



Office of the City Manager

ACTION CALENDAR  
March 24, 2009

To: Honorable Mayor and Members of the City Council

Submitted by: Ann-Marie Hogan, City Auditor

Subject: Budget Transparency, Internal Controls, and Delayed Action on Audits

RECOMMENDATION

Continue discussion of Council's role in providing leadership in improving internal controls and risk management. Discuss status of Council direction that internal control impacts be disclosed in budget submissions. Upon conclusion, provide direction to the City Manager or request information from the City Manager or City Auditor, as appropriate.

FISCAL IMPACTS OF RECOMMENDATION

A well functioning system of internal controls helps prevent service delivery shortfalls, costly inefficiencies, and fraud, waste and abuse of City resources. According to the *2008 Report to the Nation on Occupational Fraud and Abuse*, a typical organization loses 7% of its annual revenues to fraud. That would be over \$24 million in a \$350 million budget and does not include resources wasted because of weak controls.

CURRENT SITUATION AND ITS EFFECTS

When Council makes decisions in an era of declining resources, there is a forced trade off between direct services and internal controls. The community puts pressure on the Council to protect services at any cost. The entire organization feels pressure to find a way to avoid diminishing services. This pressure, and the climate of uncertainty, create new risk and can interfere with prudent decision-making.

The City is currently reviewing spending proposals for Recovery and Reinvestment Act funds. This Act includes a tremendous expectation of higher levels of accountability and oversight, with internal control requirements such as prompt reporting and frequent reviews by federal auditors. Funds may be revoked if controls are not in place.

In order to discharge their responsibilities, Council needs sufficient information to evaluate and accept the risks of budget decisions. Contrary to Council's previous direction, this year's Departmental budget submittals did not include information about possible significant internal control risks and impacts. Council is currently provided with information about the direct service impacts of budget reductions. Indirect service and internal controls budget impacts must be disclosed because the City Council has a responsibility to independently assess the actual risks of legislative actions.

This report was discussed with the City Manager before transmission to Council. The City Manager has agreed that, although department directors were not asked to evaluate internal control impacts during this budget round, staff in Finance and Budget will review departmental proposals for impacts and share the information with Council.

The auditors would also like to bring to your attention the attached list of outstanding audit recommendations. Failure to implement agreed-upon audit recommendations suggests that past budget cuts may have impacted internal controls. Action to reduce the risk of costly inefficiencies, revenue loss, or misuse of City resources may have taken a back seat because of budget cuts to support and oversight activities. Twenty-one recommendations are more than five years old.

### BACKGROUND

Since the Enron scandal, corporate boards of directors as well as legislative bodies have been expected, and in some cases required, to take a more active role in oversight of internal controls in general and financial controls in particular. One example is the City's annual letter from the outside auditors, which now states that "our audit...does not relieve the **City Council** (emphasis added) or management of their responsibility for the financial statements." More broadly, legislative bodies are now expected to take more responsibility for internal controls. Council sets the "tone at the top," the most critical of the elements of a strong ethical control environment.

In response to a series of reports about internal control risks, Council requested the City Auditor to continue to keep them informed about the internal control risks associated with employee position freezes and cuts. However, the auditors do not have access to all of the information needed to assess and evaluate individual circumstances in each department on an ongoing basis. Accordingly, in the "Invisible Problems" report issued [October 9, 2007](#) the Auditor suggested and Council voted to require that internal control risk analyses be included in annual departmental budget submissions. This requirement was not included in the recently issued budget instructions.

The City Auditor brought this matter to Council's attention in an Action Item on [February 9, 2009](#). The presentation also included long term cost saving suggestions for Council and City Manager consideration. These were:

- Increased uniformity in benefits and payroll across bargaining units
- More uniformity and consolidation in Citywide fiscal administration
- Addressing the costs of the accounting software inefficiencies.

The suggestions were primarily aimed at efficiencies that could reduce workload and costs in support and oversight functions and departments. Because of the lateness of the hour, some Council Members suggested that these issues be addressed more fully in a future meeting.

At the meeting on February 9th, Council members also suggested that the City Auditor and the City Manager meet to discuss ideas about consolidating fiscal functions in departments. The first of those meetings included discussion of consolidation of community agency proposals, especially those related to Recovery and Reinvestment Act funds. It is challenging for the City to provide a strong control environment for a large number of small programs.

The attached table of outstanding audit recommendations has been updated to include the 1999 Citywide Payroll Audit, which recommended that pay and benefits practices be standardized Citywide, as a cost saving measure. Also added is the status of Council direction that information about internal controls be included in budget submissions.

CONTACT PERSON

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Attachments:

1: Status Report on Open Audits and Council Directives as of March 2009

**Status Report on Open Audits**  
**Number of Outstanding Recommendations**  
**As of 03/24/2009**

<b>Council Direction: Budget</b>	<b>Date of Council Action</b>		<b>Outstanding</b>
Require internal control risk analyses in annual budget submissions	<b>2007</b>		1
<b>Audit Title</b>	<b>Date of Audit Report</b>	<b>Scheduled Council Report</b>	<b>Total Outstanding Recommendations</b>
Public Works Grants Audit	<b>1998</b>	5/31/2009	1
Citywide Payroll Audit	<b>1999</b>	tba	5
Departmental Budget Monitoring Audit	<b>1999</b>	6/2/2009	4
Police Staffing Audit	<b>2002</b>	5/31/2010	3
Cash Receipts/Cash Handling Audit - Treasury	<b>2003</b>	5/31/2009	1
Customer Service Cash Receipts / Cash Handling Audit	<b>2003</b>	5/31/2009	3
Information Systems General Controls Audit	<b>2003</b>	5/5/2009	3
Accounts Payable Audit	<b>2004</b>	11/18/2008 (Past Due)	1
FUND\$ Change Management Audit	<b>2004</b>	5/5/2009	11
Citywide Contract Compliance Audit	<b>2004</b>	<b>3/31/2009</b>	3
Purchase Order Audit - Select Public Works Divisions At the Corporation Yard	<b>2005</b>	10/31/2009	1
Parcel Based Special Taxes, Fees, and Assessments Audit	<b>2005</b>	4/21/2009	6
Audit of the Association of Sports Field Users	<b>2006</b>	4/21/2009	7
Follow-Up Audit of Public Works Construction Contracts	<b>2007</b>	6/9/2009	9
FY 2008 Surprise Cash Count: Permit Service Center	<b>2007</b>	4/21/2009	2
Audit of HHS Medi-Cal Mental Health Billings	<b>2008</b>	6/9/2009	1
Audit: Response Times To Calls for Emergency Medical Services Could Be Improved	<b>2008</b>	12/31/2009	12
Police - Overtime and Lost Time	<b>2008</b>	6/23/2009	5
Transfer Station Surprise Cash Count Audit	<b>2008</b>	5/31/2009	6
<b>TOTAL</b>			<b>85</b>