of organization-wide policies and procedures will be addressed in future reporting periods. A full description of project scope work performed is contained in Appendix D to this report.

Finally, significant effort was placed on evaluating the City’s control environment, considered throughout the authoritative literature as the most important element of an entity’s internal control structure and the foundation for all other controls.

In our effort to evaluate the control environment, we conducted training sessions for approximately 190 City staff and senior management to acquaint them with basic control environment concepts, and to familiarize them with terminology that subsequently would be utilized in several employee surveys regarding control environment issues.

The initial survey was prepared and distributed to a representative sample of City employees across departments and operating programs. A subsequent survey was distributed to each of the City's department and program directors. Lastly, we conducted interviews with selected City staff and performed an analysis of the City's organizational structure.

### *Findings*

#### **A. Auditor & Comptroller's Office**

- 1) **Organization** - We determined that the then current organizational structure of the Auditor's office did not serve to promote either the effective or the efficient preparation of the City's CAFR.

Span of Control Issues - The Operations Division in the Auditor's office historically has been responsible for preparation of the City's CAFR. This division was responsible for a wide variety of City-wide accounting operations (including CAFR preparation) and contains approximately two-thirds of the Audit department's staff. All of these individuals reported to one person, the division manager, who was responsible for overseeing a myriad of day-to-day functions. This extremely large span of control led, in our opinion, to an inevitable dilution in the quality and timeliness of management oversight of the CAFR process.

Allocation of Duties - Responsibilities for CAFR preparation were not confined to a discrete group, but rather were allocated among an excessively large number of individuals within the department. This, we observed, presented challenges in the coordination, communication, accountability and supervision problems throughout the CAFR preparation process.

- 2) **Business processes** - Business processes in place to identify, summarize, reconcile, and report pertinent financial data were not formalized or documented and generally did not contain necessary

controls to adequately assure the accuracy of data reported in the City's CAFR or the efficacy and ease of access to management data. Significant impediments to the accessibility of data inherent in the City's financial accounting and reporting system, together with a general lack of automated processes, resulted in numerous manually intensive, tedious processes. The results include increased workloads, more opportunities for human error which is inherent in all manual processes, and significant delays in meeting deadline dates.

3) **Other Issues -**

Training - The lack of adequate training, while prevalent throughout the City organization was, we noted, particularly acute in the Auditor's professional staff. The accounting and reporting of municipal financial transactions is a complex subject matter area governed by numerous accounting rules and standards – many of which are highly conceptual in nature and elusive in their proper interpretation and application.

The lack of adequate professional training provided to the Auditor's staff over the past 10 years, has contributed directly to the significant and substantial errors in the FY 2003 CAFR. The annual savings realized by the elimination of training for staff in both the Auditor's and Financial Management offices has been more than offset by the millions of dollars expended to date in an effort to correct those errors.

*The accuracy and completeness of accounting information is negatively impacted if accounting staff is not privy to the nature of management decisions and unfamiliar with the operations of the departments they serve.*

Centralized Accounting - We noted that the City's accounting function is centralized to a degree that isolates accounting staff from the City departments for which they are responsible - both physically and (consequently) operationally. As a result, a risk exists that staff may either be unaware that certain management actions have been

taken, or unaware of the logic (and therefore the financial impact) of those actions for accounting purposes.

The accuracy and completeness of the accounting services provided to the operating departments is negatively impacted to the extent that accounting staff is not privy to the nature of management decisions and unfamiliar with the operations of the departments they serve.

Additionally, it was apparent that this current high-degree of centralization impacts the quality of financial statement production, insofar as accounting staff is not always aware of management decisions and other significant activities or financial exposures in the City's departments.

Audit Independence - The concept of an auditor's independence is an essential element in the Codes of Ethics of both the accounting and auditing professions.

An auditor's 'stock-in-trade' is her or his opinion. The value of the auditor's opinion is rooted in the auditor's *objectivity*. The auditor's objectivity is rooted in the auditor's *independence* within the organization. To the extent that an auditor's opinion is less than objective, the value (and reliability) of that opinion is diminished.

