

2003-2004 SANTA CLARA COUNTY CIVIL GRAND JURY

INQUIRY INTO FINANCIAL AND PERFORMANCE AUDITS FOR THE COUNTY AND CITIES IN THE COUNTY

Summary

The Santa Clara County Civil Grand Jury (Grand Jury) reviewed the auditing practices of city and county governments in Santa Clara County (County). It found that the City of San Jose (San Jose), the County, and to a lesser extent, several other cities in the county make effective use of financial and performance audits to save money and to increase service and efficiency. Several cities have no formal auditing program and may be passing up savings and efficiency improvements.

Background

All government jurisdictions in the state are required to have an annual financial audit, often summarized in a lengthy document called a Comprehensive Annual Financial Report (CAFR). In addition, most of the government entities within the County routinely commission audits of the operations of departments within their organizations. These audits probe in greater depth and in more detail into the operations of the audited departments than do the annual financial audits. They may be done by an internal auditing division or contracted to an external agency. The audits may focus on either or both the financial and management performance of the organization.

The Grand Jury surveyed the fourteen municipalities listed in Appendix A regarding their past use of audits. It was found that over the last three years, seven cities regularly used external audits to assess government functions. Three had less extensive programs and four had no audits beyond the CAFR.

The City of San Jose has the most extensive internal auditing program in the County and provides an effective example to emulate. It is managed by the Office of the City Auditor (City Auditor), reporting to the City Council. Section 805 of the San Jose Charter outlines the City Auditor's primary duties:

- Conduct or cause to be conducted annual post audits of all the City's fiscal transactions and accounts kept by or for the City, including the examination and analysis of fiscal procedures and the examination, checking, and verification of accounts and expenditures;

- Conduct performance audits, as assigned by the City Council, to determine whether (1) City resources are being used in an economical, effective, and efficient manner; (2) established objectives are being met; and (3) desired results are being achieved;
- Conduct special audits and investigations as assigned by the City Council;
- Submit a monthly report to the City Council of the City Auditor's activities, findings, and recommendations to improve the administration of the City's fiscal affairs; and
- Perform other such auditing functions consistent with the City Charter and submit reports as required.

As part of a comprehensive audit system, the City Auditor states that:

“Determining which areas to audit and allocating scarce audit resources to those areas is the key to a successful internal audit function. To assess the relative importance of potential audit subjects, the City Auditor prepares an annual risk assessment model of the City's budgeted programs and revenue sources. For each of 300 specific budgeted programs or revenue sources, the model compares the following factors:

- proposed expenditures
- estimated revenues
- fund type
- capital expenditures
- three-year revenue trend
- number of staff
- estimated beginning fund balance
- value of fixed assets
- date of audit request
- date of last audit

For each specific budgeted program or revenue source, the model scores each of the above factors from 0 through 10 based on a series of tables the City Auditor designed. In addition, the City Auditor weights each of the above factors from 1 to 5 according to their relative importance to produce a weighted score for each budgeted program or revenue source. The model then sorts these weighted scores from highest to lowest and recommends that the City Council Finance Committee include in the City Auditor's Annual Audit Workplan those budgeted programs or revenue sources with the highest weighted scores. Because the City Auditor applies this scoring system evenly across the entire citywide organization, it promotes a sense of fairness to auditees and helps ensure that audit resources will be focused on those areas with the highest audit potential.”

During 2003, the office issued nine reports. The City Auditor's principal objective is to identify \$4 in savings (or increased revenues) for every \$1 of audit cost. For the last four years, the office

identified approximately \$10 in savings for every \$1 spent on the auditing function. As an essential aspect of the audit system, the City Auditor prepares a quarterly follow-up report on the status of all those audit recommendations that the San Jose City Council has approved but which remain unimplemented.

The most striking example of a successful audit was one on the vehicle replacement process of the Fleet Management Division of the General Services Department. The audit led to reduced vehicle purchases and saved San Jose from planned spending of \$11 million. In addition, the audit identified projected savings for the following two years that approached \$20 million. Vehicles were being purchased before they were needed and sitting idle because of a process that lacked feedback, communication, and the proper checks. The recommendations from the audit were to fix the process so that the system would use San Jose funds efficiently.

The other government entity which has a wide-ranging audit program is the County. It performs approximately a dozen audits per year under the management of the Internal Audits Division, which does most of the financial audits. The majority of the performance (or management) audits are performed by the Harvey M. Rose Accountancy Corp., an external auditor that is very familiar with County operations through years of working together. By having both internal and external auditors, the County follows an auditing best practice of changing auditors periodically.

