



Office of the City Auditor

PRESENTATION

June 10, 2003

To: Honorable Mayor and  
Members of the City Council

From: Ann-Marie Hogan, City Auditor

Subject: CITY AUDITOR'S BUDGET DISCUSSION AND FY2004 AUDIT PLAN

In response to your request that I address Council on the subject of the budget, this presentation includes:

- Information about “what the Auditor does” and what we have accomplished
- Advocacy for effective internal controls, oversight, and administrative and technical support in order to deliver City services and information equitably and efficiently
- Discussion of the need for Council to maintain a realistic approach to the resources needed for support and oversight as pressures continue to mount over the next few years for a “magic bullet” to cut the budget without reducing front line services

The City Auditor's Office provides independent oversight of City operations; its mission is to be a catalyst for improving City government. Oversight and administrative functions are part of the City's internal control system, provided by the Auditor's Office and other “support and oversight” departments, as well as by staff in operating departments. Our audits attempt to provide answers to questions that Council and the City Manager need to answer in order to manage delivery of City services and allocate increasingly scarce City resources:

- Are we assigning sufficient resources to planning before taking action?
- Are we assigning sufficient, and appropriately qualified, resources to the task of monitoring and oversight of performance?
- Are we holding contractors and employees accountable for high quality results?
- Are we allocating sufficient and appropriately managed resources to assure good system design and technology support?
- Are the programs we are funding working effectively?

Our audits provide specific recommendations for strengthening the City's internal controls and improving the efficiency, effectiveness, and equity of City service delivery.

**Internal controls** are all of the policies, practices, systems, and procedures an organization uses to ensure protection of assets and accomplishment of objectives. They include not only checks and balances over computer access and cash handling, but also performance measurement systems, staff training, accurate accounting and reporting, adequate supervision and oversight, audits, and sufficient staffing.

### **Audit Accomplishments for Fiscal Year 2002 and 2003 to Date**

The value of performing audits lies in the successful implementation of the audit recommendations. The auditors have made progress in continuously improving the skills of the auditors, utilizing improved technology, and planning audits that result in recommendations with significant impact. Most importantly, we have seen measurable improvements in the timeliness and thoroughness with which City staff implements our audit recommendations. These improvements would not be possible without the strong support and active engagement of the City Manager and his staff, past and present members of the Council Ad-Hoc Audit Advisory Committee, and Department Directors.

- **Compliance/Revenue audits:** Business License audits, performed by entry level auditors, historically identify revenue at a rate significantly in excess of our costs. As of 5/31/03, we have identified over \$400,000 in one-time revenue this year. This is expected to result in significant future annual revenue as well, since unlicensed or under-reporting businesses are expected to continue to pay taxes in the future.
- **Internal Controls and Performance Audits:** A survey of all City cash handling locations, including in depth audits of several of the locations, resulted in changes to Citywide monitoring of cash assets. An audit of controls over City vehicles resulted in recommendations which may reduce costs to the City as well as ensure more effective vehicle monitoring. A report on opportunities to improve Police staffing has provided support for efforts to restructure Police services. Audits of Information Technology, contracts and procurement compliance with Council policy, internal controls to prevent purchasing fraud, and construction contract change orders are currently in progress.
- **Payroll Audit:** The Payroll Audit Division developed better reports for monitoring lost time due to sick leave and workers' compensation and worked on recommendations to reduce payroll system inefficiencies resulting from provisions in the employee bargaining agreements. Internal controls over confidentiality and security of payroll checks were enhanced with the help of new technology.
- **Implementation of Audit Recommendations:** We instituted an "outcome-based" performance measure aimed at achieving 40% implementation of all audit recommendations before the audit is published. Last year, the result was 60% implementation; so far this year, it is 55%.
- **Training and Task Force Support:** Many of the actions recommended in our audits require improvements to the City's financial systems as well as enhancement of employee skills. The City Auditor has partnered with Finance, Human Resources, Vista College, and the City Manager's office in a number of ongoing initiatives related to employee training, improved documentation, and developing a long term plan to identify needed steps to improve the City's financial software systems.

**Budgeting for Internal Controls, Oversight, and Other Support Services**

Because of continuing budget constraints, Council is under tremendous pressure not to cut direct services to the public. It is important to remember that the undervalued "back office/administrative functions" include vital protection of City assets as well as oversight of City performance.

