



Office of the City Auditor

ACTION CALENDAR

December 13, 2011

To: Honorable Mayor and Members of the City Council  
From: Ann-Marie Hogan, City Auditor  
Submitted by: Ann-Marie Hogan, City Auditor  
Subject: City Auditor's Annual Report for Fiscal Year 2011

RECOMMENDATION

Request the City Manager:

1. Make timely implementation of audit recommendations a high priority.
2. Disclose internal control risks of recommended budget cuts in future budget reports.

SUMMARY

In 2011, we once again succeeded in our mission to improve performance of City operations, save money, and promote transparency and accountability. The City Manager and staff helped us achieve this by agreeing to take action on 100 percent of the 80 recommendations we made in our nine audit reports.

CURRENT SITUATION AND ITS EFFECTS

Our audits provided City management with guidance for preventing fraud risk and inefficiency, and for protecting the City's grant revenue and reputation. We recommended specific actions City management should take to increase oversight and transparency, and to provide clear communication to Council and the public. As budget cuts occur, it becomes more critical for our audit recommendations to be implemented timely to mitigate the effects of reductions in staff who have oversight responsibilities.

Although City management continued to support our efforts by agreeing to implement our recommendations, fiscal year 2011 was a year of limited progress. Important recommendations continue to remain open affecting three of the City's most important risk areas:

- The risk of fraud and the lack of computer controls to address that risk.
- The risk of losing state and federal grants and the lack of guidance and software to address that risk.
- Lost opportunities for efficiencies or cost savings.

Budget cuts also continue to threaten City operations. We once again urge the City Manager to include an analysis of internal control risks resulting from budget cuts in the

annual proposed budget. The City Manager should balance reductions to City administrative services so as not to jeopardize fiscal accountability, and state this as a budget policy.

### BACKGROUND

The audit function is an essential element of the City of Berkeley's public accountability. The City Auditor's independence and accountability, mandated by the City Charter, means the public, the Council, and City staff can rely on us for objective information and practical advice. We rigorously review and analyze City performance, and we do our best to give you the information you need about complex and difficult issues.

### POSSIBLE FUTURE ACTION

Taking action on our audits will reduce financial risk, regulatory risk, and operational risk. It will also help protect the City's good reputation.

### FISCAL IMPACTS OF POSSIBLE FUTURE ACTION

In fiscal year 2011, we conservatively estimated nearly \$340,000 in loss avoidance, potential savings, or revenue recovery. Over a five-year period, the results could exceed \$1.7 million.

### CONTACT PERSON

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Attachment: City Auditor's Annual Report for Fiscal Year 2011

# City of Berkeley



## City Auditor's Annual Report Fiscal Year 2011

Prepared by:

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Jack Gilley, Auditor II, CFE

Presented to Council on December 13, 2011

**City Auditor’s Annual Report for Fiscal Year 2011**

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## City Auditor's Message

The audit function is an essential element of the City of Berkeley's public accountability. The City Auditor's independence and accountability, mandated by the City Charter, means the public, the Council, and City staff can rely on us for objective information and practical advice. We rigorously review and analyze City performance, and we do our best to give you the information you need about complex and difficult issues.

The City Auditor's reports give me more trust and confidence in what City government is doing.

- Berkeley Resident

In 2011, we succeeded in our mission to improve performance of City operations, save money, and promote transparency and accountability. The City Manager and staff helped us achieve this by agreeing to take action on 100 percent of the 80 recommendations we made in our audit reports.

Unfortunately, 2011 was also a year of limited progress on implementing important recommendations affecting three of the City's most important risks:

- The risk of fraud and the lack of computer controls to address that risk.
- The risk of losing state and federal grants and the lack of guidance and software to address that risk.
- Lost opportunities for efficiencies or cost savings.

