Memorandum

City of Dallas

DATE April 25, 2008

TO Members of the Finance, Audit & Accountability Committee
Chair Mitchell Rasansky, Vice Chair Jerry Allen, Mayor Pro Tem Dr. Elba Garcia, Vonciel Jones Hill, Angela Hunt, Ron Natinsky and David Neumann

SUBJECT Improvements to Financial Reporting

The Committee's April 28th agenda includes the Subject briefing. Briefing materials are attached for your review.

Please contact me if you need additional information.

David Cook
Chief Financial Officer

Cc: Honorable Mayor and Members of the City Council
Mary K. Suhm, City Manager
Tom Perkins, Jr., City Attorney
Deborah Watkins, City Secretary
Craig Kinton, City Auditor
Ryan S. Evans, First Assistant City Manager
David O. Brown, Interim Assistant City Manager
Ramon Miquez, P.E., Assistant City Manager
Jill A Jordan, P.E., Assistant City Manager
A.C. Gonzalez, Assistant City Manager

Improvements to Financial Reporting

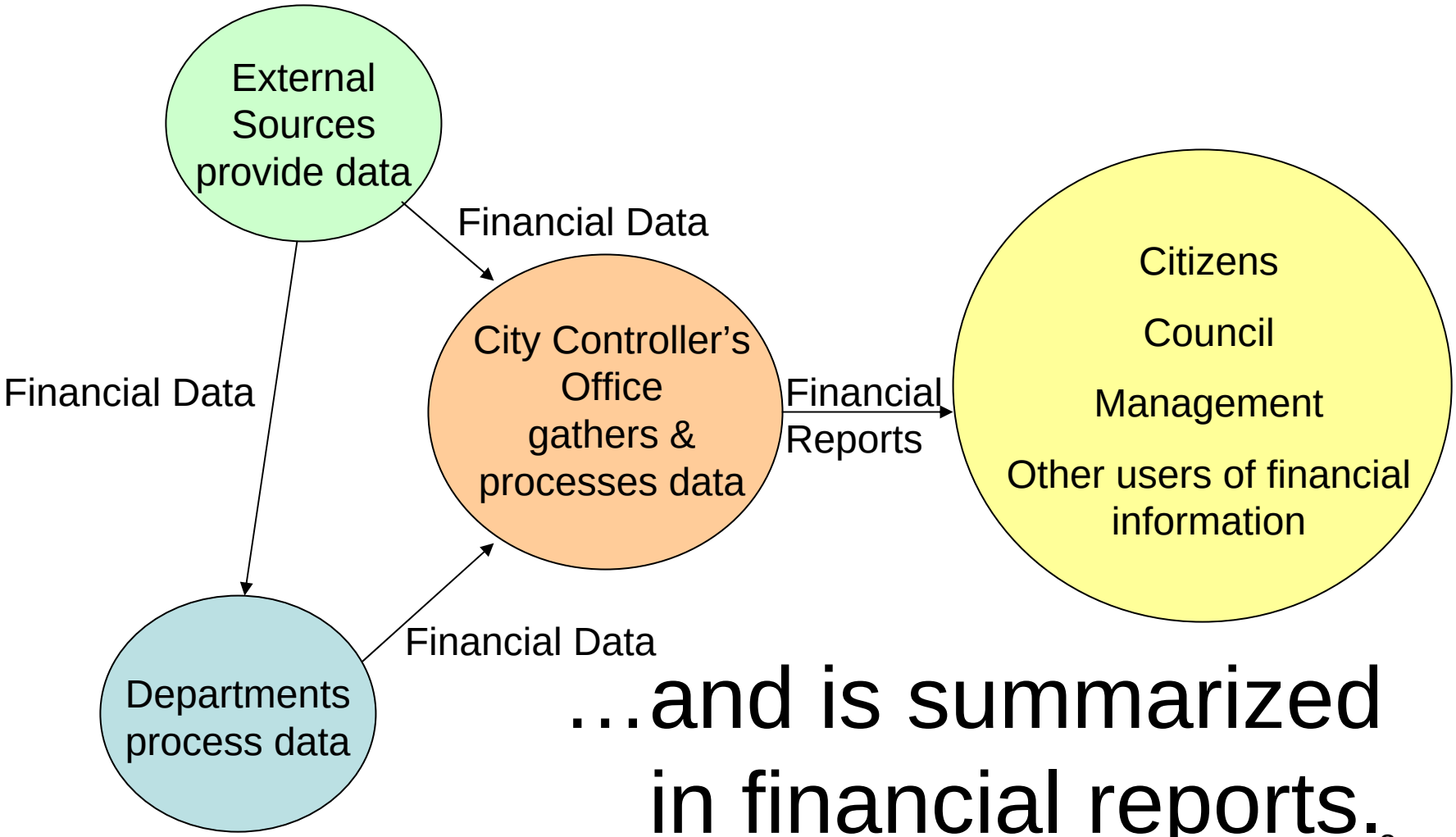
Finance, Audit and Accountability Committee

