

**City of San Diego**

***ANNUAL REPORT ON  
INTERNAL CONTROLS***

***January 1, 2008***

**Internal Audit  
Eduardo Luna, CIA, GGFM, Internal Auditor**



## THE CITY OF SAN DIEGO

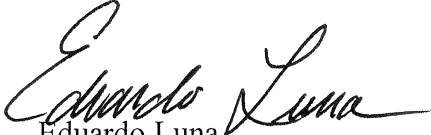
January 3, 2008

Honorable Council President Peters and Councilmembers  
City of San Diego  
202 C Street  
San Diego, CA 92101

Transmitted herewith is the 2008 Annual Report on Internal Controls. This report is in accordance with the San Diego Municipal Code Section 22.0708. The required certification signed by the Chief Operating Officer will be issued under separate cover.

This report will be presented to the Audit Committee at its January 28, 2008 meeting. The Internal Audit staff members that participated in the preparation of this report are Kyle Elser, Tricia Mendenhall, and Danielle Knighten.

Respectfully submitted,

  
Eduardo Luna  
Internal Auditor

cc: Honorable Mayor Sanders  
Jay M. Goldstone, Chief Operating Officer  
Michael Aguirre, City Attorney  
Andrea Tevlin, Independent Budget Analyst  
Stan Keller, SEC Consultant



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## **Introduction**

In October 2004, the San Diego City Council adopted Ordinance 19320 in order to achieve “a high standard of quality in and efficacy of the City’s financial and disclosure practices.” To implement Ordinance 19320, San Diego Municipal Code Section 22.0708 requires the City Auditor and Comptroller to perform an annual evaluation of the City’s internal financial controls and their operation and meet with the City’s independent auditors to review the design and operation of the City’s internal financial controls.

San Diego City Charter Section 39 has established that the City Auditor and Comptroller “shall be the chief fiscal officer of the City.” Under the current strong mayor form of government, the chief fiscal officer of the City is the Chief Financial Officer. To ensure proper independence in the evaluation of the City’s internal financial controls, the Internal Auditor performed the required annual evaluation of the City’s internal financial controls and their operation. The Internal Auditor began work on October 22, 2007 and reports directly to the Chief Operating Officer. The Internal Auditor also communicates and consults with the City’s Audit Committee regarding Internal Audit activities and audit results.

This 2008 Annual Report provides a status update on management’s remediation efforts to correct the weaknesses that have been identified in the Kroll Report, as well as the internal control letters from the independent auditors (KPMG LLP and Macias Gini & O’Connell LLP), and the prior Auditor and Comptroller’s Internal Control Reports. Specifically, we focused on evaluating the internal controls identified in those reports that may have a direct impact on the timely and accurate preparation of the City’s annual financial statements. Internal Audit has begun performing assurance testing to determine if the weaknesses have been corrected as stated by management. Included in this report is the required internal control certification signed by the City’s Chief Operating Officer and Comptroller.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions.

## Internal Controls

Government Auditing Standards establish that internal control “comprises the plans, policies, methods, and procedures used to meet the organization’s mission, goals, and objectives. Internal control includes the processes and procedures for planning, organizing, directing, and controlling program operations, and management’s systems for measuring, reporting, and monitoring program performance.” Management is responsible for developing, implementing, and maintaining internal controls. Ultimately, internal controls provide reasonable, but not absolute assurance that the organization’s goals will be achieved.

The various external and internal reports have identified internal control weaknesses or errors that require corrective procedures or actions by management or those in charge of City Governance. To comply with Ordinance 19320, we evaluated the remediation status of the prior internal control weaknesses identified that have a direct impact on the timely and accurate preparation of the City’s Comprehensive Annual Financial Report (CAFR). To better evaluate these items, we used the following categories:

Category	Description	Exhibit
<b>CAFR Preparation</b>	Processes and procedures related to the recording of transactions and creation of the City’s CAFR.	A
<b>Information Technology</b>	Information technology systems and related controls used to process, store and record the City’s financial data.	B
<b>Financial Disclosure</b>	Policies and procedures related to the accuracy of information given as an attachment to the CAFR in footnotes or supplementary form.	C
<b>San Diego City Employees’ Retirement System (SDCERS)</b>	Policies, procedures and transactions related to the City’s retirement benefits and contributions.	D
<b>Budget</b>	Policies, procedures and goals related to providing accurate, timely and adequate budgetary information.	E
<b>Assessments</b>	Policies and methodologies used to determine the valuation of actuarial information and deferred maintenance.	F
<b>Control Environment</b>	Policies and procedures related to management’s role and responsibility for accurate financial reporting.	G
<b>Training</b>	Policies and procedures used to ensure staff are adequately trained in areas related to financial reporting.	H