Taking action on our audits reduces financial risk, regulatory risk, operational risk, and risk to the City's good reputation. Fraud experts estimate that a typical organization loses 5 percent of its annual revenues to fraud.<sup>1</sup> If applied to Berkeley's 2011 budget of \$319 million, the amount lost to fraud would be nearly \$16 million. The following table lists the types of risks we addressed in five of our 2011 audits and the funds potentially at risk (also see page 6).

| 2011 Audits  | Key Risks Addressed in Audit | Potential Cost or Liability |
|--|------------------------------|-----------------------------|
| <u>Efficiency and Transparency of Contract Fiscal Management Needs Improvement</u> | Financial, Operational       | \$70 million (cost)         |
| <u>Audit: City Fuel Operations Need Improvement</u>                                | Financial                    | \$1.8 million (cost)        |
| <u>Employee Benefits: Tough Decisions Ahead (Audit Report)</u>                     | Financial                    | \$253 million (liability)   |
| <u>Payment Card Acceptance Audit: Is Cardholder Information Safe?</u>              | Financial, Reputation        | Incalculable                |
| <u>Police Property and Evidence Room: Further Improvements</u>                     | Financial, Reputation        | Incalculable                |

<sup>1</sup> 2010 Report to the Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners

In 2005, and again in 2007, Council voted to ask the City Manager to include an analysis of internal control risks for budget cuts in the annual proposed budget. In 2004, and again in 2010, Council requested that the City Manager's budget message include a re-statement of Council's previously stated budget policy to balance reductions to City administrative services so as not to jeopardize fiscal accountability. We urge the City Manager to take action. We also urge the City Council to ensure they have the tools and information they need to conduct appropriate oversight of City operations.

We issued nine audits in 2011 telling management how to take action to prevent fraud risk and inefficiency, and how to protect the City's grant revenue and reputation. We recommended specific steps for increasing oversight and transparency, and for clearer communication to Council and the public. Four of these audits are overdue for their first six months' progress report to Council. The following table shows the number of recommendations implemented and outstanding for audits we issued from FY 2006 through FY 2011:

**Audit Recommendations by Fiscal Year  
Audit Reports Issued in Fiscal Years 2006 Through 2011**

|   | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|------|------|------|------|------|------|
| Number of Audits  | 5    | 5    | 10   | 5    | 8    | 9    |
| Number of Recommendations   | 48   | 55   | 63   | 67   | 92   | 80   |
| Fully Implemented   | 41   | 49   | 60   | 48   | 72   | 22   |
|   | 85%  | 89%  | 63%  | 72%  | 78%  | 28%  |
| Will Not Implement  | 0    | 4    | 1    | 1    | 1    | 0    |
|   | 0%   | 7%   | 2%   | 1%   | 1%   | 0%   |
| Open Recommendations<br>(Not Implemented and Partially Implemented) | 7    | 2    | 2    | 18   | 19   | 58   |
|   | 15%  | 4%   | 3%   | 27%  | 21%  | 72%  |

Data is as of September 30, 2011.

In addition to the outstanding recommendations cited in the table, 18 recommendations from our reports issued between fiscal years 1998 and 2005 still have not been implemented (see Appendix A).

**2011 Audits: Recommended Actions to Reduce Risk of Fraud and Loss of Grant Revenue, and Achieve Cost-Saving Efficiencies and New Revenue**

**Inefficient Contract Monitoring: Software and Guidance Lacking Efficiency and Transparency of Contract Fiscal Management Needs Improvement**

(July 13, 2010) – City departments use multiple databases to monitor contract spending limits, balances, and terms. These systems are not integrated with the City’s financial and work management software (SunGard/HTE). Staff in each work unit update data separately, which is inefficient and likely to result in errors. The City had not fully explored the option of acquiring an affordable contract module that would interface with the City’s financial software and City departments lacked written guidance for contract monitoring. Failure to monitor contractor performance can result in overcharges and not meeting contract requirements.

\$70 million in contracts: stand-alone systems are inefficient and could be inaccurate; monitoring procedures lacking.

**Three Hundred Year-End Adjustments: Grant Revenues at Risk**

**Lack of Support for Payroll Adjusting Journal Entries: Grant Revenue at Risk?**

(October 26, 2010) – The Department of Health Services (DHS) did not attach enough support to sampled payroll adjusting journals entries (AJE) to document the necessity and accuracy of the adjustments. We identified this problem in our 1999 Budget Monitoring report, but the former Finance Director and former Budget Manager declined to implement our recommendation. DHS spent more than \$8 million in grant funding in the first six months of fiscal year 2009, and made more than 300 AJEs to grants during the fiscal year.

There were 300 adjustments to Health Department records. The City could lose funding if grant auditors find insufficient explanation.