April 28, 2008

Purpose

- Provide a brief overview of the City's financial reporting process
- Explain what the City has done to improve the accuracy and efficiency of financial reporting
- Outline steps to be taken in the future

Financial data comes from many sources…

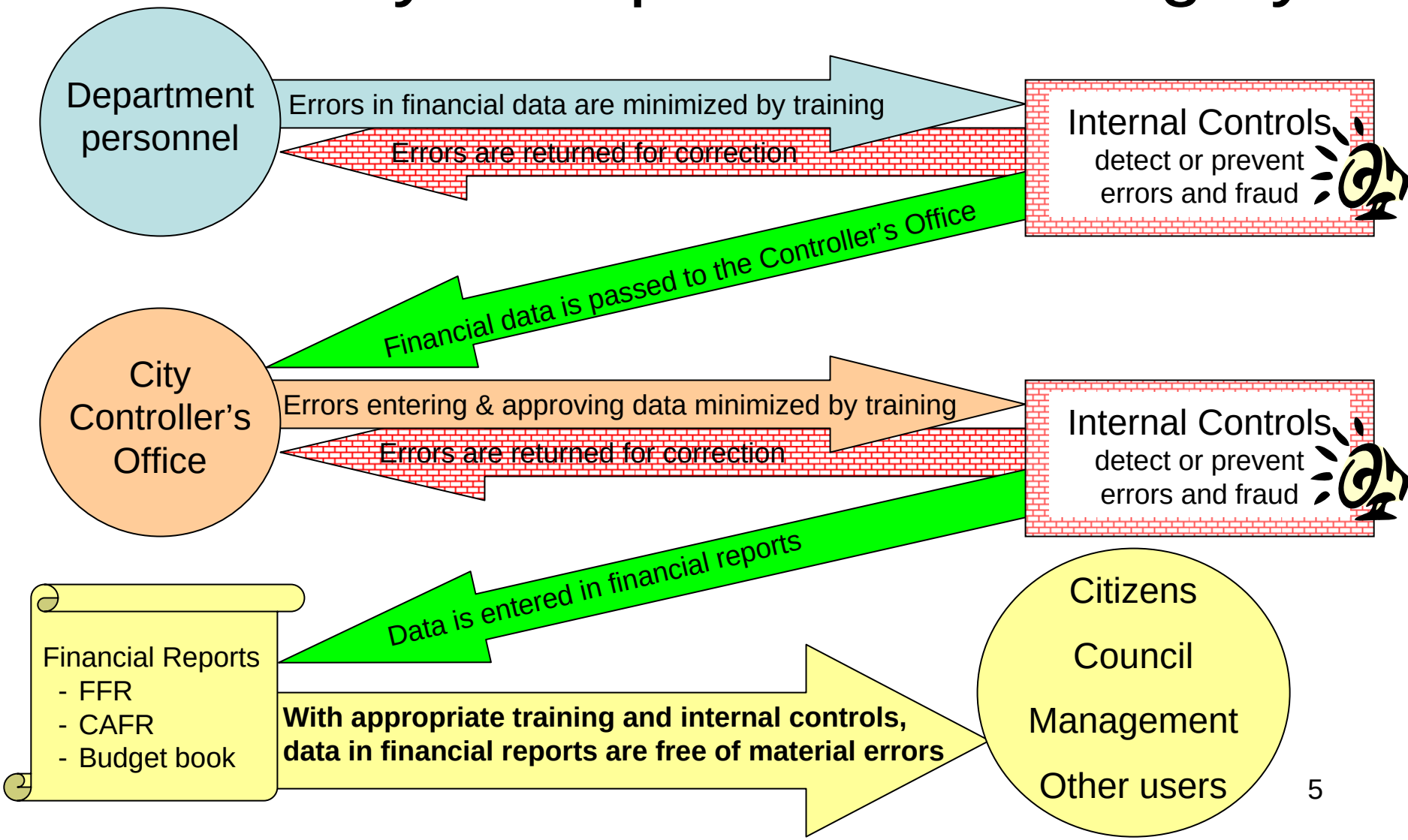


…and is summarized in financial reports.