In practice, this independence serves to provide an environment of 'checks and balances', helping to ensure that policy makers and the public are privy to the full disclosure of data and other information critical to an informed decision-making process.

The concept of 'checks and balances' and the controls inherent therein, are diminished at least perceptively, and often in reality, when the auditor is hired by and reports to the Chief Executive Officer of the organization. This will happen with the advent of the Strong Mayor form of government.

Accessibility of Financial Data - A significant impediment to the accurate and timely preparation of the CAFR as well as timely monitoring and analysis of budgeted expenditures and revenues is the absence of a computerized financial system that provides easy access to and adequate documentation of pertinent data.

Budget Issues - We noted several opportunities to improve the budgeting process. These include revising the structure of the budget to more accurately reflect the organizational structure of the City and the need to estimate budgeted revenues and expenditures on a monthly basis. Additionally, we noted the opportunity to improve the construction of the City's annual Appropriations Ordinance in order to enhance the City Council's control over budget adjustments.

Control Environment Issues - *Entity-wide* control environment issues are addressed below. However, as these issues pertain to the Auditor's office, the recently appointed Auditor observed, early on, that in both internal and external interactions involving Auditor & Comptroller management staff there appeared to be a general hesitancy on the part of staff to engage in open discussion of issues. This was evident in situations when a higher ranking City employee (whether from inside or outside of the Auditor's office) had previously expressed an opinion concerning the issue at hand.

*...there appeared to be a general hesitancy to engage in open discussion of issues.*

### **B. Control Environment ('tone-at-the-top') Issues**

Although we found that various mechanisms were currently in place which are typically supportive of a positive control environment (an established Ethics Commission, campaign disclosure requirements, codes of conduct, etc), we found a general reluctance on the part of staff at all levels to engage in discussion of controversial issues.

### **C. Organization-wide Controls**

We noted significant breakdowns in controls needed to assure the communication and transmission of accurate and timely accounting data between the Auditor's office and the operating departments. An analysis of the causes of several errors found in the FY 2003 CAFR disclosed significant process deficiencies, a lack of adequate communication between operating departments and Auditor personnel, and the general absence of accounting expertise in several departments due to the over-centralization of accounting activities in the Auditor's office.

## Conclusions

- A. Auditor & Comptroller Issues** - Neither the organizational structure of the Auditor's office nor the allocation of duties within that structure served to promote the achievement of the Department's objectives in an efficient or effective manner. Business processes were found to be poorly designed, manually intensive, and not documented.

A lack of accounting expertise in the service departments due to the over-centralization of accounting functions in the Auditor's office, in our opinion, inhibits the accuracy and timeliness of financial reporting and increases the risk of financial disclosure omissions in future financial statements.

The general lack of technical as well as operational training, we believe, has contributed to the preparation of financial statements that did not meet the minimum requirements of the accounting profession as promulgated by the Government Accounting Standards Board (GASB).

Finally, issues of the Auditor's organizational independence, and the overriding issue of an authoritarian control environment in the Department, and to some extent, in the City organization, led to a deafening silence, rather than to the open discussion and proper resolution of the financial reporting issues the organization faced in preparing the FY 2003 CAFR.

- B. Control Environment** – Organizational modifications to the City's accounting functions, adequate training for the City's professional finance and accounting staff, and effective automation of (and control over) the City's business processes can all be satisfactorily achieved and implemented over time.

*...it becomes critical to assure the creation of a climate of honesty and openness...*

The effectiveness of these efforts, however, can be partially or totally negated by the 'tone-at-the-top' of the organization. To avoid this possibility, it becomes critical, therefore, to assure the

creation and maintenance of a climate of honesty and openness that allows people to feel safe enough to discuss difficult issues.

**C. Organization-wide Controls** - Several significant inter-departmental accounting processes that pertain to the origination, transmission, interpretation, and reconciliation of financial data between the operating departments and the Auditor's office need to be carefully examined and re-engineered. Multiple manual entry of identical data should be minimized or eliminated by development of shared databases, and necessary data reconciliations between departments should be performed frequently and on a timely basis.

