Internal Audit Report 18-05
Citywide Risk Assessment
December 2018

City of Sioux Falls
Internal Audit Department
Carnegie Town Hall
235 W. 10th Street
Sioux Falls, SD 57117-7402
www.siouxfalls.org/council/internal-audit

CITYWIDE RISK ASSESSMENT
INTERNAL AUDIT REPORT 18-05

INTRODUCTION

The City of Sioux Falls' (City) Internal Audit is required by our Internal Audit charter to provide the Audit Committee with an annual assessment of the adequacy and effectiveness of the City's process for controlling its activities and mitigating its risks. The information in this report is intended to better inform the Audit Committee of how City management ensures that the City can achieve its objectives in an effective and efficient manner while complying with laws and policy, and ensuring proper financial reporting.

BACKGROUND

Risk for purposes of this report is the potential that a chosen action or activity (or failure to act) will lead to a loss or an undesirable outcome. If a risk is not identified and mitigated or controlled it could result in:

- Financial losses to the City.
- Reputational damage to the City as an organization and its employees.
- Injuries to employees or citizens.
- Failure to provide the expected level of municipal services to citizens.

Risks can be managed in at least four different ways:

1. Accept the risk. This may be a good strategy for very small risks.
2. Avoid the risk. This is a good strategy for risks that have a very large impact.
3. Transfer the risk. This is done through the use of insurance or hiring third parties to perform a service.
4. Mitigate the risk. This is the most commonly used method to reduce or limit the impact of a risk.

Risks to the City as an organization might be categorized as follows:

- Hazard risks. Examples would be tort liability, property damage, or work place safety issues.
- Financial risks. Examples would be fluctuating tax revenues, liquidity risk, and unfunded liabilities.
- Operational risk. Examples would be customer/citizen satisfaction, reputational risk, cyber risks and data security, aging and failing infrastructure, and fraud.
- Compliance risk. Examples would be failure to comply with federal or state regulations resulting in fines, penalties, or loss of future funding.

Risk is managed by the employment of internal control. The generally accepted definition and framework of internal control was developed by the Committee of Sponsoring Organizations (COSO) in 1992 and revised several times since.[1] The COSO model defines internal control as: *A process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance of the achievement of objectives in the following categories:*

- *Effectiveness and efficiency of operations*
- *Reliability of financial reporting*
- *Compliance with applicable laws and regulations*

The following five components of the COSO model work to support the achievement of an organization's mission and business objectives. The components are:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

Management is primarily responsible for designing and implementing internal control in an organization with the ultimate responsibility resting with the board of directors (elected officials in government). Internal auditors and others assist management and elected officials with their responsibilities. In the City, this assistance would include not only the Internal Audit division, but also the City Attorney's office, Finance department, and Human Resources. External auditors, federal and state regulators, and consultants also provide management with guidance, oversight, and recommendations. However, the primary responsibility for internal control rests with City directors, managers, and supervisors.

OBJECTIVES

The objectives of this assessment were to:

1. Identify the biggest risks the City is currently facing.
2. Identify risks which the City may be facing in the next five to ten years.
3. Identify the Major Organizational Units/departments with the greatest inherent risks.
4. Identify City processes and contracts or agreements with the greatest inherent risks.
5. Identify areas for Internal Audit coverage in 2019 and future years.
6. Identify significant risks currently faced, how they are currently controlled and mitigated, and recent audit coverage of these risks.

---

[1] COSO is supported by five supporting organizations, including the Institute of Management Accountants, the American Institute of Certified Public Accountants, the Institute of Internal Auditors, the American Accounting Association, and the Financial Executives International.

SCOPE AND METHODOLOGY

The scope of this assessment included all eleven Major Organizational Units (MOUs) of the City. We interviewed management of all MOUs using a standard questionnaire. We reviewed risks assessments done in prior years by Internal Audit and updated information based upon interviews with management and internal audit work performed in the past four years. We researched common risks currently facing municipalities in the United States and determined if the City is also facing these risks.

Due to resource and time constraints, we assessed inherent risks but did not identify the residual risks. Inherent risk is the risk that still remains after controls have been taken into account.

RESULTS

Biggest current risks
The consensus of City management was:
- Maintaining expected level of services to a continually growing and expanding city. This includes infrastructure, public safety services, and cultural and recreational services and amenities.
- Tax revenue growth, particularly in sales tax, which has been less than the historical rates of growth.
- Cyber threats including data security.

