

## Office of the City Auditor 2001 Annual Report

**EDMONTON****1. Introduction**

The Office of the City Auditor (OCA) is pleased to present a summary of its activities during the year 2001.

The year 2001 marked the first full year of operation following the change in the OCA's reporting relationship that took place in 2000. Prior to 1997, the OCA reported directly to City Council. From 1997 to 2000, the OCA reported to the City Manager. In 2000, City Council decided that the OCA would once again report to City Council. The most significant change from the pre-1997 arrangement was the implementation of an audit committee (a role performed by Executive Committee when dealing with audit matters) through which the OCA reports to City Council.

Changes in operational styles and relationships with both Council and the Administration over the past two years (e.g., focusing more on solutions and effective relationships) have enhanced the OCA's ability to communicate effectively with Council and to facilitate change in the way the City does business.

The OCA also continues to communicate regularly with the City's external auditor, especially during the annual project planning process, to ensure that duplication of audit effort is minimized.

During 2001, all recommendations provided by the OCA were accepted or accepted with modification and scheduled for implementation by the Administration. An increasing number of

requests have also been received from the Administration for assistance with cost-effective operational and system controls; operational policies and guidelines; and design and delivery of corporate training initiatives.

**2. Observations****Overall Operation**

The OCA's involvement in the Closing the Gap Expenditure and Revenue Review project resulted in an overview of City operations at a level that has not been previously achieved by the OCA. After reviewing the associated data, the OCA believes that the City as a whole is operating with a reasonable degree of effectiveness and efficiency. While there are specific areas that present the potential for incremental improvements, there are no program areas that are operating with obvious significant inefficiencies or lack of purpose.

During the review, the OCA's impression was that City staff are passionate about providing meaningful service either directly or indirectly to the citizens of Edmonton to the best of their ability. This was true of those providing both physical support services (e.g., roadways, waste, emergency response, etc.) and social support services.

**Role of the Audit Committee**

The year 2001 was the first full year in which the City of Edmonton had an active audit committee. This relatively new initiative has contributed to a close working relationship with the Administration while ensuring the

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independence of the OCA. As the events surrounding the collapse of Enron become more apparent to the outside world, some issues that impact the roles of audit committees are emerging.

One of the issues catching the attention of the Securities and Exchange Commission relates to the risk associated with employing external audit firms to do substantial work beyond financial statement audits. Corporations need to ensure that when hiring their external audit firm for significant amounts of consulting and internal audit work they do not compromise governance control structures. A recent report in the *Globe and Mail* (April 22, 2002) indicated that only 36 of the TSE 100 companies reported the fees paid to their external auditors in sufficient detail to be able to determine the percentage paid for services other than audit. Of those 36 companies, 14 paid at least two-thirds of the funds remitted to their external auditors for work other than direct audit services. Of the total payments made by the City (including EPS and Edmonton Public Library) to its external auditor, 23% (\$79,000) were for other than direct audit services.

Another issue that is receiving attention is that of the role of the audit committee in monitoring governance issues within a corporation. Audit committees are charged with a governance oversight role and must be independent of the administrative arm of the organization. As elected members of City Council, the City's Audit Committee satisfies that measure of independence.

As the City's Audit Committee enters its second full year of operation, increasing attention is being given world wide to

the governance role of audit committees. City Council has an opportunity to further enhance the role of its Audit Committee by adopting applicable best practices from the private sector.

Current standards in the corporate world require that audit committees be structured in such a way as to guarantee that they have at least one member who has the necessary accounting or related financial expertise to provide independent financial oversight. At present, the governing documents for the City's Audit Committee do not have a provision to ensure that at least one member has the financial expertise, as recommended by the Joint Committee on Corporate Governance (the Saucier report).<sup>1</sup> The recommendations of the Saucier report related to audit committees are attached for information (Appendix A).

In light of the changing roles and demands on audit committees in today's environment and the fact that the City's audit committee has completed its first full year, it would be timely to conduct a full comparison of the current structure against the recommendations of the Saucier report. The OCA is prepared to undertake this review if Council so chooses. The OCA would likely contract with someone with subject matter expertise to ensure that the final recommendations to Council are fully aligned with best practices.