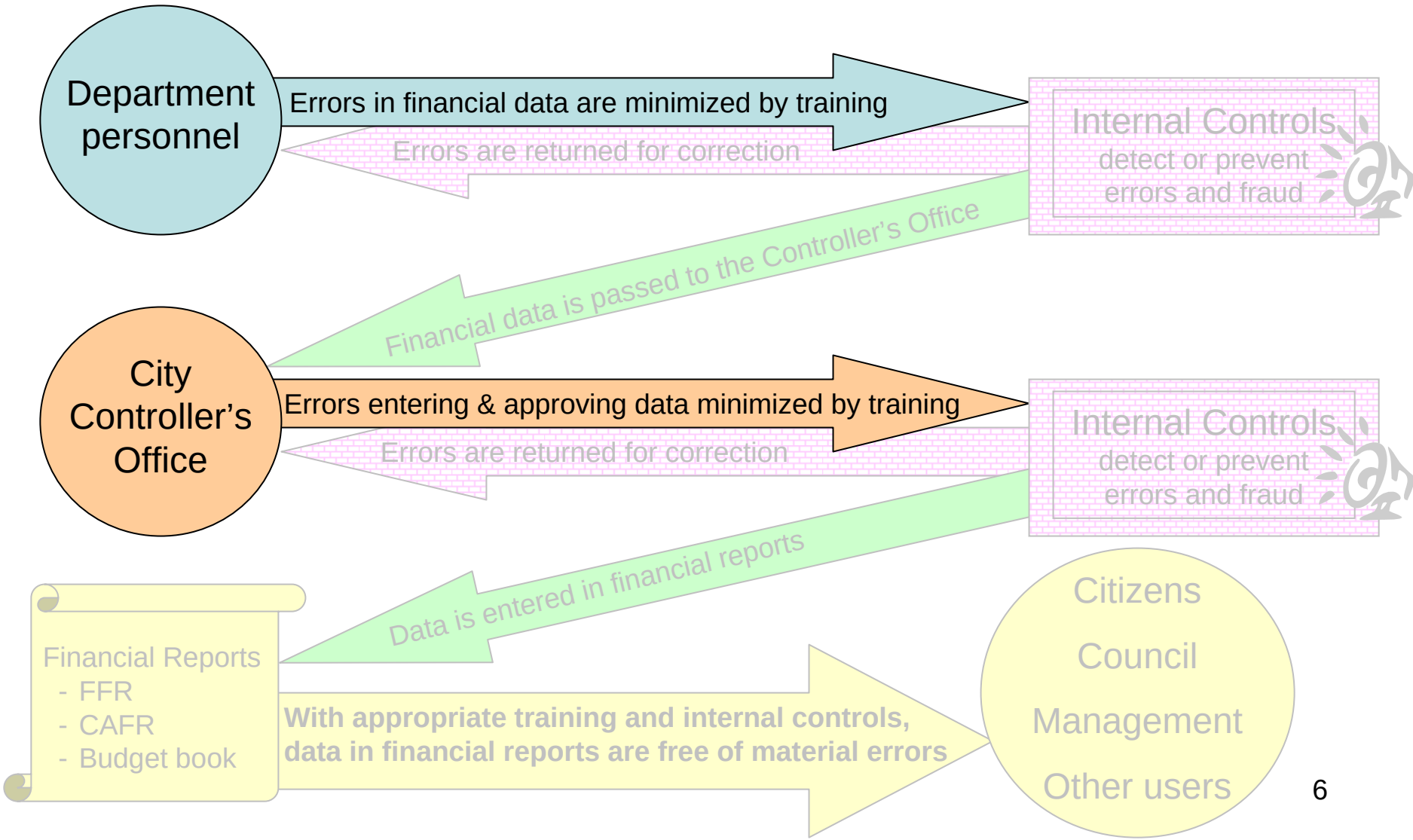
Our goal: Improve accuracy & timeliness of financial reports

- For financial reports to be meaningful, the data must be:
  - Accurate – amounts should be supported by adequate documentation
  - Complete – all transactions must be included
  - Reported in the correct period – transactions should be reported in the correct fiscal year (the process is complicated at year-end when a transaction may be included in the budget report, but not in the basic financials)
  - Categorized correctly – Summary categories include assets, liabilities, net assets, fund balance, revenues and expenses/expenditures
- Errors may be minimized and timeliness improved by
  - Ensuring that staff are well trained and understand:
    - City policies and procedures
    - Proper governmental accounting procedures
  - Designing effective internal controls
  - Centralizing certain tasks within the Controller's Office

