# CITY OF PHILADELPHIA
# PENNSYLVANIA

OFFICE OF THE CONTROLLER

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**REPORT ON INTERNAL CONTROL
AND ON COMPLIANCE AND
OTHER MATTERS**

**CITY OF PHILADELPHIA**

**FISCAL 2010**


City Controller
**ALAN BUTKOVITZ**

# CITY OF PHILADELPHIA

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ALAN BUTKOVITZ
City Controller

GERALD V. MICCIULLA
Deputy City Controller

May 17, 2011

Honorable Michael A. Nutter, Mayor
City of Philadelphia
215 City Hall
Philadelphia, PA 19107

Dear Mayor Nutter:

In accordance with the Philadelphia Home Rule Charter, the Office of the City Controller conducted an audit of the basic financial statements of the City of Philadelphia, Pennsylvania as of and for the fiscal year ended June 30, 2010, and has issued its Independent Auditor's Report dated February 22, 2011.

In planning and performing our audit, we considered the City of Philadelphia, Pennsylvania's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City of Philadelphia, Pennsylvania's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the city's internal control over financial reporting.

Attached is our report on internal control over financial reporting and on compliance and other matters, dated February 22, 2011 and signed by my deputy who is a Certified Public Accountant. The findings and recommendations contained in the report were discussed with management at an exit conference. We included management's written response to the findings and recommendations as part of the report. We believe that, if implemented by management, these recommendations will improve the City of Philadelphia, Pennsylvania's internal control over financial reporting.

We would like to express our thanks to the management and staff of the City of Philadelphia for their courtesy and cooperation in the conduct of our audit.

Respectfully submitted,

ALAN BUTKOVITZ
City Controller

cc: Honorable Anna C. Verna, President
and Honorable Members of City Council
Rob Dubow, Director of Finance and other
Members of the Mayor's Cabinet

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**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

To the Honorable Mayor and Honorable Members
of the Council of the City of Philadelphia

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Philadelphia, Pennsylvania as of and for the year ended June 30, 2010, which collectively comprise the City of Philadelphia, Pennsylvania's basic financial statements and have issued our report thereon dated February 22, 2011. Our report was modified to include a reference to other auditors, and to the adoption of a new accounting pronouncement. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the following entities, as described in our report on the City of Philadelphia, Pennsylvania's basic financial statements.

<u>Primary Government</u>
Municipal Pension Fund
Philadelphia Gas Works Retirement Reserve Fund
Fairmount Park Commission Departmental and Permanent Funds
Philadelphia Municipal Authority
Pennsylvania Intergovernmental Cooperation Authority

<u>Component Units</u>
Community College of Philadelphia
Delaware River Waterfront Corporation
Pennsylvania Convention Center Authority

Component Units (Continued)
Philadelphia Parking Authority
Redevelopment Authority of the City of Philadelphia
Community Behavioral Health
Philadelphia Authority for Industrial Development
Philadelphia Gas Works

This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of the Pennsylvania Intergovernmental Cooperation Authority, Delaware River Waterfront Corporation, Pennsylvania Convention Center Authority, Philadelphia Parking Authority, and Community Behavioral Health were not audited in accordance with *Government Auditing Standards*.

We have also audited the basic financial statements of the School District of Philadelphia, a component unit of the City of Philadelphia, in accordance with *Government Auditing Standards* and issue a separate report on the School District's internal control over financial reporting and on compliance and other matters.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the City of Philadelphia, Pennsylvania's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City of Philadelphia, Pennsylvania's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the City of Philadelphia, Pennsylvania's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified a combination of deficiencies in internal control over financial reporting that we consider to be a material weakness and other deficiencies that we consider to be significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the inadequate oversight and review procedures over the financial reporting process, described in the accompanying report, to be a material weakness.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies, which are discussed in greater detail in this report, to be significant deficiencies:

- Inadequate controls over the amounts reported for capital assets because the city does not have a real property management system to facilitate accounting for and reporting of its real property assets.

- Delays in implementing system components and weak controls with the city's water billing system, which adversely affected collections, and left the system susceptible to errors and irregularities.

- Inadequate monitoring of the third party administrator's management of the city's workers' compensation plan.

- Deficiencies in the procedures used to generate accounts payable balances increased the risk of misstating reported liabilities.

- Failure to revise Standard Accounting Procedures, which serve as the basis for the city's system of internal control, to reflect the automated processes and the practices currently in use.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the City of Philadelphia, Pennsylvania's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed the following instance of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, and which is discussed in greater detail in this report:

- Non-compliance with Act 148 grant reporting requirements resulted in delays in billing and reimbursements.

We noted certain matters that are not required to be reported under *Government Auditing Standards*, but nonetheless represent deficiencies in internal control over financial reporting that should be addressed by management. We will communicate these matters to management of the City of Philadelphia, Pennsylvania in separate reports.

CITY OF PHILADELPHIA

OFFICE OF THE CONTROLLER

The City of Philadelphia, Pennsylvania's written response to the material weakness and significant deficiencies identified in our audit is included as part of this report. However, the response has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the management of the City of Philadelphia, Pennsylvania, others within the entity, and City Council and is not intended to be and should not be used by anyone other than these specified parties.

