



**The Honorable City Council  
Palo Alto, California**

**August 5, 2002**

## **City Auditor's Quarterly Report**

### **Recommendation**

The City Auditor's Office recommends the City Council review and accept this quarterly report.

### **Introduction**

In accordance with the Municipal Code, the City Auditor prepares an annual work plan for the City Council's approval, and issues quarterly reports to the City Council describing the status and progress towards completion of the annual work plan. The purpose of this report is to provide the City Council with a status report on the activities of the Office during the past three months.

### **Summary of Results**

We issued the following reports to the City Council since our last status report in April 2002:

- **A Study of Infrastructure Contract Processing Times** (April 2002) – Our study provided baseline information on the infrastructure contracting process, and indicated there is room for the City to improve its contract processing times. The City Council Finance Committee accepted the results of our review by consensus on April 16, 2002. The City Auditor will continue as a member of the Infrastructure Contract Streamlining Team to assist with the review of current and proposed procedures.
- **Assessment of Utility Risk Management Procedures** (July 2002) – The City has made considerable progress in addressing Utilities Department risk management issues. Improvements will help protect the City's financial interests. We presented the results of our review to the Utility Advisory Commission on July 10, 2002 and to the City Council Finance Committee on July 16, 2002. The Finance Committee voted 4-0 to accept the report and adopt the audit recommendations.

Audits of sales tax, property tax, transient occupancy tax, and utility users' tax are in process. Preliminary findings from the transient occupancy tax review reveal a high degree of compliance among taxpayers with the City's municipal code provisions.

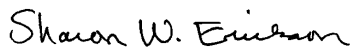
The following assignments are also in process:

- Analysis of the Long Range Financial Plan;
- Service Efforts and Accomplishments Report;
- Audit of Code Enforcement; and
- Controls Review of the Proposed Enterprise Resource Planning System.

Information on the status of each assigned project is attached (pages A-1 through A-5). I have reviewed this information with the ad-hoc Audit Committee (Council members Beecham, Freeman, and Morton), and will continue to meet with them on a quarterly basis to monitor the status of current and future projects.

*Response to Council referral 4/1/02:* The ad-hoc Audit Committee has revised its draft roles and responsibilities to reflect previous Council action that the Annual Financial Statements be heard at the Finance Committee and as Reports of Committees at the City Council (see attachment B-1). The Committee continues to recommend that performance audit reports be heard at either the Finance Committee or Policy and Services Committee, and be included in the City Council packet as information.

Respectfully submitted,



Sharon W. Erickson  
City Auditor

Attachments:

- A. City Auditor Project Status as of July 31, 2002
- B. Notes from discussion about Audit Committee role

## City Auditor Project Status as of July 31, 2002

Audit Project and Preliminary Objectives	Status	Accomplishments Year-To-Date	Items to be Completed
<b>ADMINISTRATIVE ITEMS</b>			
<p>1. <b>Auditor's Office General and Administrative</b> – Several improvements in the audit approval, planning and oversight process will be implemented. We will revise quality control procedures as necessary to ensure compliance with the National Association of Local Government Auditors' Peer Review Standards. Detailed audit programs will clearly define work to be performed, and records will be improved with respect to audit project tracking and audit work performed. Other important tasks include filling our vacant audit position, preparing staff performance evaluations, and updating the City Auditor's web page. To facilitate communication and coordination with Council Appointed Officials and staff, the City Auditor will attend weekly executive staff meetings.</p>	On-going	<p>Edwin Young, Senior Auditor, started work in Nov-2001. Edwin brings more than 25 years of audit experience in a variety of government environments.</p> <p>We revised the City Auditor procedures manual, and instituted new audit-tracking and time-reporting procedures. Staff performance evaluations updated Dec-2001.</p> <p>The City Auditor regularly attends City Council, Finance Committee, and Executive Staff meetings.</p> <p>In Aug-2001, we moved to new offices on the 7<sup>th</sup> floor (space vacated by the City Attorney).</p> <p>In May-2002, the Office attended the National Association of Local Government Auditors conference at Lake Tahoe thereby fulfilling a large part of our training requirement for the year.</p> <p>In May-2002, Pablo Federico, a student intern from Stanford, began assisting with the Service Efforts and Accomplishments Report and other audit projects.</p> <p>Renata Falk, Senior Auditor, started work Jul-2002. Renata has a background in performance and internal audit. She received her BS in Journalism from Boston University, and her MPA from Louisiana State University.</p> <p>We redesigned the Auditor's Office website and posted audit reports and other information at <a href="http://www.city.palo-alto.ca.us/auditor/">www.city.palo-alto.ca.us/auditor/</a>.</p>	Done