Training and internal controls are necessary to improve data integrity



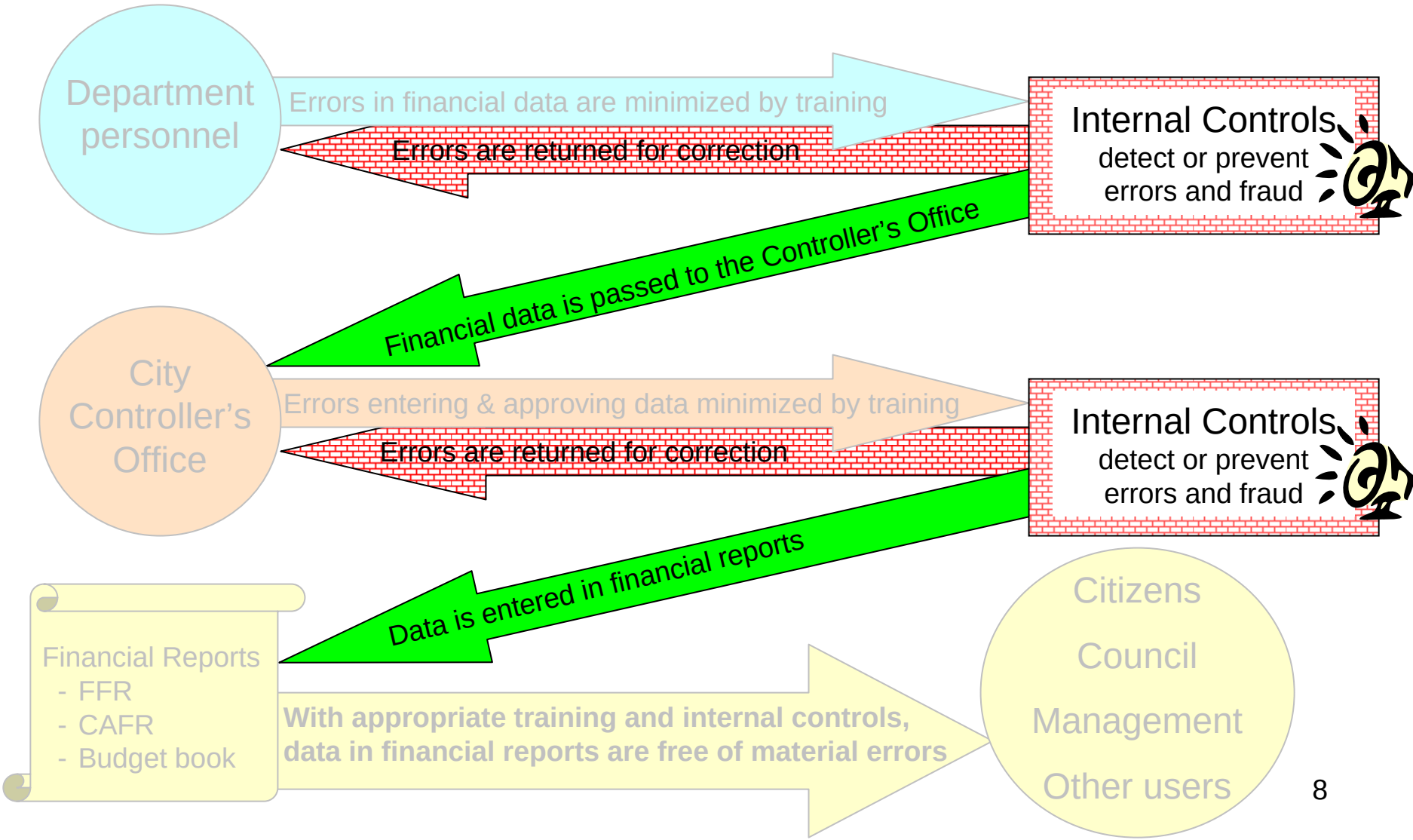
Training


Department personnel
Errors in financial data are minimized by training
Errors are returned for correction
Internal Controls
detect or prevent errors and fraud
Financial data is passed to the Controller's Office
City Controller's Office
Errors entering & approving data minimized by training
Errors are returned for correction
Internal Controls
detect or prevent errors and fraud
Data is entered in financial reports
Financial Reports
- FFR
- CAFR
- Budget book
With appropriate training and internal controls, data in financial reports are free of material errors
Citizens
Council
Management
Other users

Training

- Improves the accuracy of financial data entered into the system
- Staff must understand the City's policies and procedures
- Additionally, accounting standards are constantly changing
- Six new Governmental Accounting Standards Board statements will guide or change accounting standards and will be implemented between fiscal years 2008 and 2010 (See Appendix)

Internal Controls



Internal Controls

- Internal controls are the tools used by management to achieve management's objectives of:
  - Efficiently using resources;
  - Complying with policies, laws and regulations;
  - Demonstrating reliability of financial reporting; and
  - Achieving those objectives effectively.
- Internal control policies and procedures are designed to prevent undesired actions and events, and to alert management
- Effective internal controls must be maintained to ensure accurate and complete financial data

