

**APPROVED MINUTES
APPROVED ON 4/18/2016**



**CITY OF SCOTTSDALE
AUDIT COMMITTEE**

MONDAY, FEBRUARY 22, 2016

**Kiva Conference Room
3939 North Drinkwater Blvd
Scottsdale, AZ 85251**

REGULAR MEETING

PRESENT: Suzanne Klapp, Chair (arrived at 4:06 p.m.)
Virginia Korte, Councilmember
Kathy Littlefield, Councilwoman

STAFF: Sharron Walker, City Auditor
Kyla Anderson, City Auditor's Office
Lai Cluff, City Auditor's Office
Kroy Ekblaw, Community Services Division
Bill Murphy, Community Services Division
Dan Worth, Public Works Division
Martha West, Public Works Division
Laurel Edgar, Public Works Division

GUESTS: Virginia DeSanto, ASU Foundation
Don Couvillion, ASU Foundation

CALL TO ORDER

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

1. Approval of Minutes, Regular Meeting, January 25, 2016

COUNCILWOMAN LITTLEFIELD MOVED TO APPROVE THE MINUTES OF THE JANUARY 25, 2016 REGULAR MEETING. COUNCILMEMBER KORTE SECONDED THE MOTION, WHICH CARRIED BY A VOTE OF TWO (2) TO ZERO (0). CHAIR KLAPP WAS NOT YET PRESENT.

**2. Discussion and Possible Direction to Staff regarding Audit No. 1605
Preserve Operations**

Kyla Anderson, Senior Auditor, stated that the audit was performed to evaluate Preserve operations and sustainability. The Community Services Division manages the Preserve, which currently consists of 30,000 acres, 11 trailheads and 170 miles of trails. Direct Preserve operating expenses of \$570,000 combined with indirect and overhead costs total over \$680,000 this fiscal year. The McDowell Sonoran Conservancy (MSC) is expected to contribute over \$930,000 in volunteer labor to the city. Because of the MSC volunteers, the City is able to provide an enhanced level of service. Per the agreement with MSC, the City provides free facility usage, which is expected to total \$140,000 this year. The audit found that the Preserve cost center does not include all directly related salaries. The Preserve Director, Manager and Natural Resources Coordinator, who all have part-time Preserve responsibilities, are paid fully from other cost centers. With these additional salaries, the Preserve cost center budget would be approximately 60 percent higher annually.

A ten year projection created by Community Services staff did not include increased operating costs associated with planned new and expanded trailheads. These costs are estimated to be \$75,000 in Fiscal Year 18/19. Future staffing needs were determined anecdotally, rather than using workload indicators, such as annual visits or trail mile increases. Further, there is no contract administrator for the City's agreement with the MSC, and as such, an annual report from the Conservancy required by the contract has not been requested. Two parcels worth \$335,000 donated in 2010 are not recorded in the City's capital asset records. The Preserve Ordinance and City policy do not provide a mechanism for the public to appeal permit decisions by the Preserve Director.

Councilwoman Littlefield stated concern over the absence of the land value in the Treasury's books, noting that this equated to undervaluing the assets of the City. She suggested a method is needed for asset verification on a periodic basis to ensure that all assets are included in the records.

Chair Klapp arrived.

Councilmember Korte asked for the reasoning behind the salary costs being charged to other (non-Preserve) cost centers. Kroy Ekblaw, Preserve Director, replied that it was simply a matter of the cost center that his position originated from, going back approximately ten years. Bill Murphy, Community Services Director, noted that the Preserve Manager and Natural Resources Coordinator are in Community Services, but are performing dual jobs. When maintenance was taken over in 2009, (the budget) set up at that time was not enough to cover what needed to be done. So staffing has been supplemented since that time. There is a work management system in place and they may be able to use it to track the supplemental time more efficiently. Mr. Murphy noted the division can pull the information when needed.

