



## MEMORANDUM

**To:** City Council

**From:** Craig Hametner, City Auditor

**Date:** October 28, 2014

**Re:** FY14 Annual Report

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The following annual report is being submitted pursuant to Ordinance 2013-51, Section 2-233(b)(10). "The duty to submit an annual report to the Finance Committee and the City Council within 90 days after the fiscal year end. The report will indicate the audits that were completed, the major findings, the corrective action taken by administration and any significant issues not fully addressed by management."

In October of 2013, I briefed you on the mission of Internal Audit. That mission is as follows:

- Ensure the city is applying its resources effectively, efficiently, and economically
- Ensure the city is in compliance with laws, regulations, and policies and procedures
- Ensure the city has adequate safeguards over its assets
- Ensure the city has appropriate revenue management in place
- Ensure the city's financial and operational information is reliable

This department serves the public interest and honors the public trust. It promotes accountability throughout the City.

Throughout this first year I have attempted to work in accordance with the above mission and the ordinance that established this office.

According to the representation letter provided to our external auditors, “We acknowledge our responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.”

According to the transmittal letter in the Comprehensive Annual Financial Report, “Management of the City is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the City are protected from loss, theft or misuse, and that adequate accounting data is compiled to allow for the preparation of financial statements in conformity with Generally Accepted Accounting Principles.” The City Auditor’s Opportunities for Improvement assist city management in meeting their responsibilities.

Additionally, the Government Finance Officers Association states, “Prudence in the management of public funds requires that there be adequate control procedures in place to protect those funds. A sound framework of internal control is necessary to afford a reasonable basis for finance officers to assert that the information they provide can be relied upon.”

Generally Accepted Government Auditing Standards (GAGAS) state, “Audits performed in accordance with GAGAS provide information used for oversight, accountability, transparency, and improvements of government programs and operations.”

Internal controls are designed to protect a local government from loss or misuse of its assets and to protect against public sensitivity risk. Sound internal controls help ensure that transactions are properly authorized and that the information contained in financial reports is reliable. Internal controls aid the organization in providing reasonable assurance that it will reach its objectives and prevent and/or detect fraud. My audits indicate that the opportunity for fraud, waste and abuse is possible. With weak internal controls you may not even know it is taking place. The Fraud Triangle consists of Incentive, Opportunity and Rationalization. If the city intends to stop Fraud it must stop the Opportunity. Preventing the Opportunity requires a good internal control structure.

The latest Association of Local Government Auditors Benchmarking Survey indicated that the Evaluation of Internal Controls had the highest task percentage for 92 respondent audit shops. 95% of the respondents stated they evaluated internal controls. The second highest was Compliance.

Internal controls must be built into the process or system upon commencement of that process or system. Therefore, the cost of internal controls must be factored into the total costs of the process or system.

Before the Internal Audit department came into existence there was no function at League City that examined internal controls. The result has been audits that have reflected weaknesses in Internal Controls.

#### City Attorney Audit – In-house or Outsource

Objective – The objective of this audit was to determine if there is an advantage of proceeding with an In-house City Attorney vs. continuing the current practice of Outsourcing the function.

Evaluation – Compared going-away costs to coming-in costs of a fully-costed established legal office of a comparative city. Discussed quantitative and qualitative aspects to decision. Demonstrated how variable costs and fixed costs enter into the decision.

Overall Conclusion – All comp cities show numerous attorneys and staff personnel necessary to fill a fully functioning Legal Department. In fact, the outsourced Ross Banks firm used 5-6 attorneys to provide legal service to League City. Also, Gregg & Gregg used more than 1 attorney to provide legal services to League City. Taking into consideration variable and fixed costs, quantitatively speaking the variable approach is advantageous by \$114,000 at this time; however, that may not continue in the future. Qualitative issues were the potential reluctance on the part of employees to seek legal assistance and the availability of the outsourced City Attorney. The city needs to have a process in place to identify and accumulate outputs/outcomes from whoever the City Attorney is.

Action Taken - Council will be bringing two In-House Attorneys and one-half support person into the creation of a Legal Department.

#### Inventory Controls for Water and Sanitary Sewer Line Repairs

Objective – The objective of this audit is to determine if accountability exists for the inventory assets.

