

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

CITY OF PHILADELPHIA

FISCAL 2008



CITY OF PHILADELPHIA

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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, 2008, which collectively comprise the City of Philadelphia, Pennsylvania's basic financial statements and have issued our report thereon dated February 20, 2009. Our report was modified to include a reference to other auditors, the adoption of new accounting standards, and the exclusion of a previously included component unit. 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.

Primary Government

Municipal Pension Fund

Philadelphia Gas Works Retirement Reserve Fund

Fairmount Park Commission Departmental and Permanent Funds

Philadelphia Municipal Authority

Pennsylvania Intergovernmental Cooperation Authority

Component Units

Community College of Philadelphia

Penn's Landing Corporation

Pennsylvania Convention Center Authority

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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, Penn's Landing 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:

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- Lack of adequate controls during the city's implementation of its new water billing system.
- Lack of adequate oversight and review procedures over the preparation of the city's Comprehensive Annual Financial Report (CAFR).
- Deficiencies in the operating effectiveness of certain information technology controls for key financial systems.
- Lack of adequate controls over the amounts reported for capital assets because the city does not have a real property management system.
- Deficiencies in the procedures used to generate accounts payable balances.
- Failure to obtain an annual service auditor's report from the Third Party Administrator responsible for the city's workers' compensation program.
- Inadequate documentation of the city's system of internal control because most Standard Accounting Procedures have not been 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 conditions regarding the problems with the city's new water billing system and oversight and review procedures over the preparation of the city's CAFR to be material weaknesses.

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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

C I T Y O F P H I L A D E L P H I A
O F F I C E O F T H E C O N T R O L L E R

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 material weaknesses 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.

February 20, 2009

ALBERT F. SCAPEROTTO, CPA
Deputy City Controller

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FINDINGS AND RECOMMENDATIONS

NEW WATER BILLING SYSTEM

The city purchased a commercial off-the-shelf utility billing system known as “basis2” to replace the existing system used by the Water Revenue Bureau (WRB). The conversion to the new system began in January 2007 with an expected completion timeframe of thirteen months. The city’s old water billing system stopped processing transactions on December 31, 2007, and the new basis2 system became operational on January 2, 2008. Despite claims that the new water billing system was finished ahead of schedule, our review of the system implementation process, and our audit testing of the new system’s billing, adjustment, financial reporting, and enforcement functions uncovered significant control weaknesses, and financial reporting errors. As discussed below, key system components were not fully developed, tested, or working correctly. We believe that the initial time frame to complete the conversion in thirteen months was overly optimistic, and that rushed and inadequate planning during the system implementation process contributed to this situation.

System Implementation Did Not Follow Standard Practices and Controls

Our audit found that the city’s introduction of the basis2 system did not follow standard information system implementation practices and controls. We noted the following:

- The city did not parallel run the new and old systems so that problems could be identified and corrected before basis2 was independently operated.
- The WRB did not properly and timely reconcile the ending data in the old system to the beginning data in the new system to verify the completeness and accuracy of the data transfer. We requested this reconciliation in July 2008, and it took the WRB another month to provide a reconciliation. The WRB gave us two different versions of this reconciliation, the second of which indicated that \$32,087 of accounts receivable from the old system did not migrate over to basis2.
- The duties of basis2 project team consultants responsible for system programming were not adequately segregated. Programmers responsible for developing and making changes to the system software should not have access to current production data or the ability to update data. From January 2, 2008, when basis2 went live, until May 2008, these consultants routinely ran the daily computer batch jobs that updated basis2 records.
- In the early months of implementation, the system did not always identify the name of the actual user who ran certain batch jobs, instead indicating a user name such as “anonymous”.

Basis2 Did Not Calculate Customer Bills Accurately

During its first six months of operation, there were numerous problems with customer bills generated by basis2 because of flaws in its bill calculation program. Audit testing disclosed that out of \$269 million in customer billing transactions created by basis2 from January through June 2008, \$44 million (sixteen percent) were overbillings which were eventually cancelled. While basis2 had a control feature called “outsort” to identify erroneous bills in order to prevent them from being mailed to customers, it did not work as designed and its selection criteria appeared to be set too high. Consequently, there were instances of large erroneous bills being mailed to customers. For example, one residential customer whose previous monthly bill was \$53 received a bill for \$331,164.