Gerald V. Micciulla

February 22, 2011

GERALD V. MICCIULLA, CPA
Deputy City Controller

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**RESPONSE TO AUDITOR'S REPORT**

## FINANCIAL REPORTING

Philadelphia's Home Rule Charter assigns the Office of the Director of Finance (Finance) with overall responsibility for the city's accounting and financial reporting functions. One of the duties assigned to Finance's Accounting Bureau is the preparation of the city's Comprehensive Annual Financial Report (CAFR). To complete this task, the Accounting Bureau must collect, analyze, and summarize great amounts of financial data and other information that it obtains from the city's accounting system, various city departments, and component units. Our current audit continued to find weaknesses in the city's controls over the financial reporting process that adversely affected the city's ability to issue a timely, accurate, and complete CAFR.

### Staff Turnover and Reductions Compromise CAFR Preparation Process

In our previous reports, we commented about staff reductions, which in recent years have made the Finance Accounting Bureau's task of preparing the CAFR more difficult to complete, and have compromised its ability to perform adequate reviews and approvals of the financial statements and related footnote disclosures. Over the past decade, the Accounting Bureau's staff size has been reduced from 64 positions in fiscal year 2000 to only 45 in fiscal year 2010.

These staff reductions have resulted in top Accounting Bureau management being responsible for preparing significant and highly complex sections of the CAFR, such as the full accrual government-wide statements and the debt payable derivative instruments footnote. Since top management was preparing these CAFR sections, there was no independent review of their work, and their ability to adequately review financial statements and footnote disclosures prepared by subordinate employees was limited. Consequently, there was an increased risk for financial reporting errors and omissions.

In its response to our previous report, management stated it was working with the city's Personnel Department to fill the vacant positions. One notable vacancy, the key position of accounting manager, had been filled in June 2010. In addition, management stated that it would continue the training program it instituted, which consisted of "knowledge transfer teams" and multi-tasked duties.

Despite implementation of this succession planning strategy, our current audit disclosed no significant improvement in the quality of the CAFR submitted for audit. We again found that financial statements were provided to us in an untimely manner, with numerous errors and omissions of critical data that impeded the audit process and timely reporting. For example, accurate footnote disclosures, full accrual government-wide statements, and the Management Discussion and Analysis were all provided late in the audit process. We identified approximately $1.1 billion in errors within the CAFR that required audit adjustments.

Recommendation:

To provide the Accounting Bureau with adequate staff to prepare the CAFR and the ability to perform independent supervisory reviews of CAFR financial statements and footnotes, we continue to recommend that the director of finance analyze workload and staffing levels in the Accounting Bureau and fill all vacancies deemed necessary [50107.01].

Stronger Controls Needed Over Reporting of Receivables

The City of Philadelphia's Department of Revenue (Revenue Department) is responsible for calculating an accurate amount due for taxes and accounts receivables, as well as determining a reasonable estimate of amounts deemed uncollectible at year-end for inclusion in both the City of Philadelphia's and School District of Philadelphia's CAFRs.

During our current year testing, we found several errors in the amounts reported by the Revenue Department relating to taxes and accounts receivables. These errors resulted in adjustments totaling over $322.4 million. Specifically, we found that accounts receivables were overstated by $81 million, city tax receivables were overstated by $76.6 million, School District tax receivables were understated by $38 million, and the allowance for doubtful accounts was overstated by $126.8 million. In our opinion, significant turnover of experienced staff responsible for determining the year-end receivable balances, together with assigned staff not following written procedures, and the lack of a diligent independent review of receivable activity all contributed to the misstatements that occurred.

The Revenue Department also did not update its basis for estimating uncollectible receivables as of June 30, 2010. As such, the City Controller's Office had to rely on the prior year basis in order to evaluate the reasonableness of the current estimate for uncollectible amounts reported for taxes and accounts receivable at year-end. Neglecting to update this methodology unnecessarily complicated the reporting process and contributed to the above material misstatement of receivables.

Recommendations:

The Revenue Department acknowledged the errors noted above were caused by an unusual staff turnover and the resulting problems that ensued when employees had to quickly assume new duties. However, to ensure the errors do not recur, we recommend that the Revenue Department follow their written procedures to accurately determine year-end receivable balances, and annually update the estimated basis for determining uncollectible tax and accounts receivable amounts. We also recommend that an independent review of year-end receivable activity be performed [500110.01].

Inadequate Preparation and Review over the Deposits and Investments Footnote

GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, in effect since fiscal year 2005, was designed to inform financial statement users about deposit and investment risks that could affect the city's ability to provide services and meet its obligations as they become due. The required disclosures provide information to assess common risks inherent in deposit and investment transactions.

During our audit work, we found that Finance had not developed written procedures for the preparation and review of the deposits and investments footnote disclosure, included in the city's CAFR. Numerous deposit and investment accounts were misclassified and/or omitted.

Additionally, Lotus 1-2-3 spreadsheets used by the Accounting Bureau to prepare the related CAFR footnote were not properly updated with corrected data. For instance, when adjustments were required to correct the footnote, the Accounting Bureau appropriately adjusted the main summary worksheet, but never updated the supporting worksheets linked to the footnote file. Consequently, the related footnote was incorrect. In total, we observed approximately $411 million in errors pertaining to the deposits and investments footnote disclosure.

We believe that a lack of detailed written procedures contributed to the above errors. Written procedures would have helped ensure the proper classification and inclusion of deposit and investment accounts. In addition, insufficient instruction on how to properly utilize Lotus 1-2-3 spreadsheet files used to prepare the footnote, together with a lack of supervisory review, also led to the errors we identified during the audit.

