

Report of the Ad Hoc Citizens
Advisory Committee

to the

City of San Diego
Audit Committee

April 28, 2008

Bill Woolson, Committee Chair
Michael McCraw
Doug Sawyer

Documents Examined

The following documents were examined by the Committee during the course of its investigation:

1. Scope of Work for Ad Hoc Advisory Committee, September 25, 2007
2. CAFR Review Questions
3. Ordinance Number O-19612, May 02, 2007
4. Statement of Operating Principles, Revised April 10, 2007
5. Responsibilities of the Audit Committee Under Federal Law, February 7, 2007
6. Category B Financial Reform and Kroll Report – Charter Review Committee
7. Conducting an Audit Committee Interview – Sample Questions to Ask
8. XII. Remediation – Kroll Report
9. Report on Implementation & Remediation of IT Audit Findings, June 19, 2007
10. Second Annual Report on Internal Controls – IBA 07-18
11. Annual Report on Internal Controls, January 1, 2006
12. Second Annual Report on Internal Controls, January 1, 2007
13. Initial Report of Independent Consultant to the City of San Diego, Stanly Keller, June 7, 2007
14. First Annual Report of Independent Consultant to the City of San Diego, Stanley Keller, March 25, 2008

Financial Processes

Process Documentation

Finding: Lack of Process Documentation

The committee asked for the documentation available for the processes used to manage the city finances and to produce the CAFR and found out these did not exist and/or were not available.

Recommendation: Document all financial processes

It is virtually impossible to have any assurance of financial integrity without documentation of the financial processes. Extensive process documentation is the first step to comply with Sarbanes-Oxley. As the City migrates to SAP and other automated systems the “As-Is” processes need to be documented in order to determine how to migrate the existing processes and data to the new “To-Be” systems.

Process Framework

Finding: The current processes do not adhere to an established best process framework.

The Committee recognizes the City is currently engaged in upgrading its financial systems to remove manual controls and install automated controls via such software as SAP.

Recommendation: As the City upgrades its financial processes, the new processes should follow a best process framework.

The Committee recommends that attention be paid to existing best process frameworks such as COSO, ITIL, and COBIT as the City upgrades its financial processes. If the upgrades follow best practices, the effort will be paid off with enhanced controls, improved audibility, better efficiency, more transparency, and easier upgrades in the future.

Internal Audit Function

Organizational Structure

Finding: Lack of Autonomy of the City's Internal Audit Function

The Committee notes that the Kroll Report and the initial report of Stanly Keller call for an Internal Audit Function independent of the financial operations organization. We also note that the current Charter inhibits achievement of this independence. Stanley Keller recommends submission to voters for approval in June 2008, "the creation of an office of the City Auditor that is separate from the current office of the Auditor and Comptroller and with direct reporting responsibility to the Audit Committee." (Keller report March 25, 2008)

Recommendation: Create an Internal Audit Function embodied in the "City Auditor" appointed by the City Council

The Charter Reform Committees' Report Section B discusses the creation of the City Auditor, which presumably would be staffed to perform the internal audit function.

Section 7 of Part B indicates that the Charter Reform Committee recommends that the City Auditor "be appointed by the City Manager in consultation with the audit committee and confirmed by the City Council." **This committee agrees that the City Auditor should be appointed and not elected but disagrees in the method of appointment. We suggest that the City Council appoint the City Auditor based on recommendations of the Audit Committee.** This assures the appointment is

made by elected representatives of the entire city and is independent of the "Line Organization" reporting to the Strong Mayor.

The Internal Audit Function should not engage in any activities associated with producing, entering, or changing financial data or the preparation of the financial reports. There should be a clear separation of duties with the role and responsibilities of the Internal Audit Function limited to auditing the city's financial reporting and testing the control structure.

Role of the City Auditor

Finding: The role of the City Auditor is not well defined.

Although the need for a revised internal audit function is well understood, the role has not been clearly defined.

Recommendation: The Role of the City Auditor should reflect industry best practices.