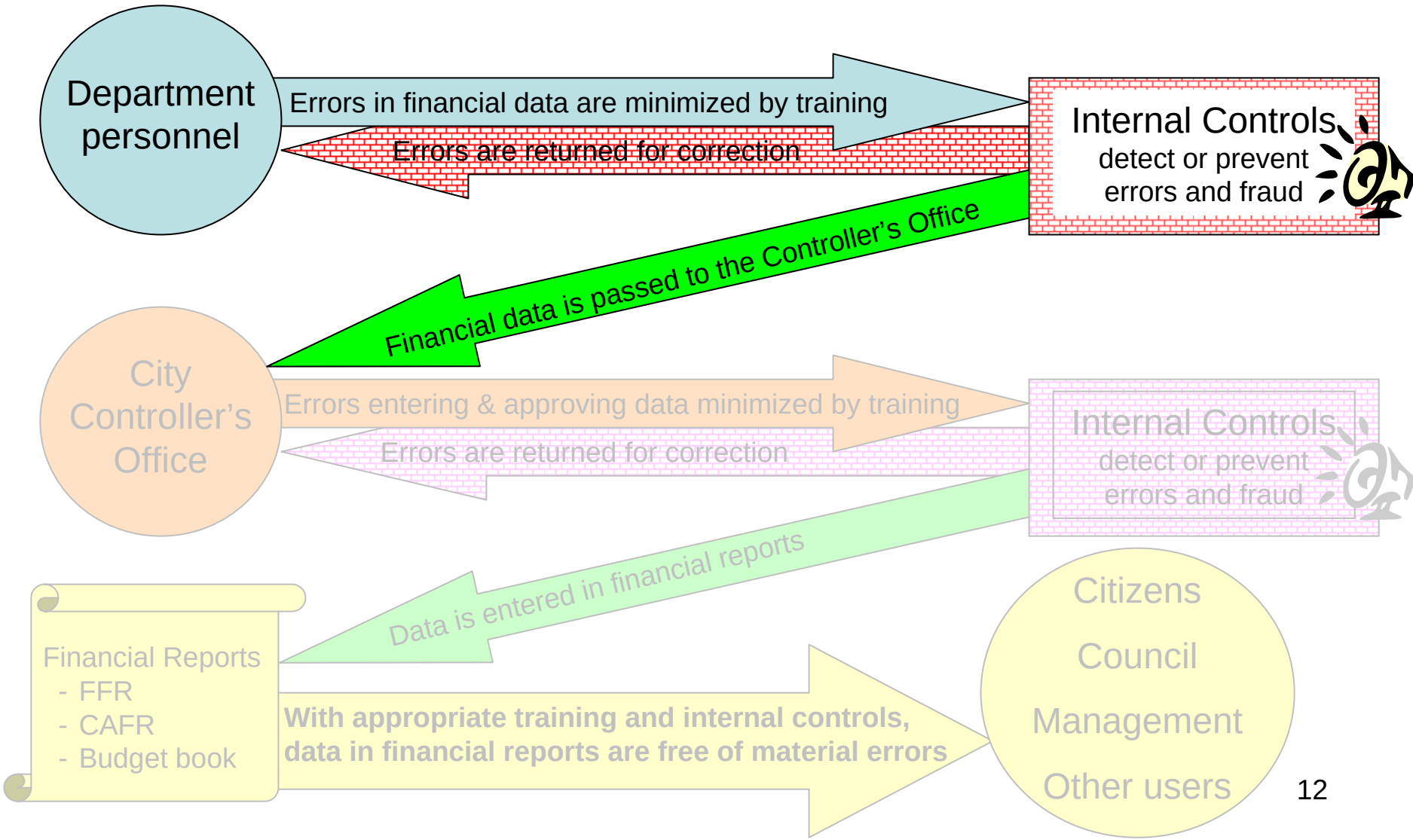
Internal Controls

- Controls exist **at all levels** to provide assurance to management that risk of fraud or material misstatements in financial reports is minimized
- Financial policies and procedures should be established, standardized and documented through narratives and flowcharts
- Effectiveness of controls must be constantly monitored
- Examples of controls include:
  - Segregation of duties
  - Verification of data
  - Periodic reconciliations
  - Security of assets and records

Internal Control Limitations

- Internal controls may not prevent or detect all errors
  - Cost of implementing a control must be weighed against the benefits
  - Controls must be operating as designed
  - Risk of collusion
  - Risks posed by redundant controls

Decentralization



Challenges of Creating a Centralized Financial Environment

- No system of financial reporting can be completely centralized
- Data comes from many sources
  - Internally generated in the City Controller's Office (CCO)
    - Accruals necessary to convert from modified accrual to full accrual accounting
    - Fixed asset additions and deletions
    - Depreciation
    - Landfill closure and post-closure care costs
    - Capital lease and other long-term debt
  - External sources
    - Banks
    - Collection agencies
    - Dallas County property tax office
    - Insurance providers
  - Other departments
    - Encumbrances are entered by departments
    - Departments enter goods received into the system
    - Payroll time entry and approval
    - Inventory adjustments
    - Revenues and receivables
    - Grant compliance, financial status reports and requests for reimbursements

