



Office of the City Auditor

ACTION CALENDAR
February 10, 2009

To: Honorable Mayor and Members of the City Council

Submitted by: Ann-Marie Hogan, City Auditor

Subject: City Auditor's Budget Discussion

RECOMMENDATION

Discuss the City Auditor's proposals regarding budgets for Fiscal Years 2010, 2011, and future years. Upon conclusion, request additional information and future Council reports or audits, as Council may deem appropriate.

FISCAL IMPACTS OF RECOMMENDATION

The City Auditor has been asked to identify reductions in General Fund services or augmentation of revenue of \$147,543 (8%) for Fiscal Years 2010 and 2011, as part of \$4,561,210 in Citywide "across the board" reductions. Efforts aimed at preparing the City for the 2012 budget and years to come should assume that additional and far larger future savings may be needed, given projected economic conditions.

CURRENT SITUATION AND ITS EFFECTS

Because of declining revenue and increasing costs, substantial general fund cuts for most departments have been proposed, including cuts to the Performance Audit and Payroll Audit divisions of the City Auditor's Office.

The mission of the City Auditor is to provide independent oversight of City operations and to be a catalyst for improving City government. Reducing performance audits increases the odds for loss of City funds.

Audit work can lead to new revenue, cost recovery, and economic impact well beyond the audit department's annual budget. Public confidence in use of City resources is enhanced. Reducing audit work can increase City costs, whether through poor internal controls that make fraud more likely or through operational inefficiencies. Without audits, there may be increased *perception* of no oversight, resulting in increased assumptions by those so inclined that fraud committed would go undetected. For these reasons, the auditors are not proposing any reductions in Performance Audit staffing.

The City Auditor intends to meet the budget reduction request by increasing Business License revenue, in an innovative partnership with the Finance Department. Also under consideration are efficiencies in payroll, benefits, and payments oversight. They can only be achieved by action from other departments to remove barriers to efficiency in the payroll/benefits system and in contracts oversight.

Council has asked the City Auditor to continue to keep them informed about the internal control risks associated with employee position freezes and cuts. Tonight's presentation is aimed at discussing the larger Citywide budgetary concerns and to look at what action Council and the City Manager can take to prepare for the risk of even larger shortfalls three years from now. These future projections are based on continuing State and Federal deficits and the expected large increase in retirement rates, which will not affect Berkeley until 2012, the year following this two-year budget cycle.

Payroll Audit is not the only oversight or support division in the City that will find it impossible to meet target reductions without taking unacceptable risks. When "across the board" cuts are applied to direct services, the impact on service is visible in terms of delayed response or shorter service hours. When equivalent cuts are taken to oversight and support functions, the City takes on a greater risk. The impacts may not be fully disclosed to Council. The impact may be invisible in the short term, but eventually will surface as an unacceptable risk for the City.

Support and oversight departments in general may find that budget cuts in the operating departments actually increase the need for their services. Divisions such as Finance Purchasing/Accounts Payable, Payroll Audit, and Budget have the same workload whether the City has 1600 employees or 800. Their workload can be reduced, however, if there are fewer departments, more uniform practices across departments, or fewer fiscal/budgetary/payroll/payments units in operating departments.

The City Clerk's workload is not at all related to the size of the City's workforce or the size of the City. Instead, it is affected by customer demand: the number of Council meetings, candidates and ballot measures; the number of citizen commissions, and unfunded mandates ranging from Federal and State regulations to local citizen initiatives.

The Finance/Revenue workload is not affected by workforce size, but by the number of businesses in the City, and opportunities for increasing revenues.

Operating department cost reductions may also inadvertently increase internal control risks, in attempts to minimize direct service reductions. Safety risks may be heightened by elimination of a training or supervisory position. Fraud risk may be increased because position reductions interfere with segregation of inappropriate duties, allowing an individual access to change records or to appropriate assets without detection.

Council has previously directed the City Manager to take steps to improve the analysis and disclosure of impacts of budget reductions. It is critical that each department begin to formally address the risk of reduction of oversight services as part of their budget submittals to the City Manager. This analysis should be the basis of a City Manager Council report on the internal control risks of specific proposed cuts.

Council adopted a budget policy directing the City Manager to "Balance reductions to City administrative services so as not to jeopardize fiscal accountability" on [March 23, 2004](#). More recently, Council voted to require that internal control risk analyses be included in annual departmental budget submissions, as recommended in the Auditor's "Invisible Problems" report. [October 9, 2007](#). This requirement was not included in the recently issued budget instructions.

On a more positive note, there are opportunities for increased efficiencies, which if pursued, could make possible cost reductions without accompanying risk of fraud and system failure, not only in Payroll Audit but Citywide.

Among the Council priorities and policies that should be considered are:

- Increased uniformity in benefits and payroll regulations across bargaining units
- More uniformity and consolidation in Citywide financial, budgetary, payroll and contracts administration (and, in particular, grants management)
- Addressing the invisible costs of the City's deficient accounting software

BACKGROUND

Over the last several years, and most recently on [December 8, 2008](#), the City Auditor discussed with Council the need for more thorough analysis and disclosure of the impacts of budget cuts to essential oversight services. Council asked the Auditor to continue bringing this issue forward.

In the past, the City has tried to minimize direct services cuts by reducing the oversight and administrative services that support the programs. These reductions have been in the support services within operating departments, as well as in the support departments themselves. With continuing pressure on the budget, the importance of disclosing the risks to Council and of considering new policies and practices increases.

The Auditor's Office eliminated two performance auditors in prior years. Last year, instead of eliminating more staff permanently, we established an innovative program to provide non-audit services to departments with positions vacancies and salary savings.

One of the great challenges for City leaders over the next few years is that, if Berkeley increases reductions in oversight services to avoid reducing programs, "invisible problems" will not be addressed and risks of unintended consequences will increase: [Invisible Problems: Weak Internal Controls May Require Disclosure by City Manager and Council Action](#) (October 9, 2007).

This appeared to be the case in December of 2005, when I issued [Delayed Implementation of Audit Recommendations](#) and, in 2003, [Internal Control Risks Associated with Budget Cuts and Freezes](#).

Before specific budget proposals are brought forward, Council should be prepared to accept specific risks of system failure if major changes are not planned for the way the City does business. Better information and a willingness to change established practices can help Council guide the City through a future that promises new challenges.

CONTACT PERSON

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