**Equipment Replacement Underfunded; Fleet Size Still Too Costly**

**Equipment Replacement Fund – Sustainability and Transparency** (October 26, 2010) – It would cost \$3.6 million to replace City vehicles and equipment that were past due for replacement. Once that backlog is addressed, the fund would have only \$167,000 for future replacement needs. The shortfall occurred primarily because the City used the fund for purposes other than replacing aging equipment. The audit recommended reducing the size of the fleet by eliminating seldom-used vehicles to decrease repair costs. We made recommendations to

Fund was \$4.05 million to \$5.45 million short of estimated replacement costs. Retiring excess vehicles would lower costs.

achieve this in May 2003 (**Fleet Vehicle Management Audit**). This cost-saving recommendation was not implemented, although Public Works reported it implemented our previous recommendations. Even a 2 percent reduction in repairs would save over \$100,000 a year and over \$500,000 in five years.

**Liability for Future Employee Benefits Was Underfunded by Almost \$253 Million**

Employee Benefits: Tough Decisions Ahead (November 16, 2010) – This report told the City

The public has a right to know the true cost of employee benefits and the estimated liabilities. The Council needs to take action.

Council something that had not been communicated clearly: that the true cost of employee benefits and the future liabilities are not well understood and not adequately explained or disclosed in City documents. Council voted to direct the City Manager to provide better information in all budget reports. Council also voted to adopt formal policies aimed at increasing the

transparency of City benefits and compensation and to adopt a policy to attempt to simplify pay and benefits rules. Required contributions to the California Public Employees Retirement System (CalPERS) are the largest benefit cost. These costs, particularly CalPERS, are expected to rise sharply in future years unless the City acts to reduce them and negotiates necessary changes with the City's bargaining units. Options to reduce CalPERS costs include:

- Reduce salaries.
- Require employees to contribute more.
- Move to a two-tiered pension system, with different benefits for new hires.
- Reduce the number of employees.

**Significant Improvements Made in Securing Police Evidence**

Property and Evidence Room POST Study: Follow-Up Audit (January 18, 2011); Police Property and Evidence Room: Further Improvements (March 29, 2011) – In 2006, the California

Insufficient control and accountability over police evidence could jeopardize criminal prosecutions and leave it vulnerable to theft.

Commission on Peace Officer Standards and Training (POST) performed a management study of the property and evidence room. It made 18 recommendations to improve control and accountability over evidence and other seized property. We followed up on the POST recommendations and identified 15

additional opportunities to improve security and accountability over evidence and other seized property, and to improve employee health. The Police Department had not implemented the majority of the POST recommendations when we started our audit, but took action on our guidance and has now implemented all but one of POST's recommendations. The Police Department also took action on our additional recommendations, with only five remaining outstanding as of September 30, 2011.

Our recommended improvements should help protect property and ensure integrity of evidence.



### Business License Tax Audits Recover Unpaid Revenues

Business License Tax Audit Program Report for Fiscal Year 2010 (March 29, 2011) – The audit assessed \$144,000 in unpaid business license tax (BLT), penalties and interest. Since inception of BLT audits in 1982, we have billed delinquent business owners more than \$5 million. For

Our BLT audits generate revenue for years into the future.

each \$100,000 collected because of an audit, the City can expect to receive an additional \$19,000 annually. The audits are expected to have a deterrence effect, decreasing the number of businesses that underreport tax due or do not obtain a license.

### City Cannot Account For \$153,000 in Fuel Purchases

City Fuel Operations Need Improvement (April 26, 2011) – Approximately 57,000 gallons of fuel could not be accounted for as in storage or billed to users. We estimate the cost of this fuel at approximately \$153,000. These shortages occurred because:

- Two gas pumps malfunctioned, sending incorrect usage information to the user department billing system.
- Fire personnel did not always report their usage.
- Both Public Works and Fire personnel approved fuel payments without verifying that the quantity received from the vendor matched the amount invoiced.

57,000 gallons of fuel costing \$153,000 was unaccounted for.

### Tighter Access to Payment-Card Information Needed

Citywide Payment-Card Acceptance: Is Cardholder Information Safe? (May 31, 2011) – Most

Staff could potentially copy cardholder information and use it to make fraudulent purchases.

City locations that accept payment cards (i.e., debit or credit cards) had safeguards to protect cardholder information. However, employees at the 311 Call Center, the Permit Service Center, the Office of Vital Statistics,<sup>2</sup> and the Berkeley Marina could potentially copy cardholder information without being observed. Once copied, staff could have used cardholder information to make fraudulent purchases.