Recommendation:

To ensure that the deposits and investments footnote is accurately prepared and in accordance with GASB Statement No. 40, we recommend that Finance develop and implement detailed written procedures, train staff on the spreadsheet program, and perform an independent and thorough supervisory review of the supporting documentation and footnote disclosure [500110.02].

Enterprise Fund Reporting Procedures Require Strengthening

Previously, we reported that Finance had assigned responsibility for preparation of the full accrual financial statements of the Water and Sewer Fund to the Philadelphia Water Department (PWD). Our prior year review disclosed that PWD again could not provide evidence that review procedures over the financial reporting process were performed.

During our current year audit, we observed no improvement over this condition. Additionally, we now noted a lack of adequate segregation of duties, as the individual who prepared the financial statements also performed the review. This condition increased the risk that errors could occur and go undetected.

We also previously noted that PWD did not have written policies and procedures for the operation and review of its $1.8 billion capital asset inventory system. Our current audit disclosed that this condition still existed.

Further, our testing revealed that real property items were not uniquely identified in the capital asset system so as to distinguish one asset from another. The Water Department identified each item of real property using a combination of the completion date and a detailed work order number. We observed that the system often included blank, incomplete or duplicate identifying information, which we again believe could increase the likelihood of undetected errors.

Recommendations:

We continue to recommend that management establish specific review procedures to be performed by PWD personnel, such as:

- Agreeing opening account balances to prior year closing balances.
- Comparing recorded financial information to source documentation (i.e. city accounting system reports and PWD subsidiary records) to ensure accuracy and completeness.
- Reviewing adjusting journal entries for propriety and accuracy by observing supporting documentation.
- Verifying the mathematical accuracy of financial statements and supporting schedules.
- Validating that all year-end adjustments posted by Finance are properly reflected in the financial statements.

Performance of these review procedures should be documented on a checklist, and signed by a responsible PWD official. The checklist should be submitted to Finance with the respective financial statements, attesting that they have been independently reviewed and approved and that to the best of the reviewer's knowledge are complete and free from material misstatement [50105.01].

Additionally, to improve the accounting and reporting of the PWD's capital assets, we continue to recommend that PWD develop written procedures documenting the operation and review of the capital asset system [500109.01]. We also recommend that PWD ensure that the capital asset system uniquely identifies real property by providing a complete description of the assets [500110.03].

Late Receipt of Component Unit Financial Data Still Hampered Preparation and Audit of CAFR

For the past several years, we noted that late submission of financial data by some of the city's component units resulted in delays to the financial reporting and auditing processes. In addition, because the Accounting Bureau had to make significant changes to the financial statements and footnotes each time new component unit data was received, there was an increased risk of errors or omissions.

This condition had not improved. We noted that eight of the city's eleven component units failed to submit their reports by the due date requested by Finance. The two most delinquent component units, the Pennsylvania Convention Center Authority and the Redevelopment Authority, did not submit their final reports until February 2011, over four months after the date requested.

In an attempt to provide more timely information, some component units submitted draft versions of their reports. However, we believe efficient and effective preparation of the CAFR requires timely submission of complete and final financial data.

Recommendation:

We again recommend that Finance continue its efforts to secure the cooperation of all component unit management in the timely submission of their financial data to the Accounting Bureau [50102.01].

Reporting Process for Departmental Custodial Accounts Needs Improvement

In our previous reports, we had noted significant accounting and reporting errors in the departmental custodial accounts (i.e. bank accounts not under the control of the Office of the City Treasurer). Our current testing disclosed that the reporting process still had not improved. We again identified several city agencies that failed to notify the Accounting Bureau of new accounts and did not submit required monthly bank reconciliations to the Accounting Bureau. Moreover, the Accounting Bureau did not perform an effective follow-up with the noncompliant city agencies.

Standard Accounting Procedure (SAP) No. 7.1.3.b requires that city agencies submit monthly bank reconciliations for their custodial account bank accounts to Finance's Accounting Bureau for its review and analysis. Accounting Bureau personnel must summarize the activity from these bank reconciliations to arrive at the reported cash and investment amounts for the departmental custodial accounts reported in the city's CAFR. Failure to obtain custodial accounts' bank reconciliations precluded the bureau from having assurance that city agencies were preparing monthly bank reconciliations, increased the risk of financial reporting errors, and expanded the audit process by requiring increased audit testing.

Recommendation:

We continue to recommend that the Accounting Bureau continue its efforts to instruct city agencies about the necessity to prepare and submit custodial account bank reconciliations each month. In addition, a concerted follow-up effort to obtain the required reconciliations should be developed and implemented [50106.05].

FAMIS Not Utilized for Posting Aviation Year-End Journal Entries

Our current year audit work noted that Finance and the Division of Aviation (DOA) are not effectively utilizing the full accrual Aviation Fund established in FAMIS (the city's accounting system) to prepare the financial statements. Posting year-end journal entries to the accrual fund provides a clear trail of adjustments between the modified and full accrual statements, and decreases the risk for financial statement errors.

Although our testing of the Aviation Fund did not reveal any material errors, the DOA carried forward two years of manual journal entries that hampered the preparation of the CAFR. In conjunction with the DOA, Finance created the accrual fund to streamline and standardize the year-end adjustment process. However, with recent staff shortages, Finance was unable to maintain the fund. With each passing year, the required entries become larger and more complex, thereby increasing the severity of errors that could occur and go undetected.