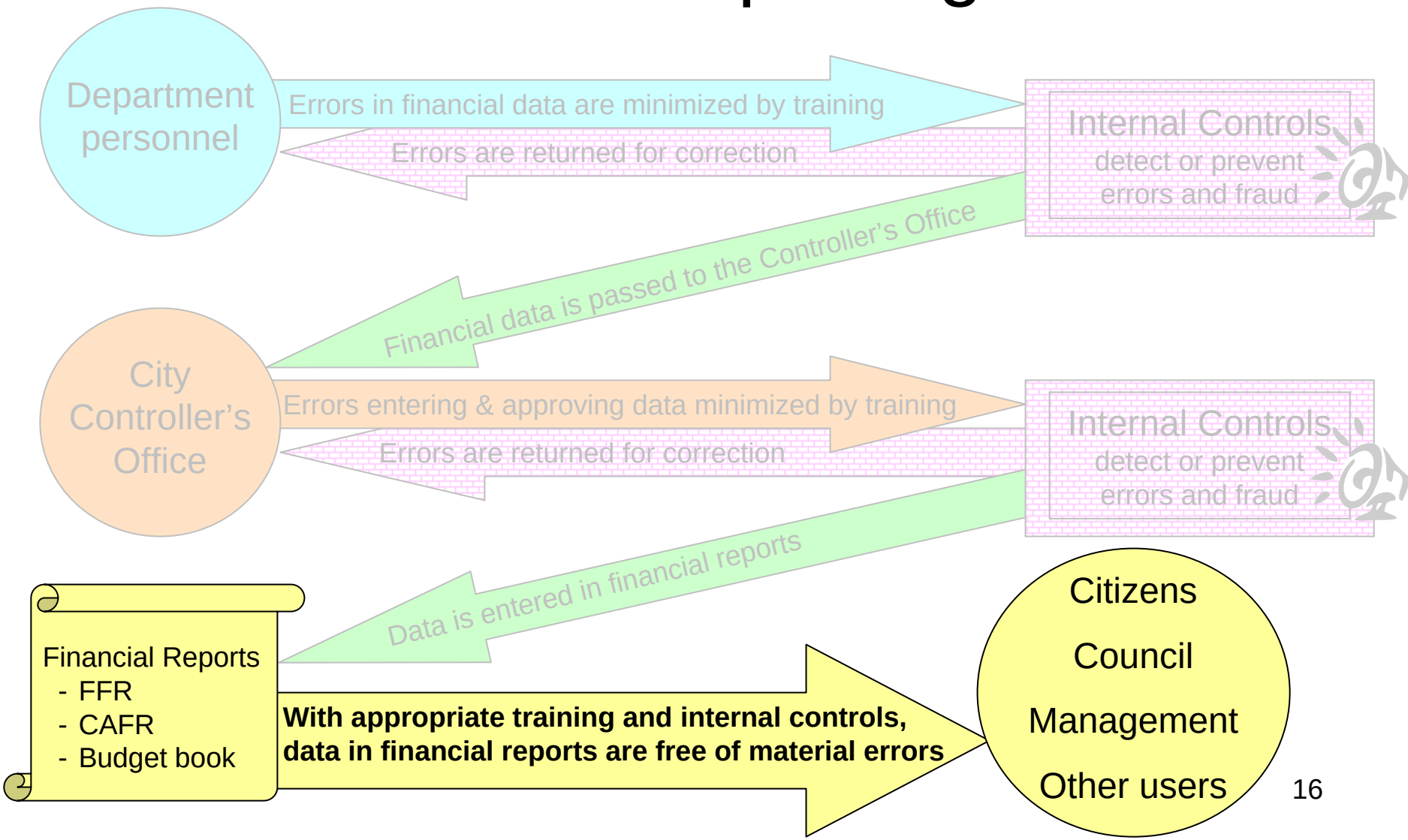
Challenges of a Decentralized Financial Environment

- Controls must be designed to provide assurance of the accuracy of financial information
- Controls must be monitored effectively to determine whether they are operating as designed
- Steps must be taken to ensure staff in the departments are well trained

Criteria Used by the City to Centralize Financial Processing

- Does centralization provide greater oversight and accountability of financial activity?
- Are redundant controls eliminated?
- Is this an efficient use of resources?
  - Financial staff in departments may develop budgets or enter encumbrances; smaller departments lack adequate staff to separate these job functions
  - Financial reporting activities may comprise a small percentage of their time

What is the City doing to improve financial reporting?



Staffing

- Steps taken to-date
  - New managers over financial reporting, reconciliations and fixed assets have been hired
  - Accounting staff have been added to areas identified as weaknesses
  - Controller's Office has utilized efficiencies gained through consolidations to supplement staffing needs in other areas of the Controller's Office
  - Temporary staff are used to immediately fill vacancies
- Future action
  - Evaluating the adequacy of staffing levels is an ongoing process
  - The City has established a mechanism through Budgeting for Outcomes to submit bids for consolidation of additional staffing should the need arise
  - Fill three vacant accountant positions by June 2008

Training

- Steps taken to-date
  - Controller's Office professional staff are required to attend a minimum of 16 hours training annually
  - KPMG provided a total of 16 hours training in the following areas:
    - Basic Governmental Accounting
    - Governmental Accounting Standards Board statements update
    - Review of the Comprehensive Annual Financial Report
    - Approach to Internal Controls
    - Designing Internal Controls for Federal Programs
    - "Yellow Book" Revisions and Other Developments
  - Fixed asset training was provided to staff throughout the City on November 8, 2007

Training (continued)

