

Date of Hearing: April 5, 2017

ASSEMBLY COMMITTEE ON LOCAL GOVERNMENT
Cecilia Aguiar-Curry, Chair
AB 804 (Cristina Garcia) – As Introduced February 15, 2017

SUBJECT: Controller: internal control guidelines.

SUMMARY: Allows the State Controller (Controller) to audit any local agency for purposes of determining whether the agency's internal controls are adequate to detect and prevent financial errors and fraud.

EXISTING LAW:

- 1) Requires the Controller to superintend the fiscal concerns of the state and to audit all claims against the state.
- 2) Allows the Controller to audit the disbursement of any state money, for correctness, legality, and for sufficient provisions of law for payment.
- 3) Allows the Controller to make such field or other audit of any claim or disbursement of state money as may be appropriate, whenever the Controller determines that an audit conducted to approve or disapprove a claim against the state is not adequate.
- 4) Requires the officer of each local agency who has charge of the financial records to furnish to the Controller a report of all the financial transactions of the local agency during the next preceding fiscal year.
- 5) Requires the Controller, by January 1, 2015, to develop internal control guidelines applicable to each local agency to prevent and detect financial errors and fraud.
- 6) Requires the Controller to develop the internal control guidelines based on standards adopted by the American Institute of Certified Public Accountants and with input from any local agency and organizations representing the interests of local agencies, including, but not limited to, the League of California Cities, the California State Association of Counties, the California Special Districts Association, and the California State Association of County Auditors.
- 7) Requires the Controller, by January 1, 2015, to post the completed internal control guidelines on the Controller's Internet Web site (website) to assist a local agency in establishing a system of internal controls to safeguard assets and prevent and detect financial errors and fraud.
- 8) Requires the Controller, with input from the agencies listed in 6), above, to update the internal control guidelines, as he or she deems necessary, and maintain a current version on the Controller's website.
- 9) Defines, for purposes of the provisions above, "local agency" to mean a city, county, city and county, special district, or any other local governmental entity, except a school district.

FISCAL EFFECT: This bill is keyed fiscal.

COMMENTS:

- 1) **Bill Summary.** This bill allows the Controller to audit any local agency for purposes of determining whether the agency's internal controls are adequate to detect and prevent financial errors and fraud. This bill is sponsored by the Controller.
- 2) **Author's Statement.** According to the author, "Proper oversight and documentation by the Controller's Office will provide the public with the accountability they deserve to ensure public assets are not misused or abused. This is good government on behalf of the people we are elected to serve. This bill would enable (the Controller) to proactively assess an agency's preparedness at ensuring public funds will be spent as required. At the end of the day, it's a tool that will enable prevention and accountability in communities throughout the state."
- 3) **Background.** Longstanding concerns about local government fiscal accountability came to dramatic light in 2011 with the exposure of unethical and illegal financial practices by numerous officials in the City of Bell. Despite serious and pervasive control deficiencies in the city's administrative and internal accounting systems, the city's independent auditor failed to report abuses such as excessive salaries, illegal loans, and questionable special fees.

In a series of follow-up audits of the City of Bell's finances, the Controller found that the independent auditor failed to comply with 13 of 17 fieldwork auditing standards and reported no significant deficiencies in any of the city's funds. The Controller also found subsequent deficiencies in his "Hercules Administrative and Internal Accounting Controls Review Report" issued in September 2012, which states:

We found the City of Hercules' administrative and internal accounting control deficiencies to be serious and pervasive; in effect, non-existent. We noted there was no oversight by the City Council over the city's financial and operational activities. From January 1, 2007, through December 31, 2010, the City Council adopted 40 ordinances, 679 city resolutions, and 360 Redevelopment Agency resolutions. With the exception of one city ordinance, every ordinance, city resolution, and RDA resolution was adopted unanimously. In essence, the City Council approved all requests submitted by the former City Manager. The former City Manager was given broad authority to enter into contracts and authorized disbursements for the city and the RDA. In addition, the city often ignored its competitive bid policy and had inadequate conflict of interest and nepotism policies. As a result, the potential for waste, abuse, and misappropriation of public funds is very high.

As part of our review, we made an assessment of various aspects of the city's internal control components and elements in accordance with standards adopted by the American Institute of Certified Public Accountants. Of the 74 elements evaluated pertaining to internal control components, we found only seven (9%) where controls were considered to be adequate.

The Legislature responded to the scandal in the City of Bell and the Controller's report of financial mismanagement in other jurisdictions with a number of bills to increase oversight of local agency financial practices. Among these measures was AB 1248 (Cooley), Chapter 190, Statutes of 2013, which required the Controller to develop internal control guidelines to

prevent and detect financial errors and fraud and to post the guidelines on the Controller's website. When introduced, AB 1248 required local agencies to comply with the Controller's guidelines. However, that provision was removed before the bill was signed into law.

