

Office of the City Auditor

INFORMATION CALENDAR
December 9, 2003

To: Honorable Mayor and
Members of the City Council
From: Ann-Marie Hogan, City Auditor *amh*

Subject: Internal Control Risks Associated with Budget Cuts and Freezes

At the November meeting of the Council Ad Hoc Audit Advisory Committee, members requested a report from the City Auditor about what risk-base criteria should be used in determining whether or not an individual position is frozen. The Mayor and Council Members have also requested more information, whether from the City Manager or from the auditors, on the internal control impacts of position cuts already in place, and those contemplated.

Internal control is a set of principles and actions aimed at providing reasonable assurance of accomplishing objectives. It helps achieve not only reliable financial and performance reporting and compliance with the law, but also effectiveness and efficiency of programs and operations.

At the most basic level, internal controls are about preventing harm and ensuring that ongoing work assigned by statute or by management is appropriately, efficiently accomplished. Council oversight is part of the system of internal control. The Council and the City Manager are responsible for maintaining a system of internal controls aimed at preventing:

- Unreasonable loss or misuse of City assets
- Loss of Public confidence in the City of Berkeley
- Failure to effectively and efficiently deliver mandated or agreed upon services

The same kinds internal controls which prevent fraud and abuse will also improve the accuracy of the data and the measurability of performance.

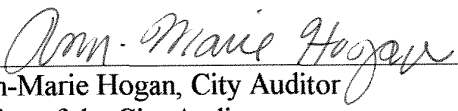
Attached for your consideration is the report to the Council audit committee regarding how internal control considerations should affect the City Manager's proposals and the City Council's decisions regarding freezing or eliminating positions. More detailed information about some of the issues raised can be found in our recent audits and in a power point presentation the auditors have prepared about internal controls and fraud prevention in a city environment. Information about the current status of internal controls in individual work units should be addressed by management.

CONTACT PERSON

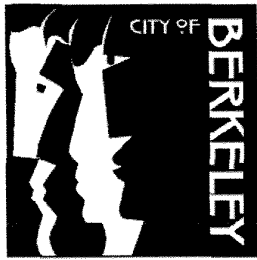
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Approved:



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

To: Mayor Bates, Council Member Breland, Council Member Maio, Council Member Wozniak
(Ad Hoc Audit Advisory Group)

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

Subject: Employee Position freezes and Cuts: Criteria and Controls

Date: November 19, 2003

This memo is in response to your request for information about the risk management issue of ensuring appropriate internal controls are in place when developing criteria for freezing or cutting particular staff positions from the budget. Internal controls should play an important role in making those decisions.

Of course, **revenue generating positions** should not be cut, but management should be required to document the full estimated and actual cost, and the estimated and actual revenue gained, in a timely, accurate, and auditable manner. Forecasting and reporting are essential elements of internal control.

Similarly, **grant funded positions** might be exempt from reductions or freezes, but only if management is able to document the full cost of the administrative burden attached to the "free" funds. This includes administrative costs in departments outside of the operation (payroll, Human Resources, Finance, etc). It also should include timely and accurate reports on whether and when the grants were billed (or an added expense for the lost interest resulting when billing is delayed).

Finally, we come to the question of tradeoffs between front line services and internal controls: adequate oversight and support of those services. The recent news articles about problems with crime data accuracy, parcel tax assessment accuracy, and control over workers' compensation costs highlight the importance of adequate oversight and management of all City services.

At the most basic level, internal controls are about preventing harm and ensuring that ongoing work assigned by legislative action or by management is appropriately, efficiently and effectively performed. The Council and the City Manager are responsible for maintaining a system of internal controls aimed at preventing:

- Unacceptable levels of loss or misuse of City assets
- Loss of Public confidence in the City of Berkeley
- Failure to effectively and efficiently deliver mandated or agreed upon services

Key issues in considering whether to freeze or eliminate a particular position are maintenance of **sufficient segregation (separation) of duties and sufficiently staffed independent verification and oversight**. Basically, the City takes a risk when any work unit or function in the City falls below the number of employees needed in order to ensure appropriate segregation of duties and sufficient supervision.