We also noted programming errors in the basis2 system that resulted in the underbilling of penalty charges on delinquent accounts. We estimated that penalty charges were underbilled by \$3 million from January through June 2008.

Weaknesses in Basis2 Adjustment Procedures Increase Risk for Errors and Irregularities

The basis2 billing problems necessitated an extremely large number of adjustments to customer accounts. From January through June 2008, there were 285,938 adjustment transactions made resulting in a \$43 million reduction of accounts receivable. Our testing of basis2 adjustment transactions noted the following significant control weaknesses:

- Documentation to support the adjustment amounts and reasons was not readily available. Causes for this lack of documentation included (1) the basis2 system design did not require that WRB employees enter an explanation when making an adjustment; (2) WRB policy did not require written documentation for certain adjustment types such as bill reversals (i.e. cancelled bills) and rebills (i.e. replacement bills); and (3) employees failed to follow WRB policy.
- Authorization of adjustments was deficient.
 - There was no electronic authorization path for supervisory approval of adjustments.
 - Adjustment dollar limits set up in basis2 for certain WRB employees did not correctly match WRB policies and employee job responsibilities, resulting in several noted instances where employees made adjustments to customer accounts in amounts exceeding their authority and in violation of WRB policies.
 - Basis2 did not have a control to prevent or detect the splitting of adjustment transactions to circumvent employee dollar limits. We did find apparent instances of adjustment splitting.

Failure to Develop Financial Reporting Component Resulted in Delays and Errors

Similar to the problems with the billing function, the basis2 financial reporting component was not adequately planned and developed, resulting in reporting delays and errors. We met with the WRB as early as February 2008 to request the financial information needed for our audit. However, the June 30, 2008 accounts receivable and revenue data was not finalized until late September 2008 which delayed our efforts to test accounts receivable. In addition, when the city converted to its new water billing system, we expected but could not find evidence that management did a reassessment of the process for determining the year-end accruals for accounts receivable and revenues. Because the timing of billings worked differently in basis2, this lack of a reassessment of the year-end accrual methodologies resulted in a \$5.7 million error in the amounts reported as accounts receivable and revenues in the Water and Sewer Fund. When we brought the above error to management's attention, adjustments were made to correct the financial statements.

Enforcement is a Work in Progress

Enforcement of delinquent accounts in basis2 is still a work in progress, with several processes still not complete, such as the Utility Service Tenants Rights Act, municipal court, collection agencies, and shutoff components. This has contributed to a \$10 million decline in collections on prior year delinquent receivables from fiscal 2007 to fiscal 2008.

Recommendations

Based on our observations during the audit, and our testing of transactions, basis2 was not operating effectively and accurately. This situation increased the risk of undetected errors and irregularities. Because of these risks, we could place little or no reliance on the controls of the city's new customer billing system, and this added significantly to the time and effort required to audit the Water and Sewer Fund accounts receivable and revenues.

City management needs to bring the new customer billing system under control. Of greatest importance is the need to improve the accuracy of customer bills and revenue collection efforts, strengthen controls over the documentation and authorization of adjustments made to customer accounts, and ensure the timeliness and accuracy of the accounts receivable and revenues reported in the Water and Sewer Fund. We recommend that management identify all basis2 processes that are still incomplete or not working correctly and develop firm benchmarks for their completion and resolution. [500108.01]

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 prior year report, 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. One notable vacancy, which has existed since June 2006, was the key position of accounting manager, who would normally be responsible for supervising the preparation of the CAFR. Our current audit disclosed no improvement over this condition. During the period of our review, the accounting manager position was still vacant, and over the past year the staff size of the Accounting Bureau has declined by four positions.

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, this situation delayed the CAFR preparation process and increased the risk for financial reporting errors and omissions. Two examples of these types of errors were:

- A \$700 million misclassification of the liquidity of the Business Type Activities' restricted assets reported in the Statement of Net Assets, and
- A \$1.6 billion understatement of defeased debt outstanding disclosed in the component unit long term debt payable footnote.