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<sup>1</sup> Saucier, Guylaine, et al, *Beyond Compliance: Building a Governance Culture*, November 2001. The Canadian Institute of Chartered Accountants, the Canadian Venture Exchange, and the Toronto Stock Exchange jointly sponsored the report. The full text of the final report is available at: <http://www.cica.ca/cica/cicawebsite.nsf/public/JCCG>

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### Performance Measures

During the past few years, it has become increasingly apparent that the degree to which performance measures have been implemented within the corporation is inconsistent.

There is an expanded set of corporate performance measures included in the 2002 – 2004 Corporate Business Plan, but there is significant variation within business units. Some areas have developed very detailed performance measures that have been in use for several years, providing the ability to monitor operational trends in a meaningful way. Other areas have relatively few performance measures in place. Some of the reasons for this inconsistency include:

- the inherent difficulty in establishing outcome-based performance measures or proxies for certain types of business
- a lack of emphasis on using performance measures as a tool for ongoing program evaluation
- the timeliness and ease with which information can be collected and confirmed

This matter has been the subject of Annual Reports from the OCA for several years; more progress is needed at the corporate level. The Administration has recently begun work on an initiative to incorporate outcome-based performance measurement and reporting into the City's regular planning and budgeting systems. The OCA believes that successful implementation of this initiative will result in regular assessment of the appropriateness of directions taken by the City's programs and increased awareness of the

efficiency and effectiveness with which the City's programs operate. In addition, it will result in an increased ability of management to track program effectiveness and identify means of pursuing continuous improvement initiatives.

### 3. Ongoing Initiatives

The OCA is involved in a number of ongoing corporate initiatives designed to improve overall control and governance within the City.

Some of the initiatives in which the OCA was involved during 2001 and will continue to pursue in upcoming years include:

- providing advice on policy development
- co-leading the Code of Ethics/Conduct policy rewrite
- providing advice on the adequacy of control systems
- investigating alleged Code of Ethics violations
- investigating alleged fraudulent acts
- participating in delivery of corporate project management training

### Economic Crime Training

The OCA's involvement in Economic Crime Awareness Training is designed to strengthen internal controls within the City in order to help reduce future vulnerability to economic crimes. The OCA participates as a co-presenter of the Economic Crime Awareness course provided to City staff. This one-day course is specifically designed to raise the awareness of management and

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supervisory staff about the extent and impact of fraud and other illegal activities in large organizations. The course has been offered to City employees a total of 19 times to date with 367 staff members participating.

The training efforts undertaken by the City may be the most significant contributing factor to the increase in the number of suspected economic crimes reported. The OCA will continue to be involved in enhancement and delivery of this training.

### Closing the Gap

The OCA's participation in the Expenditure and Revenue Review portion of the Closing the Gap project during 2001 included reviews of financial indicators, productivity and performance measures, business plans, and operational issues faced by each Branch within the City. Senior Management Team recognized that the OCA had a positive impact on the project outcome. Nearly \$11 million in reduced draws against the tax levy for 2002 were identified by Administration and confirmed by the OCA. The OCA is continuing with its involvement on this project in 2002 with a similar goal.

### Corporate Business Risk Planning

The goal of this project is to integrate Enterprise Risk Management (ERM) within the City's Strategic Framework and encourage the responsible use of resources. To strengthen the connections between these synergistic goals, the City has chosen to call this initiative Corporate Business Risk Planning (CBRP). It would also facilitate the alignment of audit plans with the

City's business plans. The project is co-sponsored by the OCA and SMT.

This project is designed to ensure that the principles of ERM are incorporated into the planning processes for both the City and the OCA. By year-end 2001, the Risk Working Team with representation from each department was in place and work had begun on developing a detailed work plan.

