



## CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

July 18, 2006

The Honorable City Council  
Attn: Finance Committee  
Palo Alto, California

### **Auditor's Office Quarterly Report as of June 30, 2006**

#### **RECOMMENDATION**

The City Auditor's Office recommends the Finance Committee review and recommend to the City Council acceptance of the Auditor's Office Quarterly Report as of June 30, 2006.

#### **SUMMARY OF RESULTS**

In accordance with the Municipal Code, the City Auditor prepares an annual work plan for approval by the City Council, and issues quarterly reports to the City Council describing the status and progress towards completion of the work plan. This report provides the City Council with an update on the activities of the Office as of June 30, 2006.

We issued the following reports to the City Council since our last status report in April 2006:

- Informational report on Q4-2005 Palo Alto sales tax (May-2006)
- Financial review of the Palo Alto Airport (Jun-2006)
- Audit of the Police investigative fund (attached)

Also this quarter, the Association of Government Accountants awarded the City of Palo Alto with a Certificate of Excellence in Service Efforts and Accomplishments (SEA) Award. This is the second consecutive year that the City of Palo Alto has won the national award. Then, in May, the National Association of Local Government Auditors awarded a silver medal for best audit from a small audit shop to our 2005 Audit of Park Maintenance. And, last week, the International City/County Management Association and the National Research Center announced that Palo Alto has won the 2005 Voice of the People Award for excellence in emergency medical, fire, garbage collection, park, and police services. The award is based on ratings for service quality from the 2005 National Citizen Survey that is contained in the SEA report.

Our revenue audits continue to yield benefits to the General Fund. The City has received \$917,597 during the fiscal year to date as a result of our in-house and contracted audits (our goal was \$235,000 in audit recoveries). This includes \$172,881 in sales tax, \$676,156 in utility users tax, and \$68,560 in cable franchise fees, and does not include audit findings that were assessed but have not yet been collected.

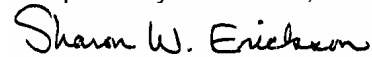
In addition to our on-going assignments, the following projects are in process (with target completion dates):

- Audit of Community Services Department class program revenue/cost recovery (Oct-2006)
- Audit of transient occupancy taxes (Oct-2006)
- Infrastructure report card (Fall-2006)
- Review of ethics policies (TBD)
- Audit of the Waste Management/PASCO contract (Dec-2006)

We are scheduled to present our proposed 2006-07 work plan to the Finance Committee in September. As part of that plan, I will propose an audit of library operations. The purpose of our review would be to identify potential operating efficiencies and cost savings. In anticipation of the City Council's need for this information, we propose delaying the upcoming vehicle maintenance/replacement fund audit, and starting the Library audit now. Staff requested the audit and agrees with this timing. We will also meet with the Library Advisory Commission to discuss the potential scope and timing of our review.

Information on the status of each assigned project is attached (pages A-1 through A-8). On behalf of the Auditor's Office, I would like to express my appreciation to City staff for their cooperation and assistance during our reviews.

Respectfully submitted,



Sharon W. Erickson  
City Auditor

Attachment: City Auditor Project Status as of June 30, 2006  
Audit of Police Investigative Fund