When we brought the above errors to Finance's attention, adjustments were made to correct the CAFR.

In addition, the preliminary full accrual government-wide statements, the deposits and investments footnote, and the management's discussion and analysis, were not provided until January 2009.

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]

Enterprise Fund Reporting Procedures Require Strengthening

Previously, we reported that Finance had assigned the responsibility for the preparation of the full accrual financial statements of the Aviation Fund and the Water and Sewer Fund to the Division of Aviation (DOA) and the Philadelphia Water Department (PWD), respectively.

The deficiencies that compromised controls over the DOA's financial reporting process have been corrected, and are discussed in the resolved prior year findings section of this report. However, as previously reported, there are still no formal written policies detailing the specific review procedures to be performed by PWD personnel during the 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. Our current year review of the Water and Sewer Fund full accrual statements disclosed errors totaling approximately \$8.7 million, that might have been detected by a thorough review process. When we brought these errors to management's attention, adjustments were made to correct the financial statements.

Therefore, 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.

The performance of these review procedures should be documented on a checklist, signed by a responsible PWD official, to 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]

Late Receipt of Component Unit Financial Data

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 process. In addition, because the Accounting Bureau must make significant changes to the financial statements and footnotes each time new component unit data is received there is an increased risk of errors or omissions.

This condition has not improved. We noted that seven of the city's eleven component units failed to submit their reports by the due date requested by Finance. For one component unit – the Pennsylvania Convention Center Authority – Finance did not receive finalized data until February 2009, which was more than four months after the date requested. The late submission of these reports was a primary cause for the delay in the issuance of the city's CAFR.

We again recommend that the director of finance solicit the assistance of the mayor or other administrative officials, early in the CAFR preparation process, to secure the cooperation of all component unit directors in submitting their financial data to the Accounting Bureau timely. [50102.01]

Reporting Process for Departmental Custodial Accounts Needs Improvement

Our testing of the Departmental Custodial Accounts disclosed significant errors. We found that the amount originally reported for cash and investments was understated by \$62 million. Most of this error - \$53 million – occurred when amounts from Finance’s supporting calculation schedule were misposted to the city’s CAFR. The remaining \$9 million was the result of missing bank reconciliations, the erroneous inclusion of closed accounts, and various clerical errors.

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 (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. Failure to obtain custodial account bank reconciliations precludes Finance from having assurance that city agencies are performing this critical internal control function and increases the risk of financial reporting errors.

In our previous two reports, we commented that Finance did not receive custodial account bank reconciliations from numerous city agencies and failed to contact these agencies to request the reconciliations. In the absence of current information, Finance simply used the last cash and investments balance provided by the agency, which in most cases was the previous year’s balance.

Our current year review disclosed that Finance’s director of accounting sent all city agencies a memorandum reminding them of the requirements of SAP # 7.1.3.b. Also, we observed e-mail correspondence that the director of accounting sent to city agencies requesting bank reconciliations that had not been submitted. However, our testing found that several city agencies ignored Finance’s request, most notably the Office of the Sheriff and the Clerk of Quarter Sessions whose accounts represented seventy percent of Departmental Custodial Accounts assets. In the absence of fiscal year-end balances, Finance used the last book balance provided by the agency.

We also found clerical errors. For example, the beginning balances on the supporting calculation schedule did not match the prior year’s ending balances. Also, we noted errors on this schedule caused by incorrect computer spreadsheet formulas.

When we brought the \$62 million understatement of Departmental Custodial Accounts cash and investments to Finance’s attention, adjustments were made to correct the financial statements. However, to improve the accuracy of reporting for Departmental Custodial Accounts, we continue to recommend that Finance’s Accounting Bureau continue its efforts to instruct city agencies that they are required to submit custodial bank reconciliations each month. When agencies fail to comply, especially those with significant amounts of cash and investments, the Accounting Bureau should immediately inform the Director of Finance so that appropriate enforcement action can be taken. [50106.05]

GENERAL INFORMATION TECHNOLOGY CONTROLS REVIEW

We conducted, with the assistance of a consultant, a review of the Division of Technology's (DOT) general information technology (IT) controls over financially significant systems, and we have issued a separate report to the DOT dated February 18, 2009.