Discussion

One of the functions of the Civil Grand Jury is to investigate government operations to ensure that they are operating efficiently and effectively. On a routine basis, the Grand Jury finds that that role is performed best by a disciplined auditing program administered by the government organization itself. The Grand Jury can then monitor those ongoing processes and focus its effort on deficiencies and failures, especially in those areas initiated by citizen complaints.

The Grand Jury reviewed several dozen audits and selected five of them for greater scrutiny. Those five had recommendations that could prevent significant losses, generate additional revenue, or provide substantial cost savings. The Grand Jury found that, in general, the follow-up actions in response to the recommendations were timely, complete, and professionally administered.

Two audits performed by the City Auditor indicated a need in the San Jose General Services Department (GSD) for a more active review of the resources GSD controls. Both the Facilities Management Division and the Fleet Management Division are managed by GSD and lacked adequate policies and procedures for the periodic review of their performance, as well as a program for timely corrective action. In both cases, GSD management has not only embraced an active, positive response to the audit findings, but has moved towards doing its own internal audits.

Follow-up to a San Jose Facilities Management Division Performance Audit

A report of an audit of the Facilities Management Division by the City Auditor found that the division “lacked adequate and documented procedures and controls in all three work sections.” Following the City Auditor’s Risk and Vulnerability Assessment process, 53 specific threats (unwanted events or occurrences usually involving non-compliance or abuse of a law, regulation, contract, or policy) were identified. Recommendations for the corrective process included:

- Develop a procedures manual to formally document procedures.
- Continuously develop controls and procedures to address operational threats as they arise.
- Use the procedures manual to advise and train current and new staff.
- Institute management oversight to ensure compliance with the new procedures.

Appendices to the audit gave specifics for threat details, cost-benefit analysis, procedural development, and identified priorities.

The director of the GSD responded in writing promptly and positively to the audit, making a commitment to implement all of the recommendations. The Grand Jury reviewed the new “Procedures Manual” and the performance measures, and noted satisfactory results through the first quarter of fiscal year 2003-2004. In discussions with the Grand Jury, the GSD director repeated the department’s commitment to continue the improvements, along with an additional intent to increase oversight via an internal GSD audit program.

Follow-up to a San Jose Fleet Management Division Performance Audit

Metered equipment (such as construction equipment that has a built-in meter to monitor hours of use) in San Jose is the responsibility of the Fleet Management Division. The City Auditor found that San Jose’s metered equipment was not being used efficiently, but if used in a cost-effective manner could result in a \$3.5 million economic benefit. The scope of the audit included the vehicle leasing and usage policies for all San Jose departments (from backhoes to even the scooters used at the Environmental Water Pollution Plant), and equipment maintenance and replacement.

The audit found that excess equipment was being purchased and maintained because the Fleet Management Division was meeting the needs for various San Jose departments individually rather than sharing equipment among departments. Audit recommendations included:

- Designate the Fleet Management Division as the administrator for all metered equipment.
- Develop and consistently implement utilization standards.
- Ensure development of a complete and current inventory of equipment.
- Conduct frequent utilization assessments for redeployment, retirement, or pool inclusion.
- Develop a proposal to establish a city pool of metered equipment.
- Establish a low-use metered equipment pool, together with policy and procedures.

Again, the director of GSD responded promptly and positively to this audit, making a written commitment to implement all of the recommendations and reiterated the department's intent to develop and implement an internal GSD audit program. The Grand Jury found that the division was making progress in implementing its new stated goal to ensure that metered equipment on hand was "sized to meet needs" as opposed to either falling short or exceeding the quantity required. It is working toward a community pool of equipment by consolidating various departmental needs.

Follow-up to a County Department of Planning and Development Custody Audit

Whenever there is a change in the manager of a County organization that has responsibility for County funds, an internal custody (financial) audit is performed to assure both the out-going and the in-coming manager that there are no account discrepancies. In addition, the audit provides an opportunity to assess the processes and procedures in place for handling resources and to recommend any needed improvements.