*Direct services* are in competition with internal controls or indirect services when it comes to budget dollars. However, the quality of delivery of program services is directly impacted by the quality of internal controls, administrative support, and management oversight. A good internal control system will provide mechanisms and oversight to ensure that staff time is used effectively and efficiently, and that the program and service objectives are well planned, carefully evaluated, and modified based on results of the evaluation. Failure to plan, evaluate, and correct will ultimately result in reductions in service.

As Council weighs the priorities for how City resources are used over the next several years, it is important to be realistic about the resources needed to establish and maintain effective controls over City assets and City work.

Part of the significance of the internal control system is that Council needs a way to determine how resources are currently being used. As worsening budget problems move the City in the direction of "doing a few things well", Council will need to make decisions about continuing the most necessary and the most effective programs and services, and eliminating others. It will become increasingly important to determine which programs and services are being delivered effectively and efficiently, and which are not.

The auditors hope to support these efforts by furnishing the kind of information that will be helpful in making these decisions, through our Audit Plan for the next fiscal year (attachment I). We will also be providing technical assistance and support to ongoing City Manager initiatives aimed at improving internal controls and performance reporting.

Additional examples of the significance of internal control issues in a time of budgetary constraints are included in the attached informational item, shared with Council in early April, as part of ongoing discussions in the development of the City Manager's proposed budget (attachment II). I ask that Council keep these issues in mind over the next few years as you continue to grapple with competing demands for City resources.

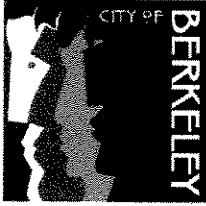
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Approved:

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Ann-Marie Hogan, City Auditor  
Office of the City Auditor



Office of the City Auditor

**Attachment I**  
June 10, 2003

To: Honorable Mayor and  
Members of the City Council

From: Ann-Marie Hogan, City Auditor *amh*

Subject: AUDIT PLAN FOR FISCAL YEAR 2004

Completion of the following audits that are currently in progress:

- Information Technology – internal controls (this may become a series of audits, given the degree of inherent risk)
- Contracts and procurement compliance with Council policy and best practices; bidding, authorization, change orders, and timeliness of execution will be addressed
- Internal controls to prevent fraud in purchasing and payables
- Change orders for construction contracts

Included in the City Auditor's fiscal year 2003 Audit Plan was an audit of youth services programs. This audit has been removed from the audit plan for the time being, based on our discussions with Council and the City Manager regarding audit priorities, and because a report on youth services was prepared this year by the City Manager.

New audits for FY 2004 will include:

- Parking enforcement
- Interagency and interdepartmental coordination of streets and sidewalks repairs (Public Works Department)
- Medi-Cal billing and reimbursement - affect of future reductions in reimbursement (Health and Human Services Department)
- Audit of the Library (requested by Library)
- Customer service/telephone response in City departments
- Continuing Business License tax revenue audits of taxpayers

Depending upon our ability to timely fill a currently vacant Senior Auditor position, we will also include:

- Follow-up on past due audit responses and recommendations from previous audits, particularly in the areas of grants billing, construction contract oversight, and Citywide payroll.
- Project management accounting
- Workers' compensation
- Additional revenue audits

**BACKGROUND:**

Article X, section 61 of the Berkeley City Charter requires that the City Auditor provide the City Council with a planned audit schedule by the beginning of each fiscal year. The Charter also states that the Auditor shall consult with the Mayor, City Council, and City Manager regarding the selection of audit entities, but that the final decision of what to audit shall remain with the Auditor.

**Developing the Audit Plan**

Priorities for audit work were identified by assessing risk and cost-benefit of possible findings and recommendations, and addressing needs for development of information required by decision makers in order to take action. Planning meetings with the City Manager and staff and the Council Ad Hoc Audit Advisory Committee were a key part of developing the audit plan.

The potential impact of budget reductions on City services and activities was a significant factor in prioritizing ideas for the audit plan. In any organization, when cuts are implemented in support and management control services, there is heightened risk that internal controls will weaken significantly. Because of this, we continue to focus on areas where internal controls are a concern or can be expected to deteriorate under the pressure of budget constraints.

We also planned our audits to effectively utilize computerized audit tools that were acquired recently. The new audit software, Audit Command Language (ACL), should improve our ability to detect internal control weaknesses, as well as generate additional revenue for the City.

