Annual Citywide Risk Assessment and Internal Audit Plan

Fiscal Year 2016 (mid-year)

Fiscal Year2017

February 2016

Executive Summary

Professional auditing standards and the City of Pasadena (City) Internal Audit Framework requires Internal Audit to assess risks challenging the City and to communicate its risk assessment activities, audit plans and resource requirements to the City of Pasadena Audit/Finance Committee.

This report describes how Internal Audit analyzed the City's risk environment, prioritized audit areas, and prepared the 16 month Audit Plan. The proposed Audit Plan includes the remaining months in FY 2016 and all of FY 2017. In the future, Audit Plans will be developed on an annual basis. The contents of this report rest upon these premises:

- Risk, control and governance largely determine the City's ability to achieve its objectives.
- City management is responsible for managing risk by implementing internal controls and providing reasonable assurance that they are operating as intended.
- Internal Audit is responsible for assessing risk by analyzing conditions that can impair the City's ability to achieve its objectives.
- Internal Audit is responsible for developing audit plans to review controls that City management has implemented to address risks.

In collaboration with City management, Internal Audit established an audit universe of auditable areas for the City and performed a high level risk assessment of each. There are many activities performed by management and staff that are designed to control risk and reduce the likelihood that a negative event will occur. The risk remaining despite those controls is called residual risk. It is important to note that the risk assessment process does not attempt to measure or rank residual risk. Instead, the goal of this process is to assess the inherent risk in each of the City's auditable areas.

The strategy for developing the proposed Audit Plan is based on the assumption that a large part of the overall risk of an auditable area is attributable to the risks of the business processes it utilizes. So as part of this year's Risk Assessment, the Internal Auditor also identified 10 key citywide business processes and assessed the level of risk each introduces in the operating environments.

During the audits scheduled as a result of this risk assessment process, the Internal Auditor will determine how existing controls within the City's auditable areas reduce inherent risk. The audit scope will be updated during the planning phase of each audit, based on the assessment of the risk remaining within the area, after considering the effects of existing controls.

Approach

Step 1: Understand City's Business Goals

The first step to completing a Risk Assessment is to understand the City Council's strategic goals and objectives. Since risk is defined as any issue (positive or negative) that may impact the City's ability to achieve its strategic goals, identifying the City's key goals is a prerequisite to identifying risk. The City Council adopted goals are identified in the FY 2016 budget as follows:

- Maintain Fiscal Responsibility and Stability
- Improve, Maintain and Enhance Public Facilities and Infrastructure
- Increase Conservation and Sustainability
- Improve Mobility and Accessibility throughout the City
- Support and Promote the Local Economy
- Ensure Public Safety

Step 2: Complete Citywide Risk Assessment: Identify, Assess, and Rank Auditable Areas

Institute of Internal Auditors (IIA) International Professional Practices Framework (Standards) requires that "*The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process.*"

The Citywide Risk Assessment is process to identify and assess potential events or situations that may prevent the City from achievement of its strategic goals and objectives. The Citywide risk assessment evaluates risk in 4 areas:

- Strategic
- Operational
- Compliance, and
- Financial.

The Citywide Risk Assessment encompasses a broader review of risks than the fraud risk assessment currently being performed by MGO. The fraud risk assessment is actually a subset of a Citywide Risk Assessment. The fraud risk assessment focuses on financial related risks and does not evaluate strategic, operational or compliance risks that may impact the City's ability to achieve its strategic goals.

The Citywide Risk Assessment started by identifying the audit universe, or list of auditable areas, to guide and define the parameters for the Risk Assessment. For purposes of this year's Risk Assessment, the auditable areas included were all departments reporting to the Office of the

City Manager. The areas not included in this assessment and proposed audit plan are the following:

- City Council;
- City Clerk;
- City Attorney;
- Rose Bowl Operating Company;
- Pasadena Center Operating Company;
- Pasadena Community Access Corporation, and
- Successor Agency to the PCDC

Risk is typically assessed along two dimensions: the likelihood, or probability, that a given adverse event will occur; and the impact of the event on strategic objectives, operations, compliance requirements and financial reporting if the event does occur. Using department metrics, interviews and certain financial data and reports, an impact and probability score was calculated to map the risk for each auditable area.

Impact is calculated using several factors including:

- financial materiality,
- degree of regulatory compliance,
- operational and strategic impact to City's objectives,
- number of key IT systems, and
- fraud risk.

