

# OFFICE OF THE CITY AUDITOR

## REVIEW OF DEPARTMENTAL ANNUAL INTERNAL CONTROL SELF EVALUATION



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**December 23, 2005**

## Memorandum



CITY OF DALLAS

December 23, 2005

Honorable Mayor and Members of the City Council  
City of Dallas

We have performed a review of City Departments Annual Internal Control Self Evaluation. Our review covered the period from September 30, 2002, to September 30, 2004. This review was conducted under the authority of Chapter IX, Section 2 of the Dallas City Charter and in accordance with the Annual Audit Plan approved by City Council.

We determined that City departments do not adhere to the internal control policy, reporting and self-evaluation steps outlined in Administrative Directive 4-9. The annual internal control self-evaluation is not identifying significant internal control issues found in subsequent audits and there is no procedure in place for the Office of Financial Services to monitor department's vulnerability rankings to ensure that all risk related functions have been examined.

We appreciate the cooperation shown by staff during our audit.

Paul T. Garner  
Assistant City Auditor

c: Mary K. Suhm, City Manager

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**REVIEW OF DEPARTMENTAL ANNUAL INTERNAL CONTROL SELF  
EVALUATION**

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## **INTRODUCTION**

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### **Authorization**

We conducted a review of compliance with the City's policies and procedures for departmental self-evaluations of internal controls (ICR) as required by Council resolution 88-3428 and Administrative Directive (AD) 4-9. This review was conducted under the authority of Chapter IX, Section 2 of the Dallas City Charter and in accordance with the Annual Audit Plan approved by the City Council.

### **Scope and Methodology**

Our review was conducted in accordance with generally accepted government auditing standards and, accordingly, included tests of the accounting records and other review procedures that we considered necessary in the circumstances.

A review is substantially less in scope than an audit. A review consists principally of inquiries and analytical procedure.

Our review included all departmental internal self-evaluation reports submitted to the City Manager for the time period September 30, 2002 to September 30, 2004. We identified 28 departments that are required to submit the internal control self evaluation report and selected for our review the Police, Water Utilities, Sanitation departments and Office of Financial Services – Controller's Division (OFS). Our review was limited to the Internal Control weaknesses identified by these departments.

The objectives of our review were to determine whether Department Directors:

1. Complied with Administrative Directive (AD) 4-9 by reviewing and evaluating internal controls and submitting the required annual report ; and
2. Have taken action to correct deficiencies identified via their Internal Control Self Evaluation.

We developed an understanding of relevant internal control structure policies and procedures through:

- Interviewing of management and staff;
- Reviewing statements of policies and procedures;
- Examining documents prepared during the departmental reviews;
- Reviewing department directors' reports to the City Manager and the CAO;
- Reviewing 23 audit reports issued by the CAO and
- Reviewing four management reports issued by KPMG the external auditors.

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## INTRODUCTION

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### Overall Conclusion

Departments do not adhere to the internal control policy, reporting and self-evaluation steps outlined in AD 4-9. The annual internal control self-evaluation is not identifying internal control issues found in subsequent audits and therefore not effective. There is no procedure in place for the OFS to monitor department's vulnerability rankings and /or ensure that all risk related functions have been examined.

### Background

Internal control is broadly defined as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the following:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

The first category addresses an entity's basic business objectives, including performance goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements. The third deals with complying with those laws and regulations to which the entity is subject. These are distinct but overlapping categories

The City's policy of establishing and maintaining a system of internal controls is designed to ensure that:

- The use of its resources is consistent with laws, regulations, and policies;
- Its resources are safeguarded against waste, loss, and misuse; and
- Reliable data are obtained, maintained, and fairly disclosed in reports.