- Steps taken to-date (continued)
  - Conducted 10 training sessions with departments on inventory reporting
  - Conducted 15 training sessions with departments on grant revenue reporting
  - Conducted 11 training sessions with departments on accounts receivable
  - Major training is tracked by Human Resources and can be monitored by Controller's Office to identify deficiencies
- Future action
  - The City's external auditors, Grant Thornton, will provide additional training on proper accounting procedures to appropriate staff throughout the City during September 2008

Internal Control Evaluation

- Background
  - An internal control evaluation identifies gaps between how a control **is** designed and operating, versus how those controls **should be** designed and operating
  - The importance of evaluating and documenting an entity's internal control structure was emphasized after corporate accounting scandals in the early 2000's
  - While not required for government, internal control evaluations are very useful in assisting management in improving control over financial reporting, cash receipts and disbursements, information technology, and other areas of potential risk
- Steps taken to-date
  - A risk assessment was performed by staff from Internal Audit and Controller's Office to identify the risk of potential weaknesses, the probability that a material error may exist in the financial statements in a particular area, and identify areas with a higher probability of fraud
  - Preliminary Request for Proposal for professional assistance was completed jointly by Internal Audit and Controller's Office
- Future action
  - Release the Request for Proposal for a consultant to evaluate and recommend improvements to the City's internal controls
    - Planned award date: June 2008
    - Planned completion date: December 2008
    - Planned implementation date: to be determined, based on consultant's findings

Internal Control Evaluation (Continued)

- Future action (continued)
  - Internal control evaluation process identified in the RFP:
    - Preliminary risk assessment will be reviewed by the consultant and revised, if necessary
    - Policies and procedures will be documented through narratives and flowcharts
    - Policies and procedures will be reviewed by the consultant to identify control weaknesses
    - Controller's Office will revise and establish effective internal controls based on consultant's review
    - Controller's Office and consultant will develop procedures to assist City Management and the Controller's Office in detecting future control weaknesses
  - Review and update Administrative Directive 4-9, "Internal Control," to ensure compliance
  - Require department directors sign a representation letter acknowledging, among other facts, responsibility for compliance with established departmental controls
  - Obtain approval from Finance, Audit & Accountability committee to move forward with the contract award

Cash Receipts and Disbursements

- Future action
  - Quarterly training will be provided to appropriate staff throughout the City on proper cash handling techniques
  - Bank of America will review the City's cash handling processes and recommend improvements
    - The service is being offered free-of-charge to the City
    - Processes to review will include cash receipts, cash disbursements and investments
    - Recommendations will provide cost saving initiatives, revenue enhancements and fraud prevention/detection
    - Project began April 24 with a presentation to City staff
    - May 5 – 23: Data gathering phase
    - Week of May 27: Onsite interviews with City staff
    - June 13: Present final report
  - Accounts Payable process is currently under review to identify potential efficiencies and to revise policies and procedures. This is being coordinated through the Zip Team process with the assistance of the Efficiency Team and Strategic Customer Services department.

Bank Reconciliation

- Background
  - The bank reconciliation process is similar to an individual balancing their checking account, but on a much larger scale: approximately 17,000 bank transactions per month.
  - Software was purchased in FY 2002 to automate the process, but still requires manual intervention to clear transactions posted to the bank and general ledger, and to contact departments when amounts posted to the general ledger differ from those posted to the bank.
- Steps taken to-date
  - Additional staff have been assigned to bank reconciliations
    - Previously, one staff accountant was assigned to this area full-time, with the Financial Reporting manager overseeing the process
    - There has been constant staff turnover in the past several years; 100% of the staff currently performing bank reconciliations have been with the Controller's Office less than two years
    - The importance of accurate bank reconciliations has been enforced by hiring a manager, Senior Accountant and two staff accountants
  - Controller's Office worked with the City Auditor's Office to identify efficiencies in the bank reconciliation process

Bank Reconciliation (continued)

- Future action
  - Controller's Office will work with the bank reconciliation software vendor to determine:
    - Upgrades to existing software, or changes necessary to the current software version
    - Adequacy and completeness of data extracted from the City's financial system
    - Further efficiencies in the bank reconciliation process
  - Controller's Office will review other alternatives to the current software system
  - Scorecard will be distributed to the City Manager and department directors identifying and aging the number of cash receipts not posted to the financial system
  - Extensive training will be provided to staff throughout the City
  - Planned implementation date for all future actions is June 2008

Ensure appropriate accounting for liabilities

- Steps taken to-date
  - Agenda items are monitored for future debt issuances, particularly with component units of the City (these are organizations which are legally separate from the City, but must be reported in the City's financial statements, such as Downtown Dallas Development Authority)
  - Existing procedures to identify proper accrual of expenditures for the Fiscal Year 2008 audit were supplemented by reviews of all cash disbursements greater than $50,000 to determine whether an accrual should be recorded
  - Independent second level review is required for all manual journal entries

Reconcile general ledger to underlying documents

- Steps taken to-date
  - Controller's Office worked with departments to obtain supporting documentation for numerous balance sheet accounts determined to be material
- Future action
  - The City's balance sheet accounts (not including revenues and expenditures) are summarized in a 430 page report
  - Due to the number of balance sheet accounts, this is an ongoing process
  - Staff will utilize time between audits to obtain additional support