## Objective, Scope, and Methodology

The objective of this review is to evaluate the remediation efforts of management to correct internal control weaknesses related to financial reporting that have been identified in the Kroll Report, as well as the internal control letters from the independent auditors (KPMG LLP and Macias Gini & O'Connell LLP), and the prior Auditor and Comptroller's Internal Control Reports. Specifically, we reviewed the internal control weaknesses identified in the following reports:

- Kroll Report of the Audit Committee of the City of San Diego, Investigation Into The San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure, August 8, 2006.
- KPMG LLP's report dated March 12, 2007 related to fiscal year ended June 30, 2003, Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards.
- Macias Gini & O'Connell's report dated April 18, 2007 related to fiscal year ended June 30, 2003, Independent Auditor's Report on Schedule of Expenditures of Federal Awards.
- Macias Gini & O'Connell's report dated May 11, 2007 related to fiscal year ended June 30, 2004, Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards.
- Macias Consulting Group, Inc.'s Electronic Data Processing Review of General Controls of the Core Financial Management System at the City of San Diego dated April 29, 2005.
- Macias Consulting Group, Inc.'s Follow Up to 2005 Electronic Data Processing Review Findings for the City of San Diego and Review of Reporting Functions dated May 12, 2006.
- Auditor and Comptroller's 2006 Internal Control Report (note that the Auditor & Comptroller's 2007 Internal Control Report restricted its scope to the findings noted in the 2006 report, no additional findings were reported).
- Macias Gini & O'Connell's report dated October 26, 2007 related to fiscal year ended June 30, 2005, Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards.

These reports identified a total of 244 internal control weaknesses or errors that require corrective procedures or actions by management or those in charge of City Governance. The scope of this report is limited to evaluating the internal control weaknesses that may have a direct impact on the accuracy and timeliness of financial reporting. Of the 244 items, we identified a total of 149 (61.1 percent) weaknesses or errors that are directly related to financial reporting that will be addressed by this report. We will test the remaining 95 items that are not directly related to financial reporting, and report on findings in subsequent remediation reports.

For each weakness, we identified a responsible official and requested information regarding the status of management's remediation efforts. For those weaknesses that management reports as remediated, we are performing assurance testing to verify that adequate corrective actions have been taken. We quantified the items that management has reported as remediated during calendar year 2007 compared to prior years, and identified items that need additional actions to be taken based on our testing to date.