Probability is calculated using the following factors:

- complexity of process,
- volume of transactions,
- known issues,
- changes in personnel or processes, and
- degree of monitoring/oversight.

Risk scores are summarized by department and mapped on a Heat Map, which is divided into 4 quadrants:

- I - Low Probability, Low Impact;
- II - Low Probability, High Impact;
- III - High Probability, Low Impact; and
- IV - High Probability, High Impact.

It is important to note that a high risk score does not mean that a department is ineffectively managed, that sufficient controls are not already in place, or that the function

is not performing properly. A high risk score indicates that a negative event in that area would be particularly damaging or more likely to occur in the absence of effective controls. Therefore, for example, departments mapped in Quadrant IV on the Heat Map are considered mission critical; provide substantial support for many City functional areas; reflect a high public need; or consume significant financial resources.

The goal is not to move auditable areas from one quadrant to another, ie. from Quadrant IV to Quadrant I. Auditable areas do shift sometimes as new issues emerge, new systems are brought online, or when significant processes or management changes occur. But the shift is usually within the same quadrant. Therefore, an auditable area whose risks have a high probability of occurring and has high impact on City operations will seldom shift to an area of low probability or low impact. The purpose of a heat map is merely to highlight areas that have significant risk to the City in order to identify and develop a risk-based audit plan to evaluate the effectiveness and efficiencies of the internal controls and business processes that management has put in place to mitigate these risks.

The FY 2016 Citywide Risk Assessment Heat Map is included in Appendix A.

Step 3: Identify Key Citywide Business Processes and their Impact on Auditable Areas

A key Citywide business process, in the context of the Risk Assessment, is a set of activities designed to provide critical support to auditable areas. Many business processes involve actions performed by multiple areas in order to achieve a common goal. In the key Citywide process of contract management, for example, the auditable area seeking a contract service would draft the scope of work, City Attorney's Office would prepare/approve the contract language and terms, and the Purchasing division would provide oversight ensuring compliance with all procurement related policies, procedures, and laws. The primary objectives of these activities are to ensure that contracted services are efficiently and effectively utilized and related risks are properly managed.

As part of the Citywide Risk Assessment, the various business processes relied upon by all or most of the auditable areas were identified. These business processes, their objectives, and their inherent risks were determined through discussions with City personnel, management input, other information gathered as part of the risk assessment process, and the Internal Auditor's own experience working with local government entities.

The purpose of identifying key business processes is to provide more effective and efficient use of internal audit resources by planning audits that will impact more auditable areas within one audit.

A complete list of these key business processes is included in Appendix B. The key business processes included in Appendix B are listed in alphabetic order rather than priority order or by

level of associated risk. The risks listed with each business process do not represent actual events but are a listing of potential risks normally associated with those key processes. Management is responsible for putting in place processes and internal controls to mitigate these risks to an appropriate level. When audits are scheduled in these areas, the auditor will evaluate the management processes and internal controls to determine whether they are effective and working as management intended.