## City Auditor Project Status as of June 30, 2006

| Original Audit Project Description and Preliminary Objectives  | Status    | Accomplishments Year-To-Date  | Items to be Completed |
|--|-----------|---|-----------------------|
| <b>AUDIT ADMINISTRATION, FOLLOW-UP, AND OTHER RESPONSIBILITIES</b>   |           |   |                       |
| <p><b>1. Annual Work Plan and Quarterly Status Reports</b> – The City Auditor submits quarterly reports to the City Council outlining project status and progress towards completing the assignments on the annual work plan.</p>  | On-going  | <p>In Sep-2005, the Finance Committee recommended approval of the FY 2005-06 work plan, and in Oct-2005, the City Council approved the plan. Quarterly reports have been issued as of September 30, 2005, December 31, 2005, March 31, 2006, and June 30, 2006.</p>   |                       |
| <p><b>2. Audit Recommendation Status Report</b> – The City Auditor issues an annual report on the status of recommendations from recently completed audits.</p>  | On-going  | <p>Recommendation status report was issued in Sep-2005 summarizing the status of 134 recommendations. The report was reviewed by the Finance Committee and the Policy and Services Committee. In Jan-2006 (CMR:118:06), the City Manager responded to a Policy &amp; Services Committee request for additional information about the status of 3 recommendations in the Span of Control Audit. During the course of the year, audit staff has been meeting with department staff to review the status of open audit recommendations. The next annual status report to the City Council will be completed in Oct-2006.</p> |                       |
| <p><b>3. Auditor’s Office Triennial Peer Review</b> – Government Auditing Standards require audit organizations to have an external peer review once every three years. The National Association of Local Government Auditors coordinates a peer review program to help member organizations meet these standards.</p> | Completed | <p>Peer review completed in Oct-2005. Based on their review, the peer review team of Amanda Noble (Deputy City Auditor, Atlanta, GA) and Jerry Shaubel (Director, Auditor General’s Office, Toronto, ON) concluded that the City Auditor’s Office was operating in compliance with government auditing standards from Jun-2001 through Jul-2005.</p>  |                       |

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|---|----------|---|-----------------------|
|   |          | In exchange for our peer review, Senior Auditor Edwin Young participated in a peer review of Jackson County, Oregon in Jun-2005; and Senior Auditor Renata Falk participated in a peer review of Portland, Oregon in Jul-2005.  |                       |
| <p><b>4. Meeting attendance</b> – To facilitate communication and coordination of efforts, the City Auditor attends the City Council meetings, Finance Committee meetings, and the City Manager's weekly executive staff meetings.</p>  | On-going |   |                       |
| <p><b>5. Utility Risk Oversight Committee (ROC)</b> – Since issuance of our Assessment of Utility Risk Management Procedures in Jul-2002, the City Auditor has acted as an advisor to the ROC.</p>  | On-going | The Auditor is continuing as an advisor to the ROC as it evolves into the broader Utilities Oversight Committee.  |                       |
| <p><b>6. Independent Police Review Panel</b> – The City Auditor will participate in an independent panel to review internal investigations and citizen complaints. The panel will make recommendations to the Police Chief and the City Manager, who will retain final authority on disposition.</p>  | Dropped  | On May 8, 2006, the City Council approved a job description and implementation timeline for a Police Auditor contract position.   |                       |
| <b>REVENUE AUDITS<sup>1</sup></b>   |          |   |                       |
| <p><b>7. Sales tax audits</b> (on-going) – Sales tax represents about 16 percent, or \$19 million, of projected General Fund revenue for 2005-06. We contract with MBIA MuniServices (MMC) for quarterly sales tax audit and information services. We also conduct audits in-house. Both types of audits focus on verifying that Palo Alto is getting the appropriate allocation of local sales tax. We report the results of audits in the Auditor's Office Quarterly Report. Sales tax information reports (provided by MMC) are separately transmitted to the City Council on a quarterly basis.</p> | On-going | <p>MMC has provided quarterly sales tax information reports summarizing Q1-2005 sales (Jan-Mar 2005), Q2-2005 sales (Apr-Jun 2005), Q3-2005 (Jul-Sep 2005), and Q4-2005 (Oct-Dec 2005) that were distributed in Aug-2005, Nov-2005, Jan-2006, and Apr-2006 respectively. Confidential information on specific businesses is not reported in accordance with state law.</p> <p>In the first quarter of the fiscal year, the City received \$27,299 in sales tax recoveries related to misallocation of tax</p> |                       |

<sup>1</sup> We conduct our revenue audits in accordance with applicable government auditing standards, and report the results of our revenue audits in the Auditor's Office Quarterly Report. In accordance with state law, confidential information about specific businesses is not included in these reports.