## 4. Completed Projects

During 2001, the OCA completed 21 projects that resulted in reports submitted to members of City Council and the Administration. This is reflective of a fundamental change in approach that has been initiated by the OCA during the previous year. The new approach requires identifying key issues early in the planning process, dealing appropriately with non-key issues, and generating short, timely, and informative reports. This approach has shown significant improvement in the readiness with which the Administration responds to our reports and implements the recommendations.

The published reports generated during 2001 are listed below and are categorized by the type of project they represented. The date in parentheses is the date the report summary was included in the quarterly report presented to Audit Committee. Summaries of each report produced during 2001 are on the Office of the City Auditor's website at:  
[http://www.gov.edmonton.ab.ca/corp\\_services/auditor/prior\\_reports.html](http://www.gov.edmonton.ab.ca/corp_services/auditor/prior_reports.html).

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### Fraud Investigations (3 projects)

- Towing Services Review (January 29, 2001)
- Investigation into Fraudulent Claims – Subsidized Program (March 19, 2001)
- Investigation into Cash Irregularities – City Facility (June 25, 2001)

### Operational Audits (14 projects)

- Drainage Efficiency Review (January 29, 2001)
- Project Management – Cost Estimating Follow-up (January 29, 2001)
- Land Inventory Management Review (January 29, 2001)
- Surplus Inventory Review (January 29, 2001)
- Consultant Review (January 29, 2001)
- Review of Payroll and Benefits – DATS Drivers (March 19, 2001)
- Telecommunications Services Contract Review (March 19, 2001)
- Payroll and Benefits – Data Analysis (June 25, 2001)
- Payroll and Benefits – Direct Deposit Process Follow-up (June 25, 2001)
- Snow and Ice Control Audit (June 25, 2001)
- Cash Handling Review – City Golf Courses (November 26, 2001)
- Cash Handling Review – Coin Processing Centre (November 26, 2001)

- Cash Handling Review – Valley Zoo (November 26, 2001)
- Turf Maintenance Follow-up (November 26, 2001)

### Proactive Reviews and Consultation (4 projects)

- Unmetered Energy Review (June 25, 2001)
- Closing the Gap Expenditure and Revenue Review Project (November 26, 2001)
- Municipal Election 2001 (November 26, 2001)
- Payroll and Benefits – Risk/Control Self Assessment (November 26, 2001)

## 5. Performance Trends

Table 1 (attached) presents the performance results for the OCA for the year 2001 with comparisons against the data reported in 1999 (the first year that detailed performance data was reported). In 1999, the OCA began to circulate post-audit evaluation questionnaires to its clients to provide feedback that can be used to facilitate continuous improvement.

As can be seen from the data presented in Table 1, the OCA has been able to make significant improvements in its operations over the past three years. However, there are still areas that would benefit from increased focus. During 2002, the OCA intends to initiate development of comprehensive benchmarking measures to compare its operations with similar organizations.

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**6. Conclusion**

The OCA has made significant productivity gains during 2001 by redesigning its fundamental methodology and philosophy regarding scoping and performance of audit projects. The change relates to the recognition that the OCA's greatest

effectiveness comes from those areas in which it can contribute toward process improvement in response to medium to high operational risks. This change is expected to ensure that productivity gains are enhanced and that the OCA continues to provide value-added services.

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Table 1: 2001 Performance Measurement Data – OCA