Based on observations during this review and testing of controls, we found problems related to the following IT general control areas:

- **IT Governance** – Formal policies and procedures were not available or were not adequately documented. This creates a risk of inconsistent application of controls designed to secure data, maintain a stabilized IT environment, and maintain the availability of systems.
- **Security Administration** – There is a segregation of duties issue between security administration and transactional responsibilities in the applications within the scope of this review. It was noted that the granting of access was not role-based to ensure users are restricted to the access they need to perform their jobs. Inappropriate administrative access may allow employees to perform functions that are outside their responsibility or expertise, and could compromise the data within financially significant applications.
- **Security Monitoring** – Monitoring controls have not been established to regularly evaluate the configuration, authorization, and appropriateness of access to the city's computer resources. As a result, the city does not have the ability to detect instances of inappropriate access.
- **Change Control** – The change control process is not applied consistently to all production systems and needs to be updated. This creates the risk that program changes not approved by an authorized user could compromise the data within the affected system.
- **Disaster Recovery** – The disaster recovery plan's documentation does not appear to include several key elements, such as an evaluation of the critical systems, determination of acceptable downtime, and identification of key contact information, that are critical to the successful execution of the plan across all areas should a disabling event occur. As a result, management runs the risk of an inability to restore all system resources after a disabling event.

We recommend 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.

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 noted 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 on spreadsheets, and make operations more efficient. Also, as future staff changes occur with Finance personnel responsible for capital asset accounting and reporting, a streamlined, comprehensive capital assets system will improve the transition for the new employees responsible for capital assets.

Land Costs Not Properly Allocated to Asset Locations

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.

Asset Information Not Properly Recorded

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 eight properties during fiscal 2008 that generated approximately \$3.0 million. Out of these eight properties, only three were recorded in the city's fixed asset ledger. There were no records for the other five 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 assets.

Formal Periodic Physical Inventory of Real Property Assets Is Needed

In our prior year report, we reported that only the Philadelphia Water Department and the Division of Aviation periodically check the physical existence and condition of their real property assets. Our current year testing disclosed we again could not find evidence that the city's other real property assets have been recently inventoried by the city.

The Government Finance Officers Association recommends that every government 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. In addition, Standard Accounting Procedure, SAP E-7201, specifies 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.

Finance personnel stated that they believe this condition 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 recorded assets will be periodically inventoried, we believe that the procedures described by Finance are not sufficient.

To improve the accounting and reporting of the city's capital assets, we again 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]

ACCOUNTS PAYABLE

In our prior year report, 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, 2008. As such, this methodology fails to include those transactions that had the related goods or services delivered in fiscal year 2008, but invoiced and paid in fiscal year 2009. We also noted that FAMIS does not have a data field for recording the date that the goods or services were received, and ADPICS only requires this information for some but not all transactions. In addition, Finance's program for extracting payable data from ADPICS is limited to those vouchers created during fiscal year 2009. Hence, this methodology fails to capture those vouchers created during fiscal year 2008, but not paid until fiscal 2009.

As a result, accounts payable balances were misstated by \$10,415,336 and \$16,926,749, in the Grants Revenue and Health Choices Behavioral Health (HCBH) Funds, respectively. When we brought the above errors to management's attention, an adjustment was made to correct the HCBH fund only.

Although we were informed that, to improve the accuracy of reported accounts payable, Finance implemented 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. [50107.03]

We also continue to recommend 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. [50107.04]

WORKERS' COMPENSATION CLAIMS PROCESSING CONTROLS

The Risk Management Division of the Office of the Director of Finance (Risk Management) is responsible for the city's workers' compensation program; however, Risk Management does not directly administer the program. It contracts with a Third Party Administrator (TPA) to process workers' compensation claims against the city. During fiscal 2008, the city incurred \$52.3 million in costs related to its workers' compensation program. Accordingly, it is essential for the city to have reasonable assurance that workers' compensation claims processed by the TPA are valid, recorded correctly and disbursed in accordance with an established claims settlement process.

