CITY OF PHILADELPHIA
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REPORT ON INTERNAL CONTROL AND ON COMPLIANCE AND OTHER MATTERS

CITY OF PHILADELPHIA

FISCAL 2009

City Controller

ALAN BUTKOVITZ

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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, 2009, which collectively comprise the City of Philadelphia, Pennsylvania's basic financial statements and have issued our report thereon dated February 18, 2010. Our report was modified to include a reference to other auditors. 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, Community Behavioral Health, and the Philadelphia Gas Works 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 would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A *control deficiency* 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the following deficiencies, which are discussed in greater detail in this report, to be significant deficiencies in internal control over financial reporting:

- Inadequate oversight and review procedures over the financial reporting process adversely affects the preparation of the city's Comprehensive Annual Financial Report (CAFR).

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

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

- 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 increases the risk of unrecorded liabilities.

- Most Standard Accounting Procedures which serve as the basis for the city's system of internal control are not being revised to reflect the automated processes and the practices in use today.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we consider the condition regarding the inadequate oversight and review procedures over the preparation of the city's CAFR to be a material weakness.

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.

The City of Philadelphia, Pennsylvania's written response to the significant deficiencies and the material weakness 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. We have also included our comments to the City of Philadelphia, Pennsylvania's responses that we believe do not adequately address our findings and recommendations.

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.

Albert F. Scaperotto

February 18, 2010

ALBERT F. SCAPEROTTO, CPA
Deputy City Controller

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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 Reductions Compromise CAFR Preparation Process

In our previous reports, we noted that staff reductions 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 1999 to only 48 in fiscal 2009. One notable vacancy, which has existed since June 2006, has been the key position of accounting manager, who would normally be responsible for supervising the preparation of the city's CAFR.

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 deposits and investments footnote. Since top management is preparing these CAFR sections, there is no independent review of their work, and their ability to adequately review financial statements and footnote disclosures prepared by subordinate employees is limited. Consequently, there is an increased risk for financial reporting errors and omissions.

In its response to our previous report, management acknowledged the less than optimal staff size of the Accounting Bureau which is due to budget constraints. To alleviate this condition, Finance instituted a training program that consisted of "knowledge transfer teams" and classroom training which should lead to the involvement of more Finance staff members with the CAFR preparation process.

Despite the implementation of this succession planning strategy, our current audit disclosed no significant improvement in the quality of the preliminary CAFR. We again found that the 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, the footnote disclosures, full accrual government-wide statements, and Management Discussion and Analysis were all provided late in the audit process; approximately $140 million in reporting errors to the preliminary CAFR were identified; and a $77.8 million account balance line item was erroneously omitted from the printer's proof version of the CAFR.

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]

<u>Enterprise Fund Reporting Procedures Require Strengthening</u>

Previously, we reported that Finance had assigned the responsibility for the preparation of the full accrual financial statements of the Water and Sewer Fund to the Philadelphia Water Department (PWD). Our prior year review disclosed the existence of deficiencies that compromised controls over the PWD's financial reporting process. Although we were informed by PWD personnel that review procedures were implemented during fiscal 2008, evidence documenting these review procedures could not be provided.

This condition has not improved. Current year testing disclosed errors totaling $33 million which could have been detected by an established and thorough review process. Some of these errors occurred when Finance posted year-end adjustments, however, these adjustments were never communicated to the PWD. PWD's accountants did not compare its financial statements to the final FAMIS account balances. When we brought this to management's attention, PWD corrected its financial statements.

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

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

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

In addition, we noted that written policies and procedures for the recently implemented capital asset recordkeeping system do not exist. During fiscal year 2006 the PWD implemented a new capital asset system to account for the Water and Sewer Fund's real and personal property assets, valued at approximately $1.7 billion. However, written procedures documenting the operation of the capital asset system and related review procedures have yet to be developed. As a result, recordkeeping errors could occur and go undetected.