To paraphrase a question Councilmember Atkins asked in an Audit Committee Meeting, "How will we know we can trust the CAFR to be accurate?" Although the answer to that question is complex in the details pertaining to the current situation in the City Finances, from an operational point of view, the answer is simpler. **Industry relies on a strong and thorough internal audit function and the City should do the same.**

Currently the internal audit is reacting to the findings of the external audits, which it has to do given the current situation. However, **the City Auditor should become proactive performing all the audit tasks the external audit performs with at least the same intensity.** This includes random interviews with staff at all levels about knowledge of their role and responsibilities, how they record their time, and pressures from management and peers to cut corners; reviewing automated and manual internal controls for adequacy if they worked as documented; and testing the controls to determine if they work as documented.

The accepted findings of the City Auditor should be remediated with similar vigor to that done for findings by the external auditor.

When all the current material weaknesses have been remediated, when the internal auditors experience a reduction in issues during their investigations and testing, and when the external auditor's report has only suggestions for improvement, the City and potential investors will have confidence in the CAFR.

Audit Committee

CAFR Review Questions

Recommendations: Some questions should be modified/removed and Internal Audit should be interviewed.

The Committee believes that these questions asked in committee meetings should be *pro forma*. Each respondent should complete and sign a document prior to the meeting answering these questions. Any negative responses should be documented in detail including a "get well" plan if appropriate.

Referring to memo Titled: "CAFR Review Questions:"

- II.2. This question should be removed here and asked of the internal auditor.
- III.2. These "conflict of interest" questions should be answered in detail as part of the engagement contract. A better question might be, "Have you reviewed personnel assignments and city contracts for any potential conflict of interest and was any remediation action taken?"
- *Add* Has the firm been engaged to provide any services to the City of San Diego besides the independent audit of which the audit committee is not already aware?

The Committee suggests that questions be asked of the Internal Auditor; again we expect that any negative answer be documented in a report prior to the interview. These questions include:

- Was the independent audit performed in accordance with generally accepted accounting principles (GAAP) or generally accepted government accounting standards (GASA)? If not, why?
- Overall, is management cooperating with the internal audit team? Does management have a positive attitude in responding to findings and recommendations, or is it insecure and defensive of findings?
- Are you aware of any disagreements between management and the internal auditors?
- Has management set an appropriate "tone at the top" with respect to the importance of and compliance with the internal control system around financial reporting?

- Are you aware of any current or past occurrence of any type of fraud in the organization? Do you know of any situations where fraud could occur?
- Do you have the freedom to conduct audits as necessary throughout the organization?
- Were you restricted or denied access to requested information?
- Have you been pressured to change findings, or minimize the language in those findings so as to not reflect badly on another member of management? Are findings and recommendations given the level of discussion needed to properly satisfy any issues raised, to your satisfaction?
- Do you feel comfortable raising issues without fear of retribution?
- Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, professional practice, or the mores of sound government?

Review of internal control remediation activities

Finding: The Audit Committee reviews the status of internal control remediation activities.

The Audit Committee reviews at its sessions the status of projects designed to remediate material weaknesses in the internal control structure. In these reviews the project manager is asked to summarize the current progress, describe any roadblocks, and provide an estimated completion date.

Recommendation: These reviews should be more formalized and structured to facilitate tracking over the course of the project and comparisons of progress among projects.

The Committee recommends that audit findings of control deficiencies and reporting errors from various sources be cast in a common framework to produce a single documented set of issues from which the organizations can plan remediation and the Audit Committee can track progress.

The Committee recommends that each organization entity that have control remediation projects present at least quarterly a standardized report to the Audit Committee. This report should consist of a briefing for presentation at the Audit Committee meeting and a backup document with more detail for review by the Audit Committee before the presentation. Each task should be assigned a

unique number and brief description that doesn't change during the life of the project.

The briefing charts(similar to those presented by the CIO) might contain the item #, brief description, risk level, completion date, %complete, a stoplight color column (red, orange, green) indicating red – behind schedule, orange – on or near schedule but problems ahead, green – on or ahead of schedule and no foreseen problems.

The more detailed document might contain at least a page for each item and contain the item#, brief description, detailed description of audit finding (preferably copied directly from the audit report), responsible organization, source(s) of finding (external audit, internal audit, self disclosure, etc.), risk assessment, remediation plan tasks and schedule, acceptance test plan, and change history.

The Committee believes that formal project planning and project status reviews by the Audit Committee can only help to speed up the remediation efforts and to provide a transparency into the process that will improve the confidence of the City's citizens and investors alike that the City is doing the right thing.