In order to promote that policy and to determine compliance with the federal standards established in the Federal Manager's Financial Integrity Act, the City Manager has promulgated policies and procedures requiring each department to evaluate its system of internal accounting and administrative controls. Those policies and procedures are in AD 4-9. This AD specifies procedures for:

- Reviewing the adequacy and effectiveness of internal accounting and administrative controls in departmental programs and functions.
- Preparing a report on the status of the department's system of internal accounting and administrative controls; and
- Assessing the current status of prior audit recommendations.

## INTRODUCTION

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Directors of each department are responsible for:

- Establishing and documenting internal control procedures specific to their departments' operations;
- Ensuring compliance with the established procedures;
- Modifying those procedures to address changes in the way their departments operate;
- Evaluating their internal control procedures using the AD's guidelines; and
- Reporting annually on November 1<sup>st</sup>, to the City Manager and City Auditor on whether their departments' systems of internal controls comply with the objectives established in Council Resolution 88-3428.

Directors' must report identified control weaknesses found and describe plans to correct them.

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## OPPORTUNITIES FOR IMPROVEMENT

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We identified certain policies, procedures, and practices that departments need to improve. Our review was not designed or intended to be a detailed study of every relevant system, procedure, and transaction. Accordingly, the opportunities for improvements presented in this report may not be comprehensive of the areas where improvements may be needed.

### **1. Compiled vulnerability assessments are not being used to assess risk across the City departments.**

Internal control self-evaluation reports (ICR) are required to be submitted by departments to OFS. OFS has traditionally received the departmental ICRs without compiling them into a composite report and developing a citywide risk model. A risk model is a management-planning tool that could assist the City Manager's Office, at an early stage in the City's budget process, to determine what compensating controls are needed to mitigate the City's risk. An annual risk model and composite report would also assist management in identifying the trends of those risks pertaining to City operations.

The U.S. Government Accountability Office (GAO) standards for internal control emphasizes the role of management to provide a systematic, organized, structured approach to assessing the internal control structure. These standards stress the need to continually assess and evaluate the internal control structure that it is well designed and operated, appropriately updated to meet changing conditions. Specifically the current pronouncements of Statements on Auditing Standards (SAS) outlines the role of management to examine internal control to determine how well it is performing, how it may be improved, and the degree to which it helps identify and address major risks for fraud, waste, abuse, and mismanagement.

### **We recommend the Director of the Office of Financial Services:**

Revise AD 4-9 to annually:

- Prepare a composite report of the departments ICRs to the City Council, City Manager's Office and the City Auditor's Office for review,
- Develop and update a city-wide risk model based upon the ICRs; and
- Assess what compensating controls are needed for the identified risks.

### **Management's Response:**

Management does not agree with these recommendations.

A. Given the number functions performed by many Departments, the development of a composite report of all Department Internal Control Self Evaluations would be a significant undertaking. This report would require additional resources to manage and may not yield material benefits. Examples include:

## **OPPORTUNITIES FOR IMPROVEMENT**

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- Dallas Water Utilities, a relatively large department, has approximately 24 divisions with many divisions performing multiple vulnerability assessments. The estimated number of vulnerability assessments they would submit is approximately 180.
- Office of Financial Services, a relatively small department, would complete approximately 10 assessments.

The provision of a composite report of all Department Internal Control Self Evaluations is not required in the current Administrative Directive 4-9. It is the responsibility of the Department Director to evaluate the internal control procedures using guidelines established in this Directive and provide required annual reports stating whether their department's system of internal controls complies with objectives set forth in Council Resolution 883428.

The grand total of all assessments could be approximately 1,500 to 2,000 and a composite report of that magnitude would be difficult to develop and manage. It would likely be too large to provide meaningful information and findings.

Department Directors are more knowledgeable and in a better position to fully understand and assess the risks and controls needed to safeguard and insure our resources are in compliance with regulations, etc.

In view of the limited available resources to prepare a detailed composite report, we will take steps to train the department to monitor vulnerability assessments and understand the significance of the internal control reviews.

- B. The Office of Financial Services City Controller's Division agrees that training is important to the Internal Controls process and we will continue to provide training on this topic. Internal Controls training was offered from November 2004 through May 2005. Classes will also be provided in FY2005-06.

