

Date: December 2, 2011

From: Monty Van Wart
Charter Review Committee Member

To: Charter Review Committee

RE: Internal Audit Functional Reporting and Citizen's Audit Committees

Dear Charter Committee Colleagues:

I write to you as we move toward our deadline for completing our tasks. Perhaps the largest issue still in front of us is regarding the possibility of turning the internal auditor into being a charter officer and adding a citizen's audit committee. While I have personal preferences on the issue which I will voice in our deliberations, I am concerned that the issue has become unclear. The following is an understanding of the landscape of this issue as a public administration generalist.

Rationale for Independent Review of Financial Functions. At its heart, the critical issue of concern is the accounting principle of separation of duties to ensure that financial execution and review are not overseen by the same person. Size of the operations plays an important role here. For example, if the agency is composed of a dozen people, the receipts must be done by one clerk and the deposits by another. The issue of separation of duties applies not only to the prevention of fraud, but also in order to the assurance that financial management is accessible to external review and consideration to ensure that financial policies are being properly and prudently executed even where there is no intent for fraud or gross mismanagement. As organizations become more complex, however, the separation of financial duties is often placed in different divisions or agencies, and the measures to ensure that the policy board or legislative body have direct access to fiduciary correctness outside normal administrative reporting channels becomes even more important. For example, in a complex organization like the federal government, there is the independent General Accountability Office (3000+ personnel) that reports to Congress, as well as 73 Inspectors General who are nominated by the President, as well as internal audit functions in larger agencies. Many jurisdictions have independently elected officials who have an audit function as their prime responsibility or as a part of a portfolio of responsibilities (e.g., combined treasurer-auditor and comptroller-auditor functions are common). Generally speaking, separation is considered greatest when the auditor is elected, moderate when the auditor reports to the policy body/legislative body, and weakest when it reports to the executive officer or an administrative subordinate of the executive officer.

Background for the Interest on an enhanced audit position. The public's heightened interest in independent audit functions has grown in both the private and public sector, but for differing reasons. On the private sector side, a series of major financial scandals led to the passage of Sarbanes-Oxley Act of 2002 which strengthened both external and internal audit controls for publicly traded companies. Problems of insufficient separation of functions and audit independence led to massive fraud, oversights, and claims of executive ignorance. On the public sector side, the California scandals in Bell and Vernon have touched a national nerve recently, as have the international public finance concerns in Europe. The Orange County default (1994) was also unusual, and it reminded the public and bond markets that sovereign accounts can default. Although the public's concern for public sector accounting transparency has increased tremendously, there has been little concrete evidence beyond a very limited number of cases that public sector auditing failures have been frequent or widespread. Exceptions

include the Department of Defense with its enormous and highly political contract budget and large federal programs such as occurs in bogus Medicare billings. Of course, the public's concern can be considered its own rationale and the bar for transparency and fiduciary compliance in the public agencies is exceedingly high because the stakes are so important and long-term.

Functional roles: There are a number of functional roles, some of which can be disaggregated or combined. Those roles include:

1. External auditor: this is required by law. While the scope of the audit may vary and sometimes may be expanded, it looks at fiscal soundness in general, as well as financial controls. Enterprise funds are often subject to a separate audit. This is essentially a high-level, after-the-fact function, as well as a confirmation of system integrity at a global level. Detailed analysis of the audit function must be separately commissioned and is unusual. This function (review of the CAFR: Comprehensive Annual Financial Report) must be functionally separate and independent.
2. Internal audit: internal audit may be limited to financial investigation, but frequently includes performance reviews as well. It looks at ongoing operations on either a cyclical basis or based on requests from the legislative body or the administration due to policy changes or perceived problems. It is sometimes separately elected (e.g., Los Angeles or Oakland). It sometimes reports to the legislative body (e.g., the General Accountability Office whose head is the Comptroller General of the U.S., and cities such as San Diego and San Jose) and sometimes to the administration (e.g., cities of Fresno and Riverside). Sometimes the functions of tax collections and payroll are combined with auditing (e.g., State Controller or County of Riverside Auditor-Controller).
3. Audit and finance committee functions are various and can be disaggregated or combined, according to structural preferences of the jurisdiction. In the City of Riverside, these functions are combined under the Finance Committee, a standing Council Committee function.
 - a. Companies and public sector entities are required to have independent audit committees to select, task, monitor, and review the findings of the external auditor. In the public sector, these external audits are largely restricted to the review of the CAFR and enterprise funds.
 - b. Organizations have committees that review internal audit functions that are relatively detailed and technical in nature.
 - c. Organizations have committees that review upcoming and ongoing budget expenditures.
 - d. Organizations have committees that look at performance and policy reviews.
 - e. Sometimes organizations have citizen boards and commissions that review finances and audit functions (e.g., City of New Haven's Financial Review and Audit Commission and the City of Irvine's Finance Commission). This is generally a duplicative function that is meant to add citizen input and transparency into a technical area. While not very common, it is not rare.

In my opinion, **the major issue is choosing among the following options:**

1. Do we want to consider the view of some that it is time for increased independence and/or outside review of the financial audit function? If so, the four major options being considered by us at this point are:
 - a. To make the auditor a charter officer reporting to the Council or the Finance Committee with primarily financial and performance responsibilities, but other responsibilities as well that are assigned by Council.

- b. To provide a charter citizens' Audit Committee.
- c. To provide both a charter auditor officer and an audit.
- d. To provide neither a charter auditor officer or citizens' audit committee.

In my opinion, **the following issues are not a significant part of the discussion:**

- 2. The Council's Finance Committee will be largely unaffected by either an internal auditor reporting to the Council or an additional citizen review committee. Indeed, the Finance Committee's oversight of the internal audit function would be structurally strengthened by making the internal auditor a charter officer.
- 3. Enlargement of staffing or duplication for a charter auditor officer. There need be no additional staffing since an internal audit function with sufficient staffing already exists for a city the size of Riverside. It would essentially be a transfer of functional responsibilities from the executive branch to the legislative branch as is commonly done in this area.
- 4. Precedent for charter auditor. The bulk of the larger cities in California and indeed the nation have moved to an independent auditor, either by election or Council appointment. For example, the City of Modesto moved to a council-appointed from a management-appointed auditor in 2008. This does not imply the City of Riverside must or should take this step; it is only to say it would be in line with the national trend and part of a growing common practice.

Appendix:

Principal CA Cities

Auditor reporting status

	Name		
1	Los Angeles	3,792,621	Elected
2	San Diego	1,307,402	Audit Committee (Council Committee)
3	San Jose	945,942	Council
4	San Francisco	805,235	Council (Controller)
5	Fresno	494,665	<i>City Manager</i>
6	Sacramento	466,488	Council
7	Long Beach	462,257	Elected
8	Oakland	390,724	Elected
9	Bakersfield	347,483	<i>City Manager/Finance (also have treasurer)</i>
10	Anaheim	336,265	<i>City Manager (also have treasurer)</i>
	Riverside	303,871	<i>City Manager/Finance Director</i>
	Stockton	291,707	Council
	Modesto	201,165	Council
	Berkeley	112,580	Elected

Sources: Memorandum from Cheryl Johannes to Paul Sundeen (July 28, 2011) and additional review of city websites by author.