We recommend that written procedures documenting the operation and review of the capital asset system be developed. [500109.01]

Late Receipt of Component Unit Financial Data

In our prior reports, we have commented on the late submission of financial data by some of the City's component units. This condition results in delays to the financial reporting and auditing process, and increases the risk of errors or omissions due to the significant changes to the financial statements and footnotes each time new component unit information is received.

This condition has not improved. Our current review disclosed that nine of the City's component units did not submit their reports by the due date requested by Finance. The most delinquent component unit, the Philadelphia Redevelopment Authority, did not submit its finalized report until February, 2010, over four months after the date requested.

In an attempt to provide more timely information, many component units submitted draft copies of financial data. However, the efficient and effective preparation of the CAFR requires the timely submission of complete and final financial data.

We again recommend that the Office of the Director of 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

Our testing of the Departmental Custodial Accounts continues to disclose significant accounting and reporting errors. We again found that cash and investments were materially understated in the amount of $54 million. The causes of the misstatement included failure of departments to provide required information, ineffective follow-up by Finance to those unresponsive city departments, and a lack of close supervisory review.

Standard Accounting Procedure (SAP) # 7.1.3.b requires that city agencies submit monthly bank reconciliations for their custodial accounts (not under the control of the Office of the City Treasurer) to Finance for their review and analysis. Finance personnel must summarize the activity from these bank reconciliations to arrive at the reported cash and investment amounts for the Departmental Custodial Accounts in the city's CAFR. Several city agencies did not submit monthly bank reconciliations. Failure to obtain custodial account bank reconciliations precludes Finance from having assurance that city agencies are preparing monthly bank reconciliations and increases the risk of financial reporting errors.

We continue to recommend that the Accounting Bureau continue its efforts to instruct city agencies that they are required to prepare and submit custodial account bank reconciliations each month. [50106.05]

NEW WATER BILLING SYSTEM

Last year we reported significant control weaknesses related to the city's new water billing system, known as basis2, which became operational on January 2, 2008. We found that key system components were not fully developed, tested, or working correctly. Current year testing indicates some progress has been made in correcting system deficiencies; however, other control weaknesses were not corrected until after fiscal year 2009, or corrective action is still needed.

One of the Water Revenue Bureau's (WRB's) primary reasons for implementing a new water billing system was to enhance revenue collection efforts through the use of an automated case management system. A key component of this system – the Utility Services Tenants Rights Act (USTRA) process – worked under the old system, but was not operational during fiscal year 2009. The WRB indicated enforcement activity had to be suspended for 73,000 potential USTRA accounts until the process became functional under basis2. This finally occurred in December, 2009.

Another impediment to enforcement efforts was the new water billing system's inability to refer certain delinquent accounts to outside collection agencies for assertive collection efforts. Unlike the old system that routinely referred delinquent receivables from commercial, vacant, and landlord accounts, initially the new system was only referring commercial accounts to outside collection agencies. In addition, contracts with outside collection agencies expired in December, 2008, and collection efforts by outside agencies did not resume again until September, 2009.

While progress has been made in the areas of financial reporting, billing, and adjustments, significant control weaknesses persist. The feature for automatically calculating penalty continued to undercharge delinquent accounts throughout fiscal year 2009. We estimate unbilled penalties amounted to $2 million during this period. Also, an electronic authorization path for supervisory approval of adjustments is still not in place. Further, the new water billing system is unable to prevent or detect a user that circumvents their established, authorized adjustment limit by "splitting" one large adjustment into numerous smaller adjustments.

We believe that the recent economic conditions, along with delays in implementing system components, and the weaknesses noted above, have contributed to a growing net receivable, which increased $9 million dollars from fiscal year 2008 to fiscal year 2009. In addition, these uncorrected weaknesses continue to leave the system susceptible to errors and irregularities.

