

Office of City Auditor Memorandum



Date: April 6, 2012

To: Council President Sally Clark
Councilmember Mike O'Brien, Chair, Energy & Environment Committee
Councilmember Tim Burgess, Chair, Government Performance & Finance Committee

From: David G. Jones, City Auditor *David G. Jones*

Subject: Office of City Auditor Plan for a Review of Seattle City Light's Financial Controls

Introduction

Following the arrest of a former Seattle Public Utilities (SPU) employee on suspicion of diverting over \$1 million of the public's money to his private bank account, you asked the Office of City Auditor to prepare a scope of work for an assessment of financial safeguards at Seattle City Light, and to hire and oversee a consultant to conduct this work. What follows is:

- 1) Background information on what we know about auditing that has occurred and is occurring at City Light,
- 2) Our proposed short-term response to your request, and
- 3) Our initial thoughts on future, longer-term audit work that could be conducted at City Light.

Background on Audit Work Performed at City Light

City Light has undergone and continues to have audits performed on some of its activities, but to the best of our knowledge there has not been systematic, thorough auditing of City Light's system of internal controls¹ for either its revenues or expenditures. However, we do know through conversations with City Light financial managers that there is currently insufficient

¹ Internal controls are steps an organization takes to help ensure that it meets its objectives and manages risk, and they play a major role in preventing and detecting fraud. Examples include written policies and procedures, authorization signatures, an accounting system, management reviews, segregation of duties, training of staff, audits, security systems, and standardized hiring practices.

information about the internal controls over City Light's various revenue streams and the number of such revenue streams. What follows is our understanding, which may not be complete, of the recent and ongoing audit work performed at City Light².

Financial Statement Audits: Both City Light and SPU hire private sector audit firms, commonly referred to as external audit firms, to determine whether the utilities' annual financial statements are "fairly presented" in accordance with the Government Auditing Standards and the Generally Accepted Accounting Principles. These firms perform some review of existing internal controls and transaction testing, but this work is generally focused only on areas that are material to the financial statements and could impact financial reporting accuracy. The materiality levels for a large enterprise such as City Light are very high, often in millions of dollars. The utilities, at their discretion, may also contract with their external audit firms for additional audit work. City Light's current external auditor is Baker Tilly³.

Additional Work Being Conducted by City Light's External Auditor: Because of the heightened risk due to the fraud discovered at SPU, Baker Tilly will do additional audit work this year at City Light concerning the handling of revenues. We met with City Light's Interim Financial Services Officer on March 23, 2012 to learn about the additional audit work being conducted by Baker Tilly. The manager of Baker Tilly's City Light financial statement audit also joined us for part of this meeting. We learned that through interviews and review of documents, Baker Tilly plans to:

- Create an inventory of all areas in which City Light employees "touch cash",
- Conduct interviews with City Light staff responsible for intake of revenue to verify the staff's understanding of existing controls,
- Determine whether documentation of controls exists and is accurate, and
- Identify gaps between existing controls and best practices as defined by Baker Tilly.

Our office plans to use the results of Baker Tilly's additional audit work to inform our plans for future audits at City Light.

Compliance with Specific External Standards: City Light is subject to audits for compliance with requirements established by the Federal Energy Regulatory Commission (FERC) and the North

² City Light has a unit (Corporate Performance Division) that, among several other duties, has responsibility for reviewing internal business processes and determining ways in which they can be improved. While this unit reviews situations in which internal controls require improvement, it is not an independent audit function (i.e., its director reports to the Financial Services Officer who reports to the Superintendent) that follows audit standards.

³ It should be noted the Office of City Auditor does not perform financial audits. Washington State law assigns the authority for financial audits of local governments, such as the City of Seattle, to the State Auditor's Office. State law requires that the State Auditor's Office certifies local government's annual financial statements. The City of Seattle's financial statement is called the Comprehensive Annual Financial Report (CAFR).

American Electric Reliability Corporation (NERC). These compliance audits are focused on applicable regulations. These include, for example, bulk electric system reliability standards and information technology security requirements.

