

THE CITY ATTORNEY

CITY OF SAN DIEGO

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REPORT TO THE HONORABLE
MEMBERS OF THE AUDIT COMMITTEE

AUDIT COMMITTEE RESPONSES TO CITY AUDITOR AUDIT RECOMMENDATIONS

INTRODUCTION

This report discusses the Audit Committee's role when management's comments are inconsistent or in conflict with the Auditor's findings, conclusions, or recommendations, or the Auditor is not satisfied with management's planned corrective actions. As explained below, the Audit Committee may not reject management's responses, nor may it direct or control management operations. The City Council, to whom the Audit Committee reports, exercises ultimate responsibility for ensuring management meets its internal control and financial responsibilities¹.

DISCUSSION

PRESENTATION OF AUDITOR FINDINGS

The City Auditor (Auditor) is charged with presenting to the Audit Committee audit findings that may include deficiencies in internal control, fraud, illegal acts, violations of contract or grant contracts or agreements, and abuse. The Auditor's findings should be clearly developed and include comments from the responsible managers or officials of the audited department or entity (collectively referred to as "management"). Government Auditing Standards (GAS), §§ 6.42, 6.45. If management's response is in writing, the Auditor should attach the writing itself, or a summary of the writing, to the audit report. If management's response is verbal, the Auditor should include a summary in the audit report. GAS § 6.46. This ensures fairness. GAS § 6.45.

When management's comments are inconsistent or in conflict with the Auditor's findings, conclusions, or recommendations, or when the Auditor is not satisfied with management's planned corrective actions, the Auditor should explain the basis of the disagreement in his audit report. GAS § 6.49. If, on the other hand, the Auditor finds management's comments valid and supported by sufficient, appropriate evidence, he should reflect this in his audit report. GAS § 6.49.

¹ The Mayor's responsibilities as they relate to management of City staff and the Mayor's working relationship with the City Council is described in San Diego Charter sections 250 through 295.

THE KROLL REPORT

The Kroll Report (Report) described the City's financial reporting and control processes as inadequate, lacking transparency, and not supported by sufficient competent resources. The Report's remediation plan suggested creation of an independent internal auditing function and improved oversight of both the internal and external auditing processes. Report at 250. The Report also suggested formation of an Audit Committee: "[s]ince 1997, the GFOA² has recommended that "[e]very government should establish an audit committee or its equivalent." GFOA Recommended Practice, Establishment of Audit Committees (1997 and 2002), Government Finance Officers Association (October 25, 2002). Specifically, the Report stated:

The auditor of a state or local government's financial statements must be independent, both in fact and appearance. A properly constituted audit committee helps to enhance the financial statement auditor's real and perceived independence by providing a direct link between the auditor and governing board.

One important advantage of an audit committee is that it helps to facilitate communication between management, the auditors and the governing board. An audit committee also limits the reliance governing bodies must place on the technical expertise of the independent auditor. An audit committee is useful, too, in helping to focus and document the government's process for managing the financial statement audit.

(Emphasis added.)

The Report visualized an Audit Committee that would serve as a bridge between the independent auditor's management, and the City Council.

PROPOSITION C

Proposition C, approved by the voters on June 3, 2008, amended the San Diego Charter (Charter) to comprehensively change the City's financial reporting and accounting structure³. As explained in the ballot measure, the City Council sought to "more clearly separate the City's internal auditing function" so that a new officer, the independent City Auditor, would be supervised by a restructured Audit Committee instead of the City's Manager, the Mayor⁴.

² Government Finance Officers Association.

³ This resulted in amendments to San Diego Charter section 39, the addition of sections 39.1, 39.2, and 39.3, and amendments to sections 111, 117, 265, 270, and 280.

⁴ The Impartial Analysis from the City Attorney stated: "The Auditor would perform the City's internal audits and investigations and would be appointed for a 10-year term by the Manager, in consultation with the Audit Committee, with Council confirmation. The Audit Committee would oversee the City's internal auditing and control practices; direct the Auditor's work; and recommend the City's outside auditor, monitoring its work. The Audit Committee would consist of two Councilmembers, one of whom would chair the Committee, and three public members..."

The Charter revisions are intended, in part, to ensure City management does not compromise the independence of the City Auditor. Accordingly, management is not appointed to the audit committee.

Also clear is the Audit Committee's oversight responsibility over the audit function, but not over management. Efforts to direct the work of management jeopardize the important division between these functions.

SAN DIEGO CHARTER SECTION 39.1

The Charter itself does not include as an Audit Committee responsibility the right to direct management or to reject management's response to a City Auditor recommendation. Specifically, the Audit Committee:

- oversees the City's auditing, internal controls and any other financial or business practices required of it by the Charter;
- directs and reviews the work of the City Auditor;
- recommends to the Council the City Auditor's annual compensation;
- recommends to the Council the annual budget of the Office of City Auditor;
- annually reviews the City Auditor's performance;
- recommends to the Council the retention of the City's outside audit firm and, when appropriate, the removal of such firm;
- monitors the engagement of the City's outside auditor;
- resolves all disputes between City management and the outside auditor with regard to the presentation of the City's annual financial reports; and
- undertakes such additional responsibilities and duties as set forth by ordinance.