The level of accounting expertise in the departments should be enhanced and department directors should be responsible for the financial (as well as the operational) integrity of their department's operations.

The need to provide timely financial data to the operating departments in an easily accessible, user friendly format is, we believe, essential to prompt and accurate posting of accounting transactions. An effective financial reporting system will also facilitate timely monitoring of financial activities at all levels within the City organization. To accomplish this managers need to be given the proper staff and tools.

## Remediation

**A. Auditor & Comptroller Issues** - The Auditor & Comptroller has developed a Departmental Reorganization Plan for the Auditor's office which was presented to, and approved by the City Council in August 2005. The plan addresses the following remediation measures:

- 1) Establish a Financial Reporting Division within the Auditor's office responsible for preparing the CAFR and tasked with the objective of developing processes and controls to enable the accurate and timely preparation of the City's CAFR and other interim reporting.
- 2) Re-allocate various duties among Auditor & Comptroller operating divisions in a manner which groups similar overlapping

responsibilities and tasks to promote process efficiency, improve the quality of work product, and to enhance accountability.

- 3) Establish the position of 'Chief Accountant', a Certified Public Accountant, who would serve as the City's accounting theoretician. This individual would be responsible for setting organization-wide accounting policies and for ensuring on-going adherence to those policies.
- 4) Provide training to professional and clerical personnel on an on-going basis. Technical training in accounting and reporting subjects, management training focusing on process improvement techniques, and expanding the computer capabilities of clerical staff via Excel and Access data base training are all training priorities.
- 5) Design and implement a Financial Reporting System using Web based state-of-the-art technology to provide user-friendly access to a promptly updated budget and operating results to the City's financial, policy-making, and operational departments.
- 6) Work with the Financial Management Department to implement an enhanced budgeting process requiring monthly estimates of budgeted expenditures and revenues, monthly monitoring of results for each City department, and a more accurate reflection of the City's organizational structure. This procedure would permit budget adjustments and restatement of budget priorities if needed, to be made by the Council on a more timely (i.e. monthly) basis.

Subsequent to implementation of a monthly budgeting process, Financial Management should work with the Auditor's Office and the City Attorney's Office to modify the Appropriations Ordinance to enhance City Council's control over budget adjustments.

- 7) Decentralize certain accounting functions by providing operating departments with qualified accounting staff. The quality of an organization's accounting is, to a large extent, dependent upon the individual accountant's understanding of the operational decisions underlying accounting transactions. The quality of the

City's accounting will improve to the extent that the accountants are familiar with the 'business' and the management decision-making processes of the departments for which they are responsible.

- 8) Auditor independence issues will be addressed via a separate recommendation and presentation to the Council. The objective of our recommendation is to ensure the independence of the City Auditor, while at the same time removing the element of any undue political pressure from the Auditor's office.

Based on our experience, independence is most enhanced by the organizational model whereby the Auditor is hired by, and reports to an Audit Committee comprised of three to five individuals, a majority of which are members of the public sector.

In the absence of an Audit Committee, several large California municipalities promote audit independence by providing the Auditor with a long-term (ten year) contract which can be terminated only by a unanimous vote of the municipality's legislative body. The Federal government's Chief Auditor, the Comptroller General of the United States, is appointed for a 15 year term.

Another option, an elected Auditor position, while preferable to the City's current reporting model, is in our opinion the least desirable of available alternatives for several reasons. The most significant, from the author's many years of observation, is the Auditor's susceptibility to pressures from special interest groups and other politically powerful members within the entity. To ensure one's re-election, the office holder cannot avoid becoming cognizant of her/his dependency on those who wield local political influence and the impact of her/his decisions on those individuals and/or groups.

- 9) Control environment issues in the Auditor's office will be addressed by actions taken within the Auditor's office as well as those actions taken within the context of the City-wide organization. The Auditor has adopted and will promulgate, on an on-going basis, an environment that encourages contrary

opinions and open communication among staff. Annual one-on-one meetings between the Auditor and each of approximately one hundred staff members have been instituted.

