



City of Lockport

Independent Audit Services

Report of Examination

Period Covered:

January 1, 2012 — December 31, 2012

2014M-238



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

December 2014

Dear City Officials:

A top priority of the Office of the State Comptroller is to help local government officials manage government resources efficiently and effectively and, by so doing, provide accountability for tax dollars spent to support government operations. The Comptroller oversees the fiscal affairs of local governments statewide, as well as compliance with relevant statutes and observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations and governance. Audits also can identify strategies to reduce costs and to strengthen controls intended to safeguard local government assets.

Following is a report of our audit of the City of Lockport, entitled Independent Audit Services. This audit was conducted pursuant to Article V, Section 1 of the State Constitution and the State Comptroller's authority as set forth in Article 3 of the New York State General Municipal Law.

This audit's results and recommendations are resources for local government officials to use in effectively managing operations and in meeting the expectations of their constituents. If you have questions about this report, please feel free to contact the local regional office for your county, as listed at the end of this report.

Respectfully submitted,

*Office of the State Comptroller
Division of Local Government
and School Accountability*



State of New York Office of the State Comptroller

EXECUTIVE SUMMARY

The City of Lockport (City) is located in Niagara County, encompasses 8.4 square miles and serves approximately 21,100 residents. The elected Common Council (Council) is the legislative body responsible for managing City operations, including establishing internal controls over financial operations, and for maintaining sound financial condition. The Mayor is a member of the Council and serves as the City's chief executive officer. The elected City Treasurer, as chief financial officer, oversees accounting and financial reporting controls, supervises the preparation of accounting records and produces financial reports.

The Office of the State Comptroller's Fiscal Stress Monitoring System evaluates local governments based on both financial and environmental indicators. The City demonstrated signs of fiscal stress in several areas. Due in part to these fiscal stress indicators, we conducted audits of the City in 2013 and 2014.¹

During these audits, we found that the City's accounting records were in such poor condition that the Council and City officials were unaware of the severity of the City's fiscal stress. In addition, although the City hired a certified public accounting (CPA) firm to conduct an audit of the 2012 records, the CPA firm made no indication in its audit report that the records were in poor condition or that the City had fiscal stress issues. We questioned how a properly designed audit could be conducted without making the Council aware of the poor condition of the records and providing information to enable an accurate assessment of the financial condition. Therefore, we concluded that an audit of the City's procurement of audit services was warranted to determine if the City received the audit services for which it contracted and paid.

Scope and Objective

The objective of our audit was to determine the adequacy of the process for procuring audit services and the effectiveness of such audit services as a means for the timely detection of errors and irregularities for the period January 1, 2012 through December 31, 2012. For certain procedures, we expanded our scope to include periods before January 1, 2012 and after December 31, 2012. Our audit addressed the following questions:

- Did the City follow appropriate policies and procedures when procuring audit services?

¹ The results of those audits can be found at: <http://www.osc.state.ny.us/localgov/audits/cities/2013/lockport.pdf> and <http://www.osc.state.ny.us/localgov/audits/cities/2014/lockport.pdf>

- Did the audit work of the CPA firm comply with auditing standards specified in the contract of engagement and provide information needed for the effective oversight of City fiscal operations?

Audit Results

City officials did not follow appropriate policies and procedures when procuring audit services because they did not solicit written proposals for audit services. The City signed a contract with a CPA firm in June 1996. The City renewed the contract every five years until the City ended its relationship with the CPA firm in 2013.² We found no evidence to indicate that City officials ever solicited proposals for audit services during this 17-year period. In addition, the City does not have an audit committee to oversee and evaluate the CPA firm's work. We reviewed the CPA firm's work papers supporting their audit of the City's financial statements for the fiscal year ending December 31, 2012 to determine whether the CPA firm's audit services met generally accepted government auditing standards. The CPA firm's work papers generally met most auditing standards. However, we believe that the audit work papers were deficient in certain key areas including audit documentation, testing and supervision. If the Council and City officials had solicited proposals for audit services, then the Council may have selected a different CPA firm that may have identified that the City accounting records were in such poor condition³ and that the City was experiencing significant fiscal stress. The Council and City officials would have had the opportunity to take action earlier to address the fiscal problems facing the City.

