



## CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

July 19, 2005

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

### Auditor's Office Quarterly Report

#### 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.

#### 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, 2005.

We issued the following reports to the City Council since our last status report in April 2005

- Informational report on Palo Alto sales tax (May 2005)
- Review of SAP controls over accounts payable (attached)
- Results of Police property and evidence rooms inventory (attached)

Our revenue audits continue to yield benefits to the General Fund. The City received **\$232,895** during the fiscal year as a result of our in-house and contracted audits (our goal is \$235,000 in audit recoveries). This only includes cash received to date, and does not include audit findings that were assessed but have not yet been collected. Nor does it include estimated audit findings that are still in dispute (including utility users tax owed by AT&T Wireless and Verizon).

The National Association of Local Government Auditors awarded us the Special Project Award 2004 for best special project in the small audit shop category for our *Review of the Environmental Services Center Proposal*. In June, I traveled to the Association's annual conference in Milwaukee, Wisconsin, to accept the award and present a summary of the report to delegates from local government audit shops from around the U.S. and Canada.

In addition, the Association of Government Accountants (AGA) has awarded the Certificate of Achievement in Service Efforts and Accomplishments Reporting to our *Service Efforts and Accomplishments Report 2003-04*. Attainment of the certificate represents a significant accomplishment by a state or local government entity.

Sathvik Tantry, a Palo Alto resident and student at the Wharton School, University of Pennsylvania, is our summer intern for 2005. Sathvik is assisting with our Audit of Street Maintenance.

The following projects are in process (with target completion dates):

- Audit of cable franchise fees and customer service provisions (August 2005)
- Audit of parks maintenance (Fall 2005)

- Audit of street maintenance (Fall 2005)
- Police department survey (Summer 2005)
- Review of police building proposal (August 2005)
- Audits of sales, property, documentary transfer tax, and utility users tax revenues (on-going)

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. I would particularly like to thank Josie Stokes and Joe Saccio of the Administrative Services Department, Jim Thompson of Tax Compliance Services, and Bronwen Lacey of the Strombotne Law Firm for their continuing determination to follow up on utility users tax audit findings.

Respectfully submitted,

Sharon W. Erickson  
City Auditor

Attachments: City Auditor Project Status as of June 30, 2005  
Results of Police Property and Evidence Rooms Inventory  
Review of SAP Controls Over Accounts Payable

## City Auditor Project Status as of June 30, 2005

Original Audit Project Description and Preliminary Objectives <sup>1</sup>	Status	Accomplishments Year-To-Date	Items to be Completed
<b>AUDIT ADMINISTRATION AND FOLLOW-UP PROJECTS</b>			
<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.	Completed	In Sep-2004, the City Council approved the FY 2004-05 Work Plan. Quarterly status reports issued Nov-2004, Jan-2005, Apr-2005, and Jun-2005. The next quarterly status report will be issued in Oct-2005.	
<b>2. Audit Recommendation Status Report</b> – The City Auditor issues an annual report on the status of recommendations from recently completed audits.	Completed	Report issued Sep-2004 summarizing the status of 131 recommendations including 84 new recommendations that were adopted this year and 47 outstanding recommendations after our last status report as of Jun-2003. The next annual status report will be completed in Sep-2005.	
<b>3. Auditor's Office Triennial Peer Review</b> – Government Auditing Standards (GAS) require audit organizations to have an external peer review at least once every three years. The National Association of Local Government Auditors coordinates a peer review program to help member organizations meet these standards.	Not started	We have scheduled our review for October 17-20, 2005.  In Jun-2005, Sr. Auditor Edwin Young participated in a peer review of Jackson County, Oregon; and in Jul-2005, Sr. Auditor Renata Falk will participate in a peer review of Portland, Oregon.	Target completion date: Nov-2005
<b>4. Other Responsibilities</b>  a. <i>Executive Staff</i> – To facilitate communication and coordination of efforts, the City Auditor attends the City Manager's weekly executive staff meetings.  b. <i>Utility Risk Oversight Committee (ROC)</i> – Since issuance of our <i>Assessment of Utility Risk Management Procedures</i> in Jul-2002, the City Auditor has acted as an advisor to the ROC.  c. <ADDED> Summer intern program	  On-going  On-going  Completed	       Summer intern 2004: Kate Murdock, recent UC Berkeley Goldman School of Public Policy graduate. Kate assisted with our audit of contract contingencies, and afterwards obtained an audit position with the City of Sunnyvale, before returning to the City of Palo Alto as a Management Specialist in the Human	

<sup>1</sup> Items marked <ADDED> were added subsequent to the adoption of the Auditor's FY 2004-05 Work Plan in Sep-2004.

