



Office of the City Auditor

ACTION CALENDAR
December 13, 2005

To: Honorable Mayor and
Members of the City Council

From: Ann-Marie Hogan, City Auditor

Subject: Delayed Implementation of Audit Recommendations

RECOMMENDATION

That Council request the City Manager take the following steps to address the causes and effects of delays in implementing audit recommendations the City has previously agreed to implement:

1. Report back to Council regarding causes for difficulties in implementing audit recommendations.
2. Investigate the possibility that budget-related cuts and freezes may have impacted oversight/support functions and internal controls Citywide to a degree of unacceptable risk. This risk would include loss of City assets due to fraud, reduced revenues due to weak controls over billing and collections, and less than optimal use of resources due to diminished oversight of efficient and effective performance.
3. To the extent possible, include an analysis of potential internal control impacts in future discussions of City budgets, as well as estimated costs for resolving them.
4. Take such additional steps as Council may determine after discussion. Until the City Manager is able to explore the underlying causes of lack of implementation, Council should be cautious about committing funds to new program areas. Council should be prepared for the possibility that existing direct public services may be curtailed in the short run, in order to assign resources to resolve persistent and recurrent internal control weaknesses Citywide.

This report has been discussed with the City Manager, who has agreed to return to Council with a preliminary report on February 7, 2006.

SUMMARY

Last year, there was a significant decrease in the number of audit recommendations implemented timely by City staff. In addition, some recommendations previously reported to Council as fully implemented were subsequently reported no longer implemented. Staff reported that this was due to staffing and budgetary constraints. The possibility that Citywide budget cuts have exacerbated internal control weaknesses should be explored. In addition, a few audits completed more than three years ago should be revisited to ensure that important findings have been fully addressed.

FISCAL IMPACTS OF RECOMMENDATION

Fiscal impacts related to the Citywide untimely billing of grants and to the “civilianization” of additional Police positions have been documented in previous reports.

According to Finance staff, the City’s cost for unbilled grants can be calculated as 4% of the unbilled balance. Finance’s quarterly reports show some fluctuation in the balances, which they estimate at above \$7 million on June 30, 2005. The extent to which some of this cost could reasonably be reduced by implementation of our audit recommendations has not yet been reported to Council.

The deterioration of City business controls has led to risk of loss of City assets, as well as diminished oversight and effectiveness of service delivery. One way of quantifying this is to look at fraud risk as a percentage of the City budget.

City revenues are expected to be about \$300 million in the next year. A survey issued by the Association of Fraud Examiners suggests that a typical organization loses about 6% of its annual budget to fraud. Our earlier report used a 2% figure from a previous study on the same subject. Poor internal controls increase the likelihood of fraud, ranging from fraudulent billings by vendors and contractors to underreporting by taxpayers to misuse of City assets and City-paid time by employees. Whether the City is “typical” or not, diminished internal controls clearly result in lost dollars due to inefficiencies as well as fraud. Implementation of audit recommendations helps reduce the incidence of fraud, as well as support enhanced delivery of services.

The cost of implementing internal control improvements should not exceed the benefit. The City Manager will need to estimate the cost of implementing our recommendations and weigh these costs against the ongoing cost of the weak controls we have found in our audits. It may be that service delivery reductions will be proposed in order to free up resources to control the identified risks. This may require Council action in the future.

CURRENT SITUATION AND ITS EFFECTS

The City Auditor is responsible, by Government Audit Standards, for following up on the implementation of audit recommendations. The auditors established, as a performance measure, that 40% of our recommendations should be either fully implemented or partially implemented (as reported by the City Manager) as of the issuance (Council date) of each of our audits. This helps to ensure that the auditors will actively communicate audit results and engage in discussions about how to implement solutions, long before the report goes to Council. It also gives the departments the opportunity to demonstrate that they are well on their way to fixing the problems, by the time the report goes public.

As noted in the City Auditor's 2005 Annual Report on tonight's agenda, the rate of audit recommendations reported fully or partially implemented by the City Manager as of audit issuance date was only 26%. This compares unfavorably with 38% in 2004, and 44% in 2003.

As of November 15, 2005, of the 309 audit recommendations made in fiscal years 2003, 2004, and 2005, 109 have not yet been reported fully implemented by the City Manager. Full implementation rates reported to date are 89% for 2003, 61% for 2004, and 26% for fiscal year 2005.

Perhaps more significantly, recent information reported to Council by the City Manager suggests that some audit recommendations previously reported as "implemented" became "unimplemented" over the last year. According to the reports, this was due to staffing shortages that made it impossible to maintain expected levels of service and hours of operation for the public. As a consequence, staff stated that they felt obliged to accept greater risks in systems of internal controls. This included reducing supervisory review and reconciliation of records related to liquid assets.

Detailed information has been provided to the City Manager, who reports that he has met with the Department Directors and discussed a strategy to deal with those recommendations that appear to be less labor-intensive to resolve in the short term. A number of follow up reports from the City Manager are scheduled for Council presentation in December.