**B. Control Environment** - The objective of the following remediation measures is to help create a climate of honesty and openness throughout the City organization that allows people to feel safe enough to discuss difficult issues.

- 1) Bi-Annual, mandatory value-based ethics training is essential for all management personnel and elected officials. Such a requirement would send an important message throughout the organization that management is not only cognizant of, but also values those precepts and the adherence to those precepts in the every-day performance of our duties. Upon hire, new employees should be required to read and certify the City's written ethics policies and re-certify on an annual basis thereafter.
- 2) Establishment of an employee 'hotline' will serve to assure staff that the City management is committed to on-going adherence to ethical values, but more importantly, it will serve to give staff at all levels a voice in those instances where issues of 'doing the right thing' may become obscured by the exigencies of operational or political expediency.

**C. Organization-wide Controls** - Further implementation, monitoring, and most importantly, ownership of City-wide financial reporting controls are the responsibility of the organization's management. The annual evaluation of these controls, in accordance with the City ordinance, is the responsibility of the City Auditor's office.

- 1) Scope-enhancement of this annual internal control evaluation will continue to increase the quality of City-wide controls. Our first annual compliance effort, which is the subject of this Report, has been limited to the most essential control areas, due both to time and staff limitations. Accordingly, although controls in the operating departments and their potential impact on financial reporting issues were identified, testing of all but the most essential controls was deferred to next calendar year, beginning in January 2006.

- 2) Annual compliance with City Ordinance 19320 will require an on-going, year-round effort. Further compliance with the current Ordinance and any future internal control legislation, will necessitate several dedicated staff positions within the Auditor's office devoted to this effort. Accordingly, the nucleus of the Auditor's internal control Project Team will remain intact and a permanent Project Manager's position established for this purpose.

Although the Federally enacted Sarbanes-Oxley legislation is currently applicable only to private-sector entities, the consensus of opinion among our professional peers is that this or similar legislation will, within the next few years, become mandatory for governmental entities.

At that point, due to the forward-looking internal control legislation enacted here, the City of San Diego should be uniquely situated to lead the way as other local governmental entities become familiar with the implementation, operation and evaluation of internal controls.

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**CERTIFICATION BY CITY MANAGER  
AND  
AUDITOR & COMPTROLLER**

In accordance with the requirements of paragraph 22.0708 of San Diego City Ordinance 19320, the City Manager and the Auditor & Comptroller 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 22.1702, is made know to the City Manager and/or the City Auditor & Comptroller by others within the City and its departments, offices, agencies, and affiliated 'related agencies', particularly during the period in which the Annual Report required by this section is being prepared;
- (3) have presented in the Annual Report their conclusions about the effectiveness of their internal controls based on such evaluation as of that date;
- (4) have evaluated the effectiveness of the City's internal financial controls as of a date within 90 days prior to the Annual Report;
- (5) have disclosed 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;
- (7) the City Auditor in coordination with the City Manager has conducted an annual evaluation of the City's internal financial controls as reported in the document titled "Annual Report on Internal Controls," dated January 1, 2006, and that such report accurately identifies the results and conclusions of that evaluation.

SIGNED: \_\_\_\_\_

  
John Torell, CPA  
City Auditor & Comptroller

DATE: 12/29/2005

SIGNED: See following memorandum

Ronne Froman  
Chief Operating Officer

DATE: \_\_\_\_\_

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## THE CITY OF SAN DIEGO

### Memorandum

**DATE:** DECEMBER 21, 2005

**TO:** HONORABLE MAYOR AND MEMBERS OF THE CITY COUNCIL

**FROM:** RONNE FROMAN, CITY MANAGER *RF*

**RE:** STATEMENT OF CITY MANAGER REGARDING MUNICIPAL CODE SECTION 27.0708

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I was appointed San Diego City Manager on 28 November 2005. I was unable to perform the duty of the City Manager required under Municipal Code Section 27.0708 because it required the City Manager to act on or before 1 September 2005, two months before I assumed the office of City Manager. I cannot timely complete, within the prescribed deadline of 1 January 2005, the City Manager's duty under Municipal Code Section 27.0708. I will not be the City Manager after 1 January 2006.

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