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<p>d. &lt;ADDED&gt; Response to Grand Jury Inquiry into Financial and Performance Audits to the County and Cities in the County.</p> <p>e. &lt;ADDED&gt; Provide training for audit staff in the use of Audit Command Language (ACL) software.</p> <p>f. &lt;ADDED&gt; Taxicab permit application review.</p>	<p>Completed</p> <p>Completed</p> <p>Completed</p>	<p>Resources Department. Senior Auditor Renata Falk supervised Kate's work, and helped coordinate activities for the citywide summer intern program. Also of note, Pablo Federico, our summer intern from 2002, has been hired as an Audit Manager with the City of San Francisco Controller's Office.</p> <p>Summer intern 2005: Sathvik Tantry, a Palo Alto resident and student at the University of Pennsylvania, Wharton School, is assisting with our Audit of Street Maintenance.</p> <p>Response sent Aug-2004.</p> <p>In Sep-2004, the office coordinated a training session for 12 local government auditors in the use of the software.</p> <p>At the request of the Police Department, we reviewed the financial statements accompanying the application for a taxicab permit.</p>	
<b>REVENUE AUDITS</b>			
<p><b>5. Sales Tax Audits</b> – Sales tax represents about 15 percent, or \$18 million, of projected General Fund revenue for 2004-05. Effective March 2005 we are currently contracting with MMC Muniservices Companies 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. Audit results are reported in the Auditor's Office Quarterly Report. Sales tax information reports (provided by (MMC) are transmitted to the City Council on a quarterly basis (last one issued Jun 2005).</p>	On-going	<p>HdL Companies prepared quarterly sales tax reports for the City in Aug-2004 (regarding 1<sup>st</sup> quarter sales Jan-Mar 2004), Oct- 2004 (regarding 2<sup>nd</sup> quarter sales Apr-June 2004), and Jan-2005 (regarding 3<sup>rd</sup> quarter sales Jul-Sept 2004). MBIA MuniServices Company (MMC) prepared the quarterly sales tax report in May-2005 (regarding 4<sup>th</sup> quarter sales Oct-Dec-2004).</p> <p>In the first quarter FY 2004-05, the City received a total of <b>\$35,687</b> in sales tax recoveries related to misallocation of tax from 5 Palo Alto companies. This amount is the result of audits conducted by the City Auditor's Office and by HdL Companies. In addition, the City Auditor's office identified 3 potential</p>	<p>Audits are on-going</p> <p>Target date for next informational report: Jul-2005</p>

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		<p>misallocations from 3 separate companies.</p> <p>In the second quarter FY 2004-05, the City received a total of <b>\$38,721</b> in sales tax recoveries related to misallocation of tax from one Palo Alto company. This amount results from audits conducted by the City Auditor's Office. In addition, the City Auditor's Office identified possible misallocations from 3 new companies, and was following up with the State Board of Equalization (SBOE) regarding the status of the 3 potential misallocations reported in the first quarter.</p> <p>In the third quarter FY 2004-05, the City received <b>\$101,780</b> in sales tax recoveries related to misallocation of tax from 4 Palo Alto companies. This included \$16,441 identified by the City Auditor's Office, and \$85,339 identified by HdL. In addition, the City Auditor's Office identified 7 other potential misallocations, and is following up with the SBOE on the status of 3 outstanding items.</p> <p>In Mar-2005, after a request for proposal process, we selected MMC as our new property tax information and auditing service provider.</p> <p>In the fourth quarter FY 2004-05, the City Auditor's Office identified another 6 potential misallocations, and is following up with the SBOE regarding the status of 5 outstanding items from previous quarters; and MMC identified 2 new potential misallocations.</p> <p>Sales tax recoveries year-to-date: <b>\$176,188</b></p>	
<p><b>6. Property Tax Audits</b> – Property tax represents about 12 percent or \$13.6 million of projected General Fund revenue for 2004-05. We contract with HdL Companies for property tax auditing and information services. Audit services are designed to ensure that County assessment data for properties in Palo Alto are current and accurate. Audit results are reported in the Auditor's Office Quarterly Report.</p>	On-going	<p>In Oct-2004, HdL Companies conducted a review of unsecured property taxes for fiscal year 2004-05, and identified <b>\$1,867</b> in recoveries due from three parcels.</p> <p>In Mar-2005, after a request for proposal process, we selected MMC as our new property tax information and auditing service provider.</p> <p>Property Tax recoveries year-to-date: <b>\$1,867</b></p>	On-going