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|---|--------|--|-----------------------|
|   |        | <p>from one Palo Alto company. This amount is the result of audits conducted earlier by our previous sales tax consultant, Hinderliter de Llamas &amp; Associates (HdL).</p> <p>In the second quarter of the fiscal year, the City received \$51,149 in sales tax recoveries related to the misallocation of tax from 5 Palo Alto companies identified earlier by HdL and the City Auditor's Office.</p> <p>In the third quarter of the fiscal year, the City received \$34,921 in sales tax recoveries related to the misallocation of tax from 2 Palo Alto companies identified earlier by HdL.</p> <p>In the fourth quarter of the fiscal year, the City received \$59,512 in sales tax recoveries related to the misallocation of tax from 7 Palo Alto companies identified earlier by HdL and the City Auditor's Office.</p> <p>In addition, there are potential misallocations from 12 companies pending resolution by the State Board of Equalization. MMC identified the potential misallocations from 6 of the companies, and the City Auditor's Office identified the potential misallocations from the other 6 companies.</p> <p>Sales tax recoveries year-to-date:<br/> <b>\$172,881</b></p> |                       |

| Original Audit Project Description and Preliminary Objectives   | Status    | Accomplishments Year-To-Date  | Items to be Completed |
|---|-----------|---|-----------------------|
| <p><b>8. Property tax audits</b> (on-going) – Property tax represents about 14 percent, or \$17 million, of projected General Fund revenue for 2005-06. We have contracted with MMC for property tax auditing and information services. Audit services are designed to help ensure that County assessment data for properties in Palo Alto is current and accurate.</p> | Completed | <p>MMC completed their audit of FY 2004-05 and FY 2005-06 property tax allocations. In Mar-2006, we declined to renew the annual property/documentary transfer tax audit contract because of low audit recoveries. MMC will continue to provide sales tax audit services for Palo Alto.</p>   |                       |
| <p><b>9. Documentary transfer tax audits</b> – As part of the property tax audit program, we have contracted with MMC to ensure that the City's documentary transfer tax (about \$3 million annually) is levied when residential and commercial properties are sold, properly applied, and remitted in a timely manner.</p>   | Dropped   | <p>In Mar-2006, we declined to renew the MMC annual property/documentary transfer tax contract because of low audit recoveries (the prior year's audit recovered only \$1,375).</p>   |                       |
| <p><b>10. Utility users tax audits</b> (follow-up) – In 2002, we contracted with Tax Compliance Services to audit telephone company UUT remittances. Audit work is completed, but the Auditor's Office will continue to provide assistance as needed to achieve compliance.</p>   | Completed | <p>Project started in Jul-2002. During FY 2003-04 and FY 2004-05, the City collected \$155,410 as a result of the audits.</p> <p>During the first quarter of FY 2005-06, the City received \$71,686 as a result of UUT audits. Several items were still pending including amounts previously assessed but not collected, an appeal by one company, and the lawsuit against another company for failure to pay UUT.</p> <p>During the second quarter of the fiscal year, the City received \$107,776 as a result of UUT audits.</p> <p>During the third quarter of the fiscal year, the City received \$385,824 as a result of UUT audits.</p> <p>During the fourth quarter of the fiscal year, the city received \$110,870 as a result of UUT audits.</p> <p>UUT recoveries year-to-date (including amounts paid under protest): <b>\$676,156</b></p> |                       |