We continue to recommend that management identify all basis2 processes that are still incomplete or not working correctly, and develop firm benchmarks for their completion and resolution. [50008.01]

CAPITAL ASSET DEFICIENCIES

For the past several years, we have emphasized the need for the city to acquire a comprehensive capital asset system because controls over the city's real property assets have been weak. 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.

We again noted that Finance maintains several Lotus 1-2-3 and Excel files that accumulate the cost of capital assets and work in progress, and other spreadsheet files to depreciate assets and calculate accumulated depreciation reported in the CAFR. This situation creates a burdensome process to properly account for capital assets that can affect the accuracy and completeness of amounts reported in the CAFR and causes extensive audit review.

A comprehensive capital asset system can provide the city with detailed asset information that would eliminate a significant amount of manual record keeping duties and make operations more efficient. Also, a streamlined, comprehensive capital assets system will improve the transition when new employees become responsible for capital asset reporting.

<u>Land Costs Not Properly Allocated to Asset Locations</u>

In prior year reports, we noted certain land values in the 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 remains uncorrected, does not allow Finance to maintain an accurate book value for many city-owned properties.

<u>Asset Information Not Properly Recorded</u>

We have also previously reported the city's real property records were incomplete since certain sold properties were not recorded in the city's books. Our current year review disclosed similar deficiencies. Specifically, our testing revealed that the city sold thirteen properties during fiscal 2009 that generated approximately $7.1 million. Out of these thirteen properties, only three were recorded in the city's fixed asset ledger. There were no records for the other ten properties. Without a reliable system for recording detailed real property information, it is difficult to accurately calculate and report on the financial statements, any gain or loss that should be recognized when recording the sale of capital asset reporting.

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

Except for the Philadelphia Water Department and the Division of Aviation that periodically check the physical existence and condition of their real property assets, our current year testing disclosed no evidence that the city's other real property assets have been recently inventoried.

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. In addition, the Government Finance Officers Association (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 governments periodically inventory the physical condition of all existing capital assets so that the listing of all assets and their condition is kept current. Furthermore, the GFOA recommends that a "plain language" report on the condition of the government's capital assets be prepared, and that this report should be made available to elected officials and the general public every one to three years.

Finance personnel stated in prior years that they believe this situation is mitigated by the fact that many properties are observed by various city employees as part of their capital asset inspection, repair, or improvement procedures. However, because there is no formal documentation of which assets were observed, or assurance that all assets will be periodically inventoried, we believe that the procedures described by Finance are not sufficient. Further, our office has previously reported on the degraded condition of city owned facilities[1] which illustrates the need for a comprehensive capital asset inspection and assessment system.

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

(1) 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]

(2) 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]

(3) Every three years, develop and provide a plain language report on the condition of capital assets for the use of elected officials, and that this report be made available to the general public. [500109.02]

WORKERS' COMPENSATION PLAN MONITORING

The Risk Management Division of the Office of the Director of Finance (Risk Management), which is responsible for managing the city's $267 million workers' compensation program, contracts with a Third Party Administrator (TPA) to process workers' injury claims against the city. In the most recent actuarial analysis of workers' compensation liabilities for the city, the actuary discloses that during 2009 the TPA failed to do file maintenance on 1990 and later injury cases and

[1] Office of the City Controller Reports on Condition of Police Facilities, issued November, 2006 and Recreation Facilities Review issued June, 2008.

that case reserves were significantly inadequate for these accident years. As a consequence, the actuary determined that liabilities for claims were understated resulting in a significant increase in the anticipated liability amounts.

This situation created a dramatic rise in workers' compensation costs reported on the city's full accrual financial statements which increased from $36 million in fiscal year 2008 to $100 million in the current fiscal year.

Risk Management, which relied on the TPA to perform all of its contracted services, became aware of the TPA's failure to do file maintenance after the end of fiscal year 2009 when the TPA indicated it was revising its case reserves.