From discussions with City staff, and from staff reports to Council, it appears likely that short staffing related to budget difficulties may play a significant part in explaining not only the setbacks in these cases, but the overall slowdown in implementing recommendations. Since the data is only for three years in time, we cannot yet draw conclusions about whether budget cuts may have permanently, or only temporarily, been a major factor in weakening controls in the areas audited over the past three years.

Until the City Manager is able to explore the underlying causes, Council should be cautious about committing funds to new program areas, and should be prepared for the possibility that existing direct public services may be curtailed in the short run, in order to assign resources to resolving persistent and recurrent internal control weaknesses Citywide.

BACKGROUND

On December 9, 2003, the City Auditor submitted to Council the information report Internal Control Risks Associated with Budget Cuts and Freezes, in response to a request Council made during the presentation of the City Auditor's Budget Discussion and FY2004 Audit Plan report on June 10, 2003. These reports (and all audit reports discussed in this item) can be found on the City's website at <http://www.cityofberkeley.info/auditor/currentaudits.htm>. Council then asked if the Auditor could monitor the impact of the budget cuts and alert the Council if it appeared that internal control risks were heightened.

Tonight's report serves as an early alert to potential risks in this area. It appears reasonable that the slowdown in implementation of audit recommendations may be an "indicator" that oversight functions have been weakened to an unacceptable level. The actual "unimplementation" of recommendations previously reported as implemented may also be such an indicator.

In addition to concerns about lack of implementation of more recent audits, several older audits should be revisited by the City Manager because their "final" reports to Council indicated that some issues remained unresolved, and because the impact of "unimplementing" recommendations previously reported as completed would be significant.

Grants Audits – Fiscal Year 1998

The Public Works Grants Audit and the Health and Human Services Grant Billing Audit, submitted to Council on January 6, 1998 and September 15, 1998, are significant because of potential dollar impact of the findings. There are large dollar costs incurred when the General Fund is used to pay for expenses of grant-funded projects that the City has not billed timely.

If grant-dependent funds continue to be subsidized by the General Fund, then even with declining grants revenues resulting in an unbilled balance of \$7 million, and with the City's current 4% return on investment funds, the approximate annual financial impact of carrying a deficit balance in these funds would be over \$280,0000 annually. For this reason, and because a final follow up report to Council was never issued, the Council's Ad Hoc Audit Advisory Committee suggested that a progress report on grants billing from the City Manager should be discussed.

A follow up report from the City Manager should address not only the specific recommendations made, but whether the City is still incurring unnecessary cost because of untimely billings. These costs should be quantified, and an analysis performed to determine what the cost of solving the underlying problems would be. Some previously identified causes of this condition (in the audit reports and in the City Manager responses to Council) were:

1. **Accountability:** Lack of direct accountability of project managers (such as engineers) for ensuring timely billing,
2. **Staff capacity and training:** Lack of understanding of the City's financial systems on the part of managers in the departments and lack of skill in reviewing and reconciling financial information on the part of administrative/analytical staff in the departments, and
3. **Software:** Weaknesses in the City's financial system, FUNDS.

Departmental Budget Monitoring Audit – November 1999

Accountability, staff capacity, and software are also key elements of another audit in which recommendations are reported as still only partially implemented, the Audit of Departmental Budget Monitoring. (November 23, 1999)

Among the recommendations are these:

1. **Accountability:** We recommended that department directors provide the Budget Office with sufficiently detailed budgeted versus projected year-end revenue and expense information quarterly. We also recommended that significant variances between budgeted and projected revenues and expenses be explained in the operating departments' reports, including any corrective action taken or planned. Currently, if departmental staff appear to have difficulties in performing these tasks, the Budget Office should investigate the difficulties and formally report to the Director involved, and to the City Manager.
2. **Staff capacity:** Accurate forecasting by staff in the operating departments can only be achieved if staff has the appropriate skills, training, and direction. Accordingly, in addition to recommending annual training for budget monitors/analysts, we recommended establishing minimum skills requirements. The former Budget Manager identified required skills which could be learned on the job (proficiency in spreadsheets and database applications, and knowledge of FUNDS\$ and the City budget process), as well as skills which can only be obtained by taking college-level accounting classes, i.e. basic accounting, cost (budgetary) accounting, fund (governmental) accounting, and fundamentals of public budgeting.

The City recently mandated nine units of accounting as a prerequisite for the Senior Budget Specialist classification (applicable to new hires only) and now offers tuition and textbook reimbursement for accounting classes. Very few employees have taken advantage of this opportunity.

Full implementation of the intent of this recommendation might be facilitated if the City Manager established standards for the quality of information to be submitted to Budget each quarter, and if those standards were linked to individual performance for employees. In addition, the City Manager should mandate changes in recruitment and promotional policies in Human Resources and practices in the departments.

3. **Software:** This audit also had findings related to deficiencies in the design and use of the City's financial systems software, FUNDS\$.