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<p><b>7. Documentary Transfer Tax</b> – The documentary transfer tax (approximately \$3 million annually) is a one-time tax that is levied when residential and commercial properties are sold. We contract with HdL Companies to test County data to ensure that transfer taxes are being properly applied and remitted timely.</p>	On-going	<p>During the first quarter, HdL Companies identified <b>\$1,375</b> in documentary transfer tax due from one missing transaction recorded to the wrong jurisdiction.</p> <p>In Mar-2005, after a request for proposal process, we selected MMC as our new property tax information and auditing service provider.</p> <p>Documentary Transfer Tax year-to-date: <b>\$1,375</b></p>	On-going
<p><b>8. Utility Users Tax (UUT)</b> – UUT is calculated at 5 percent of electricity, gas, water, and telephone service (generating about \$7.4 million annually). We contract with Tax Compliance Services to audit telecommunications companies' UUT remittances.</p>	In process	<p>Project started in Jul-2002. During FY 2003-04 the City collected \$102,351 as a result of the audits.</p> <p>In the first quarter of FY 2004-05, the City collected an additional <b>\$8,773</b> as a result of the audits, and filed a lawsuit against one company (Verizon) for failure to remit more than \$2.4 million over the last 10 years.</p> <p>In the second quarter, the City received <b>\$44,286</b> in payments from 2 telephone companies as a result of these audits.</p> <p>In Mar-2005, Judge Jacobs-May (Santa Clara County Superior Court) ruled Verizon must answer the charges against it.</p> <p>In the fourth quarter the City received an additional <b>\$405</b> in payments from 2 telephone companies.</p> <p>Several items are still pending. An additional \$24,177 has been assessed but not collected (ASD will be working with the Attorney's Office to collect those amounts), one appeal is still pending (AT&amp;T Wireless), and the city's \$2.4 million lawsuit against Verizon for failure to pay UUT is still pending.</p> <p>UUT recoveries year-to-date: <b>\$53,464</b></p>	On-going

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<b>9. Audit of Cable Franchise Agreement and Fees</b> – Contracted audit work provided by the Buske Group and funded by the JPA, with franchise fee audit work to be conducted by the City Auditor.	In Process	After some delay, Comcast provided the required documentation for our review. We completed our audit work, and issued a draft report to Comcast summarizing our findings. In accordance with the franchise agreement, Comcast has 30 days to respond.	Target completion date: Aug-2005
<b>FINANCIAL AUDITS AND PROCEDURAL REVIEWS</b>			
<b>10. 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. Target date for completion of the 6/30/04 audit: Dec-2004.	Completed	<p>Maze &amp; Associates completed their audit of the financial statements as of June 30, 2004. The Comprehensive Annual Financial Report (CAFR), related audited financial statements, and Management Letter were issued Dec-2004.</p> <p>After an RFP process, the City Council approved a new contract with Maze &amp; Associates in Apr-2005. Maze &amp; Associates began their interim audit work in preparation for the audit of the June 30, 2005 financial statements in Apr-2005.</p>	
<b>11. Reviews of Financial Procedures and Controls</b> – The Municipal Code outlines the City Auditor's role in reviewing the financial and accounting procedures of the City. As time allows, we provide requested assistance in these areas and, where possible, help departments develop their own control self-assessment programs. Projects include: <ul style="list-style-type: none"> <li>a. <i>Controls Review of SAP</i> – The Auditor's Office will continue to monitor the implementation of SAP and provide advice to ASD on the adequacy of controls in the new system.</li> <li>b. <i>Cash Controls</i> – Pursuant to a request from the Finance Committee last year, the City's external auditor, Maze and Associates, is reviewing the Golf Professional's cash handling procedures as part of the annual external audit.</li> <li>c. <i>Audit of the police investigative fund</i> – Pursuant to Police Department procedures, the Auditor's Office conducts a surprise review on an annual basis.</li> </ul>	<p>On going</p> <p>Completed</p> <p>Completed</p>	<p>We have completed a review of the SAP controls over accounts payable (report attached). We plan to continue testing additional modules, and are discussing potential internal control weaknesses with system managers as we go along.</p> <p>Maze and Associates completed their review, and included their report in the Management Letter that was issued Dec-2004.</p> <p>Report issued Nov-2004.</p>	On going