We 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]

While our audit was not directed toward the identification of the workers' compensation plan's claim management practices, we believe that an in-depth study of the plan's current practices will yield viable suggestions for reducing costs and related liabilities. We offer the following observations:

- Under Pennsylvania law when an injured employee has received total disability compensation for a period of one-hundred four weeks, the employee is required, as requested, to submit to a medical examination to determine the degree of impairment due to their injury. Reevaluation of the employee's degree of impairment offers the opportunity to lower workers' compensation costs. Information provided by the TPA indicated that the number of workers' compensation cases reviewed for impairment evaluations declined significantly during fiscal year 2009. From August through June only eighteen claimant files were reviewed and considered for possible impairment rating examinations.

- Pennsylvania law stipulates that in no event shall the total number of weeks of partial disability exceed five-hundred weeks for any injury. We were informed that individual claims are routinely reserved for over 500 weeks. This can result in larger actual claim payouts over time. Establishing an active claims management system under the provisions allowed by law could reduce future plan costs.

- The city's current financial position has curtailed its ability to fund initiatives, such as obtaining funds via a bond issue to buy-out claims where advantageous to the city's interests. Such settlements may ultimately lower the total anticipated liability by permitting city managers to negotiate fixed payouts in full and complete resolution of all future claims.

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

ACCOUNTS PAYABLE

In our prior year reports, we noted deficiencies in Finance's year-end expenditure review procedures. As a result, vendor payments were recorded in the wrong fiscal period. Failure to record payments in the period that services were rendered or goods received results in misstated accounts payable and expenditure amounts reported in the financial statements.

Our current year review disclosed no improvement in Finance's year-end expenditure review procedures. Specifically, we noted that Finance's payable data extracted from the city's financial accounting system (FAMIS) and the city's purchasing system (ADPICS) only captured transactions with an invoice date on or before June 30, 2009. As such, this methodology fails to include all transactions that had the related goods or services delivered in fiscal year 2009, but were invoiced and paid in fiscal year 2010.

During our testing for unrecorded liabilities, we noted $17 million for payments related to goods or services received prior to the fiscal year-end that were not recorded as payables in the proper period.

Although we were informed that, in order to identify additional accounts payable, Finance performs a review of high dollar payment vouchers processed during the two months subsequent to the fiscal year-end, no evidence of such review could be provided. Instituting such a procedure would serve to reduce the risk of significant unrecorded liabilities. Accordingly, we continue to strongly recommend that this procedure be implemented and documentation of this review be maintained. [50107.03]

STANDARD ACCOUNTING PROCEDURES

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

Philadelphia's 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 served 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 these procedures were last updated ten years ago. Only two SAPs – 4.1.1.i, issued in September, 2000 and E-7201, updated in June, 2002 – are more recent.

The Government Finance Officer's Association (GFOA), in its recommended practices, 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 indicated it is committed to the continual review and updating of SAPs; however, due to financial constraints it does not have the staffing capacity necessary to conduct a comprehensive review of SAPs on a regularly scheduled basis.

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. [50102.06]

NON-COMPLIANCE WITH ACT 148 GRANT REPORTING REQUIREMENTS

During our current audit, we found that the Department of Human Services (DHS) did not comply with reporting requirements related to the Act 148 grant, which is the state share of the County Children and Youth Social Service Program.

In order to be reimbursed, the state requires counties to submit quarterly reports of expenditures within 45 days of the end of each quarter. For all of fiscal 2009, DHS has been consistently late in this process as shown in the table below.

Quarter Ending	Due Date	Date Invoiced	Days Late
September 30, 2008	November 14, 2008	December 24, 2008	40
December 31, 2008	February 14, 2009	March 13, 2009	27
March 31, 2009	May 15, 2009	June 16, 2009	32
June 30, 2009	August 14, 2009	Outstanding as of 2/18/10	188

As of our last day of fieldwork, DHS still had not submitted its fourth quarter report. We estimate that approximately $61 million of its fiscal 2009 allocation is due to DHS for the fourth quarter. During a period when the city was experiencing cash shortages, 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 4th quarter is due to the inability to reconcile DHS's billing system with the new Title IV-E billing system implemented by the state during fiscal 2009, and the Family and Child Tracking System (FACTS) implemented midway through the 4th quarter of fiscal 2009 by DHS.