<sup>2</sup> The Office of Vital Statistics eliminated the risk by implementing one of our alternative recommendations before our report went to Council.

**Audit Cost Savings – Fiscal Year 2011**

Our audit recommendations improve performance of City operations, save money, and promote transparency and accountability. Savings and increased efficiency are not always easy to measure. When a recommendation identifies an efficiency or risk reduction that we cannot fully quantify, we try to provide an example that conservatively estimates the loss avoidance, potential savings, or revenue recovery. The following table lists estimates from three of our fiscal year 2011 audits:

| 2011 Audits With Loss Avoidance, Potential Savings, or Revenue Recovery                              | Potential 1st Year | Potential Future Years | Total Six Years    |
|--|--------------------|------------------------|--------------------|
| <u>Lack of Support for Payroll Adjusting Journal Entries: Grant Revenue at Risk</u> (Loss Avoidance) | \$160,000          | \$160,000              | \$960,000          |
| <u>Equipment Replacement Fund: Sustainability and Transparency</u> (Potential Savings)               | \$104,000          | \$104,000              | \$624,000          |
| <u>Business License Tax Audit Program Report for Fiscal Year 2011</u> (Revenue Recovery)             | \$72,164           | \$12,704               | \$135,684          |
| <b>Totals</b>  | <b>\$336,164</b>   | <b>\$276,704</b>       | <b>\$1,719,684</b> |

**Who Are the Performance Auditors?**

City of Berkeley auditors, collectively, have more than 100 years of professional audit experience. We hold a variety of professional certifications, and participate in continuing professional education courses annually, as required by Government Auditing Standards.

Auditors from other local government audit organizations review our work every three years to ensure we continue to meet the requirements of the Government Auditing Standards. Those standards, which the City Charter requires we follow, provide a framework for conducting high quality audits with competence, integrity, objectivity, and independence.

|   |
|---|
| Ann-Marie Hogan, CIA, CGAP<br>- City Auditor          |
| Harriet Richardson, CPA, CIA, CGAP<br>- Audit Manager |
| Frank Marietti, CFE, CIA, CGAP<br>- Senior Auditor    |
| Claudette Biemeret, CGAP<br>- Auditor II              |
| Jack Gilley, CFE<br>- Auditor II                      |
| Myrna Ortiz<br>- Auditor I                            |
| Sherren Styles<br>- Administrative Assistant          |

## Transparency and Risk Reduction

Berkeley's Charter gives the City Auditor a role in reducing the risk of management override of internal controls by granting oversight of payroll and other payments.

"A government's most precious commodity is its credibility."  
- Jim Walsh, MIT Nuclear  
Reactor Subject Matter Expert

## Contracts

The Charter requires the Auditor to countersign and register all contracts. We reviewed and registered 550 contracts and contract amendments in fiscal year 2011. The City Clerk posted the contacts to Records Online at <http://www.ci.berkeley.ca.us/recordsonline/search.aspx>.

## Payroll Audit

Payroll Audit works to improve the accuracy, efficiency, and integrity of the City's decentralized payroll system. Key 2011 accomplishments include:

- Publishing a revised Payroll Manual online.
- Working with management to streamline, standardize, and simplify the rules and introduce software improvements.
- Advocating for implementation of recommendations we made in 1999 to consolidate labor codes and increase efficiencies by negotiating these changes with the City's bargaining units. We submitted 22 recommendations for the Fire Department and 27 for the Police Department for Labor and Management to consider ([Citywide Payroll Audit](#)).
- Convening bimonthly meetings to provide ongoing training and problem solving for payroll staff in all City departments.

Dr. Brian Zandipour, CPP  
- Deputy City Auditor, Payroll

Leo Reyes  
- Auditor II

Agnes Celis  
Ann del Rosario  
Candice Schott  
- Accounting Technicians

Raul Chan  
Gail Wread  
- Accounting Office Specialists III

## Conclusion

"If you're losing altitude and your plane is going down, you don't try to shed weight by tearing out your instrument panel and throwing it out."

- Governing Magazine  
July 2010

In times of scarce resources, it is especially important that management and the Council have the tools they need to exercise appropriate oversight. We are concerned that budget and staffing cuts could hamper the future ability of City Departments to implement audit recommendations.

See [Appendix A](#) for more information on open recommendations dating back to 1998.