In order to obtain such assurance, the TPA is responsible for providing Risk Management with an annual service auditor's report. This type of report would provide the city assurance that the TPA's controls relevant to the processing of workers' compensation claims on behalf of the city are suitably designed and placed in operation, and determine whether the controls tested were operating with sufficient effectiveness to provide reasonable assurance that the controls objectives were achieved. This report was not obtained during fiscal year 2008.

We recommend Risk Management require its TPA to obtain and submit an annual service auditor's report. [500108.02]

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 revised several SAPs and issued a few new procedures that are now posted on its website, none of these have been recently updated.

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.

In its response to our prior year report, Finance indicated that the budget included funding for an additional staff person who would be assigned the task of reviewing and updating the SAPs on a full time basis. Unfortunately, due to the recent budget shortfalls experienced by the city this corrective action plan was not implemented.

We continue to recommend that Finance 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]

RESOLVED PRIOR YEAR FINDINGS

Enterprise Fund Reporting Procedures Require Strengthening – Aviation

In our prior year reports, we noted the existence of deficiencies that compromised controls over the DOA's financial reporting process. Specifically, a double-entry accounting system was not used to compile the DOA's financial statements and there were no formal written policies detailing the specific review procedures to be performed by DOA personnel.

To address these conditions, the DOA, acting on a proposal made by Finance, has established a full accrual aviation fund in FAMIS, and has developed and implemented formal written policies detailing procedures to be used to prepare and review its financial statements. Based on the action taken, we consider these findings resolved. [50106.01 & 50106.02]

In addition, the DOA established a checklist for the performance of detailed review procedures that is initialed by both the preparer and reviewer of the financial statements. Therefore, we consider this finding, as it relates to the Aviation Fund, resolved. [50105.01]

Treasurer Did Not Perform Timely Investigation of Reconciling Items

In our previous two reports, we commented on an unresolved \$2.3 million reconciling item on the city's consolidated cash account bank reconciliation described as a cash receipts error which first appeared on the July 2005 reconciliation. Since this item had to be deducted from the account's book balance in order to reconcile to the account's bank balance, it represented either a \$2.3 million overstatement of the book balance or a \$2.3 million shortage in the bank account. In the prior audit, Treasurer personnel attributed \$2.16 million of this item to a duplicate revenue recording, and Finance prepared an adjustment to correct this error. However, the Treasurer's use of it as an explanation for the \$2.3 million item did not appear valid since the duplicate recording occurred in January 2006. We recommended that the Treasurer work with Finance to determine the true cause of this discrepancy and the appropriate corrective action.

Our current year inquiry of Treasurer personnel indicated that there has been no further investigation of this \$2.3 million discrepancy. However, in light of the fact that our testing of the June 30, 2008 consolidated cash bank reconciliation did not disclose any additional significant questionable reconciling items and noted only a small amount of old reconciling items, this matter is no longer considered a significant deficiency required to be reported under *Government Auditing Standards*. We will continue to monitor the resolution of the \$2.3 million discrepancy in the future as part of the annual departmental audit of the Treasurer. [50105.04]

Finance's Review of Treasurer Bank Reconciliations Requires Strengthening

In our prior two reports, we commented that Finance's review of Treasurer bank reconciliations required strengthening. Specifically, Finance personnel did not adequately analyze the reconciling items on Treasurer bank reconciliations to determine whether the cash amounts reported in the city's CAFR required adjustment. In the prior year, we noted an \$18 million cash understatement due to an unrecorded receipt that was not detected by Finance's review.

Our current audit found improvement in this condition. The Treasurer sends Finance personnel monthly lists of consolidated cash account reconciling items for their review and assistance in resolving these items. We observed evidence of Finance's review and attempts to resolve consolidated cash account reconciling items. Finance personnel informed us that they received and reviewed the Treasurer's fiscal year-end bank reconciliations. While there was no evidence of this review, our testing of the June 30, 2008 Treasurer bank reconciliations only noted \$3.8 million in unrecorded receipts which understated the reported cash balance. Given the improvement noted, and Finance management's assertion that staff will document future reviews by initialing and dating the Treasurer bank reconciliations, we no longer consider this matter to be a significant deficiency required to be reported under *Government Auditing Standards*. We will continue to monitor this condition as part of the annual departmental audit of Finance. [50105.05]