Information Technology Issues - Ongoing

Audits over the last ten years have identified still-unresolved problems with the City's financial systems software, FUNDS\$. As just one example, the Customer Service Cash Receipts/Cash Handling Audit, submitted to Council on April 8, 2003, notes significant concerns regarding the FUNDS\$ software's security design and implementation, and the lack of controls over the installation of upgrades to the various modules of the system. A key recommendation regarding the City's oversight over the financial software has been reported as only partially implemented. This recommendation is also tied to the themes of **accountability, staff capacity, and software:**

“Establish a formal module leader structure within the City that includes: A) one central authority; B) minimal qualifications for module leaders; C) minimum training requirements; D) sufficient authority in the organization; E) assigning a module leader to each module; F) incorporating module leader duties in pertinent job descriptions and; G) procedures to ensure staff are available for timely software testing and placement into production.”

Various reports from the City Manager regarding attempts to address these and other problems with the City's financial systems cite the unavailability of resources as a reason that some findings may never be cleared. For example, the City Manager's December 14, 2004 Update: Implementation of FUNDS\$ Change Management Audit Recommendations addresses a key finding that there is a lack of proper segregation of duties of the three programmers involved in the FUNDS\$ program change process. Specifically, we found that three employees have such unrestricted access that there is not only a significant risk of fraud but also failure to safeguard against loss of business continuity. Information Technology responded:

“Given the current budget situation, it is unlikely that IT will be able to expand its programming staff enough to meet current workload demand and introduce the separation of duties specified in the recommendation.” This statement is another possible indicator that oversight capacity may have been reduced to a level of unacceptable risk.

Police Staffing – April 2002

The City Manager is scheduled to return to Council on June 13, 2006, with an update on implementation of the recommendations from the Police Staffing Audit, submitted to Council on April 30, 2002. This particular audit addressed concerns about staff capacity in the technical areas of budgeting and information technology, which the Police Department appears to have taken steps to resolve. Given the City's current situation, a fresh look at the issue of hiring Community Service Officers (CSOs) for patrol duty is advisable.

Most direct services paid for by the General Fund are for public safety in the areas of protection of life, health and property. Resources must be allocated not only to baseline work in prevention (of crime, fires, and medical emergencies) some of which can be performed by non-sworn staff, but also to the higher risk/lower frequency work of emergency response (suppression), generally performed by sworn employees.

Recent Police information about the high rate of “crimes of opportunity” in the area near the University of California indicates that educating the students, merchants, and residents of the area is a priority, so that the area becomes a less attractive climate for the repeat offenders who gravitate there. As police managers in other communities have enthusiastically reported, Community Service Officers have been highly successful in educating people about crime prevention, both before the fact and as part of “cold crime follow up”. These managers have also noted that CSOs are likely to have the unique advantage of “looking more like the community they serve”. In the case of UC Berkeley undergraduates, the population is primarily female, more than 40 percent Asian Americans and Pacific Islanders, and, of course, younger than the average Berkeley sworn police officer.

In the past dozen years, there have been two reports to Council recommending implementing an effective Community Service Officer program, with a sufficient “critical mass” of employees. The first report, in 1994, by the Police Executive Research Forum, resulted in the hiring of a considerable number of sworn officers (as recommended) and a few Community Service Officers. Since issuance of our 2002 audit, the City Manager notes that the City has eliminated 12 patrol officer positions and one lieutenant.

This may be a good time to seriously reconsider the previous recommendations, for several reasons. First, subsequent to our audit report, some existing non-sworn staff have been reclassified as Community Service Officers, which should provide for more flexibility in hiring. Secondly, a civilian crime analyst will soon be hired, making this an excellent time to re-visit previously identified barriers to successful integration of non-sworn staff within the Department. Third, information provided to Council about current trends in crime rates in Berkeley suggest that a small number of Community Service Officers could be assigned to help patrol officers implement some prevention strategies in the campus area. The responsibility of the University to assist in this effort should also be considered.

RATIONALE FOR RECOMMENDATION

The audit findings and recommendations discussed in this report were previously accepted by the City Manager, who also determined a planned timeline for implementation. Although the auditors do not generally provide estimates of the cost of implementing our recommendations, care is taken to avoid making suggestions that are not economically feasible. However, staff reports indicate that implementation of some basic internal controls and systems improvements may not be feasible within current resources. This could indicate a need for City Manager and Council action in re-prioritizing allocation of resources.

ALTERNATIVE ACTIONS CONSIDERED

One alternative to the implementation of audit recommendations aimed at reducing risk of loss of City assets would be for Council and the City Manager to formally decide not to make the improvements, and to formally accept the risk of doing so. However, the auditors and management agree that this should not be attempted without a more comprehensive analysis of the costs and the benefits of making these previously agreed-upon improvements.

CONTACT PERSON

Ann-Marie Hogan, City Auditor
Office of the City Auditor
(510) 981-6750