**FINANCIAL IMPLICATIONS:**

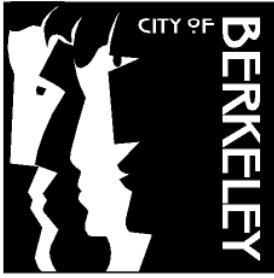
- Business License revenue from compliance audits is projected to be \$125,000 annually per FTE assigned.
- Work plan assumptions include a vacancy rate of approximately 1.5 FTE in General Audit, because of budget reduction requirements (funding for one of the entry level auditors was eliminated from the 2003 budget). This reduction will affect revenue generation, contracts oversight, and audit report completion. However, improvements in audit productivity anticipated as a result of our investment in specialized audit software this year might mitigate these impacts.
- Long range financial benefits of the audit reports, which result in improvements to internal controls and improved efficiency and effectiveness of delivery of Citywide services, are also significant.

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Approved by:

  
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Ann-Marie Hogan, City Auditor  
Office of the City Auditor



## Attachment II

April 4, 2003

To: Honorable Mayor and Members of the City Council  
From: Ann-Marie Hogan, City Auditor  
Subject: Citywide Budget Considerations

Council is about to face the very unpleasant task of addressing a deficit in the General Fund of \$15 million (depending on State funding cuts) as well as taking action to address the "Special Funds" which are also headed into the red.

We have all heard the plea "don't cut anything"; don't eliminate any community agency contracts, any staff positions providing direct services such as public safety and health promotion, or indirect services such as support to Council decision-making.

Even a cursory glance at the numbers makes clear that it is wishful thinking to believe that only the nonessential services or the weak and unproductive programs will be cut. Some good, efficient, and effective programs and services are about to go by the wayside. The question is not "whether", but "how many."

Perhaps a more serious problem is the reduction in service below the radar screen, where indirect services are cut. A reduction in supervision and oversight functions, because they are less visible to the public, is a typical response to public sector budget crises. That is why budget cuts and staffing reorganizations are a textbook "red flag" in risk assessment.

Council recently asked whether the Auditor would address the budget at a Council meeting. Auditors primarily speak "through our audits." This is not an audit, but

observations and recommendations limited to areas examined in our audit reports and related follow-up.

### **Policy Direction Needed**

Council has choices to make in some broad policy areas:

- Managing risk and protecting assets
- The degree to which the City should be doing a few things well or many things less well
- The allocation of resources among competing interests, such as prevention and enforcement

### **Managing Risk and Protecting Assets: Internal Controls**

Auditors assess the degree of risk that assets will be misappropriated, or that information will be misstated, or that programs will fail to produce their intended results ("mission failure") by analyzing the internal controls in place to mitigate those risks. *Internal controls* are the policies, practices, systems, and procedures the organization uses in order to ensure protection of assets and accomplishment of objectives.

On the list of circumstances that place an organization at high risk for unacceptable weakening of internal controls, budget cuts are at the top. Performance measurement systems, staff training, accurate and careful accounting, adequate supervision and oversight, audits, and sufficient staffing - all of these risk being perceived as less important than giving the appearance of continuing to provide services expected by the community.

### **Internal Controls over Assets: Problems Identified**

Last year, cash handling in the City was identified as a high risk area, and a series of audits found that internal controls in this area were very weak, in the locations tested. In location after location, staff was focused on serving the needs of the customers standing in front of them. This led to "short cuts" in cash handling that constituted a very high risk that funds could be stolen, and the theft go undetected.

### **Solutions in Progress: Procedures and Training**

Finance is preparing updated cash handling manuals and a training program, so that hundreds of City employees in 92 locations would learn the basics of cash handling. Supervisors and managers will learn to maintain systems that protect against theft. But allocating the funds to train staff, and continue to offer training to new employees, will take resources away from direct service delivery.

## **Internal Controls over Accurate Information: Performance Measurement**

### **Problems Identified:**

In conducting performance audits of City programs and services, the criteria we use include comparisons to "best practices" in other cities (such as the survey of other cities in the Police Staffing Audit) and comparisons of planned to actual in the program or department's own performance measures. A few years ago, one of our audits determined that internal controls over performance measure reporting were so weak that staff was reporting that they performed 400% more inspections than was true. This federally funded program was also performing a more limited type of inspection (external rather than internal), contrary to the requirements of their grant.

### **Performance Measurement Improvements in Progress:**

The City Manager and the Budget office have been working for several years to re-design and implement an improved performance measurement system. A basic question of risk management and resource allocation is whether to increase resources devoted to improving the performance measurement system, or whether to reduce these efforts so that the direct services can avoid deeper cuts.