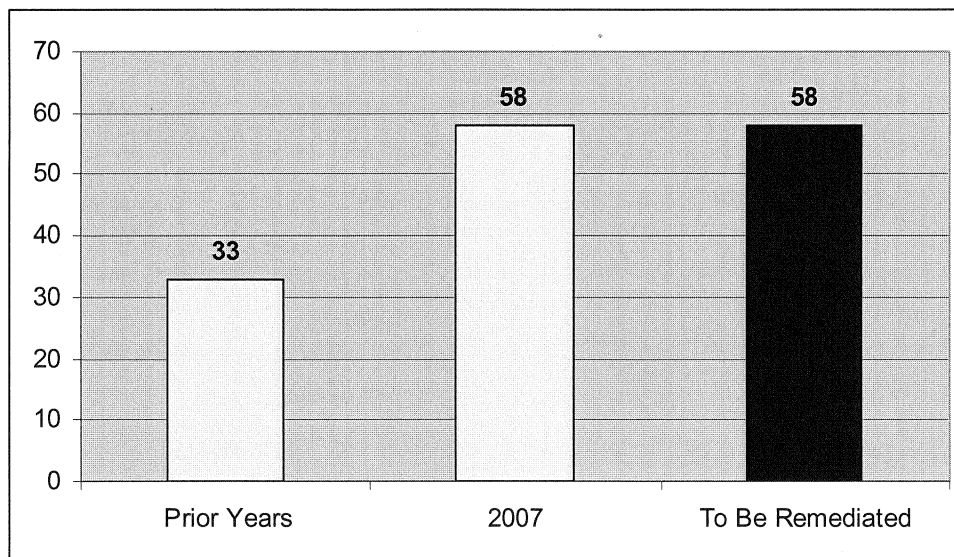
## Executive Summary

In 2007, the Administration has made significant progress in correcting prior internal control weaknesses directly related to financial reporting as identified in past reports. As of December 31, 2007, management reported that they have remediated 91 of the 149 (61.1 percent) internal control weaknesses directly related to financial reporting. Notwithstanding the progress made in 2007, the Administration needs to correct an additional 58 weaknesses to fully comply with the recommendations made by Kroll, independent auditors, and previous internal control reports. We have tested 54 (59.3 percent) of the 91 items to date, and found all have been fully remediated except for the 4 issues discussed on pages 7 and 8 of this report. We made 4 recommendations that should be considered for additional actions to be taken. See Exhibits A through H for the details of the control weaknesses and the status of remediation and testing.

## Findings

As shown in Graph 1, in prior years the Administration reported 33 weaknesses as remediated, and in 2007 they reported an additional 58. This represents a 76.0 percent increase from the prior years.

**Graph 1: Number of Internal Financial Control Weaknesses Remediated to Date**



Source: Auditor analysis of Administration information.



To verify that the reported weaknesses are being corrected, we have tested 54 (59.3 percent) of the 91 remediated items to date. Table 1 summarizes by category the volume and status of the prior internal control weaknesses identified.

**Table 1: Prior Internal Control Weaknesses Identified by Kroll, Independent Auditor’s and City Auditor & Comptroller Directly Related to Financial Reporting**

Category	Control Weaknesses Identified	Control Weaknesses Reported by Management as Remediated	Percent Management Reported as Remediated	Internal Audit's Assurance Testing Complete	Percent Internal Audit's Assurance Testing Complete
CAFR Preparation	67	31	46.3	22	71.0
Information Technology	27	16	59.3	13	81.3
Financial Disclosure	12	8	66.7	4	50.0
SDCERS Reporting	6	6	100.0	1	16.7
Budget	12	11	91.7	1	9.1
Assessments	3	3	100.0	0	0.0
Control Environment	15	10	66.7	10	100.0
Training	7	6	85.7	3	50.0
<b>TOTAL</b>	<b>149</b>	<b>91</b>	<b>61.1</b>	<b>54</b>	<b>59.3</b>

Source: Auditor analysis of Administration information.

**Note:** There are 95 other control weaknesses that are not directly related to financial reporting which we will cover in subsequent reports. These 95 other weaknesses are related to Compliance, Monitoring, SDCERS, Audit Committee, Ordinances, Internal Audit, Information Technology, and Human Resources. Altogether, there are total of 244 identified internal control weaknesses.

We found that 3 categories comprised the majority of the internal control weaknesses that still need to be remediated. Table 2 shows that 58 of the 149 items (38.9 percent) still need to be remediated. Of the 58 items, 36 (62.1 percent) pertain to CAFR Preparation; 11 (19.0 percent) are related to Information Technology; and 5 (8.6 percent) deal with the Control Environment. Based on the reported information, these 3 categories represent 90 percent of the remaining control weaknesses that still need to be remediated.

**Table 2: Status of Non Remediated Internal Controls Weaknesses Directly Related To Financial Reporting, 2007**

Category	Non Remediated Items	Percent of Non Remediated Items
<b>CAFR Preparation</b>	<b>36</b>	<b>62.1</b>
<b>Information Technology</b>	<b>11</b>	<b>19.0</b>
Financial Disclosure	4	6.9
SDCERS Reporting	0	0.0
Budget	1	1.7
Assessments	0	0.0
<b>Control Environment</b>	<b>5</b>	<b>8.6</b>
Training	1	1.7
<b>TOTAL</b>	<b>58</b>	<b>100.0</b>

Source: Auditor analysis of Administration information.