San Diego Municipal Code section 26.1701, subdivision (b), adds additional responsibilities:

- review the results of significant investigations, examinations or reviews performed by government and regulatory authorities and any management response thereto;
- acting through the Committee chair, place any item within the scope of the Committee's authority on the Committee's agenda at the request of any Committee member or City Councilmember; and
- review any issues that come to the Committee's attention which pertain to the accuracy and reliability of the City's financial practices and representations and which could have a negative impact on the ability of the public to reasonably rely upon such financial practices and representations.

Neither the Charter nor the San Diego Municipal Code authorizes the Audit Committee to reject management's responses or otherwise control or direct management operations.

GFOA BEST PRACTICE ON AUDIT COMMITTEES

The Report endorses the GFOA's best practice on audit committees. The GFOA describes the role of a government audit committee as follows:

"An audit committee is a practical means for a governing body to provide much needed independent review and oversight of the government's financial reporting processes, internal controls, and independent auditors."

"An audit committee also provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns." (Emphasis added.)

"By effectively carrying out its functions and responsibilities, an audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices, and that the independent auditors, through their own review, objectively assess the government's financial reporting practices." (Emphasis added.)

"To ensure the committee's independence and effectiveness, no governing body member who exercises managerial responsibilities that fall within the scope of the audit should serve as a member of the audit committee."

"The audit committee should present annually to the full governing body a written report of how it has discharged its duties and met its responsibilities . . ."

"The audit committee also should monitor controls performed directly by senior management, as well as controls designed to prevent or detect senior-management override of other controls . . ." (Emphasis added.)

"Nothing in this recommended practice should be interpreted so as to limit the full governing body from exercising ultimate authority."

This GFOA best practice emphasizes several points important to this Audit Committee. First, an audit committee is a tool available to a governing body for purposes of providing independent review and oversight of the government's financial reporting processes, internal controls, and independent auditors. Second, an audit committee provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns. Audit committee members do not manage City staff, nor do they direct management's work. In fact, the GFOA best practice emphasizes that members of the management team should not serve on the audit committee. Finally, the legislative body is ultimately responsible for creating and implementing policy. This responsibility does not rest with the audit committee.

“EVALUATING INTERNAL CONTROLS: A LOCAL GOVERNMENT MANAGER’S GUIDE”

As noted in the GFOA guide entitled “Evaluating Internal Controls: A Local Government Manager’s Guide:” “[m]anagement is accountable to the entity’s governing body for its performance. While management is *primarily* responsible for internal controls, the governing body is *ultimately* responsible for ensuring that management fulfills that responsibility. The governing board’s role in this regard is crucial, because management is in a unique position to override control-related policies and procedures.”

The GFOA guide further advises, “[t]he best way for the governing board to oversee management’s performance in regard to internal controls as they relate to accounting and financial reporting is to establish an audit committee. Ideally, an audit committee should include a majority of members from outside the entity (e.g., business people). Also, if possible, an audit committee should avoid the inclusion of any members of the governing board who may also exercise management responsibilities.” Again, the GFOA emphasizes the division between management and the audit committee.

Finally, the GFOA guide describes three essential elements of a government audit committee: (1) to ensure that the auditor of the financial statements is truly independent of management; (2) to provide an objective perspective on matters related to internal controls and the audit of the financial statements; and (3) to provide a communications link between management, the independent auditor and the government board.” These elements are met by selecting an independent auditor; communicating with the independent auditor; reviewing the financial statements and the results of the financial statement audit; monitoring the independent auditor; and monitoring the work of the internal audit function.

The GFOA guide notes that the independent auditor functions in some respects as a “check” on management. If management does not meet its internal control responsibilities satisfactorily, the audit committee is charged with reporting the independent auditor’s findings and its’ concerns to the governing board, thus serving as a vehicle for communication between the independent auditor and the governing board.

CONCLUSION


The Audit Committee is an important communication tool. Its’ meetings provide a forum in which the City Auditor and City management may discuss and attempt to resolve the City Auditor’s findings, conclusions, and recommendations. As noted in the Government Auditing Standards, “[e]ffective recommendations encourage improvements in the conduct of government programs and operations. Recommendations are effective when they are addressed to parties that have the authority to act and when the recommended actions are specific, practical, cost-effective, and measurable.” GAS § 8.29.

April 18, 2011

The City Auditor and City management are not going to agree on all audit findings, conclusions, and recommendations. To meet Charter requirements and legislative intent, we believe it is appropriate for the Audit Committee to refer unresolved audit report recommendations to the City Council when a majority of the Committee members conclude that management has not, will not, or cannot meet its internal control responsibilities satisfactorily. The Audit Committee accomplishes this objective by reporting the City Auditor's findings and its' concerns to the Council for appropriate action.

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By:


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Councilmembers

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