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|--|------------|--|----------------------------------|
| <p><b>11. Audit of cable franchise and PEG Fees</b> – Our audit of Comcast franchise and PEG (Public, Education, and Government) fees is complete, and a final response from Comcast is pending.</p>   | Completed  | <p>On 9/30/05, the City (on behalf of the Cable JPA) received a check for \$92,899 from Comcast in payment of audit findings related to underpayment of franchise and PEG fees. Palo Alto's share of this amount is approximately \$46,450. In accordance with the franchise agreement, Comcast also agreed to pay audit costs.</p> <p>During the second quarter of FY 2005-06, the JPA received a check from Comcast in the amount of \$22,110 for audit costs. Comcast owed reimbursement for audit costs since the audit resulted in an increase of more than 2% in franchise fee payments.</p> <p>City of Palo Alto audit recoveries year-to-date: <b>\$68,560</b></p> |                                  |
| <p><b>12. Audit of transient occupancy tax</b> (contracted audit service) – Transient occupancy tax (TOT) represents about 5 percent of General Fund revenues, or about \$6 million per year. We previously audited revenues through Jun-2002.</p>   | In process | <p>In Feb-2006, we issued a request for proposals for TOT audits. We received 2 proposals and selected Tax Compliance Services (TCS) because of their experience and lower price. TCS will be auditing all 28 hotels/motels in Palo Alto in July-August 2006. The total cost will be \$27,500.</p>   | Target completion date: Oct-2006 |
| <b>FINANCIAL AUDITS AND PROCEDURAL REVIEWS</b>   |            |  |                                  |
| <p><b>13. Annual external financial audit</b> (contracted audit service) – The City Charter requires that the City Council engage an independent certified public accounting firm to conduct an annual external audit. We have contracted with Maze &amp; Associates to conduct the audit.</p> | Completed  | <p>Audited financial statements as of June 30, 2005 issued Dec-2005 with a clean opinion from Maze &amp; Associates.</p> <p>In Apr-2006, Maze began interim audit work in preparation for the audit of the June 30, 2006 financial statements. At our request, Maze will be focusing special attention on <b>purchasing card transactions</b> this year.</p>   |                                  |

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|--|-----------|---|-----------------------|
| <p><b>14. Controls reviews of SAP</b> (on-going) – The implementation of the SAP system is having dramatic impacts on the City’s business operations and financial records. The Auditor’s Office will continue to monitor the implementation and provide advice to ASD on the adequacy of controls in the new system.</p>  | On-going  |   | Target date: TBD.     |
| <p><b>15. Audit of the police investigative fund</b> – Pursuant to Police Department procedures, the Auditor’s Office conducts a surprise review on an annual basis.</p>   | Completed | Report attached – no issues found.  |                       |
| <p><b>16. Ethics policies</b> – We will review procedures for ascertaining and handling potential conflicts of interest among city employees, and assess the need for an ethics policy.</p>  | Started   | We are in the preliminary survey phase of this review – determining what policies are currently in place and where additions might be needed.   | Target date: TBD.     |
| <p><b>PERFORMANCE AUDITS AND SPECIAL PROJECTS</b></p>  |           |   |                       |
| <p><b>17. Service Efforts and Accomplishments (SEA) Report</b> – This will be the 4<sup>th</sup> annual SEA report. The purpose of SEA reporting is to strengthen public accountability and help improve government efficiency and effectiveness. Palo Alto’s SEA report provides data about the costs, quality, quantity, and timeliness of City services. It includes a variety of comparisons to other cities, and the results of an annual citizen survey (the National Citizen Survey).</p> | Completed | <p>Report issued Feb-2006. The 4<sup>th</sup> annual report included results of the National Citizen Survey conducted in Fall-2005. We also issued a companion executive summary. To date we have distributed more than 150 copies of the full report, and more than 100 copies of the executive summary.</p> <p>In Apr-2006, the Association of Government Accountants awarded the City of Palo Alto the Certificate of Excellence in SEA reporting.</p> |                       |
| <p><b>18. Audit of parks maintenance</b> –The purpose of our audit is to assess the cost-effectiveness of parks maintenance services. The Community Services Department (CSD) is one of the areas targeted by our citywide risk assessment model.</p>  | Completed | <p>Report issued Dec-2005. The report contained a total of 22 recommendations to improve parks maintenance operations. The report was presented to the Finance Committee (Dec-2005) and Parks and Recreation Commission (Jan-2006).</p> <p>In May-2006, this report won a silver medal for best audit from a small audit</p>  |                       |



