

**APPROVED MINUTES
APPROVED ON 1/26/2016**



**CITY OF SCOTTSDALE
AUDIT COMMITTEE**

MONDAY, NOVEMBER 16, 2015

**CITY HALL
KIVA CONFERENCE ROOM
3939 NORTH DRINKWATER BOULEVARD
SCOTTSDALE, AZ 85251**

REGULAR MEETING

PRESENT: Suzanne Klapp, Chair
Virginia Korte, Councilmember
Kathy Littlefield, Councilwoman

STAFF: Sharron Walker, City Auditor
Kyla Anderson, City Auditor's Office
Lai Cluff, City Auditor's Office
Tim Conner, Office of Environmental Initiatives
Derek Earle, Capital Project Management department
Joyce Gilbride, City Treasurer's Office
Anna Henthorn, City Treasurer's Office
Dave Lipinski, Capital Project Management department
Jeff Nichols, City Treasurer
Rachel Smetana, Mayor's Office

GUESTS: Jill Shaw, Heinfeld, Meech & Co., P.C.

CALL TO ORDER

Chair Klapp called the meeting to order at 4:01 p.m. A formal roll call confirmed the presence of all Committee Members as noted above.

1. Approval of Minutes, Regular Meeting, October 19, 2015

COUNCILWOMAN LITTLEFIELD MOVED TO APPROVE THE MINUTES OF THE OCTOBER 19, 2015 REGULAR MEETING. COUNCILMEMBER KORTE SECONDED THE MOTION, WHICH CARRIED BY A UNANIMOUS VOTE OF THREE (3) TO ZERO (0).

2. Discussion and Possible Direction to Staff Regarding Audit No. 1601, FY 2014/15 Financial Audit Reports

Ms. Jill Shaw, of Heinfeld, Meech & Co., P.C. provided the presentation.

The audit of financial statements includes all funds of the City, including enterprise funds, water, and waste water. Separate audit opinions are issued for CFDs, the MPC and the SPA. Unmodified opinions were issued on all audits. The biggest change in the audit report from this year is the implementation of the new pension standards, which brought liability in the financial statements for the City's portion of the net pension liability for the ASRS and the PSPRS Police and Fire systems. No audit adjustments were proposed to the financial statements and there no disagreements with management.

Several reports are issued, including the largest report, the CAFR, which contains the opinion on the City's financial statements. The single audit reporting package is required as the City expends more than \$500,000 in federal monies. This portion examines internal controls and compliance with rules, regulations and statutes, as well as compliance with spending federal awards. The report states that an unmodified opinion was issued on all compliance requirements of the federal programs that were examined. Auditors rotate which programs are audited from year to year based on a risk assessment process. This year, the Housing Choice Voucher Program (Section 8), the Equitable Sharing Program (RICO), the Airport Improvement Program and Highway Planning and Construction federal programs were examined. There was no reportable noncompliance and no violations of laws or regulations in these areas. Auditors are required to examine compliance with expenditures of HURF monies. No noncompliance issues were found.

COUNCILMEMBER KORTE MOVED TO ACCEPT THE FY 2014/15 FINANCIAL AUDIT REPORTS AND SUBMIT THE REPORTS TO CITY COUNCIL WITH A RECOMMENDATION FOR APPROVAL. COUNCILWOMAN LITTLEFIELD SECONDED THE MOTION, WHICH CARRIED BY A UNANIMOUS VOTE OF THREE (3) TO ZERO (0).

3. Discussion and possible direction to staff regarding Environmental Quality Advisory Board Sunset Review

Sharron Walker, City Auditor, reviewed that the Board's purpose is to advise the City Council on issues related to environmental quality and prioritization of future environmental activities and programs. The Board assists the Council by providing nominations for Council established environmental achievement awards and provides assistance to staff related to coordinating efforts between the public and private sector to address environmental concerns. The Audit Committee is to evaluate whether the board or commission being reviewed is serving its intended purpose, whether the purpose should be maintained or modified, whether the purpose has been served or is no longer required. The Audit Committee is to specifically recommend to the Council whether to continue or terminate the board or commission. Tim Conner is the Board's liaison and has comments to share with the Audit Committee.

Mr. Conner described the Board's current efforts that the Council should see coming forward in the near future regard the salinity issue for water quality. The Board's focus is on alternative, salt-free technologies for water softening. In addition, they have also

established a recognition program for private entities that show that it's possible to do business in an environmentally conscious way and the Board is looking forward to bringing forward some of these that are in our city.