Step 4: Develop the Audit Plan

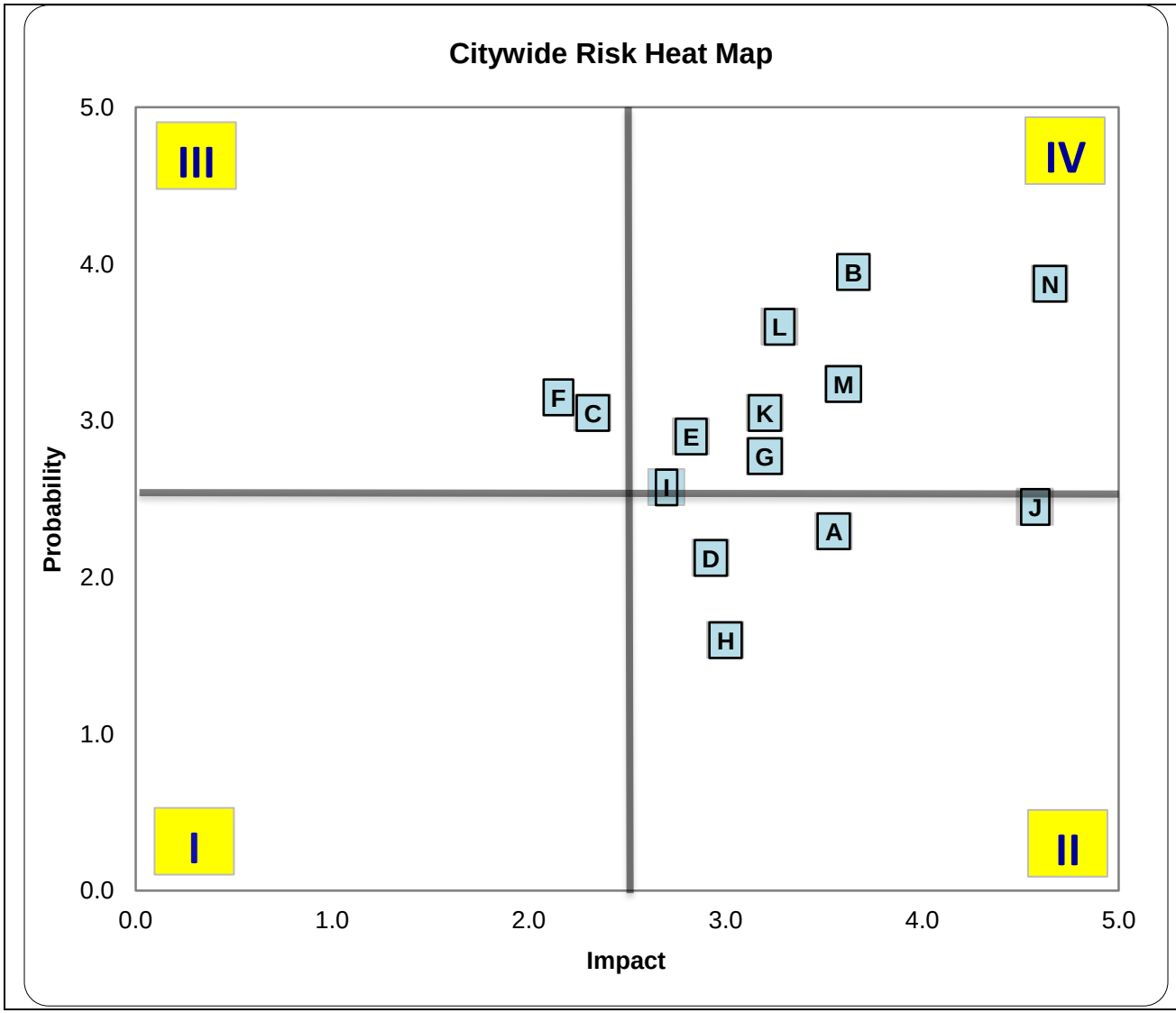
Institute of Internal Auditors (IIA) International Professional Practices Framework (Standards) requires that "*The Chief Audit Executive must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organization's goals.*"

The proposed audit plan is for a 16-month period to cover the remaining months of FY 2016 and all of FY 2017. The proposed audit plan is constrained by available staff resources and budgeted professional services dollars. The priorities that were used in developing the proposed audit plan were as follows:

- Audits identified by KPMG LLP, the Task Force on Financial Administration and Internal Controls, and Management Partners reports related to the alleged embezzlement;
- High Risk auditable areas within Quadrant II, III and IV on the Risk Assessment Heat Map; and
- Audits of key business processes that have a Citywide impact on Risk Assessment Scoring

In developing the audit plan, the hours included for each audit are an estimate. Quarterly, the plan will be reassessed and adjusted to account for unanticipated requests and progress on current audits. The Audit Committee will be briefed quarterly on the status of work completed to the Audit Plan and any adjustments that need to be made to hours and anticipated completion dates. The proposed audit plan is included in Appendix C.

Appendix A: FY 2016 City Wide Risk Assessment Heat Map



LEGEND	
A	City Manager
B	Finance
C	Fire
D	Housing & Career Services
E	Human Resources
F	Human Services & Recreation
G	Information Technology
H	Library & Information Services
I	Planning & Community Development
J	Police
K	Public Health
L	Public Works
M	Transportation
N	Water & Power

Appendix B: FY 2016 Key Citywide Business Processes

1. BENEFITS ADMINISTRATION

Objective: To ensure that employee benefit programs are managed in accordance with laws, regulations, and contract terms.