**Appendix A: Open<sup>3</sup> Recommendations as of September 30, 2011**

| Report Title  | Risk Category | Open Recommendations |            |
|---|---------------|----------------------|------------|
|   |               | Fiscal Year          | Total Open |
| Risk Categories: E = Efficiency; F = Fraud; G = Grants; O = Oversight   |               |                      |            |
| <b>Special Report to Council</b>  |               |                      |            |
| <u>Invisible Problems: Weak Internal Controls Require Disclosure by City Manager and Possible Future Council Action on Budget and Workplans</u> | F, G, E, O    | 2008                 | 1          |
| <b>Audit Reports</b>  |               |                      |            |
| <u>Public Works Grants Audit</u>  | G, E, O       | 1998                 | 1          |
| <u>City-wide Payroll Audit</u>  | E, F, O       | 1999                 | 2          |
| <u>Police Staffing Audit</u>  | E             | 2002                 | 3          |
| <u>Customer Service Cash Receipts / Cash Handling Audit</u>   | F, O          | 2003                 | 3          |
| <u>Cash Receipts / Cash Handling Audit - Treasury</u>   | E, F, O       | 2003                 | 1          |
| <u>FUND\$ Change Management Audit</u>   | F, O          | 2004                 | 5          |
| <u>Accounts Payable Audit</u>   | E, F, O       | 2004                 | 1          |
| <u>Purchase Order Audit - Select Public Works Divisions At the Corporation Yard</u>   | E, F          | 2005                 | 1          |
| <u>Parcel Based Special Taxes, Fees, and Assessments Audit</u>  | E, F          | 2005                 | 1          |
| <u>Audit of the Association of Sports Field Users</u>   | F             | 2006                 | 7          |
| <u>Follow-Up Audit of Public Works Construction Contracts</u>   | E, F, O       | 2007                 | 2          |
| <u>Audit of HHS Medi-Cal Mental Health Billings</u>   | G             | 2008                 | 1          |
| <u>FY 2008 Surprise Cash Count: Permit Service Center</u>   | F             | 2008                 | 1          |
| <u>Leases Audit: Conflicting Directives Hinder Contract Oversight</u>   | E, O          | 2009                 | 11         |
| <u>Audit of Workers' Compensation Policies and Procedures</u>   | E, F, O       | 2009                 | 7          |
| <u>Public Works Contract Monitoring: Risk of Overpayments / Lack of Inventory Controls</u>  | E, F          | 2010                 | 3          |
| <u>Over \$38,000 in Duplicate and Over Payments Recovered</u>   | E, F, O       | 2010                 | 7          |
| <u>Improved Workflow Systems Will Help Ensure Property Taxes are Adjusted for New Construction</u>  | E, F          | 2010                 | 1          |
| <u>Mental Health Adult Clinic Surprise Cash Count: Client Funds Could Be Lost, Stolen, or Misused</u>   | F             | 2010                 | 3          |

<sup>3</sup> Open recommendations include those that are in progress and those that the auditee has not started to implement. It excludes recommendations that the auditee will not or cannot implement.

| Report Title   | Risk Category | Open Recommendations |            |
|--|---------------|----------------------|------------|
|  |               | Fiscal Year          | Total Open |
| <u>Utilization of Public Works Sewer Staff Can Be Improved</u>                       | E, O          | 2010                 | 5          |
| <u>Audit: City Fuel Operations Need Improvement</u>                                  | F, O          | 2011                 | 14         |
| <u>Police Property and Evidence Room: Further Improvements</u>                       | F, O          | 2011                 | 5          |
| <u>Property and Evidence Room POST Study: Follow-up Audit</u>                        | F, E          | 2011                 | 1          |
| <u>Employee Benefits: Tough Decisions Ahead (Audit Report)</u>                       | E, O          | 2011                 | 5          |
| <u>Lack of Support for Payroll Adjusting Journal Entries: Grant Revenue at Risk?</u> | G, O          | 2011                 | 3          |
| <u>Equipment Replacement Fund - Sustainability and Transparency</u>                  | E             | 2011                 | 14         |
| <u>Efficiency and Transparency of Contract Fiscal Management Needs Improvement</u>   | E, O          | 2011                 | 4          |
| <u>Payment Card Acceptance Audit: Is Cardholder Information Safe?</u>                | F, O          | 2011                 | 12         |
| <b>Total</b>   |               |                      | <b>125</b> |

The full text of each of these reports is available on the City Auditor's website:

<http://www.cityofberkeley.info/auditor/>