Recommendation:

Since Finance has assigned the responsibility for preparation of the Aviation Fund financial statements to the DOA, we recommend that it provide DOA personnel with the appropriate training to enable them to make the necessary year-end adjustments in FAMIS. Finance, still responsible for the city's accounting and reporting functions, should review accrual fund entries for propriety [500110.04].

## CAPITAL ASSET DEFICIENCIES

A Comprehensive Capital Asset System Could Improve Reporting Accuracy and Efficiency

Philadelphia's Home Rule Charter requires that city management compile and maintain current and comprehensive records of all real and personal property belonging to the city. For the past several years, we have emphasized the need for Finance to acquire a comprehensive capital asset system because controls over the city's real property assets had been weak.

We again observed that Finance maintained several spreadsheet files in Lotus 1-2-3 and Excel to accumulate the cost of capital assets and work-in-progress, and to compute, as well as account for depreciation on the assets reported in the CAFR. In our opinion, the use of multiple software programs and spreadsheet files to account for capital assets and related depreciation has created a cumbersome and onerous process. Moreover, it can affect the accuracy and completeness of amounts reported in the CAFR and requires extensive audit effort.

We believe acquiring a comprehensive capital asset system could provide the city with detailed asset information that would eliminate significant amounts of manual recordkeeping time and make the Accounting Bureau's operations more efficient. We also think that a comprehensive system would improve the transition process when new employees become responsible for capital asset reporting.

Land Costs Not Properly Allocated to Asset Locations

In prior year audits, we noted certain land values in the city's fixed asset ledger were aggregated into lump sum amounts. Land values for individual properties, reported as part of a larger parcel of land, were not specifically identified. This methodology, which remained uncorrected for fiscal year 2010, did not allow Finance's Accounting Bureau to maintain an accurate book value for many city-owned properties, which could make it difficult to calculate the gain or loss recognized when accounting for individual property disposals.

Subsequent to our audit, we were informed that although Finance acknowledged the above inherent recording weakness, at this time there are no plans to specifically identify land values. Further, Finance stated that this condition only applied to land acquired prior to the implementation of GASB Statement 34 in fiscal year 2002. Therefore, we will no longer report on this condition. However, we caution Finance that when individual properties are disposed, the above unresolved condition may require the development of a reasonable cost basis in order to accurately record the gain or loss on future disposals.

Asset Information Improperly Recorded

We have also previously observed that the city's real property records were incomplete since certain sold properties were never recorded in the city's books. Our current year audit disclosed that twenty properties, identified by the city as sold for approximately $3.5 million during fiscal 2010, were never included in the city's fixed asset ledger. However, we were notified that these properties were acquired through the city's foreclosure process and as such, were not used in city operations. Consequently, Finance's Accounting Bureau did not consider these properties as capital assets, and properly excluded them from the city's fixed asset ledger. Therefore, we will no longer report on this condition. However, we will continue to monitor the city's real property sale transactions to ensure they are properly recorded.

<u>Periodic Physical Inventory of Real Property Assets Is Required</u>

Both the city's Finance Office and the Government Finance Officers Association (GFOA) either require or recommend that a physical inventory of real property assets be taken periodically. For example:

- Finance Standard Accounting Procedure, SAP E-7201, specifies that the Procurement Department shall physically inspect all city-owned real property on a cycle basis and check against the inventory listing to determine actual existence, condition and propriety of use.

- GFOA recommends that governments periodically inventory tangible capital assets, which include real property, so that all assets are accounted for, at least on a test basis, no less often than once every five years. It also recommends that governments periodically inventory the physical condition of all existing capital assets so that the listing of all assets and their condition is kept current. Additionally, the GFOA suggests that a "plain language" report on the condition of the government's capital assets be prepared, and that this report be made available to elected officials and the general public every one to three years.

Our current year audit work determined that both the PWD and the DOA periodically checked the physical existence and condition of their real property assets. Except for the assets held by these two agencies, we saw no evidence that the city's other real property assets had been recently inventoried or that any type of "plain language" report on the condition of the capital assets had been prepared.

At the exit conference, Finance personnel asserted that they believed this situation is mitigated since many properties are observed by various city employees as part of their capital asset inspections, repair, or improvement procedures. However, they agreed that since the process is not formally documented, these procedures are not sufficient to resolve the above condition.

<u>Recommendations</u>:

To improve the accounting and reporting of the city's capital assets, we recommend that management:

- Design or purchase a computerized capital asset management system that will provide accurate and useful information such as the book value and related depreciation for each city owned asset [50104.01].
- Periodically take physical inventories of all real property assets, ascertain their condition and use, and ensure that related records are timely and appropriately updated to reflect the results of this effort [50106.04].
- Develop and provide a plain language report on the condition of capital assets for the use of elected officials every three years. This report should also be made available to the general public [500109.02].

## WATER BILLING SYSTEM

In prior years, we reported significant control weaknesses related to Basis2, the city's water billing system. Our current year testing indicated that some of the control weaknesses still existed and required corrective action. We again observed that an electronic authorization path for supervisory approval of adjustments still had not been developed. Additionally, the water billing system remained unable to prevent or detect a user that circumvented their established, authorized adjustment limit by "splitting" one large adjustment into numerous smaller adjustments. Lastly, improvements to the penalty function had been made, however, erroneous penalty amounts were printed on bills for accounts entitled to discounts.

Recommendation:

We recommend that management continue its efforts to resolve the above remaining control deficiencies that compromise the Basis2 billing system [50008.01].