Performance Indicator	Target	1999	2000	2001
<b>Customer Relationships (1 - 5)</b>				
<b>Communication</b> How well the client was informed of objectives, process, timeframe, and emerging findings.	4.5	4.4	4.4	4.4
<b>Understanding of client's business</b> How well the audit staff demonstrated their understanding of the issues and challenges faced by the client.	4.5	3.9	4.0	4.3
<b>Professionalism</b> How well the audit staff demonstrated professional behaviours and attitudes in their dealings with clients.	4.5	4.4	4.4	4.7
<b>Quality of findings</b> How practical and thorough the audit findings were and how openly the audit staff communicated with the clients	4.5	4.0	4.3	4.3
<b>Overall average</b> Overall judgement by the client of the value received from the audit.	4.5	4.2	4.3	4.5
<b>Internal Measures</b>				
<b>% Recommendations accepted</b> Best audit practices will result in the majority of recommendations being accepted by the client.	90%	82%	76%	86%
<b>% Recommendations accepted with modification</b> Some recommendations may require minor adjustments to be operationally practical.	10%	9%	24%	14%
<b>% Recommendations rejected</b> Best audit practices should result in relatively few recommendations being rejected.	0%	9%	0%	0%
<b>% Administration &amp; training hours vs. available time</b> Administration activities include strategic planning, training, library time, office meetings, informal consultation with clients, etc.	15%	18%	23%	16%
<b>% Chargeable time vs. available time</b> This is a measure of the use of available time working on projects.	85%	82%	77%	84%
<b>Projects completed per auditor</b> This is a measure of office productivity.	2.5	1.1	1.5	2.6
<b>Learning</b>				
<b>Days of City-funded training &amp; development per employee</b>	8.0	8.4	7.8	7.4
<b>Financial</b>				
<b>% Actual vs. budget amounts</b> The primary reason for the budget variance in 2001 was the delay of a project that was to have required significant consulting expertise.	90% to 110%	95%	89%	81%

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### Appendix A: Saucier Report<sup>2</sup> Recommendations for Audit Committees

**Note:** The recommendations included in the Saucier report that are applicable to audit committees in general are quoted in this appendix (with source page numbers in parentheses). Status commentaries that are specific to the current structure at the City of Edmonton are also included in bracketed *[italics]* at the end of each section. Some headers have been slightly modified for clarification. All other text is quoted directly from the Saucier report.

#### Audit committee structure

With regard to audit committees, we believe that there needs to be close coordination and communication between audit committees of parents and subsidiaries. There should be a common appreciation of the control frameworks and cultures of the entities, and substantial sharing of information. (p. 25)

*[This implies that the audit committee of EPCOR should be in close communication with the City's audit committee.]*

...with regard to "financial literacy," we are following the Blue Ribbon Committee's recommendation that audit committee members be "financially literate." U.S. practice has gone in two directions. The NYSE has adopted this recommendation but leaves the definition of financial literacy to the board to determine...Our recommendation is that we follow the practice of the NYSE. (p. 28)

*[In order to comply with this recommendation, Council would need to adopt a definition of "financial literacy."]*

#### Recommendation:

The governance guidelines relating to audit committees should be amended to reflect the following:

- 1 Audit committees should be composed solely of outside directors who are also "unrelated."

*["Unrelated" is defined later in the report as "a director who is independent of management and is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation..." As elected officials, members of City Council satisfy this criterion.]*

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<sup>2</sup> Saucier, Guylaine, et al, *Beyond Compliance: Building a Governance Culture*, November 2001. The report was jointly sponsored by the Canadian Institute of Chartered Accountants, the Canadian Venture Exchange, and the Toronto Stock Exchange. The full text of the final report is available at: <http://www.cica.ca/cica/cicawebsite.nsf/public/JCCG>

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- 2 All members of the audit committee should be “financially literate” and at least one member should have accounting or related financial expertise. The definition of and criteria for “financial literacy” should be determined by each board.

*[The current governing documents do not ensure that this criterion is met.]*

- 3 Audit committees should adopt a formal written mandate that is approved by the full board and that sets out the scope of the committee’s responsibilities. This mandate should be disclosed to shareholders, and a regular assessment of the effectiveness of the committee against the mandate should be conducted and reported to the full board. The audit committee mandate should set out explicitly the role and responsibility of the audit committee with respect to:

- its relationship with and expectation of the external auditors;
- its relationship with and expectation of the internal auditor function;
- its oversight of internal control;
- disclosure of financial and related information; and
- any other matters that the audit committee feels are important to its mandate or that the board chooses to delegate to it. (p. 29)

*[Current governing documents address these items, but further clarifications would enhance them.]*

### **Relationship with and expectation of external auditors**

We believe that the relationship between audit committees and the external auditors could be improved in most companies. Fundamental to such improvement is a mutual recognition that the external auditors are accountable to shareholders, and to the board and audit committee as their representatives. The external auditors are not accountable to management. Both audit committees and auditors need to work hard to improve this relationship, and management needs to understand and support their efforts...