The American Institute of Certified Public Accountants defines internal control as follows:

A process affected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use or disposition may include controls relating to financial reporting and operations objectives. Internal control is comprised of five components that work together in an integrated framework: Control Environment; Risk Assessment; Control Activities; Information and Communication; and, Monitoring Activities.

In 2015, the Controller's Office published and posted to its website the internal control guidelines required under AB 1248. This web page registered 424 visits in 2015, 217 hits in 2016, and 12 through February in 2017. Despite these posted guidelines (and numerous additional guides, manuals and reference materials covering a variety of accounting, auditing and other financial management activities of local agencies available on the Controller's website), the Controller continues to uncover deficiencies in local agencies' internal controls. For example, in its January 2017 review report for the Panoche Water District, the Controller found that 76% of the District's internal control components were considered inadequate. A review of the Lamont Public Utility District issued in July 2016 concluded that 82% of the District's internal control components were considered inadequate. A July 2015 review of the City of West Covina reported 91% of the city's internal control components to be inadequate.

- 4) **Technical Amendment.** The Committee may wish to amend the bill to correct an erroneous cross-reference to the definition for "local agency."
- 5) **Previous Legislation.** AB 2676 (Rendon) of 2014 would have expanded the Controller's authority to perform audits or investigations of counties, cities, and special districts if the Controller made specified findings that any of these local government entities violated financial requirements in state law, state grant agreements, local charters, or local ordinances. AB 2676 was held in the Assembly Appropriations Committee.

AB 941 (Rendon) of 2013 was substantially similar to AB 2676. AB 941 was held in the Assembly Appropriations Committee.

AB 1035 (Muratsuchi) of 2013 would have increased forfeiture amounts for local agencies that fail to file their annual financial transaction reports with the Controller's Office in a timely manner, and would have required the Controller to conduct an independent financial audit report for an agency that fails to file for three consecutive years. AB 1035 was amended to address an unrelated subject.

AB 1248 (Cooley), Chapter 190, Statutes of 2013, required the Controller to develop internal control guidelines to prevent and detect financial errors and fraud and to post the guidelines on the Controller's website.

AB 1345 (Lara), Chapter 231, Statutes of 2012, expanded the Controller's oversight over local government auditing practices.

SB 186 (Kehoe and DeSaulnier) of 2012 was substantially similar to AB 941. SB 186 was held in the Assembly Appropriations Committee.

AB 162 (Smyth) of 2011 would have required an audit of a local agency that revealed possible deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements or other abuses to be sent separately to the Controller immediately after the audit was concluded. AB 162 was held in the Assembly Local Government Committee.

AB 187 (Lara), Chapter 451, Statutes of 2011, authorized the State Auditor to establish a high-risk local government agency audit program to identify, audit, and issue reports on any local government agency or any publicly-created entity that the State Auditor identifies as being at high-risk for the potential of waste, fraud, abuse, or mismanagement or that has major challenges associated with its economy, efficiency, or effectiveness.

AB 229 (Lara) of 2011 was similar to AB 1345. AB 229 was amended to address an unrelated subject.

AB 253 (Smyth) of 2011 would have established the Committee on City Accounting Procedures, specified the membership of the Committee, and required the Controller, in consultation with the Committee, to prescribe uniform accounting and reporting procedures for cities. AB 253 was held in the Senate Governance and Finance Committee.

AB 276 (Alejo) of 2011 was substantially similar to AB 1035. AB 276 was subsequently amended to address an unrelated subject.

SB 449 (Pavley) of 2011 would have authorized the Controller to review the finances of cities, counties, special districts, and redevelopment agencies, and allowed the Controller to convene a local agency financial review committee to provide assistance to local agencies that seek help in averting or managing a financial problem. SB 449 was held in the Assembly Local Government Committee.

- 6) **Arguments in Support.** California State Controller Betty T. Yee, sponsor of this measure, writes, "Since becoming California's Controller, my auditors have discovered many local agencies have either inadequate or no internal controls. These discoveries have often resulted in findings that public money was spent for improper or illegal purposes.

"Under Government Code section 12410, (the Controller) has the authority to audit any public entity that receives state funding to ensure that state funding is spent in accordance with state law, but that authority does not permit (the Controller) to audit the spending of local or federal dollars.

"Under AB 804, (the Controller) would be able to review a local agency's internal controls to determine if they are strong enough to detect and prevent financial errors and fraud. Should such a review of those internal controls determine there are deficiencies, it could lead the agency in question to call for an audit itself or lead other outside groups to ask for an audit.

The goal is to ensure local agencies have the internal control infrastructure in place to ensure taxpayer dollars – state, local, and federal – are spent lawfully."

7) **Arguments in Opposition.** None on file.

REGISTERED SUPPORT / OPPOSITION:

Support

California State Controller Betty T. Yee [SPONSOR]
California Taxpayers Association

Opposition

None on file

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