Councilmember Korte asked how that impacts forecasts of operational expenses moving forward looking at Preserve needs and possible endowment. Sharron Walker, City Auditor, commented that the estimate that they did was fairly reliable, however some future operating costs were not estimated in out-years. So they can pull together the information. But if a Council member or someone else looks at the Preserve Management cost center and assumes that is what the City is spending, it substantially understates what is actually being spent. It does not affect budgeted costs, because they are all from the General Fund, just spread through different cost centers. Mr. Ekblaw stated that projections include staffing for present needs as well as what is anticipated in the future. The audit review identified that upgrades to two trailheads that are in the master plan were not in the projections. Staff is in the midst of master planning both upgrades and what they may include.

Councilmember Korte referred to the report table detailing salaries not included in the cost center, noting that over time, projections are reduced by half. Ms. Anderson stated that the Preserve Director estimated that he will not be working on Preserve matters at that point.

Chair Klapp asked about the number of appeals that currently are received. Mr. Ekblaw stated that people ask to do certain activities. If they would be impacting a trailhead by taking up parking or using a trail exclusively, permission is not given. This is based on guidelines passed by the Commission and the Council. There have been negligible instances of appeals on permit decisions but he recognizes that the point is to have a process established for when it evolves into more activity.

Councilwoman Littlefield asked about ensuring that the MSC annual report occurs on a regular basis. Mr. Ekblaw replied that several reports were received, however they were not necessarily received at the same point in time. He noted that the Council has been provided with information over the last two years, however, it was submitted in an informal format. They will work towards providing a consistent formal report, and the Conservancy has no problem with that. Councilwoman Littlefield commented that this would provide a good historical record. Chair Klapp noted that this would be much like what the Council gets from its appointed boards and commissions.

Councilmember Korte referred to the action plan, quoting, "Preserve costs could be more appropriately recorded and projected" and the management response is "partially agree." She asked what "partial" refers to. Mr. Murphy stated that the budget is mostly complete for next fiscal year, so work can be done with Financial Services after July for FY 2017/18 to create any needed cost centers.

3. Discussion and Possible Direction to Staff Regarding Audit No. 1614 SkySong Residential Rent

Lai Cluff, Senior Auditor, stated that the audit was performed to evaluate the accuracy of the SkySong residential rent calculation due to the sale of the residential units. The audit was added to the Council-approved Fiscal Year 2015/16 audit plan with approval of the Audit Committee. It was proposed by the City Auditor at the request of the Acting City Manager and the Public Works Director. Residential rent is stipulated in the SkySong ground lease and is comprised of a residential Completion payment of \$9,200 per unit completed or \$2.99 million for 325 units, and a residential Net Revenue payment, which

is 50 percent of the net revenue from the first arm's length sale of the SkySong residential, excluding the first \$40,000 per unit in net revenue or \$13 million. In June 2015, ASUF sold the apartments and in July, 2015 reported to the City that no residential Net Revenue was due to the City.

The audit found that some costs deducted in the residential rent calculation were duplicated and that certain expense categories may not be deductible under the ground lease agreement. For example, approximately \$840,000 in operating costs were deducted in both construction costs and operating expense. A \$700,000 expense for a capital contribution reimbursement was deducted as a construction expense. Garage revenues and costs from garage operations prior to the construction of the apartments were deducted as an operating expense. An annual reserve amount was deducted, although a reserve account had not been established. Other expenses not within contract definitions for Operating Expense totaled approximately \$129,000. These included owner's association expenses prior to apartment operations, non-lease related legal fees and disposition costs. Auditors also adjusted interest expense by approximately \$514,000, which had not been included. Including the interest associated with some of these costs, in total, the residential rent due to the City was understated by approximately \$377,000.

Other expenses totaling nearly \$1.1 million require further review or legal clarification. For example, some of the \$299,000 in legal fees reported under construction costs do not appear directly related to construction or operation of the residential apartments. A \$400,000 co-development fee paid to ASUF was not clearly supported and may not meet the lease definition. And a \$387,000 loan fee was paid that was not stipulated in the loan agreement. Ms. Cluff also added that the audit findings are not an indication of whether these expenses are allowable for a business, but whether they comply with the ground lease terms.