Councilmember Korte questioned whether there are existing practical alternatives to sodium chloride. Mr. Conner referred to a TAC system, that utilizes a cartridge that rejuvenates itself that is similar to a Kinetico system. Other alternatives are bottled systems that a company comes to periodically recharge. They take the cartridge, remove the salt to recycle it and then reuse the cartridge. The Board wants to see if over time the TAC is a replicable system that can be proposed as an alternative to salt or sodium based softeners. Mr. Connor noted that water from the Colorado River and other surface water arrives with some salt level. The use of salt based water softeners contributes to increased salinity levels in the groundwater.

Councilwoman Littlefield commented that this Board studies issues, whether salt in the water or solar energy, that will only grow in importance over time. As such, she was not in favor of dismantling the Board. Chair Klapp agreed, noting that it is obvious by its reports and activities that this Board takes these issues very seriously.

Councilmember Korte added that the availability of water is a growing concern, given the example of California's water restrictions. Flows from the Colorado River are not at expected levels and Arizona would be the first to lose resources. She asked whether the Board was investigating a way to mitigate the effects of reduced water availability. Mr. Conner replied that the Water Resources group provided an updated drought management plan. The Environmental Quality Advisory Board reviewed that and recommended some actions be taken now. Brian Biesemeyer is very capable of adjusting that plan if needed. No shortages are expected this year or to the trigger levels next year. He added that with SRP and water coming from the Verde River and the White Mountains, the City is not completely reliant on the Colorado River for its water services. The Board continues to monitor the drought management plan and would be willing to make recommendations for measures to be taken now.

COUNCILWOMAN LITTLEFIELD MOVED TO RECOMMEND TO CITY COUNCIL THE CONTINUATION OF THE ENVIRONMENTAL QUALITY ADVISORY BOARD. COUNCILMEMBER KORTE SECONDED THE MOTION, WHICH CARRIED BY A UNANIMOUS VOTE OF THREE (3) TO ZERO (0).

4. Discussion and Possible Direction to Staff Regarding Audit No. 1509, Scottsdale Road Improvements, Phase 1

Lai Cluff, Senior Auditor, provided an overview of the report. The audit of Scottsdale Road Improvements, Phase 1, was performed to review the procurement, compliance with contract terms and contract administration of the construction contract. For this project, Capital Projects Management contracted a CMAR (Construction Manager at Risk) and approved a GMP (Guaranteed Maximum Price) of \$9.5 million. A CMAR is hired during the design phase of a project to review payments, provide design input, create a construction plan and put together a GMP cost proposal. With a GMP contract, the CMAR assumes the risk of delivering the construction contract on time and within the agreed upon contract amount.

As part of the audit, all related City project management files, the contractor's project files, vendor invoices and job cost ledgers were reviewed. The audit revealed overpayments totaling approximately \$275,000 that could have been avoided through closer review of the contractor pay applications and change request documentation. More effective oversight of subcontractor selection and costs could result in significant project savings. Even though the subcontractor costs represent approximately \$4 million of the construction costs, a subcontractor selection plan had not been submitted for review and final subcontractor selections and costs had not been reviewed. Additionally, staff did not verify buyout savings, although there were indications that the CMAR may have realized savings of up to \$163,000 in subcontractor costs.

Several aspects of project management and contract administration are in need of improvement. There was no documentation of cost review and negotiations for the GMP. Changes were not adequately documented and were often submitted after the work was performed. The CPM inspectors did not document inspection measurements, and construction delays were not formally addressed. The procurement process was not documented sufficiently to demonstrate that required processes were followed.

Having worked for a subcontractor for five years, Councilwoman Littlefield found it disturbing that a better job was not being done to monitor subcontractors, keeping track of costs, verifying costs against contract amounts, ensuring that the work was done and ensuring that necessary paperwork was complete before payment. She added that according to the report, work for many of the change orders was performed before the change orders were even approved. In addition to concerns on this project, she questioned whether there were reasons to be concerned about other projects and related processes and procedures. Councilwoman Littlefield commented that the audit recommendations are directly in line with what needs to be done. Ms. Walker said she knows that CPM has a plan and Derek will speak to that, but her office needs to be auditing construction projects on a more regular basis.

Councilmember Korte questioned whether the plan's deadline for implementation of fixes by May would be soon enough, particularly with the new bond projects for road improvements and fire stations commencing. She expressed her concern given the millions of dollars being spent.

City Engineer Derek Earle commented that they share the Committee's concerns when they received the results. He noted that staff does have some differences with the auditor on some of the overpayments. He acknowledged that any overpayment is relevant. However, they believe the number is significantly less. A key factor to indicate is that CPM plans to hire an expert in CMAR contracts, which are unique and differ from most other contracts we do. He has previously reviewed several of the City's contracts with very good results. He's a construction expert and for previous CMAR contracts he's looked at, we haven't had any issues. He added that besides making any corrections to this project, including any funding that's due back, but more importantly education with the staff on CMAR contracts will be helpful. We assumed that our staff knew more than I think they did; training will help them. In general, most of the improvement recommendations from the auditor make sense. We believe in a lot of ways we were already compliant, for example we were documenting procurement requirements compliant with legal advice but the audit is recommending further documentation. Overall we are moving as quickly as we can get the consultant in to help us fix it.