Comments of Local Officials

The results of our audit and recommendations have been discussed with City officials and their comments, which appear in Appendix B, have been considered in preparing this report. City officials generally agreed with our findings and indicated they would take corrective action. We also provided a copy of the draft report to the CPA firm and offered to meet with them to discuss our report. The CPA firm provided a written response which we have included in Appendix B.

² The contracts on file with the CPA firm were dated June 15, 1996, June 15, 2001, June 15, 2006 and June 15, 2011.

³ See Appendix C, Audit Methodology and Standards for further discussion

Introduction

Background

The City of Lockport (City) is located in Niagara County, encompasses 8.4 square miles and serves approximately 21,100 residents. The elected Common Council (Council) is the legislative body responsible for managing City operations, including establishing internal controls over financial operations, and for maintaining sound financial condition. The Mayor is a member of the Council and serves as the City's chief executive officer. The elected City Treasurer (Treasurer), as chief financial officer, oversees accounting and financial reporting controls, supervises the preparation of accounting records and produces financial reports.

One aspect of an effective system of internal controls is an annual financial audit performed by an independent public accountant. Such an audit can be an effective oversight tool for City management by providing for the timely detection of errors or irregularities. The effectiveness of the annual financial audit as a control is dependent on the scope and quality of such audit and the resultant communications to management. Audit scope and quality are governed largely by generally accepted government auditing standards⁴ (GAGAS). These standards speak to the qualifications and responsibilities of the professionals conducting the audit, the quality of the audit work to be performed and the required communications to management. The audit scope, applicable professional standards and engagement expectations are documented in the independent public accountant's engagement letter to the governing board.

Objective

The objective of our audit was to determine the adequacy of the process for procuring audit services and the effectiveness of such audit services as a means for the timely detection of errors and irregularities. Our audit addressed the following related questions:

- Did the City follow appropriate policies and procedures when procuring audit services?
- Did the audit work of the CPA firm comply with auditing standards specified in the contract of engagement and provide information needed for the effective oversight of City fiscal operations?

⁴ See Appendix A

**Scope and
Methodology**

We evaluated whether the City’s independent audit services complied with audit standards specified in the contract of engagement for the period January 1, 2012 through December 31, 2012. For certain procedures, we expanded our scope to include periods before January 1, 2012 and after December 31, 2012.

We conducted our audit in accordance with GAGAS. More information on such standards and the methodology used in performing this audit is included in Appendix C of this report.

**Comments of
Local Officials and
Corrective Action**

The results of our audit and recommendations have been discussed with City officials and their comments, which appear in Appendix B, have been considered in preparing this report. City officials generally agreed with our findings and indicated they would take corrective action. We also provided a copy of the draft report to the CPA firm and offered to meet with them to discuss our report. The CPA firm provided a written response which we have included in Appendix B.

The Council has the responsibility to initiate corrective action. A written corrective action plan (CAP) that addresses the findings and recommendations in this report should be prepared and forwarded to our office within 90 days, pursuant to Section 35 of the New York State General Municipal Law. For more information on preparing and filing your CAP, please refer to our brochure, *Responding to an OSC Audit Report*, which you received with the draft audit report. We encourage the Council to make this plan available for public review in the City Clerk’s office.

Procurement of Audit Services

City officials should periodically seek competition for professional auditing services. One way to promote competition for auditing services is to issue a request for proposals (RFP).⁵ An RFP can provide a mechanism for fostering increased competition and can ensure that contracts are awarded in the best interests of the taxpayers. The City's procurement policy should designate whether RFPs or other similar procedures should be used to solicit auditing services. While there are no set rules regarding the frequency that City officials should solicit proposals for auditing services, a provision should be made in the policy for periodic solicitations at reasonable intervals.

City officials did not follow appropriate policies and procedures when procuring audit services because they did not solicit proposals for audit services. The City signed a contract with a CPA firm in June 1996. The City renewed the contract every five years until it ended its relationship with the CPA firm in 2013.⁶ We found no evidence to indicate that City officials ever solicited proposals for audit services during this 17-year period. In addition, the City does not have an audit committee to oversee and evaluate the CPA firm's work. The City paid the CPA firm \$19,000 for auditing the financial statements for the 2012 fiscal year. In 2013, the City obtained proposals from two other CPA firms and subsequently contracted with one of them to conduct the audit of the 2013 financial statements.