Audit Project and Preliminary Objectives	Status	Accomplishments Year-To-Date	Items to be Completed
<p>2. <b>Annual Audit Plan and Quarterly Status Reports</b> – The City Auditor will submit quarterly reports to the City Council describing our status and progress towards completing the assignments on this annual plan. Beginning in Spring 2002, the Auditor’s Office will implement a <b>risk assessment model</b> (a “key plan” item in the 2001-03 Adopted Budget) to prepare the 2002-03 annual audit plan. We will also develop an <b>annual report</b> that identifies the outcomes/accomplishments that result from internal audit efforts (a “key plan” item from the 2001-03 Adopted Budget).</p>	On-going	<p>2001-02 Annual Audit Plan submitted to City Council and approved Sep-2001.</p> <p>Status reports submitted to the City Council: Aug-2001, Dec-2001, Mar-2001, and Aug-2002.</p>	Done
<p>3. <b>Audit Recommendation Status</b> – The Municipal Code requires that the City Auditor issues an annual report on the status of recommendations from recently completed audits. This Fall we will report to the City Council on the implementation status of recommendations that were outstanding as of the City Auditor’s last audit recommendation status report to the City Council. The report will list those recommendations that have been implemented, those that should be modified or dropped, and will provide an agreed course of action to implement remaining recommendations.</p>	Completed	<p>Report issued Nov-2001 covering the status of 132 recommendations from 15 different audit reports. The next annual review will be completed Summer/Fall 2002.</p>	Done
<b>ON-GOING ASSIGNMENTS</b>			
<p>4. <b>Annual External Audit</b> – The City Charter requires that the City Council engage an independent certified public accounting firm to conduct an annual external audit. The City Auditor coordinates the annual external audit. During 2001-02, this will include:</p> <ul style="list-style-type: none"> <li>• Participating in audit progress meetings and GASB 34 implementation planning sessions;</li> <li>• Conducting a post audit survey of City management and staff to evaluate the performance of the external audit firm (a “key plan” item from the 2001-03 Adopted Budget); and</li> <li>• Contracting for the June 30, 2002 audit of the City’s financial statements.</li> </ul>	On-going	<p>Maze and Associates completed their audit of the City’s June 30, 2001 financial statements, and presented those statements to the Finance Committee in Dec-2001.</p> <p>We conducted a post audit survey of City management and staff in Jan-2002, and recommended that the City Council retain Maze and Associates for the audit of the June 30, 2002 financial statements.</p>	On-going
<p>5. <b>Quarterly Sales Tax Reviews</b> – Sales tax is the City’s largest revenue source, representing about 20 percent or \$25.6 million of total 2001-02 General Fund revenues. The City contracts with MBIA MuniServices Company/Municipal Resource Consultants (MMC/MRC) for sales tax information (on a fee-for-service basis) and sales tax allocation reviews (on a contingency-fee basis). Under the current agreement, the Auditor’s Office conducts the first review of sales tax accounts and MMC/MRC conducts a second review. The agreement with MMC/MRC for sales tax allocation reviews expired December 31, 2001. Depending on the cost/benefit of any new agreement, we will consider contracting the entire sales tax allocation review to an outside vendor.</p>	On-going	<p>Sales Tax Review 2<sup>nd</sup> and 3<sup>rd</sup> Quarters 2000 (issued Aug-2001) identified \$19,591 in misallocated revenue related to two businesses.</p> <p>Sales Tax Review 4<sup>th</sup> Quarter 2000 (issued Oct-2001) identified \$57,128 in misallocated revenue related to two other businesses.</p> <p>Sales Tax Audit Recovery Report issued Feb-2002 identified \$161,294 in recoveries. Total recoveries fiscal year to date are \$218,422.</p>	On-going