## WORKERS' COMPENSATION PLAN MONITORING

In our prior year report, we commented about the Risk Management Division of Finance (Risk Management) failing to monitor its Third Party Administrator (TPA) to ensure that all contracted services were being received. We had found that the TPA did not perform file maintenance on 1990 and later injury cases and consequently, case reserves were significantly inadequate for these accident years.

During our current year audit, we were informed that instead of periodically reviewing the case files and updating the case reserves as warranted, the TPA updated most of the case files to a "worst case" scenario. A minimum of 600 weeks of compensation was reserved on all indemnity claims where an Independent Rating Examination (IRE) was not performed. As a result, the city's workers' compensation liability reported on the city's full accrual financial statements remained significantly high.

According to the most recent actuarial report, out of over 1,300 eligible indemnity claims, only 25 IREs had been performed during fiscal year 2010. When IREs were performed, the impairment rating of the claimant was found to be less than 50 percent, and thus the prospective reserves were reduced to 500 weeks from 600, suggesting that there is opportunity for reducing costs. We were informed that Risk Management had authorized and expects the TPA to perform approximately 200 IREs per year going forward.

We continue to believe that an in-depth study of the plan's current practices will yield viable suggestions for reducing costs and liabilities. Risk Management personnel informed us that although a study would be beneficial, the city's current financial condition precludes funding for such a review.

Recommendations:

We continue to recommend that Risk Management monitor the TPA more closely to ensure that all contracted services are being received and, in particular, that case files are periodically reviewed and updated as appropriate [500109.03].

We also continue to suggest that the city explore obtaining a comprehensive review of the administration of its workers compensation plan and costs to identify deficiencies, as well as any opportunities for improvement [500109.04].

## ACCOUNTS PAYABLE

We had noted in previous reports, that deficiencies in Finance's review procedures of year-end expenditures resulted in vendor payments recorded in the wrong fiscal period. Failure to record payments in the period that services were rendered or goods received can result in misstated accounts payable and expenditure amounts being reported in the financial statements.

To rectify the above condition, Finance revised its methodology for generating the reported accounts payable balances. Specifically, Finance generated a report of payment vouchers posted in the months of July, August and September, 2010. Finance accountants reviewed these reports to determine whether the expenditures exceeding certain dollar thresholds met the criteria for being reported as accounts payable. Finance officials believed that this change in procedure simplified the process in extracting accounts payable from the city's accounting system. However, the new methodology did not prevent errors from being reported in the preliminary CAFR. Out of approximately $69.2 million in accounts payables reviewed, our testing disclosed $9.2 million in overstatements, suggesting that the review process performed by the accountants could be improved. We observed that accountants performing the review were not provided with detailed written instructions. In our opinion, this condition contributed to the inadequate review.

Recommendation:

We continue to recommend that Finance perform a careful and documented review of high dollar payment vouchers processed during the three months subsequent to the fiscal year-end. In addition, written detailed instructions on how to properly perform this review should be developed and distributed to the responsible accountants [50107.03].

## STANDARD ACCOUNTING PROCEDURES

As in our prior year reports, we again noted that the city's Standard Accounting Procedures (SAPs) had not been revised to reflect various automated processing applications and practices currently in use. As a result, these SAPs offered little or no guidance on procedures departmental personnel should follow when executing and approving transactions.

The Philadelphia Home Rule Charter requires that the director of finance establish, maintain, and supervise an accounting system which provides adequate safeguards over the city's finances. To this end, Finance has established over 200 SAPs which serve to document and provide the basis for the city's system of internal control. However, over the years, staff reductions have compromised Finance's ability to review and update these SAPs. As a result, most of the SAPs are out of date. Some are over fifty years old and do not reflect current technology, as well as day-to-day practices. Although Finance has, in the past, revised a few SAPs, most of the procedures were last updated over ten years ago. Only three SAPs are more recent.

In its recommended practices, the Government Finance Officer's Association (GFOA) advocates enhancing management involvement in implementing and maintaining a sound and comprehensive system of internal control, and that the internal control procedures should be documented and periodically evaluated for effectiveness. Failure to maintain, document, and monitor internal control procedures can, and has resulted in the perpetration of fraud within city operations.

In its response to our prior year report, management acknowledged the internal control implications of not updating SAPs and indicated it was committed to their continual review and updating; however, due to financial constraints it did not have the staffing capacity necessary to conduct a comprehensive review of SAPs on a regularly scheduled basis.

Recommendation:

We continue to recommend that Finance commit the financial resources necessary to conduct a thorough review of its SAPs. Those that are no longer pertinent should be rescinded. Those that are out-of-date but can be used to document significant internal controls should be revised to reflect the automated processes and the practices in use today. Once this review is completed, Finance should develop a schedule for periodically updating SAPs in the future [50102.16].

**NON-COMPLIANCE WITH ACT 148 GRANT REPORTING REQUIREMENTS**

In our previous report, we noted that the Department of Human Services (DHS) did not comply with reporting requirements related to the Act 148 grant. This grant represents the state share of the County Children and Youth Social Service Program.