The "Custody Audit – Part II Internal Control Report" for the County Department of Planning and Development provides an excellent example of the benefits of that kind of audit. The County Environmental Resources Agency (ERA) Administration is responsible for four departments: Planning and Development, Agriculture and Resource Management, Environmental Health, and Parks and Recreation. On March 27, 2003, the County auditor issued a report with 11 findings and 53 recommendations. None of the findings or recommendations were cause for serious concern, yet each of the recommendations would make ERA a more effective organization. By March 2004, 38 of the recommendations had been satisfactorily completed, 7 required information technology (IT) support, 5 still needed updated policies and procedures to be written, and 3 required County counsel action.

The issue involving these last three is a good example of the type of problem and possible benefit that can result from this kind of audit. The finding was "Development Services should establish policies and procedures to increase recovery of costs associated with code enforcement." (For a similar problem, see the 2003-2004 Grand Jury report entitled "Inquiry into the City of Palo Alto's Code Enforcement Process.") The Office of the County Counsel is drafting ordinance amendments that may address the recommendations:

- Record a code enforcement lien for any unpaid costs.
- Work with County Counsel to consider an ordinance that designates uncollected code violation fees as special assessments to be included in the property tax bill.
- Work with County Counsel to consider a revision to the County Ordinance to change a building code violation to a misdemeanor instead of the current charge of an infraction. The misdemeanor penalties allow much higher fines than those allowable for an infraction.

Follow-up to a County Facilities Department Capital Programs Performance Audit

A management (performance) audit was completed January 14, 2002, entitled "Management Audit of the Facilities Department Capital Programs Division of the General Services Agency." The Acting Director of the County General Services Agency (GSA) stated that "This audit was a very useful tool for improving the operations of the GSA Facilities Capital Program." The audit contained 12 findings and 46 recommendations. As of January 15, 2004, most (35) of those recommendations had been implemented or were awaiting approval by the County Board of Supervisors. Of the 11 remaining recommendations, 9 required revised policies and procedures and were in the process of being changed, one required IT support, and 1 required County counsel to revise an ordinance.

Several of the recommendations by the auditor were listed as "Priority 1", a category described as "if not corrected could lead to significant financial loss." An example of such a recommendation is: "The Board should have an independent reconciliation of project accounts to Board appropriations performed by a certified public accountant." That recommendation has been accepted and implemented.

The advantage to even well-functioning organizations of outside audits is that methods of operation which are accepted as standard procedures are reviewed critically from an external and independent, uninvolved perspective. The fact that most recommendations are quickly and enthusiastically accepted indicates both the need for the audit and the willingness of an organization to make itself ever better.

County Treasury Balances Audit

The County manages a \$3.3 billion pool of money for various entities in the County with nearly a thousand different sub-accounts. As tax monies are collected, they are placed in a sub-account before being allocated to the appropriate entity. The reserve and working funds for school districts and County government operations, including Valley Medical Center are kept in the pool. Money received as part of authorized bond sales but not yet spent are also collected together and invested as part of the total assets. Some funds are not expected to be required in the near future and are invested separately in longer term investments, but most are required to be available for current expenditures. Still, by pooling together all the funds to smooth out the cash flow fluctuations, the commingled investments can be invested within formal guidelines and restrictions for a longer duration and achieve interest rates equivalent to a 2-year U.S. Treasury bill instead of the less than 1% rates available at present for demand deposits.

The majority of the sub-accounts, as well as most of the funds (~75%), are the resources of school districts. The County had 343 trusts accounts with cash balances of \$644 million at the end of 2001. The County has been conservative financially in past years, building reserves greater than required by more aggressive accounting standards. In spite of depressed economic activity during the past several years, the pool account has not diminished as much as might be expected. In part that is because funds in one trust account often can not be diverted for other activities or to the County general fund for ordinary expenditures. An audit dated June 27, 2002,

identified several trust accounts which could appropriately be closed, freeing the funds but only for \$4 million.

Under contract to the County, the Harvey M. Rose Accountancy Corp. submitted an “Analysis of County Reserves, Fund Balances And Other Funding Issues Related to the FY 2003-2004 Budget.” Under pressure of projected budget cuts for this fiscal year and the next, the audit was more aggressive in identifying reserve funds that could be used for general County expenses, either by closing accounts or by reducing reserves exceeding minimum requirements. For instance, the counties of Los Angeles and San Francisco pay their workers compensation claims on a current basis rather than setting aside reserves for future liabilities as does the County. Including reserves for a liability self-insurance fund, the audit identified \$72 million that could be removed from reserves using more aggressive accounting. The Finance and Government Operations Committee recommendation was more conservative: move only \$8.7 million to the general fund.