**Based on our audit testing of 54 items reported as remediated, we have determined that all have been fully remediated except for the 4 issues listed below. We have made 4 recommendations that should be considered for additional actions to be taken.**

**CAFR Preparation Exhibit A – Items 2 through 22**

A specific recommendation was not made in the prior reports for all of the errors found in the CAFR. For many of these errors, no specific remediation was recommended except to correct the error in the CAFR. The Comptroller’s staff reported that these errors have been corrected, but the underlying control weaknesses are still in the process of being fully remediated. The Comptroller reported that in most cases the action remaining to be completed is the formal documentation of policies and procedures. Internal Audit’s testing of Exhibit A, items 2 through 22 verified that these errors were corrected in the CAFR, and we are considering these items as remediated. However, as the Comptroller’s staff completes their formal documentation of policies and procedures for the CAFR preparation, all of these errors should be reviewed to ensure adequate procedures are in place to reduce the risk of the same errors occurring in the future. Internal Audit plans to review the Comptroller’s documented procedures when they are finalized to determine if these errors were adequately addressed. The Comptroller advised that he has hired a Principal Accountant to help document procedures, and he has presented a project plan to the Chief Operating Officer that will be presented to the Audit Committee in January 2008.

**Financial Disclosure Exhibit C – Item 1:**

One Kroll report item stated “Continue the operations of the Disclosure Practices Working Group (DPWG) and add the CFO not only as an official member but also have this person serve as chair.” At the April 30, 2007 City Council meeting, Council accepted the Independent SEC Monitor's report to make changes to the San Diego Municipal Code (SDMC) §22.4101 - 22.4112 without exception. One of the changes includes adding the CFO to the DPWG; however, the CFO would not chair the group as suggested by Kroll, but rather the Deputy City Attorney of Finance and Disclosure will be the Coordinator. Council accepted the report with the recommended changes, and the City Attorney's office was asked to draft an ordinance to make the approved changes. To date, these changes have not been incorporated into the SDMC.

**Financial Disclosure Exhibit C – Item 2:**

A Kroll report item stated “The DPWG should report to the City’s new Audit Committee.” During our review of the current SDMC related to this item, we noted that the DPWG has not filed their report to the Audit Committee within the filing date requirements.

SDMC §22.4106(a)(3) states:

*...the Disclosure Practices Working Group shall:*

*(3) submit a written Annual Report on the Committee's work and findings to the City Council and to the Audit Committee on or before (November 1) of each year, beginning (November 1, 2005).*

Although the DPWG’s annual report was recently filed, it was not filed by November 1 2007. For timely reporting and to be in compliance with the SDMC, the DPWG should file their annual report to the Audit Committee by November 1 of each year.

**Financial Disclosure Exhibit C – Item 4:**

A prior internal control report item stated “Certain challenges face the DPWG in its compliance with Ordinance 19320, including time constraints, awareness of departmental initiatives, DPWG jurisdiction, and dissemination of information likely to reach financial markets. All communications from the Mayor, Council, and City Attorney cannot be completely monitored for potential impacts to financial markets. Therefore, further define the scope and responsibilities of the DPWG.” At the April 30, 2007 City Council meeting, Council accepted Independent SEC Monitor's report to make changes to SDMC §22.4101 - 22.4112 without exception. However, during this Council meeting, no changes were proposed to further define the DPWG's scope and responsibilities.

# **Recommendations**

## **Recommendation 1**

The Comptroller's staff should review the errors listed on Exhibit A, items 2 through 22 as they complete their formal documentation of policies and procedures for the CAFR preparation to ensure adequate procedures are in place to reduce the risk of the same errors occurring in the future.

## **Recommendation 2**

The DPWG should file their annual report to the City's Audit Committee by November 1 of each year, or this requirement should be removed from the DPWG ordinance if this filing requirement is overly restrictive.

## **Recommendation 3**

Request the DPWG draft and submit a Request for Council Action to further define the DPWG's scope and responsibilities.

## **Recommendation 4**

Take the steps necessary to finalize the changes to the DPWG ordinance so it is incorporated into the San Diego Municipal Code, including the change to add the Chief Financial Officer as a member of the DPWG, and to further define the DPWG's scope and responsibilities.

# **Conclusion**

In 2007, the Administration continued to make progress in resolving internal control weaknesses that have a direct impact on financial reporting; however, additional work remains to be done. In 2007, the Administration reported 58 weaknesses remediated, compared to 33 items in prior years. Our testing of 54 of the items revealed that all were corrected with the exception of 4 issues. The work remaining includes remediating 58 additional weaknesses directly related to financial reporting.