During the current audit, we again found that DHS did not submit the Act 148 required quarterly reports by their respective due dates. To be reimbursed for the Act 148 grant, the state requires counties to submit quarterly reports of expenditures within 45 days of the end of each quarter. For all of fiscal 2010, DHS had been consistently late in this process as shown in the table below.

| Quarter Ending | Due Date | Date Invoiced | Days Late |
|---|---|---|---|
| September 30, 2009 | November 14, 2009 | March 31, 2010 | 137 |
| December 31, 2009 | February 14, 2010 | May 3, 2010 | 78 |
| March 31, 2010 | May 15, 2010 | June 14, 2010 | 30 |
| June 30, 2010 | August 14, 2010 | January 11, 2011 | 150 |

Due to the untimely submission of the fourth quarter report, approximately $42.8 million of the fiscal 2010 net billable expenditures due to DHS for the fourth quarter was unnecessarily delayed. With the city experiencing fiscal constraints, timely reporting of Act 148 fourth quarter activity would have improved the city's cash flows.

We were informed that the cause of the delay in billing for the fourth quarter was again due to DHS' inability to reconcile its Family and Child Tracking System (FACTS) billing system with the provider based Title IV-E system implemented by the state during fiscal 2009.

The inability to timely reconcile the two billing systems also deferred the billing of direct expenditures related to the Foster Care grant until the third and fourth quarters. Direct expenditures totaling $24 million were billed in the third and fourth quarter reports, rather than as they occurred in each quarter. The late billing delayed the reimbursement of most of the approximately $7.2 million, and $6.5 million net billable expenditures related to the first and second quarter, respectively. Moreover, it hampered preparation of the city's financial statement.

Recommendations:

In order to comply with Act 148 reporting requirements, and to accelerate the reimbursement process, we again recommend that DHS:

- Submit Act 148 reports to the state by the 45th day after the end of each quarter [500109.05].
- Resolve issues with implementing the new billing systems [500109.06].
- Reconcile the FACTS billing to the Title IV-E billing system quarterly [500110.05].
- Until the above can be resolved, obtain a waiver or an extension from the state on the 45 day reporting requirement [500109.07].

CITY OF PHILADELPHIA

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ROB DUBOW
Director of Finance

May 17, 2011

The Honorable Alan Butkovitz
City Controller
1230 Municipal Services Building
1401 John F. Kennedy Boulevard
Philadelphia, PA 19102-1679

Re: Report on Internal Control and on Compliance and Other Matters – Fiscal 2010

Dear Mr. Butkovitz:

Thank you for the opportunity to discuss the contents of your draft report at the exit conference held on Thursday, May 5, 2011. We offer the following responses to the findings and recommendations found in the Controller's Office audit for Fiscal 2010.

**Financial Reporting**

<u>Staff Turnover and Reductions Compromise CAFR Preparation Process</u>
**Finding & Recommendation:** Previous Controller reports found that staff reductions in recent years have compromised the preparation and review of the CAFR, increasing the risk for financial reporting errors and omissions. You continue to recommend that the director of finance analyze staffing levels and workload in the Accounting Bureau and fill all vacancies deemed necessary.

**Response:** The Accounting Bureau is committed to producing a well-prepared CAFR that is accurate and properly reviewed. As noted in your report, staff reductions in recent years have made the task of completing the CAFR more difficult. The Accounting Bureau has added new employees to fill positions lost through attrition, and has moved staff from other units in the Accounting Bureau to fill some vacant positions. As a result, some employees who participated in the CAFR process for Fiscal 2010 did so for the first time. While overall they did very well, Accounting Bureau management is meeting with staff to review problems that they encountered and discuss ways to improve the process in the future. We anticipate an improved CAFR in future fiscal years as the staff becomes more experienced, additional training is provided, and internal improvements are made.

Stronger Controls Needed Over Reporting of Receivables
**Finding & Recommendation:** Your report finds errors relating to taxes and accounts receivables as a result of significant turnover of experienced staff, staff not following written procedures and a lack of independent review. Your report also finds that the basis for estimating uncollectible receivables was not updated as of June 30, 2010. You recommend the Revenue Department follow written procedures to determine year-end receivable balances and annually update the estimated basis for determining uncollectible tax and accounts receivable amounts. You also recommend an independent review of year-end receivable activity be performed.

**Response:** As noted in your report, the Revenue Department has experienced unusual staff turnover and has had difficulty hiring and adequately training replacement staff responsible for determining year-end receivable balances. We believe the staffing issues have been resolved and that Revenue is in a position to accurately report receivables in a timely manner going forward. In addition, the Department will follow written procedures to accurately determine year-end receivable balances and produce annual updates of the estimated basis for determining uncollectible tax and accounts receivable amounts.

Inadequate Preparation and Review over the Deposits and Investments Footnote
**Finding & Recommendation:** You indicate that your review of the CAFR found errors in the deposits and investments footnote related to GASB Statement No 40, Deposits and Investments Risk Disclosures. You recommend Finance develop and implement detailed written procedures, train staff on the spreadsheet program, and perform an independent and thorough supervisory review of the supporting documentation and footnote disclosure.

**Response:** The Accounting Bureau works to ensure that the deposits and investments footnote is accurately prepared and in accordance with GASB Statement No. 40. As such, the Bureau has begun a process to change the current system of Lotus 1-2-3 spreadsheets to an Excel file format, thereby eliminating the errors associated with reconciling data on summary and detail worksheets. Also, Accounting is currently working with the City Treasurer's Office to obtain bank statements electronically for input into the new Excel file format. The supervisor, or person responsible for note disclosure, will compare the Excel file totals to the individual bank statement amounts for completeness and accuracy. Furthermore, we will work to document the process as the new file structure is implemented, and ensure staff accountants are trained on the new system.