Capital asset reporting

- Steps taken to-date
  - New manager over fixed assets was hired to replace the previous manager
  - All complete and substantially complete projects include adequate supporting documentation
  - Capital outlay is reconciled to capital additions to ensure accuracy and completeness
  - All purchases over the $5,000 capitalization threshold were reviewed to determine appropriate treatment
  - All leases identified through the agenda process were analyzed to determine status as capital or operating lease

Inventory balances

- Steps taken to-date
  - Required all departments have, at a minimum, an annual physical inventory count and reconcile actual count to the general ledger
  - Staff from the Controller's Office were sent to various locations to observe the physical inventory count
  - Controller's Office traced all inventory balances in the general ledger to supporting documents

Decentralization

- Steps taken to-date
  - Fiscal Year 2002, Accounts Payable invoice processing was consolidated in the Controller's Office
  - Fiscal Year 2006, Dallas Water Utilities financial reporting was consolidated in the Controller's Office
  - Fiscal Year 2008, Special Revenue Division was consolidated in the Controller's Office

Decentralization (continued)

- Future action
  - Pay1 billing will consolidate numerous revenues processes and centralize the billing
    - Standardizes the process of recording receivables
    - Provides more accurate reporting
    - Enhances security
    - Implementation will continue through Fiscal Year 2009
  - Controller's Office is constantly looking into ways to further improve the financial reporting process throughout the City by consolidating functions under the direction of Controller's Office

Example of overall improvements: Purchase of equipment

- Scenario:
  - Department obtains authorization to purchase a computer worth $4,800. Shipping is an additional $500. The City's capitalization threshold is $5,000. Since the total cost of the equipment is $5,300 ($4,800 + $500), the equipment should be charged to Capital Outlay, and capitalized in the Fixed Asset system.
- Prior process:
  - Department enters a purchase order for $4,800 to supplies, since the cost of the computer falls below the capitalization threshold. A separate line on the purchase order is added for $500 shipping, which the department charges to services.
  - The invoice is sent to the department, then forwarded to Accounts Payable in the Controller's Office for payment.
  - Accounts Payable pay the invoice. Since the asset is not entered as Capital Outlay, the asset is not capitalized in the Fixed Asset system. Total assets for the City are understated, expenses are overstated, and depreciation expense is understated.

Example of overall improvements : Purchase of equipment (continued)

- Revised process:
  - Department enters a purchase order for $5,300. Shipping is no longer a separate line item on the purchase order, so the department charges the entire amount to supplies.
  - Department supervisor is required to approve the purchase order. Upon review, the supervisor changes the funding to Capital Outlay.
    - This is an example of adequate controls and proper training.
    - Approval by someone other than the person entering the purchase order provides control authorization for purchases.
    - Proper training alerts the supervisor to include all costs associated with the installation of equipment as capital.
  - When the computer is received, the department enters a receiving document in the financial system.
    - This is an example of a control designed to ensure that equipment is received prior to payment.
  - The invoice is sent directly to Accounts Payable
    - This provides a segregation of duties, where the person receiving the goods is not also paying for the goods.
    - Provides a tracking mechanism for management to identify goods invoiced but not received.

Example of overall improvements : Purchase of equipment (continued)

- Revised process (continued):
  - The Financial System checks to make sure that the purchase order, receiving document and invoice match
    - A three-way match provides assurances that the purchase of goods and services are authorized, that the City received those goods and services, and that the City is authorized to pay for them.
  - Additional controls were added to the Fixed Assets section of the Controller's Office to ensure proper accounting for capital purchases
    - Staff in Fixed Assets ensure that all purchases coded to Capital Outlay are added to the Fixed Asset system (ensures accuracy of financial data).
    - Staff in Fixed Assets review all purchases over $5,000 which were not coded to capital outlay to determine whether they meet the criteria for capitalization (ensures completeness of financial data).
    - Staff in Fixed Assets review all purchases coded to Capital Outlay which fall below the capitalization threshold of $5,000 to determine whether they meet the criteria for capitalization (ensures completeness of financial data).
- In summary, the revised process provides adequate training to department staff in identifying capital assets; controls are implemented at the department level to ensure authorization and review of purchases; segregation of duties is enforced by separating the receiving function from invoicing; and additional controls at the financial reporting level are implemented to ensure accuracy and completeness of the financial data being reported.

Recommendation

- Staff will continue with steps outlined in Future Action items

Appendix

Future GASB Statements

Statement Number	Title	Year of Implementation
45	Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions	2008
48	Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues	2008
49	Accounting and Financial Reporting for Pollution Remediation Obligations	2009
50	Pension Disclosures	2008
51	Accounting and Financial Reporting for Intangible Assets	2010
52	Land and Other Real Estate Held as Investments by Endowments	2009