### **Auditor's Comments**

GASB pronouncements and the *Government Accounting, Auditing, and Financial Reporting* book published by the Government Finance Officer's Association impose increased responsibilities on the Office of Financial Services. The City Controller's Office, a component of OFS is responsible for designing and evaluating the effectiveness of the City's Internal Control system and disclosing significant deficiencies in its operation. The annual self-assessment reports allow OFS to review and determine if the risk to City resources are being mitigated.

The implementation of a composite report is not a reassessment of the departmental self-evaluations. It is a summary enabling OFS, the City Council, City Manager, and City Auditor the ability to be more effective and efficient when assessing the City's potential risk and what controls are being implemented to reduce the City's risk and liabilities.

## OPPORTUNITIES FOR IMPROVEMENT

### 2. The annual internal control self evaluation is not effective

The process of self evaluation is not identifying internal control issues found in subsequent audits. For fiscal years 2002, 2003 and 2004, the City Auditor issued 23 reports that identified internal control deficiencies of departments. For the same period, KPMG, the City's external auditors, issued management reports dealing with internal control weaknesses.

Our analysis revealed that 24 departments or 85% of departments submitting their self-evaluations did not address internal control weaknesses that CAO or KPMG identified nor did they address them in the subsequent reviews of self evaluation.

The following tables reflect some of the more significant control weaknesses identified by the CAO and KPMG.

#### CAO Reports

Fiscal Year	Department	Brief Description of weaknesses identified by:	
		CAO	Department's self evaluation
2003	CIS	Security issues over physical & logical data.	IC evaluation did not identify any of these weaknesses
2004	BDPS	Surplus store inventory weaknesses.	Self evaluation did not evaluate weaknesses identified by CAO
2004	Code Compliance	Lack of controls over revenue processing	Self evaluation did not evaluate weaknesses identified by CAO
2004	Park & Rec	Inadequate documentation of purchasing policies, procedures and animal food storage.	Self evaluation did not evaluate weaknesses identified by CAO
2005	EBS	Inadequate monitoring of issuing and usage of fuel Service Cards	Self evaluation did not evaluate weaknesses identified by CAO
2005	DDS	Lack of segregation of duties. Inadequate control over forms and receipts	Self evaluation did not evaluate weaknesses identified by CAO
2005	Aviation	Aviation department's property records do not account for leasehold improvements and leases are not standardized.	Self evaluation did not evaluate weaknesses identified by CAO

## OPPORTUNITIES FOR IMPROVEMENT

### KPMG Reports

<i>Fiscal Year</i>	<i>Department</i>	<i>Brief Description of weaknesses identified by:</i>	
		<i>KPMG</i>	<i>Department's self evaluation.</i>
2001	CCO	Bank Reconciliation differences were not reconciled. Fixed Assets not properly accounted for and safeguarded.	Department's self evaluation did not identify weaknesses
2002	CCO	Bank Reconciliation differences were not reconciled Fixed Assets not properly accounted for and safeguarded	Department's self evaluation did not identify weaknesses
2002	Human Resources	Inaccurate Payroll records resulting from lack of due diligence in requirement gathering phase of HRIS.	Department did not submit reports.
2003	CCO	Fixed Assets not properly accounted for and safeguarded	Department's self evaluation did not identify weaknesses

The process of self-assessment needs to be planned, organized and documented, and must include all potential risk related functions, followed up by trained staff at the beginning of a fiscal year.

Management has not adequately communicated to staff the importance of reliable annual self evaluation as a risk control mechanism. Awareness and understanding of internal controls is inadequate among employees responsible for self-evaluation of internal controls. Departments do not have adequately trained staff to perform internal control self- evaluation.