In order to comply with Act 148 reporting requirements, and to accelerate the reimbursement process, we 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]
- Until the above can be resolved, obtain a waiver or an extension from the state on the 45 day reporting requirement. [500109.07]

RESOLVED PRIOR YEAR FINDINGS

General Information Technology Controls Review

In our prior report, our review of the Division of Technology's (DOT) general information technology (IT) controls over financially significant systems found problems related to IT governance, security administration, security monitoring, change control, and disaster recovery.

We recommended that the DOT make enhancements to the IT control structure in order to improve the operating effectiveness of controls and security over financially significant systems.

Our current review has found that DOT has initiated certain improvements and, as a result of these improvements, the conditions cited above no longer represent significant control deficiencies that adversely affect the city's ability to reliably collect, summarize, and report data in financially significant systems.

For purposes of this report, we consider this finding resolved. In a separate report to DOT management, we will address the individual IT general control areas, the improvements made to date, and make recommendations on completing the process.

Workers' Compensation Claims Processing Controls

In our previous report we commented that the Third Party Administrator (TPA) hired, by the Risk Management Division of the Office of the Director of Finance (Risk Management), to process workers' compensation claims against the city did not provide an annual service auditor's report to Risk Management. This type of report should provide the city with assurance that the TPA's controls are suitably designed and placed in operation.

Our current year inquiry disclosed that the TPA provided to Risk Management a service auditor's report on controls placed in operation and test of operating effectiveness of the processing and payment of workers' compensation claims. This report, which is dated May 7, 2009, covers the period from September 1, 2008 to February 28, 2009. This finding is considered resolved. [500108.2]

Accounts Payable

We noted, in our previous reports, that the city's financial accounting system does not have a data filed for recording the date that goods or services were received, and the city's purchasing system (ADPICS) only requires this information for some, but not all, transactions. At year-end, Finance's program for extracting payable data from ADPICS is limited to those vouchers created during fiscal year 2010. Hence, this methodology could fail to capture vouchers created during fiscal year 2009, but not paid until fiscal 2010.

We had recommended that Finance revise its criteria for extracting payable data from ADPICS so that vouchers paid, instead of vouchers created in the subsequent fiscal year, are used. Finance has indicated that the current system cannot be modified to accommodate this recommendation. Since the system cannot be modified, Finance asserts that it has adopted an alternate procedure to review high dollar payment vouchers in order to identify accounts payable. Therefore, we will no longer repeat this finding. [50107.04]

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ROB DUBOW
Director of Finance

June 1, 2010

The Honorable Alan Butkovitz
City Controller
1230 Municipal Services Building
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Philadelphia, PA 19102-1679

Re: Report on Internal Control and on Compliance and Other Matters – Fiscal 2000

Dear Mr. Butkovitz:

Thank you for the opportunity to discuss the contents of your draft report at the exit conference held on Tuesday, May 11, 2010. I am pleased that your report notes that we have resolved several of the prior year's findings. The following are the Finance Department's responses to the recommendations in the report.

Financial Reporting

Staff Reductions Compromise CAFR Preparation Process

Finding & Recommendation: Previous reports found that staff reductions in recent years have compromised the preparation and review of the CAFR. In particular, you noted that the accounting manager position is a key position that has been vacant since 2006. You recommend that the director of finance analyze staffing levels and workload in the Accounting Bureau and fill all necessary vacancies.

Response: The Accounting Bureau is committed to producing a well-prepared CAFR that is accurate and properly reviewed. In part because of the City's current financial position, however, the Accounting Bureau is required to perform its normal duties with fewer resources. In addition, Accounting has faced some additional challenges during the past year with the loss of some of its senior level employees. We have completed a review of the staffing and have developed a succession plan that includes the reinstatement of the Accounting Manager position to the budget. In fact, the accounting manager position has been filled effective May 31, 2010.