Treasurer Bank Reconciliations Were Not Prepared Timely

In the prior audit, we reported that the Treasurer did not timely prepare bank reconciliations with 41 of its 62 bank reconciliations not completed until three or more months after June 30th. The bank reconciliation for the city's consolidated cash account, into which the majority of daily city revenues are deposited, was not completed until over five months after fiscal year-end. This condition occurred because the accountant who prepared the majority of reconciliations transferred to another department in November 2006 and was not replaced until August 2007. Because of these delays, the Treasurer was late in submitting reconciliations to Finance for review and in certain cases did not forward them at all.

Our current audit testing found that the majority of June 30, 2008 Treasurer bank reconciliations were prepared within two months after fiscal year-end. The reconciliation for the city's consolidated cash account was completed by November 4, 2008. The Treasurer provided copies of June 30, 2008 bank reconciliations to Finance personnel for their review. This finding is considered resolved. [50107.02]

Real Estate Assessment Procedures

In our prior reports, testing found that the Board of Revision of Taxes (BRT) evaluators did not always document the criteria they applied to justify market-value reductions used in establishing real estate assessments. Our current testing revealed that criteria for reductions to market values were documented and approved by supervisors. We also commented that market-value reductions exceeding certain dollar thresholds were not being reviewed and approved by the board in compliance with the agency's assessment precepts. Our testing revealed that board approval was evidenced for properties with market-value reductions over certain dollar thresholds. We consider

these findings resolved and will continue to monitor these conditions in the future. [50107.05, 50107.06, 50107.07]

Additionally, we previously commented that evaluators did not document their verification that requested changes to properties' market values had been accurately input into the BRT's assessment file, and their supervisors did not review and approve this work. Also, while state law (72 P.S. § 5341.7) requires that the BRT issue evaluator precepts annually, the BRT last issued precepts in 1993. Our current audit disclosed that these findings were not corrected. However, since our current year testing of market value changes did not find any input errors and BRT management advised us that new precepts are being developed, and in light of improvements made to the assessment process described above, these matters are no longer considered to be significant deficiencies required to be reported under *Government Auditing Standards*. We will continue to monitor these conditions in the future and report upon them in the annual departmental audit of the BRT. [50106.06, 50106.07, 50106.08]

RESPONSE TO AUDITOR'S REPORT



CITY OF PHILADELPHIA

OFFICE OF THE DIRECTOR OF FINANCE

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ROB DUBOW
Director of Finance

June 8, 2009

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 2008

Dear Mr. Butkovitz:

Thank you for the opportunity to discuss the contents of your draft report at the exit conference held on May 8, 2009. 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.

New Water Billing System

Finding & Recommendation: Your report found control weaknesses and financial reporting errors in the new water billing system used by the Water Revenue Bureau, including inaccurately calculated customer bills, weak adjustment procedures, inadequate planning and development of financial reporting and incomplete enforcement of delinquent accounts. You recommend that management identify processes to improve the control and financial reporting weaknesses listed above.

Response: We agree with the Controller's finding that the system was not operating effectively and accurately from the start. At the same time, much has been fixed or improved since those early months and the period upon which the findings were based. It is true that during the first six months there were problems with the bill calculation; however, the majority of the errors were caught prior to sending the bills out and cancelled in the system. Since that time, all known billing issues have been logged and are fixed or being addressed.

We concur with the importance of having the proper controls over the documentation and authorization of adjustments made to customer accounts. The Basis2 system requires an adjustment transaction and does not allow original transactions to be modified. Currently, an adjustment explanation can be entered, but is not required in Basis2; however, an enhancement to the system is being developed to require an explanation for any adjustment that is made. We also agree that ensuring the accuracy of reporting and collecting accounts receivables is a priority, and we will continue to work with the Water Revenue Bureau to improve the system.