AD 4-9 requires departmental directors to periodically:

1. Evaluate internal controls to ensure compliance with policies, standards and procedures established by the City for proper control of its resources.
2. Ensure vulnerability assessments are performed by appropriate section/division managers and determine the relative potential for loss/negative impact in programs and functions.

Staff accountability is one of the five Key Focus Area priorities to concentrate City resources on critical challenges. A lack of management oversight and lapses in the periodic review of internal controls can result in increased risks to City resources and render ineffective the safeguards provided by an efficient system of controls.

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## **OPPORTUNITIES FOR IMPROVEMENT**

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We recommend the Director of the Office of Financial Services ensure that the process of self-assessment is planned, organized, documented, and include all potential risk related functions.

### **Management's Response:**

Management does not agree with this recommendation. The basis for the City Auditors comment cited examples of additional findings from the City Auditor's reviews and from the external auditors. Given the size and depth of functions performed in the City of Dallas, this in itself does not indicate a problem with the Internal Controls process.

The internal control process provides a useful structure for Departments in evaluating risks, processes and procedures. However, it is not the only process used by Departments for this purpose. Others include the annual budget process, the performance management system, and the employee performance appraisal system. In addition, the City Manager assigns special projects annually which result in an in-depth review of programs, processes, and systems with the specific intent to make improvements, including internal control improvements. FY2004-05 examples include consolidated collections and upgrade of the City's financial system which required very detailed review of business practices, controls etc. Projects are also scheduled in FY2005-06.

Again, Department Directors are more knowledgeable and in a better position to fully understand and assess the risks and controls needed to safeguard and insure our resources are in compliance with regulations, etc.

### **Auditor's Comments:**

The annual Internal Control Self Evaluation is independent of the other control mechanisms mentioned in management's response. Administrative Directive 4-9 makes the annual self-evaluation a monitoring tool in assessing controls weaknesses and risk, the other mechanisms addressed by management supplement the evaluation and any identified weakness should be reported in the self-evaluation annual report.

### **3. Some departments do not comply with the reporting requirement of AD 4-9.**

Based on the Internal Control Reviews submitted for fiscal years 2002, 2003 and 2004, we identified a trend where departments did not comply with the November 1<sup>st</sup> deadline to file the statement with the City Manager's office.

A. For the fiscal year ended September 30, 2002,

## **OPPORTUNITIES FOR IMPROVEMENT**

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- 12 departments did not submit an annual report.
- 8 departments submitted an annual report after November 2002.
  - 4 were submitted in April 2003
  - 1 was submitted in May 2003
  - 3 were submitted in June 2003

### B. For the fiscal year ended September 30, 2003

- 8 departments did not submit an annual report.
- 8 departments submitted an annual report after November 2003.
  - 4 were submitted in December 2003
  - 4 were submitted in April 2004.

### C. For the fiscal year ended September 30, 2004

- 9 departments submitted an annual report after November 2004.
- 12 departments did not submit an annual report.

The process of self-evaluation, prescribed by AD 4-9, requires that a vulnerability assessment be conducted. In the absence of such vulnerability assessments, we concluded that these departments have not filed the Internal Control Review statement as prescribed by AD 4-9.

AD 4-9 provides generalized policy and procedural guidance for the departmental internal control self-evaluations. Lack of an adequate system of internal control can affect an entity's performance and profitability and result in a loss of resources. It also impacts the reliability of financial reporting and compliance with laws and regulations and damages management's reputation.

We recommend that the Director of the Office of Financial Services implement procedures to ensure compliance with the deadline to file the annual statement with the City Manager.

### **Management's Response:**

Management agrees. Some Departments have not complied with the reporting requirement of AD 4-9. However, departments may have performed internal control self-assessments and tested controls without reporting formally to the City Manager.

As AD 4-9 is specific in requiring a written statement of compliance with the AD, the Director of Office of Financial Services will provide an annual reminder to Department Directors to reinforce the importance of this requirement. The City Controller will report to the City Manager all departments not complying with the reporting requirements of AD 4-9 in November 2005.