Chair Klapp asked whether Capital Projects staff works with the Treasurer's accounting and financial staff or whether the department has its own internal staff to check invoices and authorize payment. Mr. Earle explained that this work is through the Project Management Group and that there are checks in place. Field personnel confirm amounts. He stated the department's belief that nothing was paid that was not properly billed. The auditor is suggesting that staff better document the measurements in the field. Then the invoices are also checked by project management assistants for correct math and calculations. They are then checked by the project manager for proper progress.

Specifically in regards to the incorrect sales tax application, the CPM documentation shows that all the correct sales tax rates were applied. There was a change in sales tax rates midway through the project, but our indications are that they were properly applied and work continues to determine what may have been missed. He stated that CPM thinks they were properly charged. Unfortunately, it's difficult for the auditor to share the details during the audit process.

Ms. Walker stated that they do not provide audit working papers, however Lai has spent a lot of time going over the details with the CPM staff. In reference to the sales tax error, the CPM noted on a change request document that the rate needed to be corrected. However, the contractor was paid before this change document was processed and that's why they were paid the wrong rate. In response to a question from Chair Klapp, Mr. Earle stated that the City could go back to the contractor to correct this.

Ms. Walker stated that in regard to overpayment differences, a main concern related to the final pavement preservation change order. The general conditions rate charged on this change order was much higher than what the general conditions rate was during the original project. The audit questioned why \$120,000 was paid, rather than the approximately \$42,000 that would have been paid based on the original rate. To her knowledge, that is the only amount that the auditors saw completely differently than CPM. The auditors have reviewed everything that was questioned with CPM.

Chair Klapp asked about any instances of underpayment. Ms. Cluff replied that other items were generally paid according to contract. Chair Klapp noted that it seems odd that nothing was underpaid. Mr. Earle commented that CPM is going to get a report from a third party independent consultant, which includes a thorough review of the contractor's records and resulting recommendations. CPM has already found in its discussions with the contractor that he made mistakes in the administration of the project, which flowed through to inaccuracies in billing. The contractor was not treating the contract as a CMAR. In response to Chair Klapp's question, Mr. Earle commented that the CMAR is operating as a construction manager and has responsibility that everything is properly bid and all the job cost documentation is given to the City. In this case, there are instances where the contractor may have overcharged or undercharged its internal accounts, which carried through in inaccuracies in billing. The contractor was treating it as a low-bid contract, billing the City the fixed amount and that is part of the problem. Our other contractors have properly billed and have properly done the buyouts. The project manager probably needs more training and the contractor wasn't billing the correct way. Mr. Earle stated they think this is an isolated instance.

Councilwoman Littlefield referred to the report and noted a comment that staff would be looking for the minimum required by law. She suggested that this should not be the

goal. The goal should be to ensure that all records are complete, so that all steps can be followed and verified through the audit process, specifically in regards to change orders and changes in contract. Mr. Earle clarified that that the comment regarding minimum state requirements referred to the procurement process. Based on the City Attorney's advice, staff had not previously published the individual scores. Ms. Walker added that this is not just for the auditor's sake, but to ensure that City staff are following the City's established processes. This is the reason for setting the bar higher than just the minimum of what the statute requires.

In response to a question from Councilmember Korte, Mr. Earle replied that staff performance is under review. Councilmember Korte suggested a critical review of performance. She noted the absence of the Director of Public Works at the Audit Committee meeting in light of the seriousness of the issue. Mr. Earle stated that Mr. Worth was traveling at the time of this meeting, however, ultimately he himself accepted responsibility for the situation. To date, he has identified a couple of individuals with a misunderstanding of the CMAR administration process on both the construction and project management sides. A strong approach with all managers will be undertaken to ensure a strong understanding.

Councilwoman Littlefield commented that there seems to be a repeat of problems, specifically in regards to training our staff to make sure they understand the jobs that they need to do and how to do it.

5. Discussion of Audit Report Process

Ms. Walker provided the presentation to outline another area of how staff meets its responsibilities to the Audit Committee. Staff's timeline is determined by the date an upcoming report will be presented to the Audit Committee. The process deadlines are developed working backwards from that date. The Council has a policy that meetings and agenda items are to be posted ten days in advance. Prior to this, staff needs a day or two to compile and do quality control review of the final report, and before that happens, management is allowed 15 days to respond to a draft report. So the reporting review process begins approximately four weeks prior to the Audit Committee meeting. But she tries to get the drafts out three weeks in advance rather than two to allow more time for working through any issues that come up.