In response to a question from Councilwoman Littlefield, Ms. Walker stated that this residential rent was a one-time calculation and is not subject to ongoing monitoring.

Dan Worth, Public Works, stated that the auditors helped identify issues that require further investigation. Staff will be looking at the audit findings with a plan to resolve findings by the end of May. Don Couvillion, ASU Foundation, added that there may be differences in interpretation of the contract that need to be reviewed.

Councilmember Korte asked about protocols for project management. Mr. Worth replied that there is no specific protocol, as this is a unique contract situation. The ground lease includes a payment to the City which is predicated on the net of their revenues and expenses associated with a component of the development at SkySong. Given the uniqueness and complexity of the situation, the auditor was asked for help in reviewing the documentation.

Chari Klapp commented that having the auditors review this one-time calculation was a good way to handle the situation and the department can now work on resolving the issues to come to an agreement on what the number should be.

4. Presentation and Discussion Regarding Audit Fieldwork Process

Sharron Walker, City Auditor, provided the presentation. The audit fieldwork process begins with the objective as defined in the audit plan. Initially, the team gathers information to understand the program or the contract that is being audited. The team collects background information from the division or the department and also looks through budget records, accounting records and sometimes reviews Council, Board or Commission minutes or videos. The process may also include ride-alongs or tours to understand how a program operates. Program staff is informing auditors about the types and quantities of records they keep, their format and how long they are retained. Sometimes audit evidence comes from other sources, such as the County's record of property values or a different department, such as GIS mapping or a state or federal agency. At this time, there is also a determination on whether the audit objective needs to be revised and what audit methods are most effective for completing the audit.

A key component to the process is identifying the criteria that apply, including contract terms, applicable laws or rules, best practices or performance standards. Once this is complete, decisions are made regarding the specific auditing steps. Auditing standards require obtaining sufficient appropriate evidence to provide a reasonable basis for findings and conclusions. Appropriateness is a measure of the quality of the information gathered while sufficient is a measure of quantity. Another consideration refers to the types and sources of evidence available, such as through observation or inquiry.

Examples of data reviewed include: financial data, maps, vehicle maintenance records, interviews with staff and external experts. IDEA software allows for extensive data analysis. Once conclusions are reached, they are broken down into finding elements. The condition, cause, criteria and effect provide the basis for developing the recommendation.

In response to a question from Chair Klapp, Ms. Walker stated that the analysis is worked on by the audit team and she reviews the work and provides input. As a group, findings are evaluated to determine whether they are significant and need to be formally addressed. For example, the recommendation about the MSC annual report was made because much of the information comes in bits and pieces, but the historical value and the impact is more significant when those pieces are put together and they're complying with that requirement. Councilwoman Littlefield commented that one reason she thinks it should be more formalized is that many audit issues come from a lack of that kind of record keeping and due to staff changes. Records like that could be a strong bridge so that problems do not keep recurring.

Ms. Walker commented on her final slide, noting that at the point where sufficient data is collected to compose a draft report, there is a team meeting with management staff to discuss any concerns. If any additional information is provided, it is assessed and any adjustments made to the draft report.

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

Ms. Walker stated that a meeting will not be needed in March. The biennial certified audit, or development impact fees audit, is contracted and will begin soon. It should be complete by June. The scope of work for the contracted IT audit is still being developed, and should take place between March and June. The new construction contract audit should be identified and underway by the April meeting.

6. Discussion and Possible Direction to Staff Regarding Agenda Items for Next Audit Committee Meeting (April 18, 2016)

Ms. Walker stated that for the April 18th meeting, there will be a Human Relations Commission Sunset Review scheduled. In addition, there should be one audit on cash handling controls and accountability. Quarterly updates will also take place as well as a first discussion of preliminary FY 2016/17 audit plan.

Public Comment

No members of the public wished to address the Committee.

Adjournment

The meeting adjourned at approximately 4:52 p.m.

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