If the County accepted all the measures suggested by the audit as acceptable accounting, as well as some budget cuts and revenue improvement actions, approximately \$245 million could be added to the general fund budget. The County has chosen a more aggressive accounting stance to the extent of transferring ~ \$50 million to fiscal years 2003-04 and 2004-05 budgets.

A number of the reserve transfers were overdue since the reserve accounts had been dormant for a decade, no longer had a function, or were otherwise obsolete. Those monies were not serving the public and transferring them to the County general fund would allow them to contribute to the local economy while preserving some County services and spending.

Conclusion

Financial and performance audits are a proven means of reducing risk, saving money, and improving efficiency in city and county government operations. San Jose and the County have formal and extensive auditing programs that have more than paid for the costs of the audits. Several other cities in the County have less extensive programs, and a few have no formal program. Since both the costs and the savings of an auditing program should scale proportionately, the Grand Jury recommends that all municipalities perform appropriate financial and performance audits.

Finding I

The City of San Jose and the County of Santa Clara make effective use of internal and external financial and performance audits to improve the functioning of their government operations. Both were found to be diligent in following up on the findings and recommendations of the audits.

Recommendation I

None.

Finding II

The Office of the City Auditor of San Jose makes effective use of a risk analysis to focus audits on the most vulnerable areas of government operations and those functions with the potential for greatest savings.

Recommendation II-A

All municipalities in the County should consider performing and annually updating a formal risk analysis of their operations similar to that done by San Jose.

Recommendation II-B

Municipalities in the County should consider performing internal or external audits of the most vulnerable operations identified in a risk analysis.

Finding III

Several cities in the County do not have financial and performance management auditing programs.

Recommendation III

Municipalities in the County without auditing programs should consider using local external auditors such as the City Auditor, via a contract, or the County's external auditor to perform audits if an internal auditor is not cost-effective.

PASSED and **ADOPTED** by the Santa Clara County Civil Grand Jury on this 13th day of May 2004.

Richard H. Woodward
Foreperson

Appendix A

Number of Municipal Financial and Performance Audits Completed (in addition to the required external financial audit/CAFR)

Municipality	2001-2	2002-3	2003-4	Comments
City of Campbell	0	0	0	
City of Cupertino	0	0	0	
City of Gilroy	3	3	1	IF, IP, EP
City of Los Altos	1-2	1-2	3-5	IF, EP
Town of Los Altos Hills	0	1-2	1-2	EP
Town of Los Gatos	0	0	1	EP, CIM
City of Milpitas	0	0	0	
City of Monte Sereno	1	1	1	IF
City of Morgan Hill	3-5	3-5	3-5	EF, IP, EP
City of Mountain View	3-5	>5	>5	IF, EF, EP
City of Palo Alto	3-5	3-5	3-5	EF, IP
City of Santa Clara	0	5	0	EP
City of Saratoga	0	0	0	
City of Sunnyvale	>5	>5	>5	EF, IP, EP

Legend:

- IF** – internal financial,
- EF** – external financial,
- IP** – internal performance,
- EP** – external performance
- CIM** – uses continuous improvement methodology

References

Documents

“An Audit of the Fleet Management Division of the General Services Department's Vehicle Replacement Program,” City Audit dated February 7, 2003.

“Analysis of County Reserves, Fund Balance And Other Funding Issues Related to the FY2003-2004 Budget,” Harvey M. Rose Accountancy Corp. Financial Audit, June 12, 2003.

“Custody Audit – Part II Internal Control Report,” County Audit dated March 27, 2003.

“Management Audit of the Facilities Department Capital Programs Division of the General Services Agency,” County Audit dated January 14, 2002.

Letter from the Acting Director of the General Services Agency, January 15, 2004.

Letter from the Director of the Environmental Resources Agency, March 5, 2004.

Management Audit of the Controller-Treasurer Department of the Finance Agency, June 27, 2002.

Office of the City Auditor website: <http://www.ci.san-jose.ca.us/auditor/www.shtml>.

Report Number 03-08, “An Audit of the Facilities Management Division of the General Services Department,” August 2003.

Report Number 03-11, “An Audit of the Utilization and Replacement of the City’s Metered Equipment,” January 2004.

Interviews

Interview with San Jose City Auditor, September 4, 2003.

Meeting with the GSD Director and Facilities Management Division staff, November 20, 2003.

Meeting with the GSD Director and Fleet Management Division staff, April 15, 2004.