While writing reports, the auditors take into consideration that they are not merely communicating with the audited area and City management, they are also writing the report to communicate with Council and the public. Therefore, staff provides context on what has been audited, the program location, reasons why the program is in place and how much is being spent or being generated in revenue. The objective, scope and methodology section is dictated by auditing standards. It describes what records were reviewed, what staff was interviewed, and similar to give the reader an idea of how the audit was conducted.

The majority of time is spent on findings and conclusions, results and recommendations for improvement. The report goes to management in draft form and is still a working paper, exempt from public records requests. Auditing standards require auditors to provide the draft to management, so that they have the opportunity to comment and respond. It has also been incorporated in the City Code that the auditor provides the draft so that management can provide an action plan. City Code also sets the 15

calendar day timeline for management response. The City Auditor, the Audit Committee, or the full Council can extend the timeline, however the auditors generally work this out if needed. At this point, the most complete parts of the draft report are the background, the objective, scope and methodology, and the findings and conclusions.

Remaining processes include internal and external reviews of the draft within the office and then reviewing the draft with management. The draft and final report go through a quality control process before it is submitted to the Audit Committee. The auditors schedule a time to meet with the audited area's management to review the draft. The City Manager is always invited to the meeting. The auditors solicit input on tone, factual content and recommendations. If changes are made to the draft as a result of the meeting, the auditors provide the revisions to management. At the same time this external review is occurring with management, internally within the office, staff is reviewing every page of the report and referencing back to their supporting work to verify the facts. Ms. Walker herself reviews all the work as audits are in process and assists with writing the reports. An independent reviewer, an auditor who was not on the audit team, also reviews the draft for discrepancies.

When management provides the action plan, the team compiles it into the report. Ms. Walker, the independent reviewer and the team review this final report once again. Final quality control checks and a formatting review are performed. The report is then finalized and signed off by Ms. Walker.

Before the Audit Committee meeting, the only place the report is publicly available is the Audit Committee meeting agenda. After the meeting, the auditors post the audit report to the City Auditor's main page, to the Audit Reports page and to the City's archived documents.

In response to a question from Chair Klapp, Ms. Walker stated that most surrounding cities with city auditors have been posting their audit reports to their websites within the last 2-3 years.

In response to a question from Councilmember Korte, Chair Klapp commented that most cities don't have a city auditor. Ms. Walker agreed, noting that in the Valley there are four others with only one other reporting to the Council.

Chair Klapp noted that changes to the website have made items easier to find online. She added that there is rarely an absolute disagreement between the auditors and staff.

Ms. Walker commented that at a future meeting, they will review the audit fieldwork phase. Chair Klapp observed that the reports explain in pretty good detail what has been done during the audit and the amount of work is impressive. Ms. Walker stated that with the 4-5 weeks for the report processing, the teams do an amazing amount of work in two months.

Councilwoman Littlefield inquired as to the follow-up procedure and timeline for making corrections and for making sure that the recommendations are being followed. Ms. Walker explained that there is a specific follow-up process. In general, three to six months are allowed for follow-up, depending on the complexity of the issue to be resolved. Follow-ups are made with the audited area on progress made towards the recommendations. The auditor then reports back to the Audit Committee in the follow up

report. Chair Klapp commented that historically, most audit recommendations have been implemented, with few exceptions. Up to this time, none of these have risen to the level where Council has had to act.

6. Discussion and Possible Direction to Staff Regarding Status of FY 2015/16 Audit Plan

Ms. Walker reviewed the 2016 City Council meeting calendar. Indications are that the federal Department of Homeland Security will be completing the SCADA network contracted audit.

The County contracts with auditors who are available for providing a variety of different audits. There are six to seven firms that have been approved for IT related audits. One of the types of available audits is an IT risk assessment, which looks at the department to identify risks. Prior to the Audit Committee's January meeting, Ms. Walker plans to pursue this option and present a plan at that meeting.

There is no December Council meeting scheduled.

7. Discussion and Possible Direction to Staff Regarding Agenda Items for Next Audit Committee Meeting (January 25, 2016)

The SkySong residential rent audit is planned for January 2016, and Ms. Walker will let the Committee know if that is not going to happen.

8. Discussion and Possible Direction to Staff Regarding Agenda Items for Next Audit Committee Meeting (January 25, 2015)

There were no items recommended.

Public Comment

No members of the public wished to address the Committee.

Adjournment

The meeting adjourned at approximately 5:10 p.m.

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