## **Internal controls over Resource Use: Budget Monitoring Problems Identified**

Our budget monitoring survey of several years ago revealed that the City's budget was controlled for overall results by projections and estimates by the City Manager's office, but that individual departments lacked the capacity to monitor their own budgets properly. Identified barriers to appropriate budget monitoring included persistent problems with the City's financial software, lack of policy regarding what kind of skills were required of a budget monitor, lack of training in accounting, information systems, and budgeting, and failure to review and compare budgeted to actual expenditures.

### **Budget Monitoring Improvements in Progress:**

Progress has been made in implementing our recommendations. The skills needed by budget monitors were identified, but implementing the requirement is still in progress. Departmental budget monitors have been enthusiastic about accounting training offered by Finance, but the resources to teach and the time required to attend accounting classes have been intermittently available. Replacing the City's financial software is under study. The resources to do a thorough study are not yet identified, nor has the source of the \$5 to 10 million dollar cost (informally estimated by IT) of selecting, purchasing, and installing a replacement.

The effects of the continuing barriers to budget monitoring at the departmental level include "top down" control. The City uses blunt instruments instead of the scalpel; hiring freezes, recruitment slowdowns, and a variety of built in "target savings" that help prevent budget overruns, but result in random, rather than planned, service cut backs. This is a significant barrier to ensuring that resources allocated for a specific purpose are



spent for their intended purpose, though it works as a mechanism to prevent overspending.

**Doing a few things well: Are the programs we are funding working effectively?  
How can we reward the effective programs and eliminate the others?**

Council has frequently requested audits or information about the tangible results of services being provided by community agencies and by staff. In our audit work, we've found that many programs and services provided by the City could be managed more effectively and efficiently. Based on review of audit reports from other cities, the causes of poor performance in our City are typical of other cities as well. These are some things that cities fail to do, which result in wasted resources:

1. Assign sufficient resources to planning before taking action
2. Assign sufficient, and appropriately qualified, resources to the task of monitoring and oversight of performance
3. Hold contractors and employees accountable for high quality results

**Assigning sufficient resources to planning ahead** is particularly hard in a municipal environment, since there is pressure from the public to “get it done now.” Both in public sector and in private sector, insufficient resources devoted to planning ahead have resulted in some spectacular failures. This is true of software systems in particular.

The City of Oakland’s installation of new payroll and accounting software is a case in point. Reports on that debacle provide evidence that there was not enough up-front planning, that the city did not have an adequate system in place for monitoring payroll accuracy on a regular basis, and that the selection process and the performance oversight of the contractors was inadequate.

**Assigning resources to monitoring performance** is a budget issue for Council in terms of deciding which community agencies and programs to cut. Council can

1. Make across the board cuts
2. Attempt to eliminate programs which are performing poorly, or
3. Increase resources allocated towards poorly performed services, if the services are considered important enough to prioritize them ahead of the others.

This is an issue for work performed by City staff as well as by contractors. Council has a responsibility to determine to what extent the City must fund oversight of a large variety of individual contracts, programs, and services so that they can make informed decisions about doing “a few things well”.

**Community Agency Monitoring: Areas for Improvement by Staff and Council**

In our report on community agency monitoring, the contract monitors surveyed reported inconsistencies in the resources devoted to monitoring agencies, a need for training for

contract monitors and a lack of Citywide standards for skills and expectations of contract monitors, as well as Citywide standards for monitoring.

Our reviews of individual community agencies have indicated that, even when oversight results in findings of poor performance, Council has been very reluctant to decide that funding should be withheld.

Finally, our review of job training and placement programs concluded that, due to the way that the performance measures and the monitoring of these programs were planned and implemented, we could not provide the information Council had requested: an unduplicated count of the number of clients served (an “output measure”), and establishment of whether those placed in jobs were still employed one year later (an “outcome measure”.)

### **Progress Made in Staff Oversight of Community Agencies**

In response to these audits, the City Manager convened a small group of contract monitors, who performed a substantial amount of work in revising performance measures for community agency contracts. This included conducting training for community agencies as well as City staff, so that agency contracts performance measures designed to measure results as well as efforts ("outcome measures" in addition to "input and output measures") were included in the training. The procedures and processes for coordinating staff and commission review of all community agency funding requests have also been improved.

**More Work and Decisions Ahead on Community Agencies:** Work has not yet been completed to develop Citywide standards to monitor these contracts, and to extend training to all staff who are currently assigned to monitor contracts. If Council wishes to have better information about what community agencies are accomplishing, one of the ironic budget trade-offs is between giving financial support to the agencies, and obtaining information about whether the investment was worthwhile.