Segregation of Duties is aimed at preventing an individual from committing fraud, or misusing or abusing City resources or position, in such a way that it can be concealed in the normal course of duties. It also provides an internal check to minimize human errors. Typical examples of fraud in a municipal environment include theft of cash, and ordering goods for personal use with city funds. A typical example of abuse of position would be fixing a parking ticket.

Segregation of duties is an issue at each of the City's ninety-plus cash handling locations, and for employees in operating departments authorized to go in to the computer and order goods, enter employee time, contract for services, and so on. It is even more critical in the centralized oversight work units in Finance (Accounts Payable, Treasury, Purchasing, Customer Service, and Accounting), Human Resources, Payroll Audit, and Information Technology.

Our audits have found inadequate segregation of duties to be a recurring finding in the City, in physical access to assets as well as computer authority to authorize activities. More recently, staff has explicitly stated in their responses to our audits, and in their follow up reports to Council, that vacant positions and inadequate staffing are currently preventing them from timely addressing the specific segregation of duties problems. The auditors have not audited the accuracy of these comments, but we bring them to your attention for consideration.

Supervision and independent oversight: Sufficient supervision can be used to mitigate the risk of failing to separate incompatible duties. However, when positions are frozen or cut from an entity's budget, middle management, technical professionals, and supervisors, rather than front line service providers, are frequently targeted, since their work is less visible. These positions provide oversight in reviewing contracts, overseeing the quality of the work of contractors, directing and monitoring staff, and performing budgeting and performance auditing functions. Eliminating such functions increases the risk of fraud as well as inefficiency, waste of resources, and mission failure (failing to achieve program objectives).

Supervision and independent oversight is also needed in order to ensure that employees are working in a safe environment. Workplace injuries and misuse of the workers' compensation system have high human costs as well as City resource costs. Management by walking around, access to **reliable** data to pinpoint the problems, and oversight of the claims administration contractor are all critical but invisible oversight functions.

Cost of Controls Should Not Exceed the Benefit: Internal controls are important to ensure the best use of City resources. However, it's a basic tenant of risk management and internal control that the cost of a control should not exceed the benefit. The cost of a control can be estimated fairly easily. Calculating the risk and the benefit is a more complex and less objective task.

The Institute of Certified Fraud Examiners estimated that 2% of the typical entity's annual budget is lost to fraud each year.

Taking this with a grain of salt, but simply using it as a convenient way to analyze numbers of a manageable size, it does help to put the risk in perspective if we think of the possibility of losing 2% of our budget, over \$5.6 million dollars, annually.

How much oversight should be invested in order to mitigate the risk in the area of payments, as opposed to the area of payables, for example? Of the over \$123 million in payments made by the City each year, 2% is \$2.46 million dollars; of the nearly \$70 million in cash and cash equivalents handled each year, 2% is about \$1.4 million. It's worth some cost in adequately staffing, supervising, and auditing these areas to reduce the risk.

The question is, should more resources be put in to staffing and auditing payables than receipts because the dollars are bigger? The actual loss of funds in a small cash handling unit for a public program in the City might be small. However, the damage to the ethical fabric of the City can be severe if controls are so lax that a culture of tolerance of abuse develops.

Partly for this reason, the City Manager asked our office and Finance to prioritize audits, training, and other oversight activities in Citywide cash handling over the last two years. The City has put a lot of work into formalizing expectations of ethical behavior and preventive controls over the last two years, with the message delivered in a variety of ways from the City Manager and from the auditors.

In nine years of completing many audits and investigations in the City, my personal observation is that more resources are wasted due to inefficiency than to intent. Some of those inefficiencies can be explored and corrected by front line staff and supervisors, by prioritizing better training or software development, or by our audits. Still others are the result of unfunded mandates (from whatever level of government) and policies that need correcting by legislative action.

While attempting to protect the front line services, I'd like to ask Council to remember to support the internal control structure and practices that ensure wise oversight over resources, and that will help make the programs and services more effective, as well as more efficient.