Potential Risks:

- Under/over payroll withholding and/or City incorrect contribution for benefits programs are not discovered in a timely manner
- Self-insured plans are over/under funded
- Compliance and financial reports are not prepared accurately
- Benefits payments are made for services not received
- Plan provisions are not consistent with legal requirements
- Benefits paid to ineligible employees or dependents
- Outdated technology increasing risk and inefficiency
- Untimely managing and processing life event changes
- Non-compliant initial Consolidated Omnibus Budget Reconciliation Act (COBRA) participant notification
- Payments to benefits' providers may not be made in a timely manner, causing promised benefits to be interrupted or cancelled
- Errors in qualified COBRA beneficiary tracking

Primary Auditable Area:

- Human Resources - Employee Benefits/Health Insurance

2. BUDGET

Objective: To ensure that a budget system is managed and maintained that facilitates allocation and use of resources in line with the City Council's priorities

Potential Risks:

- Unapproved expenditures
- Unmet critical needs
- Budget assumptions and methodologies are not scrutinized
- Appropriate budget monitoring is not performed (variance analysis etc.)
- Baseline budget assumptions are not revisited periodically
- Over/under budgeted expenditure/revenue
- Adequate reserves may not be available or budget cushion may not be adequate in the case that budget assumptions are significantly incorrect or unexpected events occur that requires deviation from the budget plan
- Complexity of the budget process, the budget itself and/or various areas of the budget may overwhelm the controls and processes of City departments and finance function

- Budget may not consider all potential sources of revenue available to the City in any given year

Primary Auditable Area:

- Finance (Operating Budget)
- Public Works (Capital Budget)

3. CASH MANAGEMENT/INVESTMENTS

Objective: To ensure that investments are identified, accounted for, invested, and reported in accordance with the City needs and all applicable laws, regulations, and policies.

Potential Risks:

- Optimum liquidity may not be maintained resulting in unmet cash need
- Excessive risk of losing principle
- Violation of state investment law
- Risk not appropriately compensated for
- Excessive investment expense
- Execution of unauthorized transactions
- Missed investment opportunities
- Outdated investment policies resulting in loss of reasonable returns
- Certain investments may be too complex to properly evaluate and may be subject to fraud risks by investment managers or investment vehicles

Primary Auditable Area:

- Finance - Treasury
- Water & Power

4. EMPLOYEE MANAGEMENT

Objective: To facilitate employee recruitment, training, retention, compensation and ensure compliance with employment related laws and regulations.

Potential Risks:

- Best qualified employees with required skillsets are not hired
- Vacant positions or promotions are not timely filled
- Safe working environment is not maintained resulting in potential liability to the City
- Employees are over or under compensated resulting in increased cost or recruitment difficulty
- Labor and employment laws are not complied with
- Employees are not provided adequate training resulting in reduced productivity

- Grievances are not properly handled
- Employee data is not maintained confidentially
- Job responsibilities may be overly complex, ill-defined, or may unnecessarily overlap responsibilities in other positions

Primary Auditable Area:

- Human Resources - Recruitment & Classification, Safety and Training
- Police – Live Scan

5. GENERAL ACCOUNTING

Objective: To ensure that internal and external financial reporting requirements are timely met and financial transactions are executed and recorded as authorized.

Potential Risks:

- All reportable transactions are not captured and reported timely
- Reporting standards are incorrectly interpreted and applied
- The system does not produce management reports that meet user needs
- Unauthorized transactions
- Fraud or embezzlement
- Erroneous reporting
- Comprehensive Annual Financial Report (CAFR) is not accurately and/or timely compiled to meet reporting requirements
- Significant deficiencies and/or material weaknesses have an adverse impact on accuracy and/or completeness of CAFR
- Tyler Munis (or parts of it) could be too complex and/or poorly designed, increasing the probability of inaccurate and/or non-complete financial information

Primary Auditable Area:

- Finance
- Information Technology – Project FRED

6. GRANTS

Objective: To ensure that the City identifies, applies for and manages grants that help meet its objectives. The grant life cycle, including cost/benefit analysis of grants being applied for and life cycle costs including maintenance and replacement are considered prior to applying for grants. The management review, approval, and oversight processes are effective.