### **Performance and Monitoring: other City contracts**

Several years ago, we were asked to develop a performance audit program for large City construction and engineering contracts (primarily funded by the Sewer Fund). Because we discovered that none of these contracts contained right to audit clauses, our work in this area was limited to evaluating internal evidence in the contract monitors' files. We have not recently performed follow-up work to see the extent to which the findings of our audit were addressed, although we have noted that there are now right to audit clauses in all City construction contracts. An audit of contractors' performance of these contracts remains a high priority. Audits of specific contracts and particular kinds of contracts in this area were suggested by the Council Ad-Hoc Audit Advisory Committee as well as by the City Manager's office. Both the quality of contract monitoring by City staff and the quality of the performance of the contractors should be examined.

As we reported to Council last year, the auditors noted a high rate of non-compliance with various administrative and Council requirements during the years that we conducted desk reviews of all contracts before signing them. Untimely execution and amendment of contracts and lack of evidence of conformity to Council policies were among the most common deficiencies.

Resources assigned to review all contracts before they were countersigned were eliminated from our budget last year. Instead, our audit plan for the current year includes performing compliance reviews of a small number of contracts. We will evaluate whether compliance with various contract regulations has improved now that the Citywide contract instructions have been updated and made available to staff on-line. The question of whether staff is adhering to procedures for competitive solicitation is of particular interest. We have only recently reassigned staff away from revenue identification tasks so that we can complete at least one limited purpose review of contracts this fiscal year.

### **Performance Measurement of City-staffed Programs and Services: Allocating Resources Among Competing and Complementary Programs and Services**

#### **Evaluating performance: which programs and services are performed effectively?**

The degree to which the City can effectively plan, monitor, and allocate resources among a large variety of small programs will depend upon the continuous improvement of the City's performance measurement and budgetary monitoring systems.

Our audit reports, and the related follow up reports from the City Manager, provide detailed information to Council about the performance of the programs and services selected for audit.

In some cities, such as Austin, Texas, the City Auditor's office is heavily involved in monitoring the quality of the City Manager's performance measurement and reporting systems, as well as the internal controls in place in each work unit to prevent falsification of reports. This assists Council and the City Manager in continuously improving the quality of the information reporting.

In other cities, such as Palo Alto and Portland, Oregon, the City Auditor produces an annual Service Efforts and Accomplishments Report, including surveys of customer satisfaction from City residents, as well as reports on the performance measures and results in each Department. This allows Council and the public to have an independently verified report on how well the City is implementing its plans.

Both of these approaches help improve the quality of reporting to Council, but the tradeoff is that fewer audit resources are available for doing in-depth investigation and analysis of the significant risk areas in the City.

## **Policy Direction: Which Programs and Services are the Most Essential?**

In addition to evaluating the appropriate level of resources to devote to quality control (monitoring and reporting as opposed to front line services), Council also needs to make some tough choices about which services are “more essential than others.”

In the same way that an army travels “on its stomach”, direct services are moved along by the “support services” such as cash handling and payroll, and needs for those services fluctuate with the number and size of the programs.

When it comes to direct services to the public, some of the tradeoffs are between prevention and detection, between getting at the root cause of a problem and ameliorating the problem after it gets worse. The competition for services is not just a competition between funding police officers or funding public health nurses, but among competing needs in each department.

For example, a certain amount of property crime in Berkeley, as well as a certain amount of workers’ compensation injury, is due to lack of awareness of good safety precautions. How much time should the Police Department spend on giving talks at student gatherings, senior centers, and neighborhood meetings about safety as opposed to doing detective work after the theft has occurred? How many hours of staff time should be devoted to training supervisors and employees about safety practices and how many hours should be spent analyzing trends in worker injury? Should mental health resources be more specifically targeted towards pre-schoolers and their parents, or towards adults at risk for homelessness?

All of these are questions that must be answered in order to manage the City’s risk, to improve our ability to perform effective service to the community, and to allocate resources among competing priorities.

### **Conclusion**

Thank you for the opportunity to provide some perspective on the City’s budget issues through the eyes of the audits that my staff has conducted in recent years. I hope I’ve answered some of the specific questions asked. If Council has other related questions, or requests for clarification, I would be happy to include them in an updated version of this draft, in my Council presentation after the recess.

cc: Weldon Rucker, City Manager  
Phil Kamlarz, Deputy City Manager  
Paul Navazio, Budget Manager  
Department Directors