Directors and managers also mentioned the following as other current risks:
- Increase in lawsuits where the City is a defendant.
- Rising crime rate in general and methamphetamine use specifically resulting in increased law enforcement spending and social disruption.
- Transit system funding.
- Natural disasters such as the emerald ash borer infestation and flooding.
- Supply of affordable housing not keeping up with the need.
- Potential for political demonstrations that could disrupt traffic and strain law enforcement resources.
- Fraud in general.
- Management turnover as key managers retire.

Future risks
The following were identified as emerging risks in the next five to ten years:
- Changes in technology resulting in now unforeseen challenges and risk. An example would be *smart cities.*[2]
- Ensuring our City workforce is educated and trained for the technology they will be required to use in their jobs.

---

[2] A smart city is a municipality that uses information and communication technologies to increase operational efficiency, share information with the public, and improve both the quality of government services and citizen welfare.

- Climate change resulting in an increase in weather events such as blizzards and torrential rains.
- Active shooter events.
- Succession planning as long-tenured City employees retire.
- Recruitment and retention of City employees.

MOUs with the greatest inherent risks
We reviewed a previous risk assessment performed by Internal Audit in 2015 and identified this list of MOUs/departments with the highest level of inherent risks:
1. Public Works
2. Police
3. Health
4. Affordable Housing

These four MOUs/departments were considered high risk due to these risk factors:
- Size in terms of amount of expenditures, revenue and number of employees.
- Time elapsed since last audit.
- Status of training.
- Status of written policies and procedures.
- Impact of operations on the health and safety of residents.
- Volume of cash processed.
- Instances of fraud.
- Complexity of operations.
- Interest of public, elected officials, and the media in department operations.
- Degree of change in department managers, new services, or increased responsibilities.
- Degree of change in technology used by department.
- Requests by management.
- Degree to which department is subject to federal or state regulations.
- Sensitivity of inventory.
- Amount of confidential information generated or safeguarded by the department.

Based upon our current assessment, we consider Public Works, Police, and Health to continue to have the highest inherent risks. Affordable Housing had been classified as high risk in 2015 due to requests from management, time since last audit, and management turnover. Those risk factors no longer apply and Affordable Housing is no longer assessed as high risk.

Public Works, Police, and Health have high inherent risks due to the size of their departments, complexity of operations, impact of operations on the health and safety of residents, interest of public, elected officials, and media in department operations, and the degree to which the departments are subject to federal and state regulations. All three MOUs must mitigate financial risks, hazard risks, operational risks, and compliance risks. Internal Audit has focused extensive audit coverage of these three MOUs in the past ten years.

City business processes and contracts or agreement with greatest inherent risk
We identified the following business processes as having the greatest inherent risk due to
complexity of operations and volume of City funds processed:
- Payroll including pension payroll.
- Accounts payable.
- Purchasing and procurement to include purchasing card (P-card) use.

We identified the following six contracts or agreements as having the highest inherent risk due to
public visibility and interest and the volume of City dollars expended. Additionally, these
organizations are outside the internal control framework of the City to a great extent. These are
all contracts or agreements to operate and maintain City-owned facilities:
1. SMG agreement for the Denny Sanford Premier Events Center, Sioux Falls
   Convention Center, Sioux Falls Arena, Sioux Falls Stadium, and Orpheum
   Theater. (This would include the separate agreement with Ovations who provide
   food and beverage service for these entertainment venues.)
2. First Transit agreement for the transit system (Sioux Area Metro).
3. Washington Pavilion Management, Inc. agreement for the Washington Pavilion.
4. Landscapes Unlimited for the Sioux Falls public golf courses (Elmwood, Kuehn,
   and Prairie Green).
5. Great Bear Recreation Park, Inc. for the Great Bear Recreation Park.
6. Sioux Falls Zoological Society for the Great Plains Zoo and Delbridge Museum
   of Natural History.

We did note during this assessment work that the City has been moving towards more
centralization and formality in regard to the management of risks. For example, the Police
department is now performing a regular risk assessment of City facilities from a safety and
security perspective. The City created a new position (2018) of Safety Coordinator in the
Human Resources department. This position is now filled and this employee will assist in the
development, coordination, and implementation of the City's comprehensive safety policies and
programming. The City Council approved a Fraud Control Policy in 2012 that addresses
citywide fraud risks. This policy was developed by Internal Audit, Human Resources, and the
City Attorney's office.

More work should continue in this direction. Enterprise Risk Management (ERM) is a formal
risk management framework popular in for-profit corporations but is not common in local
governments in the United States. It includes the methods and processes used by organizations
to manage risks and seize opportunities related to the achievement of their objectives. However,
it can be expensive and time-consuming for an organization to develop their ERM framework.
The Government Finance Officers Association (GFOA) recommends as a best practice that state,
provincial, and local governments adopt the COSO *Internal Control-Integrated Framework
(2013)* as their conceptual basis to provide reasonable assurance that they are achieving their
operational, reporting and compliance objectives. Internal Audit recommends movement toward
that goal. See **Recommendation One** below.