The CAFR schedules that the Controller mentions are highly technical. The level of expertise required, as well as staff workload, is taken into account when assigning tasks relating to the CAFR. In order to ensure that there are adequate resources in place to complete these tasks, as well as other accounting functions, the Accounting Bureau is continuing its training program that consists of "knowledge transfer teams" and classroom training. The Knowledge Transfer Teams meet every other week, pairing accountants who explain their job to their counterpart and show them the tools that they use to do their jobs. On alternating weeks from the Knowledge Transfer Team meetings, classroom training is given on the CAFR and various GASB pronouncements so that more staff members will have the knowledge to do the more complex tasks associated with the preparation of the CAFR. This process, in addition to reinstating and filling the Accounting Manager position, should improve the CAFR preparation process.

<u>Enterprise Fund Reporting Requires Strengthening</u>

Finding & Recommendation: Your finding relates to the shifting of responsibility for the preparation of the full accrual financial statements of the Water & Sewer Fund to the Philadelphia Water Department (PWD). You indicate that you were informed that financial reporting review procedures have been implemented in the PWD, but that there is no **written** documentation of these, including a checklist to indicate completion of the individual procedures. Additionally, you recommend that written procedures be developed for the operation and review of the capital asset system.

Response: PWD continues to use its accounting system in order to provide it with the information necessary to do its financial reporting. The Accounting Bureau will meet with PWD staff to instruct them in the proper use of the City's Accounting system in conjunction with their internal system. While it is optimum to have written procedures for the PWD's capital asset system, resources have not been identified to formally draft and memorialize those procedures.

<u>Late Receipt of Component Unit Reports</u>

Finding & Recommendation: Your report found that late submission of financial data by some of the city's component units resulted in delays to the financial reporting and auditing process. You recommend that management continue its efforts to secure the cooperation of all component unit management to timely submit their financial date.

Response: We agree that the timely submission of all component unit reports is critical to the timely issuance of the City's CAFR. We will continue to impress upon the component units the need to allow themselves adequate lead time so that reports can be done on a timely basis

<u>Reporting Process for Departmental Custodial Accounts Needs Improvement</u>

Finding & Recommendation: Your report found that Finance did not receive custodial account bank reconciliations from several city agencies, causing financial reporting errors. You recommend the Accounting Bureau continue to instruct city agencies of the requirement to prepare and submit monthly custodial bank reconciliations.

Response: The Accounting Bureau will continue to request that departments provide us with the required custodial account bank reconciliation information. We will review further our internal processes to see if improvements may be made to ensure the submission of timely information. Regular follow-up will occur with departments to ensure future compliance.

New Water Billing System

Finding & Recommendation: Your report found control weaknesses in Basis2, the City's new water billing system, including delays in implementation of system components that have contributed to a $9 million net receivable growth from FY08 to FY09. You recommended that management identify all Basis2 processes that are still incomplete or not working correctly, and develop firm benchmarks for their completion and resolution.

Response: As you know, the Basis2 system was implemented in January, 2008, just prior to the beginning of this Administration. We concur with your finding from last year that the timeframe for implementation was optimistic and that the system was not fully developed, tested or working correctly before it was taken live. Since January, 2008, the Water Revenue Bureau (WRB) has been working diligently to identify all of the system-related processes that have not been fully implemented or that are not working correctly. WRB closely monitors and prioritizes open items through the use of Bugtracker, a central repository for identifying and resolving outstanding process issues.

In response to your more specific findings:

- You indicate that enforcement activity had to be suspended for 73,000 potential Utility Services Tenants Rights Act (UTSRA) accounts until the automated case management component of the system became operational in December, 2009. However, during the development of USTRA, enforcement activity was not deferred in its entirety. WRB continued to bill, penalty update, lien, dun with past due reminder notices, exercise manual collection efforts, and, in some cases, refer eligible accounts to Sheriff Sale.