Enterprise Fund Reporting Procedures Require Strengthening
**Finding & Recommendation:** You recommend the following for the Philadelphia Water Department (PWD): that PWD management establish financial review procedures on financial reporting processes; that these procedures be documented and included in a checklist to be signed by a responsible PWD official; that PWD develop written procedures documenting the operation and review of the capital asset system; and that PWD ensure real property is uniquely identified in the capital asset system.

**Response:** In response to prior year audit findings regarding Enterprise Fund Statements, PWD in 2007 contracted and obtained the services of the former PWD Utility Accounting Manager. This consultant, along with current PWD Finance staff, assists with both the preparation and review of the financial statements. We believe this practice mitigates the risk of errors. Current procedures include, but are not limited to:

- Comparing all opening account and fund balances to the prior year closing balances and documenting all on separate worksheets; and
- Reviewing any journal entry or financial transaction, along with supporting documentation, prior to posting to financial statements.

As a result of the performance of these procedures, significant errors and misstatements were not found during the current year audit. In FY 2011 and thereafter, PWD will utilize a checklist to provide additional written evidence that these procedures were performed in accordance with the recommendation by the Controller. The checklist will be submitted to Finance with the respective financial statements, attesting they have been independently reviewed and approved and that to the best of the reviewer's knowledge are complete and free from material misstatement.

Additionally, while we agree with the Controller that it is optimum to have written procedures for PWD's capital asset system, resources have not been identified to formally draft and memorialize those procedures. PWD will review how its capital assets are identified to reduce the likelihood of errors or misstatements and explore the improvement or replacement of its current fixed asset accounting system and procedures.

Late Receipt of Component Unit Financial Data Still Hampered Preparation and Audit of CAFR

**Finding & Recommendation:** Your report finds that the late submission of financial data by some of the City's component units resulted in delays to the financial reporting and auditing process, increasing the risk of errors or omissions. You recommend that management continue its efforts to secure the cooperation of all component unit management in the timely submission of their financial data.

**Response:** We agree that the timely submission of all component unit reports is critical to the timely issuance and accuracy of the City's CAFR. The Office of the Director of Finance regularly communicates with all of the component units and stresses the importance of timely reporting. We will continue to impress upon the component units the need for timely reporting.

Reporting Process for Departmental Custodial Accounts Needs Improvement

**Finding & Recommendation:** Your report finds that the Accounting Bureau did not receive custodial account bank reconciliations from several city agencies, causing financial reporting errors, and that Accounting did not perform effective follow-up with the noncompliant city agencies. You recommend that Accounting continue to instruct City agencies of the requirement to prepare and submit monthly custodial bank reconciliations. You also recommend a follow-up effort to obtain the required reconciliations be developed and implemented.

**Response:** We agree that the preparation and submission of custodial account bank reconciliations from all City agencies is critical to the timely issuance and accuracy of the City's CAFR. The Accounting Bureau will continue to request the bank reconciliations from all departments. As recommended by the Controller, an escalation process is in place to ensure that the required reconciliations are provided. The current escalation process is as follows: 1. Accountant requests materials, 2. Accountant Supervisor requests materials, 3. Accounting Manager requests materials at appropriate department supervisor level, 4. Accounting Director request made at deputy/commissioner level.

FAMIS Not Utilized for Posting Aviation Year-End Journal Entries

**Finding & Recommendation:** Your report finds that the full accrual Aviation Fund is not being used to prepare financial statements. Although your testing of the Fund did not reveal any material errors, you recommend that Finance provide the Division of Aviation with training to make the necessary year-end adjustments in FAMIS. You also recommend that Finance review accrual fund entries for propriety.

**Response:** We agree that posting year-end journal entries to the accrual fund provides a clear trail of adjustments between the modified and full accrual statements, and decreases the risk for financial statement errors. When time and resources permit, Finance will provide the training and review consistent with the Controller's recommendations.

**Capital Asset Deficiencies**

**Finding & Recommendation:** Your report states that Finance employs a burdensome process to account for the City's real property capital assets. You recommend that the City acquire a comprehensive capital asset system as an improvement over the current process. Also, you recommend periodic physical inventories of all real property assets as well as the development of a plain language report on the condition of the government's capital assets.

**Response:** We agree that it would be beneficial for the City to have a capital asset system. Unfortunately, resources have not been identified to fund either the system or the ongoing operating costs of staff that may be required to maintain the system, including maintaining accurate cost history records, accurate depreciation history, and providing a detailed inventory of the major systems in all of the buildings that the city owns. In the meantime, the current system will continue to be used. It should be noted that the current methodology used by the Accounting Bureau provides financial information that is accurate and auditable, even though it does not provide the level of detail that a capital asset system might provide.

As stated in your report, while we believe that a physical inventory of assets is being conducted as a matter of course by the departments to see what their capital needs are, there is no formalized written process to document that the physical inventory is occurring. In response to the Controller's recommendation, the Accounting Bureau will provide guidance to the departments and require them to submit documentation of their physical inventory on an annual basis.

In addition, you agreed that you will no longer report on the conditions included in your comments on "Land Costs Not Properly Allocated to Asset Locations" and "Asset Information

Improperly Recorded" as you agreed that Finance provided an adequate response indicating that we are properly allocating and recording these assets.

**Water Billing System**

**Finding & Recommendation:** Your report indicates that the following control weaknesses were present in Basis2, the City's water billing system: 1) lack of an electronic authorization path for supervisory approval of adjustments; 2) inability to prevent or detect circumvention of authorized adjustment limits; and 3) erroneous penalty amounts on bills for accounts entitled to discounts. You recommend resolution of the above-mentioned weaknesses.