#### **Recommendation:**

Audit committee mandates should explicitly affirm that the external auditor is accountable to the board of directors and the audit committee, as representatives of the shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate and, where appropriate, recommend replacement of the external auditor.

Auditors must recognize that their ultimate client is not management, and work constructively and meet regularly with audit committees to build an effective relationship.

Each board should determine for itself how it will approach the challenge of developing its relationship with external auditors. We believe there are three key outcomes that must be achieved and the audit committee mandate should explicitly recognize them.

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- The audit committee needs to assure itself that the auditors are independent. It must have access to all information about the audit firm's relationship with the corporation that is necessary in order to come to a reasonable conclusion.
- The audit committee needs to assure itself that the external auditors are satisfied that the accounting estimates and judgments made by management, and management's selection of accounting principles, reflect an appropriate application of GAAP.
- The audit committee must develop a relationship with the external auditors that allows for full, frank and timely discussion of all material issues, with or without management as appropriate in the circumstances.

Achieving these outcomes will require, in most instances, a change in attitude on the part of auditors and management about the role and importance of the audit committee. (pp. 30-31)

*[The external auditor is currently hired and supervised by the Administration, not the audit committee. The external auditor reports to the audit committee upon completion of its report.]*

### **Relationship with and expectation of the internal audit function**

There are many operational aspects of the audit committee's relationship with the internal audit function that are important for the effective oversight of the internal control framework and culture. Where a corporation has an internal audit function, the audit committee should approve its mandate, be satisfied that it has adequate resources to perform its responsibilities, and ensure that the director of internal audit has direct and open communication with the committee.

Where internal audit does not exist, the audit committee has an important oversight role that goes beyond the normal operational issues.

#### **Recommendation:**

The audit committee should periodically request from management a review of the need for an internal audit function and, on the basis of this review, determine whether such a function should be instituted. (p. 31)

*[Under the current structure of the City of Edmonton, the Office of the City Auditor provides the internal audit function and reports to City Council through the audit committee. There is no direct reporting relationship with the Administration. This criterion is satisfied.]*

### **Responsibilities with regard to disclosure of information**

The audit committee mandate should set out its responsibilities with regard to the disclosure of financial and related information. Due to recent regulatory rulings, there is diverging behaviour in the U.S. and Canada that we believe deserves comment. In the

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U.S., external auditors (but not necessarily audit committees) are now required to review quarterly financial statements before they are disclosed.

In Canada, the Ontario Securities Commission (OSC) has recently mandated that the board review quarterly financial reports before they are distributed to shareholders. We are aware, however, of instances where financial information was released to the public by way of a press release before the audit committee or the board reviewed the quarterly reports and we do not believe that this is consistent with the intent of the OSC ruling. There is also no requirement in Canada that external auditors review quarterly financial statements prior to board consideration.

### **Recommendation:**

The OSC should revise its regulation to make it clear that either the audit committee or the board should review quarterly financial reports and related financial documents before any public disclosure of the information. Audit committees, as a matter of best practice, should ask external auditors to review this material before considering it. (p. 32)

*[While this recommendation is specific to the Ontario Securities Commission, it applies more generally to the recommendation that audit committees and/or Boards of Directors review financial reports and related documents prior to their public release (an important factor in the case of a public corporation). In the case of the City, the documents are produced annually and are reviewed by Council.]*

## **Blue Ribbon Committee Recommendations (U.S.)**

### **Recommendations**

The Committee recommends that [companies] ... have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this report entitled "Financial Literacy") or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee and, further, that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate and,

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where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate. (pp. 46-49)

*[These recommendations from the Blue Ribbon Committee do not directly apply to public sector corporations in Canada, but the principles are applicable. The governing documents for Council's Audit Committee would need additional enhancement to fully incorporate these principles. Any such enhancement should include provision for ensuring that at least one member of the audit committee has an accounting or related financial background as described in the Saucier report.]*