Financial Reporting

Staff Reductions Compromise CAFR Preparation Process

Finding & Recommendation: Your report found that staff reductions in recent years have compromised the preparation and review of the CAFR. You recommend that management 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. Yet, due to the City's current financial position, the Accounting Bureau is required to perform its normal duties with fewer resources. Currently, there are no budgeted vacancies in the Accounting Division. While we agree that this level of resources is not optimal, it is an ongoing challenge that the Finance Department and other agencies throughout the City face.

The CAFR schedules that the Controller mentions are highly technical. The level of expertise required, as well as staff workloads are 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, over the course of the past year the Accounting Bureau has engaged in a 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.

Enterprise Fund Reporting Requires Strengthening

Finding & Recommendation: Your report found that the prior year's financial reporting process deficiencies at the Division of Aviation have been corrected, yet there are no written financial reporting procedures for the Philadelphia Water Department personnel. You recommend that management establish procedures to be performed by the Philadelphia Water Department as part of their financial reporting process.

Response: As described by the Controller, the Accounting Bureau has worked with both the Division of Aviation and the Water Department to strengthen their financial reporting. The

Division of Aviation has chosen to use the current accounting system to help facilitate their financial reporting. In using the current accounting system, many of the impediments surrounding the financial reporting of the Division of Aviation have been successfully removed. The Accounting Bureau continues to work with the Division of Aviation to resolve the remaining technical issues that exist.

The Water Department continues to use its accounting system in order to provide it with the information necessary to do its financial reporting. We also note that the Water Department suffered the loss of a key member of its staff. Current employees are working to gain a deeper understanding of the accounting system. As a result, we expect future reporting will be improved.

Late Receipt of Component Unit Reports

Finding & Recommendation: Your report found 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. You recommend that management solicit assistance from other administrative officials to further encourage all component units to submit their financial data on time.

Response: We agree that the timely submission of all component unit reports is critical to the timely issuance of the City's CAFR. During the preparation of the FY 2008 CAFR, one of the component units engaged new auditors. As a result, the lead time required by the auditor had to be extended so that they could perform the required internal control review. Another agency was delayed because they were waiting for an actuarial report of their GASB 45 liabilities. We will continue to impress upon the component units the need to give themselves adequate lead time so that reports can be done on a timely basis.

Reporting Process for Departmental Custodial Accounts Needs Improvement.

Finding & Recommendation: Your report found that Finance did not receive custodial account bank reconciliations from several city agencies, causing financial reporting errors. Your report also found clerical errors. You recommend the Accounting Bureau continue to require the monthly submission of custodial bank reconciliations from city agencies, and that appropriate enforcement action be taken if agencies fail to comply.

Response: The Accounting Bureau will continue to request that departments provide us with the required custodial account bank reconciliation information. Regular follow-up will occur with departments to ensure their future compliance.

In addition, the Accounting Bureau had a new staff member perform this task and their unfamiliarity with the computer software led to some discrepancies. In the future, as the new employee becomes more familiar with the process to gather and report this information the discrepancies should not occur.

General Information Technology Controls Review

Finding & Recommendation: Your February 18, 2009 DOT report found problems relating the several IT general control areas, including IT governance, security administration, security monitoring, change control and disaster recovery. In that report, you recommended that DOT make enhancements to the IT control structure in order to improve financially significant systems.

Response: I understand that Chief Information Officer Allan Frank responded to the recommendations included in your February 18, 2009 Division of Technology report. A copy of Mr. Frank's response is attached.

Capital Asset Reporting Deficiencies

Finding & Recommendation: Your report found that Finance operates 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. 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.

Accounts Payable

Finding & Recommendation: Your report notes that there remain deficiencies in Finance's year-end expenditure review procedures, resulting in vendor payments recorded in the wrong fiscal period. You recommend instituting an expenditure review procedure as well as revise the criteria for extracting payable data so that vouchers paid (rather than vouchers created in the subsequent fiscal year) are used.

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 between encumbrances and accounts payable is that invoices have been received for the accounts payable. The encumbrances represent a reservation of funds for contracts that the City has with a vendor but for which an invoice has not been received. We will work to properly classify entries in all instances.

Workers' Compensation Claims Processing Controls

Finding & Recommendation: You found that there was no annual service auditor's report from the third party administrator who processes workers' compensation claims against the City during the fiscal year 2008. You recommend Risk Management require this annual report moving forward.