Audit Project and Preliminary Objectives	Status	Accomplishments Year-To-Date	Items to be Completed
		<p>In Apr-2002, we contracted with Hinderliter, deLlamas &amp; Associates (HdL) for sales tax information and audit services. The Council approved a resolution authorizing HdL to access sales and use tax records. HdL has completed their first quarterly review and is investigating 4 accounts for possible misallocation of about \$28,000 in additional point of sale dollars. We will report on actual recoveries when received.</p> <p>In May-2002, we successfully disputed the SBOE's reallocation of nearly \$600,000 from the City's quarterly sales tax distribution. The \$600,000 was credited back to the City's account pending resolution of our 1999 appeal. The sales tax in question relates to allocations from one Palo Alto business for 4/1/92 through 3/31/95.</p>	
<b>NEW ASSIGNMENTS</b>			
<p>6. <b>Contracted Revenue Audit Services</b> – Several of the City's major revenue sources have not been audited in some time. Because of limited in-house resources, we propose contracting for revenue audit services this year. There are several vendors who specialize in conducting revenue audits on a contingency-fee basis. The Auditor's Office will prepare an RFP to assess interest in conducting the following audits (in addition to the quarterly sales tax reviews mentioned above). Revenue audit areas include: property tax, documentary transfer tax, transient occupancy taxes, and utility users tax.</p>	On-going	<p>In Nov-2001 we issued an RFP for revenue audit services. A team representing the Auditor's Office, Economic Resources, and ASD reviewed the proposals and selected HdL companies for sales and property tax audits and reporting services, and Tax Compliance Services for TOT and UUT audits.</p> <p>In Jun-2002, Tax Compliance Services (TCS) completed fieldwork on all 29 TOT hotel facilities in the City of Palo Alto at a cost of \$27,500. The review indicated a high degree of compliance, and identified \$40,165 in potential underpayments. Total recoveries to date are \$7,200.</p> <p>HdL has completed two portions of the property tax review. First, HdL confirmed 19,281 secured parcels in the City of Palo Alto for the 2001-02 tax year. Second, HdL reviewed 1998-99 through 2001-02 unsecured parcels and identified \$1.7 million in unsecured assessed valuation that may have been miscoded (it should be noted that</p>	On-going

Audit Project and Preliminary Objectives	Status	Accomplishments Year-To-Date	Items to be Completed
		<p>this only represents \$2,100 in estimated net revenue to the City). This information has been forwarded to the County Assessor for correction. Other portions of the property tax and documentary transfer tax review are continuing.</p> <p>TCS has initiated the UUT audit of 120 telecommunications providers. TCS estimates this audit could take as long as 18 months depending on the promptness with which providers respond to our information requests.</p>	
<p>7. <b>Study of Infrastructure Contract Processing Times</b> – The City Manager’s Office has initiated a CityWorks Contract Streamlining project team to improve the timeliness of infrastructure-related contract processing. The Auditor’s Office will assist the team by flowcharting the contract approval process, reviewing a sample of contracts to document bottlenecks that effect timeliness, and performing a critical path analysis to assess opportunities for improvement. This may include benchmarking against private industry.</p>	Completed	Report issued Apr-2002. The City Auditor will continue to meet with the streamlining team to provide advice and assistance in revising policies and procedures.	Done
<p>8. <b>Assessment of Utility Risk Management Procedures</b> – As a consequence of changes to the utility industry and the volatility of energy markets, the City is in a position where business risks are much different than under historical operations. The Utilities Department has engaged several experts to advise the City in this area, and has implemented risk management procedures related to the purchase and sale of commodities – a significant source of our current risk. The focus of our review will be on assessing the adequacy of Utility risk management procedures, the appropriateness of designated scopes of authority and levels of management oversight, and the adequacy of management reporting.</p>	Completed	Report issued Jul-2002. The City Auditor will participate as an advisor to the Risk Oversight Committee to provide advice and assistance in revising risk management policies and procedures, and implementing audit recommendations.	Done
<p>9. <b>Independent Analysis of the Long Range Financial Plan</b> – The City Manager will be presenting an update to the long-range financial plan this fall. The City Auditor has been asked to provide an independent assessment of the feasibility and completeness of the plan.</p>	In Process	Audit fieldwork tested the forecasting model, revenue and expenditure assumptions, and the completeness of information about the City’s long range financial commitments. We provided the preliminary results of our review to ASD so that our recommendations can be incorporated into the revised long range financial plan.	We will provide comments at the City Council Study Session on the Long Range Financial Plan in Oct-2002.
<p>10. <b>Service Efforts and Accomplishments (SEA) Report</b> – The purpose of SEA reporting is to provide consistent, reliable information on the performance of City services that is viewed as credible and objective. We will develop a prototype for an annual report that summarizes workload and</p>	In Process	We are conducting a preliminary survey of available performance measurement data and benchmarking information. We will be meeting with department staff to review the	Target completion date: Fall-2002 to the Finance Committee.