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|--|------------|--|-----------------------------------|
|  |            | shop from the National Association of Local Government Auditors.   |                                   |
| <p><b>19. Audit of street maintenance</b> – Review of the street maintenance program including criteria for prioritizing street repairs, and coordination of subsurface work.</p>  | Completed  | Report issued Mar-2006. The report included a total of 21 recommendations to improve the street maintenance program. The Finance Committee reviewed the City Manager’s implementation plan in Jun-2006.  |                                   |
| <p><b>20. Police department survey</b> – The Auditor’s Office is conducting a random survey of drivers of vehicles that are stopped to determine how they feel they were treated during the stop. The Office is also conducting a comparison survey of persons requesting service.</p>   | Completed  | Report issued Feb-2005. The report was presented to the Human Relations Commission on February 9, 2006.  |                                   |
| <p><b>21. Review of police building proposal</b> – In response to a colleagues’ memo regarding a developer’s proposal to build a new police building downtown, the City Council directed the City Auditor to review the project and provide her comments and assessment to the City Council.</p>   | Dropped    | In Aug-2005, we issued a memorandum to the City Council supporting the recommendation to issue a Request for Statements of Interest (SOI). In our opinion, this was an important step to ensuring a fair and open process. On October 4 <sup>th</sup> , the City received four responses to the SOI. In Dec-2005, the City Council appointed a Blue Ribbon Task Force to review the proposal. On June 26, 2006 the Task Force presented the results of their review and the Council accepted staff’s recommendation to proceed with the project. |                                   |
| <p><b>22. Audit of CSD class program revenue/cost recovery</b> (carryover project from 2004-05) – The purpose of this audit is to determine the income/subsidy of class programs net of direct and indirect costs. CSD was one of the areas targeted by our citywide risk assessment model.</p>  | In process | We identified class-related revenues and expenses (including direct, indirect, and overhead costs) for each category of classes. We issued the draft report for staff comments in June, but due to scheduling conflicts will not be presenting the report until Oct-2006.  | Target completion date: Oct-2006. |
| <p><b>23. Audit of entrepreneurial programs</b> (carryover project from 2004-05) – The City has a number of “entrepreneurial programs” including IT services, animal control, BLS ambulance service, dark fiber services (the Electric Fund was one of the areas targeted by our citywide risk assessment model), and training programs. The</p> | On-going   | Because of Santa Clara County’s recent release of a proposed business plan for the airport, we selected the <b>Palo Alto Airport</b> as our area of focus for financial review this year. We reviewed the  |                                   |

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|---|-------------|---|-----------------------------------|
| purpose of this review is to analyze the net revenue and cost/benefit of <i>one</i> of these programs.  |             | County's allocation of costs and overhead to the Palo Alto airport, and the financial viability of airport operations. Report issued June 6, 2006. The report was presented to the Joint Community Relations Committee on June 13, 2006, and to the City Council on June 19, 2006. The Santa Clara County Airport Commission is scheduled to discuss the issue on August 1, 2006. |                                   |
| <b>24. Audit of vehicle replacement and maintenance fund</b> – This internal service fund has 16 full-time equivalent employees and projected 2005-06 expenditures of \$5.8 million. The vehicle replacement and maintenance fund was one of the areas targeted by our citywide risk assessment model. The purpose of this review is to evaluate economy, efficiency and effectiveness of fleet and equipment replacement and maintenance operations. | Not started |   | Target start date: Fall-2006      |
| <b>25. Audit of the Waste Management/PASCO contract</b> – The estimated payment to PASCO for refuse collection, hauling, and disposal in 2005-06 is \$8.5 million. The Refuse Fund was one of the areas targeted by our citywide risk assessment model.   | Started     | We are in the preliminary survey phase of this project, and are doing preliminary investigation to determine the scope of our review.   | Target completion date: Dec-2006  |
| <b>26. Infrastructure report card</b> – The purpose of this project is to assess the impact of increased capital spending on the City's infrastructure, including utilities. The Capital Improvement Program was one of the areas targeted by our citywide risk assessment model.   | In process  | We are in the fieldwork phase of this project – reviewing available information about Palo Alto's level of spending, and summarizing the condition and value of Palo Alto's infrastructure assets.  | Target completion date: Fall-2006 |