Internal audit coverage for 2019 and following years

The following are recommended for the consideration of the Audit Committee for 2019 and the next few years:

- Major business processes such as payroll, procurement, and accounts payable. These could be addressed on a rotating schedule such as every four years. However, a more efficient method may be the development of continuous auditing or monitoring protocols which would address any issues on a timelier basis. See **Recommendation One** below.
- An audit of the City's business continuity plan. This plan, known as the Continuation of Operations Plan (COOP), was developed in 2013 and is being revised and updated this year.
- Developers are required to sign a Construction Agreement which requires a bond such that the City is not held financially liable and financial resources would exist to finish a project if a developer could not finish completion of roads in a new development. An audit could be performed to determine if this management strategy is performing as expected.
- Lawsuits/torts-claims against the City. This could be an audit of the City's relationship with the South Dakota Public Assurance Alliance and how this partnership with the Alliance covers the City in cases where the City is held liable for damages in a lawsuit. See **Recommendation Two** below.
- Audits of the management companies operating City-owned facilities listed above on a three-year cycle. These contracts or agreements would be audited every three years with an average of two such audits scheduled for each year.
- Other entities receiving City funding or remitting money to the City should also be audited on a schedule. However, all such entities need to be identified and a risk assessment performed to develop the appropriate audit frequency. See **Recommendation Three** below.

Current citywide risks, how controlled, and when last audited

Due to length of this list, we prepared a document separate from this report showing the following:

- Description of the risk.
- How it is mitigated.
- Whether there has been audit coverage of this area.

RECOMMENDATIONS

We made the following recommendations to address the issue noted in this assessment:

1. Audit Committee and Internal Auditors should initiate discussion with appropriate City Directors and the Mayor to begin developing a risk management framework as follows:
    - An inventory of city-wide risks.
    - A ranking of these risks by probability of occurrence and degree of impact.
    - Mitigation strategies.

- Responsible parties for mitigation of these risks.
- Identification of key control activities.
- A schedule of who and how often these activities are monitored through audits, consultant studies, or accreditations.
- A schedule of specific continuous monitoring and auditing activities and who is responsible for each. Such activities often use data extraction software and other technology tools to increase efficiency.

Such a framework should include Internal Audit, the City's Risk Manager, the City's Safety Coordinator, the Finance Director, and other appropriate City directors, managers, and staff. A full-scale Enterprise Risk Management framework may be too ambitious; however, a more modest framework such as the COSO model could be developed in 2019 and expanded in future years as needed.

2. Internal Audit shall call the Executive Director of the South Dakota Public Assurance Alliance. The Director would be invited to make a presentation to the Audit Committee on the type of lawsuits, claims, and related issues that South Dakota municipalities are seeing. This would provide further information to the Committee about risks facing the City. Members of the administration would be invited to such a presentation.

3. Internal Audit shall continue to review the current audit universe and update it. The audit universe is a list of all City divisions, contracts, and agreements, and processes that would be subject to review by Internal Audit. This will include not only City MOUs and major processes but also agreements with outside entities that receive City funds or remit revenue either directly or indirectly to the City. This will be presented to the Audit Committee at the first Committee meeting of 2019.

CONCLUSION

The City has taken great strides toward centralizing and formalizing the identification and management of citywide risks. Based upon the results of audit work the past ten years and this year's risk assessment, we conclude that management has identified and been successful in addressing citywide risks. Implementation of the recommendations listed above will assist in these efforts going forward.

AUTHORIZATION

The Sioux Falls City Council approved this assessment by resolution in February 2018 as part of the 2018 Annual Audit Program. The Internal Audit Division operates under the authority of an Internal Audit Charter adopted by City Council resolution 11-13.

AUDIT STANDARDS

Internal Audit conducts its work in accordance with the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors.

STATEMENT OF INDEPENDENCE

Internal Audit is administratively and operationally independent of the programs and departments it audits, both in appearance and in fact. The Internal Audit Manager is accountable to an Audit Committee appointed by the City Council per section 32.022 of the Code of Ordinances of Sioux Falls, SD.

DISTRIBUTION OF REPORT

This report is intended for the information and use of the Mayor and City Council, management, and others within the City of Sioux Falls. However, the report is a matter of public record and its distribution is not limited.

PERFORMED BY

Rich Oksol
Internal Audit