Potential Risks:

- Grants that the City qualifies for and has a need for are not identified and applied for
- Unallowable or questioned costs
- Increased federal or state oversight

- Unable to demonstrate compliance with grant terms due to lack of policies, procedures and/or systems
- Grants accepted do not align with the City goals resulting in unanticipated results
- Grants are accepted without assessing the recipient entity's ability to cost effectively fulfill grant terms
- Co-mingling of grant funds in financial accounts
- Incorrect labor coding on grant funded projects
- Inability to produce timely grant compliance reports
- Grants are applied for that have unanticipated long-term life cycle costs
- Lost revenue from failure to identify all eligible costs
- Absence of performance reports on grant funded projects
- Overhead rate proposed on grant applications are not supported
- Inability to timely report accurate grant expenses to Grantee
- Indirect costs may not accurately or fairly allocate between various grants and non-grant departments
- Grants reimbursements could potentially be withheld or required to be returned because of poor management of grant billings and/or advance draws of grant funds
- Inadequate understanding of federal grant compliance requirements (OMB A-133) could negatively impact the City's ability to obtain new grants and/or require return or withholding of existing grant funding
- Inadequate management of subrecipient's compliance to grant requirements could negatively impact the City's ability to obtain new grants and/or require return or withholding of existing grant funding

Primary Auditable Area:

- Finance
- Fire Department
- Housing and Career Services
- Human Services and Recreation
- Planning
- Police Department
- Public Health
- Public Works
- Transportation

7. INFORMATION TECHNOLOGY

Objective: To ensure that information technology (hardware and software) is acquired, implemented and used to best meet the needs of the City; and information produced is guarded against unauthorized access or use.

Potential Risks:

- Non-compliance with Information Technology (IT) related Federal, State, and local laws
- Business goals are not met due to lack of communication between process owners and IT service providers
- Outdated systems affecting productivity and increasing risk to business goals
- Privacy violations due to lack of or adherence to policies and procedures
- Risk to service continuity due to inadequate disaster recovery policies and procedures
- Waste and inefficiency due to lack of coordination between leveraging of existing and acquisition of new and emerging technologies
- System and software change management controls are absent or work ineffectively
- System conversions are not managed effectively possibly increasing project budget, increasing project schedule, and/or impacting user department's ability to meet City strategic objectives
- Timely changes of employee/vendor access to system does not occur
- Cybersecurity controls are not adequate to prevent unauthorized access or use of data
- Inadequate consideration or planning for estimated IT product or service life cycles, could result in poor or nonexistent capital replacement plans
- Inadequate understanding of critical business processes dependency on IT systems could negatively impact the City's ability to complete its strategic objectives

Primary Auditable Area:

- Information Technology
- Water and Power

8. PAYROLL

Objective: To ensure that payroll transactions are processed accurately and timely in compliance with relevant legal and regulatory requirements and timely and accurate information is provided to support management decision making and grant reporting requirements.

Potential Risks:

- Fictitious employees in the system
- Recurring errors due to heavy reliance on computer systems
- Incorrect changes in employee status, pay rates, withholding etc
- Employee contract terms not entered correctly in the system
- Payments made for time not worked
- Inaccurate labor reports that are used for grant reimbursement claims
- Errors in interpreting State and Federal withholding requirements
- All compensations subject to withholding and reporting are not captured
- Time and labor data is not reviewed and approved by supervisors
- Overtime payments are incorrectly calculated

- Taxpayer identification is not correct
- Tyler Munis conversion impacts timely payment of payroll, inadequate controls and/or incorrect calculation of payroll
- tax withholdings, voluntary employee withholdings and other payroll deductions are not timely remitted to appropriate entities
- Required tax compliance reporting is not timely and/or accurately prepared and issued

Primary Auditable Area:

- City departments' timekeeping systems
- Finance
- Human Resources
- Information Technology

9. PROCURE TO PAY

Objective: To ensure that all necessary goods and services are used strategically to best meet the City's goals and objectives and associated risks are properly managed.