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<p><b>12. Streamlining Initiatives</b> – As time allows, the Auditor's Office makes itself available to (1) independently assess the cost/benefit of streamlining projects, and (2) provide advice on the adequacy of streamlined controls and procedures. Projects include:</p> <p>a. <i>Cost-benefit analysis of library fines</i> – In cooperation with the Library Department, we will assess the cost versus benefit of imposing and collecting library fines. Target start date: TBD (if time permits).</p>	Not started		Target completion date: TBD (if time permits)
<b>PERFORMANCE AUDITS AND SPECIAL PROJECTS</b>			
<p><b>13. Review of Environmental Services Center Proposal</b> – The City Auditor agreed to do a review of the proposal's assumptions and financial implications, and to provide that information to the City Council in a study session prior to approval of a consultant contract for an Environmental Impact Report for the ESC.</p>	Completed	Report issued Nov-2004. Auditor's comments regarding staff's response issued Feb-2005.	
<p><b>14. Audit of Contract Contingencies</b> – The objective of this audit was to evaluate the appropriateness of contract contingency levels, the approval process for using contingency dollars, and actual contingency usage. Target date: Dec- 2004.</p>	Completed	Report issued Mar-2005.	
<p><b>15. Service Efforts and Accomplishments (SEA) Report</b> – 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). Our aim is to provide the City Council, staff, and the public with an independent, impartial assessment of past performance to help make better decisions about the future. Target issuance date: Jan-2005.</p>	Completed	<p>Report issued Feb-2005 including results of second annual citizen survey.</p> <p>In addition, in Sep-2004, audit staff participated in a training session with the Association of Government Accountants (AGA), helping to develop guidelines for the nationwide Certificate of Achievement in Service Efforts and Accomplishments Reporting.</p> <p>In Oct-2004, the City Auditor participated in a panel discussion about the uses of citizen surveys at the International City-County Management Association's annual conference.</p> <p>In Jan-2005, the City Auditor participated in a peer review of the Washington State Department of Transportation's service efforts and accomplishments report.</p>	



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		<p>In Mar-2005, the City Auditor participated with Administrative Services staff in two "Budget 101 Introduction to the City Budget" sessions offered to the public, and prepared an executive summary of the SEA report for those sessions.</p> <p>In Jun-2005, the AGA awarded the City the <i>Certificate of Achievement in Service Efforts and Accomplishments Reporting</i>.</p> <p>The next SEA report (including the 3<sup>rd</sup> year of survey data) will be issued in Dec-2005.</p>	
<b>16. Audit of the City's Workers' Compensation Program</b> – The purpose of this review was to identify additional opportunities to control claim costs in the face of rising medical costs. Target date: Jan/Feb-2005.	Completed	Report issued Apr-2005.	
<b>17. Community Service Department Review</b> – Our FY 2003-04 audit work plan included an organizational review of the Community Services Department. That project was delayed because of pending retirements and reorganization efforts. Since departmental reorganization is continuing, we propose two smaller projects: <ul style="list-style-type: none"> <li>a. <i>Audit of Parks Maintenance</i> – An analysis of cost-effectiveness of parks maintenance contracting versus staffing. Target start date: Feb-2005.</li> <li>b. <i>Audit of CSD class program revenue/cost recovery</i> – Determine the income/subsidy of class programs net of direct and indirect costs, including staffing. Target start date: Spring-2005.</li> </ul>	<p>In process</p> <p>Not started</p>	<p>We completed our preliminary survey of the parks maintenance program, and are in the fieldwork phase of the audit.</p>	<p>Target completion date: Aug-2005</p> <p>Target start date: Fall - 2005</p>
<b>18. Police property room</b> (carryover project from FY 2003-04) – The Police Department desires an independent audit of the property room. This is also responsive to a 2004 Santa Clara County Grand Jury <i>Inquiry into Police Evidence Rooms in Santa Clara County</i> . Target start date: Feb-2005.	Completed	Report issued July 19, 2005.	
<b>19. Audit of street maintenance</b> – The resurfacing and reconstruction of City streets is a major component of the CityWorks program, including estimated 2004-05 General Fund expenditures of \$2 million, and a five-year capital improvement program totaling \$12 million. Our review would include the criteria for prioritizing street repairs, and coordination of subsurface work.	In process	We are in the preliminary survey phase of the audit.	Target completion date: Fall -2005

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<b>20. Audit of entrepreneurial programs</b> – The City has a number of “entrepreneurial programs” including IT services, animal control, BLS ambulance service, and training programs. The purpose of this review would be to analyze the net revenue and cost/benefit of <i>one</i> of these programs.	Not started		Target completion date: TBD (if time permits)
<b>21. Wastewater Treatment Fund</b> – Wastewater treatment is a major city program with estimated 2004-05 expenditures of \$20.4 million, a five-year capital program totaling \$24.7 million, and 69 full-time equivalent staff.	Not started		Target completion date: TBD (if time permits)
<b>22. &lt;ADDED&gt; Police Department Survey</b> – At the request of the Police Chief and the City Manager, the City Auditor’s Office will work with the Police Department in conducting a random survey of drivers of vehicles that are stopped to determine how they feel they were treated during the stop.	In process	We are in the planning stages of this project.	Target start date: Jul-2005
<b>23. &lt;ADDED 5/9/05&gt; Review of Police Building Proposal</b> – In response to a colleagues memo regarding a new police building proposal, the City Council directed the City Auditor to review the project and provide her comments and assessment to the City Council.	In process	We are reviewing the history of the project and documents supporting the current proposal.	Target date: August 8, 2005