Evaluation – Inquired with Management regarding general accountability over the Line Repair Inventory, segregation of duties, documentation, safeguarding of assets and reporting requirements. Observed the premises where the inventory is stored to include the small tools inventory. Calculated the approximate value of purchases for FY11, 12 and 13.

Recommendations – Significant deficiencies found for Inventory Controls in this area. I provided a 10-point program for significant improvements. They are as follows:

- No one is accountable for the Line Repair inventory
- Organize the inventory
- Take a physical inventory
- Implement proper recordkeeping of the inventory

- Update the Comprehensive Annual Financial Report with the physical inventory
- **Access to the inventory should be controlled access only**
- Segregation of duties needs to be improved
- No one is accountable for the Small Tools Inventory
- The video cameras need to be functional
- Create policies and procedures

Action Taken: This audit brought out the fact that there is a systemic issue with other departments having the same issue. **Internal controls were not built into the process at the beginning of this program.** Follow-up to be completed in FY15.

#### Procurement Card Audit

##### Objectives –

- Determine if general controls for the P-card program are designed appropriately and operating effectively
- Through data analysis, determine if the P-card program has any lapses in internal control that may cause fraud, waste, abuse or non-compliance with State Law and local policies and procedures

Evaluation – As of the audit, the city had 207 cards being used with a total spend of \$5,571,510. The rebate is \$88,882 in FY13. There was a total of 14,642 transactions with an average spend of \$381. A thorough review was done of the P-Card program

##### Recommendations – The major findings are as follows:

- Monthly Reviewers time must be reallocated
- Update Policies and Procedures and the Prohibited MCC's
- New department rep training and annual refresher training
- P-Card Limits must be adjusted
- **Use the city's large purchasing power to leverage for discounts from various vendors**
- Review the proper account coding for capitalized items
- Do away with departmental cards and emergency cards
- Require the proper documentation for sole source and emergency purchases or eliminate those purchases from the p-card program
- Require cardholders to get the required amount of quotes
- Require IT to go through Purchasing
- Require all IT purchases to go through IT
- Create a monitoring mechanism that checks monthly for the \$50,000 threshold and explain in the Policies
- Verify the accuracy of the rebate
- Ensure the city has the latest amendment in its possession

- **Consider a Single Use Account free analysis to determine if that payment system would be advantageous to the City.**

Action Taken: Follow-up to be completed in FY15

#### Contract Administration Audit

Objective – Evaluate the process and determine if accountability is in place

Subobjectives – Determine if general controls are sufficient and appropriate

Verify compliance with Big League Dreams Contract

Evaluation – Sampled 36 contracts in 14 different departments. At the time of the audit there was no complete population of contracts in the city.

Recommendations – The major findings are as follows:

- Create a more comprehensive contract policy manual
- Provide training on the new policy manual
- **Proper initial review of Contracts by the City Attorney and Purchasing**
- **Assign Accountability, Put the Guidelines in place and provide Training for the responsible parties**
- Use the Central Repository which is Laserfiche
- Revisit the laws that affect 4B Industrial Development Corporations
  - Training for the City official
  - Consideration for Parks and Finance’s work on the 4B
  - Federal tax exemption
- **Put limits on the duration of automatic renewals**
- **Big League Dreams General Liability Coverage is \$1,000,000 short**

Action Taken: Follow-up to be completed in FY15

#### Capital Improvement Program – Project Delivery Audit

Objective – Determine if the process is as efficient and effective as it can be.

Evaluation – This audit came down to determining if the city has the means to determine if project delivery is efficient and effective.

Recommendations – The city’s reporting system for the CIP actual vs. budget dollars is in place and working effectively.

The city’s reporting system for the CIP actual schedule vs. budget schedule needs improvement along with linking schedule with cost. The major findings are as follows: These findings deal with additions to the Project Manual and the eventual implementation.

- Incorporate a Lessons Learned Section
- Keep a past history on Contractors
- Document a Risk Assessment for each project
- Incorporate Project Manager Performance Measures
- **Incorporate a reporting requirement that links budget with schedule such as Earned Value Analysis**
- Provide training to all Project Managers on the Project Manual
- Schedule variances could be part of the lessons learned
- Keep the CIP spreadsheet updated

Action Taken: Follow-up will be completed in FY16.

A total of 43 recommendations were made from four audits.