- Your report indicates further delays in enforcement activity due to the system's inability to refer delinquent accounts to outside agencies. The delay in collection activity and collection contracts between December, 2008 and September, 2009 was related to renegotiation of contract terms and conditions. Once contracts were in place, programming, testing, and implementation with the new agencies occurred timely.

- Your report indicates correctly that an electronic authorization path for supervisory approval of adjustments is still not in place. Although workflow software that would enable such functionality was not purchased with the Basis2 system, the Basis2 team is working diligently to build this functionality into the system. The development is in the final testing phase, and WRB is already generating an adjustment transaction report that is reviewed by a supervisor of the Accounting Unit for discrepancies.

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.

Response: We agree that it would be beneficial for the City to have a capital asset system. Unfortunately, resources are not available to fund either the system or the ongoing operating costs of staff that may be required to maintain the system, keep the inventory information up to date, and perform the regular inspections that you recommend for all City property. Until the resources have been identified to purchase and implement such a system, the current system will continue to be used. In the meantime, we are investigating the use of the City's GIS system to see if that technology could be leveraged to help with asset identification and inspections. While the Controller does point out some deficiencies with the current system, 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 would provide.

Workers' Compensation Plan Monitoring

Finding & Recommendation: Your report states that the third party administrator (TPA) who processes workers' injury claims against the city for the Division of Risk Management failed to do file maintenance on 1990 and later injury cases. Further, you state that because of this understatement of liabilities for claims and a significant increase in the anticipated liability amounts, there was a dramatic rise in workers' compensation costs reported on the city's full accrual financial statements from $36 million in FY08 to $100 million in the current fiscal year. You recommend that Risk Management monitor the TPA more closely to ensure all contracted services are being received, and in particular, that case files are periodically reviewed and updated.

Response: We disagree with your comment about the failure to do file maintenance and the inadequacy of case reserves. The City's TPA, CompServices Inc (CSI), had established reserves for the 3,500 open files. The actuary found it likely that the reserves were not adequate for some of the files and asked CSI to review this. During the course of your audit, Risk Management and CSI were in the process of reviewing and updating the City's reserving practices. The reserves have been updated and are now adequate. As far as monitoring of the TPA, Risk Management meets with the TPA bi-weekly. Also, at any given time, Risk Management is performing some level of file review. In particular, they review files in all instances when problems or concerns are brought to their attention (lack of pay, wrong rate, medical treatment issues, etc); in all instances when Heart & Lung cases reach 6 months of no-duty status; and in all instances when maximum medical improvement is reached to make a determination of permanent and partial (P&P) disability. Risk Management's focus on closer management of the files has resulted in improved condition of the files in areas other than case file reserving. Costs have been transferred back to the TPA when these reviews have revealed significant deficiencies in proper claims management.

Additionally, your report included the following statement:

> "Pennsylvania law stipulates that in no event shall the total number of weeks of partial disability exceed five-hundred weeks for any injury. We were informed that individual claims are routinely reserved for over 500 weeks. This can result in larger actual claim payouts over time. Establishing an active claims management system under the provisions allowed by law could reduce future plan costs."

We believe that the current system is in accordance with the provisions allowed by Law. In fact, there is no limit to the duration of temporary **total** disability benefits, which represents the status of the vast majority of our claimants. Since there is no limit to the duration of temporary total disability, the reserve in excess of 500 weeks represents responsible reserving practices. Currently, there are only about 17 claimants on temporary **partial** disability, and appropriately, there is a limit in the claims system that prevents these claims from being reserved for over 500 weeks.

Accounts Payable

Finding & Recommendation: Your report notes that deficiencies remain in Finance's year-end expenditure review procedures, resulting in vendor payments recorded in the wrong fiscal period. You recommend instituting a procedure to review high dollar payment vouchers processed during the final two months of the fiscal year to reduce the risk of unrecorded liabilities.