**Response:** The Water Revenue Bureau has been working diligently to identify and correct remaining weaknesses in the Basis2 system. Each of the issues identified in your report have been addressed. On June 20, 2010, the penalty calculation for customers entitled to a discount was corrected. In addition, systems enhancements were implemented on August 15, 2010, including implementation of an electronic authorization path for supervisory approval of adjustments, and implementation of restriction limits (per individual and per level of supervisory responsibility) on credit adjustments that can be made on an account. This means that the system is now able to effectively prevent a person from circumventing their established, authorized adjustment limit by "splitting" one large adjustment into two or more smaller adjustments. As an additional measure, the system generates an adjustment transaction report that is reviewed daily for discrepancies and to ensure that all transactions conducted are allowable and within established limits.

**Workers' Compensation Plan Monitoring**

**Finding & Recommendation:** You recommend that Risk Management better monitor the third party administrator (TPA) and, in particular, ensure that case files are periodically reviewed and updated as appropriate. You also recommend the City explore obtaining a review of the workers compensation plan's current administration to identify deficiencies and opportunities for improvement.

**Response:** Risk Management is committed to monitoring the City's TPA to ensure that all contracted services are being received. As such, one full-time employee and one contractor are specifically dedicated to this task. In addition, three other staff members are responsible for portions of this work. We have set a goal for the TPA to perform approximately 200 Independent Rating Examinations (IRE) per year going forward – up from the 25 IREs that were performed in FY2010. We will work with the TPA to achieve this goal. Furthermore, we agree that it could be beneficial to perform a study of the plan's current practices and have recently learned of your office's intention to bring in an outside consultant to undertake such an effort. We look forward to working closely with your office as that study is conducted to maximize its benefits to the city's workers compensation program.

**Accounts Payable**

**Finding & Recommendation:** Your report finds $9.2 million in overstatements out of approximately $69.2 million in accounts payables reviewed. You recommend Finance perform a careful and documented review of high dollar payment vouchers processed during the three months subsequent to the fiscal year-end. You also recommend that written detailed instructions be developed on how to properly perform this high-dollar-payment review.

**Response:** As noted in your report, and in response to previous comments regarding weaknesses in accounts payable, we developed a new methodology for determining accounts payables during the three months subsequent to the fiscal year-end. As part of this new methodology, staff was provided with lists of items to review and instructions on how to proceed with that review. We will continue to work to properly classify accounts payable entries in all instances.

**Standard Accounting Procedures**

**Finding & Recommendation:** Your report notes that the City's Standard Accounting Procedures (SAPs) have not been revised to reflect automated processing applications and practices currently in use. You recommend that Finance conduct a thorough review of its SAPs and develop a schedule for periodic updates.

**Response:** The Accounting Bureau is committed to continual review and updating of its SAPs. On a limited basis, and to ensure that we are in compliance with any changes in accounting regulations, these procedures are updated. While we agree that a comprehensive review and update of the procedures should be conducted on a regular basis, currently we do not have the staffing capacity to do so.

**Non-Compliance with Act 148 Grant Reporting Requirements**

**Finding & Recommendation:** Your report finds that the Department of Human Services (DHS) does not comply with the reporting requirement related to the Act 148 grant that requires submission of invoices within 45 days of the end of each quarter. Your report also notes DHS' inability to reconcile its Family and Child Tracking System (FACTS) billing system with the provider-based Title IV-E system implemented by the state in FY2009. You recommend that DHS submit Act 148 reports by the 45-day reporting requirements; that they resolve issues with implementing the new billing systems; that they reconcile the FACTS billing to the Title IV-E billing system quarterly; and that until the above is resolved, DHS obtain a waiver or extension from the state on the 45-day reporting requirement.

**Response:** DHS is committed to full compliance will Act 148 grant reporting requirements. As noted in your report, DHS has significantly reduced its delay in submitting quarterly invoices, and is on track to further reduce those delays. However, for FY2010, Title IV-E rate approvals by the Commonwealth of Pennsylvania's Department of Public Welfare have been significantly delayed, resulting in DHS' inability to complete the FY2010 Act 148 4th quarter invoice in a timely manner. Several IV-E rate packages remain unapproved even 10 months after the close of FY2010.

Historically, DHS has not submitted its Act 148 4th quarter invoice in a timely manner because of the need to consolidate fiscal information from multiple outside sources. Previously, DHS has requested waivers to the Commonwealth's 45-day report submission requirement but never received a response/approval to the waiver request. DHS will resume the practice of requesting an extension of the 45-day deadline from the Commonwealth for the submission of its 4th Quarter Act 148 invoice.

Furthermore, through increased training and coordination DHS has been able to resolve issues related to FACTS data reconciliation as well as those related to the implementation of the new IV-E billing system. We consider these issues resolved.

Thank you for the observations provided in your report and for the opportunity to respond. We look forward to continued cooperation with your office.

Sincerely,

Rob Dubow
Director of Finance

cc: Anna Wallace Adams, Chief of Staff, Finance
Anne Marie Ambrose, Commissioner, Department of Human Services
Rumana Ahmad, Deputy Commissioner, Department of Human Services
Michelle Bethel, Deputy Revenue Commissioner, Water Revenue Bureau
Joe Clare, Deputy Commissioner Finance & Administration, Water Department
Maia Jachimowicz, Assistant Finance Director
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