Response: We agree with the Controller's recommendation that Risk Management require the submission of an annual service auditor's report from the third party administrator who processes workers' compensation claims against the City. Since the time of our exit conference, we have obtained an audit for the period September, 2008 through February, 2009, and Risk Management will provide the Controller with a copy of that report. We will continue to require annual audits of the program going forward.

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. Due to the constraints on the City's financial position, however, we do not currently have the staffing capacity to conduct a comprehensive review and update of the procedures on a regularly-scheduled basis.

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

Sincerely,



Rob Dubow
Director of Finance

- cc: Michael Kauffman, Director of Accounting
Barry Scott, Risk Manager
Keith Richardson, Revenue Commissioner
Michelle Bethel, Deputy Revenue Commissioner, Water Revenue Bureau
Catherine Paster, First Deputy Director of Finance
Albert Scaperotto, Deputy City Controller
Maia Jachimowicz, Assistant Finance Director



CITY OF PHILADELPHIA
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February 9, 2009

Alan Butkovitz
City Controller
Office of the Controller
1230 Municipal Services Building
1401 John F. Kennedy Building
Philadelphia, PA 19102-1679

Mr. Butkovitz:

The financial controls audit performed by the Office of the Controller has identified opportunities for improvement in the management and use of financial systems. The Division of Technology (DOT) recognizes the importance of information security controls, especially in relation to these financial systems and processes, and has been working aggressively to improve the security and control posture of the City's computing infrastructure through the auditing of systems, the improvement of existing systems, and the implementation of new technologies. Specifically, DOT has been implementing enhancements in the following general areas that are responsive to the findings of this audit:

IT Governance: The Division of Technology recognizes the need for strong governance processes and controls for managing computing systems. Various levels of control have been put in place over the years, but the Division of Technology recognizes that these controls have not kept pace with technology and industry changes, which has been further hampered by staffing and resource constraints. The Division of Technology is now aggressively working toward implementation of industry standard best practices for governing systems, including the introduction of strong change management, project management, and the implementation of standards-based processes. Improvement has been realized and ongoing improvement is expected as processes are implemented, resource constraints are resolved, and systems are enhanced or upgraded.

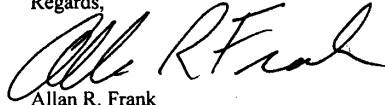
IT Controls & Security: One of our top priorities is to ensure that appropriate internal IT process standards and controls are in place across all areas of our operations. In addition, we take seriously our responsibility to safeguard the information and technology assets of the City government through appropriate security measures and technical means. We have instituted an ongoing IT Security Program which not only focuses on DOT applications, network and data center operations, but also across all agencies within the City. We, in fact, routinely test for weaknesses as part of a security improvement and remediation program. In particular, our top priority is ensuring a secure data and network environment for departments and systems supporting sensitive applications and data.

Access Control: Access to systems is a critical area of control in all environments. This has presented a challenge in the City due to the distributed IT support model and lack of certain key technologies. The Division of Technology recognized the need for a strong access control methodology and has been working toward a single directory structure for the City, based on Microsoft Active Directory (AD) technology. This effort is ongoing and will allow centralized control of access, and enable the move toward single sign on for systems. In addition, the Office of Human Relations is working to improve the processes by which employees are tracked and managed. We expect to complete migration to AD in 2010 and already are seeing the benefits as we progress through the conversion.

Disaster Recovery: Recovery of systems is a critical priority for DOT. All systems are backed up and recoverable in some defined period time. For the larger systems, this is tested on a regular basis each year. However, the Division of Technology recognizes that there is room for improvement, and has been working to implement changes that will enhance the stability and survivability of key business processes and systems in the City. The ongoing efforts related to Continuity of Operations and infrastructure improvements will continue to improve the City's posture in this area.

The Division of Technology recognizes that the City computing infrastructure requires improvements and is working to implement enhancements to existing systems, and to replace systems that no longer provide the stability and security required for modern computing processes.

Regards,



Allan R. Frank
Chief Information Officer