State Auditor's Office Accountability Audits: The State Auditor's Office conducts an annual "accountability audit" of Seattle City government, which involves reviewing several types of internal controls covering the entire City. Their work typically touches on some internal controls involving City Light. Because the State Auditor's Office accountability unit assigned to Seattle has to also perform work related to certifying the City's annual financial statement and audits of federal funds received by Seattle, it has limited time and resources for the accountability audit.

State Auditor's Office Performance Audit of City Light: In 2008, the State Auditor's Office, which under Washington State law has the authority to conduct performance audits of local governments, hired the consulting firm Ernst & Young to conduct a performance audit of City Light operations from 2006 to 2008.

Office of City Auditor: Our office has performed limited work at City Light since 2002, when the City Council tasked us with hiring and overseeing the work of the consulting firm Vantage to review the overall management of City Light ([Review of Seattle City Light 31 October 2002](#)). Since 2005 we have focused most of our limited internal controls audit resources on reviewing the primary revenue streams (i.e., revenues that are collected from a household's or business's utility bill) at the City's other large utility, SPU, and have published five audits since 2007 on SPU's primary revenue streams. As you may know, at the request of City Councilmember Godden, we have recently initiated an audit of the SPU secondary revenue stream where the alleged fraud occurred that led to the recent arrest of the former SPU employee.

Current Office of City Auditor Work Involving City Light:

CCSS Transactions Controls Review In 2011 we worked with SPU to investigate fraud identified among SPU employees who worked on their own accounts in the customer billing system that covers both utilities, the Combined Customer Services System (CCSS). While working with SPU on the CCSS Investigation project, we became aware of internal control weaknesses associated with various types of CCSS transactions. These control weaknesses made it possible for the employee abuses to occur and to go unnoticed for longer than they should have. We worked with SPU and City Light staff to better understand past procedures, current procedures, and planned procedures for the near future. We also note that both SPU and City Light are currently reviewing their policies and procedures for CCSS transactions and seeking to improve them where needed. We will be publishing a report on our review of CCSS Transaction Controls later this year. This report will reflect the status of internal controls that allowed the employee abuses to occur, all actions already taken by City Light and SPU to improve internal controls,

and City Light and SPU's planned actions to improve internal controls. We have completed gathering information for this report and are currently working on incorporating input from SPU and City Light to create a draft list of potential findings, and then we will issue a draft report to the utilities to solicit their comments before we finalize the report.

CCSS Data Mining While working with SPU on the CCSS Investigation project, we determined there was a need to review all employees with access to the CCSS system to determine if they made inappropriate transactions to their own SPU and SCL accounts or to those of close family members. While most CCSS users work for either SCL or SPU, some work for other non-utility departments, including the Departments of Human Services and Neighborhoods. We are utilizing data mining audit software (i.e., ACL) and applying a consistent set of queries across all CCSS users in order to proactively look for inappropriate transactions. We have been working with an ACL trainer in this effort. The types of inappropriate transactions we are running queries on include:

- Employees who reversed fees (i.e., late fees, interest charges, shut-off fees, etc.) on their own accounts,
- Employees who established or changed their own payment plans,
- Employees who put themselves on utility reduced rate programs (e.g., SCL rates are discounted by 60% with this program),
- Employees with unusual patterns of long-term account delinquencies

We are currently working on completing our initial queries to identify general statistics and averages for types of transactions and adjustments. We are also completing our initial queries to identify employees who have made transactions and adjustments to their own accounts. Once these queries are completed, our office will analyze the results to determine whether they appear to represent legitimate issues, and if so, we will then turn over employee names to SCL and SPU for comprehensive investigation.

Action Plans

As is the case with our plans to review certain SPU revenue streams, there are five levels of work that could be performed over City Light's revenue streams. However, unlike the case at SPU, we do not have a good understanding of City Light's various revenue streams and which ones should be categorized as primary or secondary. The work that needs to be performed to more fully understand City Light's revenue streams is as follows:

1. Identifying the revenue streams,
2. Determining which have controls in place (e.g., up to date and adequate policies and procedures),
3. Assessing the level of risk on the revenue streams to determine the highest audit priorities,

4. Evaluating the quality of the existing controls over specific revenue streams, and
5. Testing a representative sample of transactions for one or more specific revenue streams.

Each layer requires more time to review, with the fifth layer, transaction testing, typically being the most labor intensive.