Response: The Controller's Office noted that some accounts were under/overstated, however in no case were the amounts materially misstated. The accounts payable entries are reclassification entries that move amounts from fund balance reservations (encumbrances) to current liabilities (accounts payable). The distinction is that encumbrances represent a reservation of funds for contracts that the City has with a vendor but for which an invoice has not been received, and accounts payable represent invoices received. We will continue to work to properly classify entries in all instances and to provide estimates of these liabilities.

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 the Standard Accounting Procedures. On a limited basis, and to ensure that we are in compliance with any changes in accounting regulations, these procedures are updated. We do not, however, have the staffing capacity to conduct a comprehensive review and update of the procedures on a regularly-scheduled basis.

Non-Compliance with Act 148 Grant Reporting Requirements

Your report found that the Department of Human Services (DHS) did 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. Additionally, you recommended that DHS seek an extension of the 45-day reporting requirement until such time as they are able to meet that deadline.

In FY09, the Commonwealth implemented a new IV-E billing system and reimbursement policy. As a result, Act 148 invoices, which may only be submitted after Title IV-E billing is completed, were significantly delayed for all quarters.

Over the last several months, DHS has made significant progress in the area of IV-E billing compliance. Through increased staffing and coordination with the Commonwealth, DHS has been able to bill for IV-E and, subsequently, Act 148 for all four quarters of FY09, including submission of its final FY09 Act 148 invoice in early May, 2010. DHS expects to be up to date on IV-E and Act 148 invoicing by the close of fiscal year 2010.

Historically, DHS has not submitted its 4th quarter Act 148 invoice within 45 days of quarter close as required. With several hundred vendors and programs, it is unrealistic for DHS to submit 4th quarter invoices within the official submission window. DHS agrees with your recommendation and intends to seek an extension from the Commonwealth for submission of its 4th quarter Act 148 invoices.

Thank you for the observations provided in your report and for the opportunity to respond.

Sincerely,

Rob Dubow
Director of Finance

cc: Michelle Bethel, Deputy Revenue Commissioner, Water Revenue Bureau
Judi Cassel, Chief of Staff, Finance
Michael Kauffman, Director of Accounting
Joan Markman, Chief Integrity Officer
Catherine Paster, First Deputy Director of Finance
Keith Richardson, Revenue Commissioner
Albert Scaperotto, Deputy City Controller
Barry Scott, Risk Manager, Finance
Lauren Vidas, Assistant to the Director of Finance

Government Auditing Standards require auditors to report instances where the auditee's comments to the auditor's findings, conclusions, or recommendations are not, in the auditor's opinion, valid or do not address the recommendations. We believe this to be the case with regard to the City of Philadelphia, Pennsylvania's response regarding Workers' Compensation Plan Monitoring.

In its response, on page 15, management states that it disagrees with our comment about the failure to do file maintenance and the inadequacy of case reserves. The response states, in part, that reserves have been updated and are now adequate, and at any given time Risk Management is performing some level of file review.

Please be advised that our findings and recommendations with regard to file maintenance and case reserves are based on work pertaining to fiscal year 2009 which is the period of the audit. The file maintenance and case reserves comments, which were reported in the fiscal year 2009 actuarial evaluation of the city's workers' compensation plan, were discussed with and confirmed by the city's third party administrator. Management's assertion that reserves have been updated and are now adequate will be subject to review as part of the fiscal year 2010 audit engagement. Regarding management's statement that Risk Management is performing some level of file review, our finding pertains not to Risk Management's file review, but to the work performed by the city's third party administrator which is necessary for determining the city's liability for workers' compensation claims. The third party administrator's log of case files that it reviewed from August 2008 through June 2009 disclosed little activity. During these eleven months only eighteen claimant files were reviewed, and for five of those months, no files were reviewed.