Audit Project and Preliminary Objectives	Status	Accomplishments Year-To-Date	Items to be Completed
results information for the City's major public service areas, and provides benchmark comparisons to comparable jurisdictions. The success of the project will depend on cooperation and mutual assistance between audit staff and other City staff in utilizing existing data and management information where possible, limiting reporting to the largest and most visible services, and using a few well-selected indicators that are reliable and valid.		availability and validity of service level data.	
11. <b>Audit of Code Enforcement</b> – The objective of this audit is to assess the Code Enforcement Program's timeliness, responsiveness, and consistency of enforcement. This program was last audited in 1997.	In Process	We are conducting a preliminary survey of the Code Enforcement division to identify potential audit issues and target our work in to the most critical areas.	Target completion date: Fall-2002 to the Policy and Services Committee.
12. <b>Controls Review of the Proposed Enterprise Resource Planning (ERP) System</b> – The City Auditor has been asked to participate in selected ERP team meetings in preparation for (1) reviewing the process maps that will be used to establish ERP system requirements, and (2) conducting a system controls review prior to installation.	In Process	The City Auditor is participating on the internal ERP Steering Committee. We are available for controls, workflow, and procedural reviews as implementation progresses.	Target completion date: TBD.
13. <b>Other Bureaucracy Buster Initiatives</b> – The Auditor's Office has been asked to participate in several short projects to (1) independently assess the cost/benefit of streamlining projects, and (2) provide advice on the adequacy of streamlined controls and procedures. We will attempt to provide advice and assistance with these projects as time allows. Proposed projects include: <ul style="list-style-type: none"> <li>• Reviewing the City's write-off policy for NSF (not sufficient funds) checks less than \$25.</li> </ul>	On-going	At staff's request, we have provided advice on proposed streamlining of the City's travel and petty cash procedures.	Target completion date: TBD.
14. <b>Other Reviews of Financial Procedures and Controls</b> – Staff has asked the Office to provide advice on several other procedural and control issues. Where possible, our approach will be to help departments develop their own control self-assessment programs (a "key plan" item from the 2001-02 Adopted Budget). We will attempt to provide requested assistance in these areas as time allows. Proposed reviews include: <ul style="list-style-type: none"> <li>• Verifying that the Golf Professional's procedures for handling golf course receipts conform to City procedures.</li> </ul>	On-going	Upon request, we are available to City staff for advice on procedural and control issues. Items we have addressed so far include advice on employee use of city discounts, record keeping for management benefits, and revisions to the City's gift procedure.	Target completion date: TBD.
15. <b>Review of City Manager's Proposals to Strengthen the Bottom Line</b> – Additional item added by Finance Committee 11/20/01.	Completed	At the request of the Finance Committee, the City Auditor reviewed and commented on the City Manager's Bottom Line Proposals at the Finance Committee meeting of December 4, 2001.	

## AUDIT COMMITTEE ROLES AND RESPONSIBILITIES

Council Members Bern Beecham, Hillary Freeman, and Jack Morton  
and City Auditor Sharon Erickson  
Revised June 20, 2002

### General

- Assume Finance Committee (as a public, standing committee of the City Council) has financial oversight responsibilities.
- Assume ad-hoc audit committee role is to facilitate and coordinate relationships between Council, City Auditor, City Manager, and external auditor
- The ad-hoc Audit Committee is appointed by the Mayor, and should include at least one member of the Finance Committee and one member of the Policy & Services Committee.

### Specific

- Input and prioritization of audit topics for proposed audit work plan
- Review and recommend external auditor (e.g. participate in RFP when applicable)
- Review and recommend auditor's office budget
- Assign performance audit reports to appropriate standing committee
- As necessary, facilitate audit work (e.g. difficulty obtaining information necessary to complete audit work assigned)
- As necessary, ensure appropriate action on audit findings

### Reporting

	Audit Committee	Finance Committee	Policy and Services	City Council
Annual Audit Plan	✓			Report of officials
External auditor selection and contract	✓			Consent item
Quarterly Status Report	✓			Consent item
Annual Financial Statements		✓		Reports of Committees
Revenue Audit Reports		✓		In packet as information
Performance Audit Reports		✓	or ✓	In packet as information
Annual Recommendation Status Report		✓	or ✓	In packet as information