The following is a summary of our plans for auditing the internal controls over City Light's revenue streams, as well as expanding audit coverage to other areas.

Our short term actions are focused on City Light's revenue streams because that is the area in which the alleged theft at SPU occurred. In the longer term, we believe audits should be conducted for City Light's internal controls in many other areas. An organization's internal controls should cover a wide area of business processes in addition to revenues, including work performed by field crews, inventory, capital assets, payroll, expenses, and safety.

Short-term action plan (i.e., by the end of September 2012)

1. Using Baker Tilly's inventory of revenue streams and control procedures review, referred to above, we will hire an audit consultant to perform a risk assessment of City Light's revenue streams. This means that the consultant will use a set of risk factors (e.g., dollar value of revenue stream, extent of previous audit coverage, quality of existing management controls, etc.) to determine the priority of audits that should be conducted of City Light's various revenue streams. This information will also be helpful to our office for updating our 2011 City Light audit risk assessment (Note: our 2011 risk assessment covered more than City Light's revenue streams).
2. Using the consultant's risk assessment, we will initiate an audit of one or more of the highest risk revenue streams by hiring an audit consultant to perform the audit. We will seek to hire a consultant team that has experience in both accounting and fraud investigation. Furthermore, we will confer with the City Council and City Light to determine how to achieve sufficient audit coverage of the remaining revenue streams.
3. By no later than the end of September 2012, our plans are to have hired the new utility auditor authorized by the City Council during the 2012 budget process.

Medium term action plan (i.e., by the end of March 2013)

Our office will seek to obtain City Council approval to increase the number of auditors dedicated to auditing City Light and SPU to two FTEs for each utility (i.e., create three new positions in addition to the one utility auditor position authorized during the 2012 budget process). These four positions will provide the independence and institutional knowledge to

ensure that an increased level of ongoing independent auditing is conducted at the City's two utilities.

We have four reasons for seeking these additional positions:

1. The recent alleged \$1 million theft and the firings and discipline of several SPU employees for making inappropriate adjustments to utility bills is clear evidence that more proactive external monitoring and oversight of the utilities is needed.
2. We believe that the significant portion of the City's budget that City Light comprises, which amounts to 29% of the 2012 adopted budget, warrants more audit resources being brought to bear on the utility.
3. There is a need to build up expertise within our office on the utilities. While consultants can provide useful information, they leave after they conduct their work. There is no substitute for having someone knowledgeable of the utility working to ensure adequate controls are in place to prevent negative events, such as fraud, from occurring. Over time we believe these extra auditors would save the City money and help to avoid significant problems and costs.
4. We believe that the City would benefit from having more independent audit work conducted at the utilities.

Long-term action plan

1. Using the results of the inventory of City Light's revenue streams and our risk assessment, we will develop a schedule for performing audits of City Light's highest-risk revenue streams and operations over a defined period of time (e.g., a decade). The City Council and perhaps the Audit Committee will be able to review the list and determine the level of audit coverage it believes is prudent for the City to achieve.
2. We will also seek to increase the office's capabilities in the areas of information technology (IT) auditing and fraud investigation, either through hiring additional staff with expertise in these areas (e.g., hiring someone who is a Certified Fraud Examiner) or by contracting for this expertise.
3. By working with City Light and the Executive branch, our office would like to develop training for City Light and other City department employees on the basics of internal controls, somewhat similar to the training the City already offers on cash handling. Ideally, this training would be tailored for certain types of functions. Such training would be particularly useful for managers and supervisors who need to know how to tell whether their unit's systems of controls are adequate. We note that SPU's March 23, 2012 Work

Plan to Improve Financial Internal Controls indicates that they plan on developing and providing internal controls training to their staff during 2012. It might be useful for City Light to conduct similar training for its staff.

Conclusion

Simply performing more audits will not guarantee that fraudulent behavior will never occur at City Light. However, ensuring that a minimum level of auditing will be performed at City Light by independent parties will help decrease the odds that such behavior will occur or go undetected. While it will take time and additional resources to audit all of City Light's important internal controls and revenue streams, this should not deter us from beginning to systematically work towards this goal.

If you have any question or concerns about our plan, please contact me at 233-1095 or at davidg.jones@seattle.gov.