Potential Risks:

- Higher costs and substandard services due to ineffective competitive bidding process
- Service delivery is not in accordance with contract terms due to lack of oversight
- City is not adequately protected from non-performance or other contractor activities
- Key aspects of the contract are not in place – contract drafting, negotiations, and approval, compliance monitoring and renewal process
- Increased exposure to liability due to inadequate vendor insurance
- Contested bid awards
- Overpayment or duplicate payment of vendor invoices
- Poorly managed knowledge transfer leading to loss of intellectual property
- Failure of the contract to meet needs resulting in scope creep, cost over-runs, and quality failures, or failure to properly close out contracts
- Vendors are not paid in a timely manner resulting in increased cost and/or lost discount opportunities
- City's scope of work may not be accurate or complete
- Approved Change Order work duplicates work in original contract scope
- PCards and Petty Cash payments are used to circumvent Purchasing controls
- Vendor file may not be accurate and/or complete or may contain invalid (fictitious) vendors
- Poor performance on contracted work because of inadequate screening of contractors and vendors qualifications and abilities
- Large projects may not be monitored or inadequately monitored to verify quality work in compliance with approved contract scope

- Failure to verify vendors and contractors are eligible to work on federal or state grant funded work or are not in compliance of other laws and grant requirements could negatively impact the City's ability to obtain new grants and/or require return or withholding of existing grant funding

Primary Auditable Area:

- Finance - Accounts Payable
- City Project Managers
- Finance - Purchasing
- PCard Holders
- Petty Cash Funds

10. REVENUE

Objective: To ensure that all charges and fees allowed by law are assessed and collected in a timely manner.

Potential Risks:

- Missed opportunities for additional fees and charges
- All chargeable costs are not identified
- Unauthorized charges and fees are collected
- Collections are not recorded and reported correctly and timely
- Lower collection performance
- Adequate systems are not in place to facilitate the billing and collection function
- Adequate controls are not in place to reduce the risk of diverting collections
- Cash handling controls are ineffective to reduce potential theft
- Revenue may not be properly recorded and reported in accordance with government accounting standards
- Restricted revenues may not be accounted for in the appropriate fund
- Lack of monitoring of receivables can result in "lapping" and other fraudulent schemes

Primary Auditable Area:

- Finance
- Human Services & Recreation
- Planning
- Transportation
- Water & Power

Appendix C: FY 2016 (Midyear) & FY 2017 Proposed Internal Audit Plan

Title	Audit Objective	Area	Proposed Resources
1. Phase 1 of MGO Contract for Fraud Risk Assessment (audit started in FY 2016 will finish in FY 2017)	Complete a Fraud Risk Assessment for 6 City departments	Finance Housing & Career Services Human Services & Recreation Public Health Public Works Transportation	Outsourced $171,400 Included in FY 2016 budget
2. Operational Audit of Accounts Payable Process	To evaluate the accounts payable process to determine that vendors are paid timely, duplicate invoices are not paid. Review Special Handling Request Forms to assess process, procedures and actual practices.	Finance: Accounts Payable All other City Departments	1,200 hours
3. IT Audit of Tyler Munis modules General & Application Controls	Audit implemented Tyler Munis modules to verify general & application controls meet City's risk tolerance.	DoIT Finance	Outsourced $150,000 Requested for FY 2017 budget
4. Operational Audit of Vendor Master File & 1099 reporting	To verify accuracy & completeness of vendor master file & 1099 reporting complies with IRS requirements (KPMG recommendation)	Finance	600 hours
5. Operational Audit of Parking Garage Revenue	To verify accuracy and completeness of parking revenue	Transportation	Outsourced $175,000 Requested for FY 2017 budget

6. Operational Audit of Cash Handling (audit will start in FY 2017 and finish in FY 2018)	To verify that Citywide Cash Handling has strong internal controls and adequate segregation of duties	Finance Fire Human Resources Human Services & Recreation Library Planning Police Public Health Public Works Transportation Water & Power	1500 hours
7. Compliance Audit of PCard/Petty Cash	To verify that expenditures comply with City Council Goals and City Policies	Finance All Other City Departments	1,000 hours Co-sourced $45,000 IDEA Software – Requested for FY 2017 budget
8. Assessment of Compliance to Payment Card Industry (PCI) Standards	To verify that the City's third party credit card vendors are in compliance with PCI standards and that the City is complying with PCI standards	Finance Human Services & Recreation Information Technology Planning Transportation Water & Power	300 hours Co-sourced $50,000 Requested for FY 2017 budget
9. Phase 2 of MGO Contract Option – for Risk Assessment of Water & Power	Exercise Phase 2 option in MGO Contract to complete Water & Power Risk Assessment	Water & Power	Outsourced $197,240 Requested for FY 2017 budget
10. Continuous Audit of Payroll and Vendor Files	Review Vendor file for fictitious vendors and payroll database for ghost employees	Finance Human Resources	120 hours