The City's procurement policy does not require the use of RFPs when soliciting auditing services. The policy, which was last updated in March 2001, indicates that the Finance Committee⁷ is to be notified or a Council resolution is required when professional

⁵ An RFP generally is a document that provides detailed information concerning the type of professional service to be provided, including minimum requirements and the evaluation criteria that will govern the contract award. Proposals can be solicited via public advertisement, or a comprehensive list of potential vendors can be compiled with vendors contacted directly and provided with the RFP. Evaluation criteria and any weighing or ranking of the importance of those criteria should be set forth in the RFP. The evaluation criteria, in addition to price, can include factors such as experience, staff availability, work plan and methodology to achieve the desired result, estimated completion times and references. The vendor selection should be based on a fair and equitable review and evaluation or ranking of the proposals. A well-planned effort can help encourage qualified providers to respond to the RFP and ultimately result in increased competition and potential cost savings.

⁶ The contracts on file with the CPA firm were dated June 15, 1996, June 15, 2001, June 15, 2006 and June 15, 2011.

⁷ This committee consists of the Council, Treasurer, City Auditor and Budget Director.

services costing over \$3,001 are procured. However, the policy does not indicate which City official should provide the information to the Finance Committee or Council. The policy is also unclear on what documentation is required for the purpose or contents of the notification. For the 1996 contract, there is no indication that the Finance Committee was notified or a Council resolution was adopted. For the 2001 contract, the Finance Committee was notified. The 2006 contract was authorized by a Council resolution. The 2011 contract contained no resolution or any indication that the Finance Committee was notified.

The same CPA firm conducted an audit of the City's financial statements for 17 consecutive years. As discussed in the section of the report entitled "Effectiveness of Audit Services," the CPA firm's audit of the City's financial statements did not comply with the auditing standards as set forth in the terms and condition of the engagement contract. If the Council and City officials had solicited proposals, then the Council may have selected a different CPA firm that may have identified that the City's accounting records were in such poor condition⁸ and that the City was experiencing significant fiscal stress. The Council and City officials could have then taken action earlier to address the fiscal problems facing the City.

Recommendations

The Council should:

1. Revise the City's procurement policy to require the use of RFPs when obtaining independent audit services.
2. Periodically seek proposals for independent audit services to ensure it is receiving the desired service at a competitive price.
3. Develop a process to be used in reviewing and rating the proposals for independent audit services to ensure all requirements set forth in the RFP process are met.
4. Establish an audit committee to oversee the City's independent audit.

⁸ See Appendix C, Audit Methodology and Standards for further discussion

Effectiveness of Audit Services

The City contracted with a CPA firm⁹ to conduct an independent audit of the City's financial statements for the fiscal year ending December 31, 2012. The formal engagement letter with the City indicated the audit was to be conducted in accordance with GAGAS, issued by the Comptroller General of the United States. These audit standards consist of a series of guidelines intended to ensure quality audit work.

In their report to the Mayor and Council dated July 17, 2013, the CPA firm issued an unqualified opinion on the City's general purpose financial statements for the 2012 fiscal year, meaning that, in their opinion, the City's financial statements were fairly presented in conformance with generally accepted accounting principles.

We assessed the effectiveness of the City's engagement of an independent audit as an oversight tool for City officials by determining whether contractual audit services provided to the City met audit standards set forth in the contractual agreement. We reviewed the CPA firm's work papers supporting their audit of the City's financial statements for the fiscal year ending December 31, 2012 to determine whether the CPA firm's audit services met GAGAS. Our review considered the requirements under the auditing standards, including planning the audit, audit documentation, supervision, auditing testing and reporting on matters found during the audit.

The CPA firm's work papers met many of the auditing standards. However, we believe that the audit work papers were deficient in certain key areas, including audit documentation, testing and supervision, which resulted in the audit inappropriately concluding that the financial statements were fairly presented. As a result, City officials did not have the opportunity to address fiscal stress issues in a timely manner.

Audit Documentation

Under GAGAS, audit documentation related to planning, conducting and reporting on an audit should contain sufficient information to enable an experienced auditor who has had no previous connection with the audit to ascertain from the audit documentation the evidence that supports an auditor's significant judgments and conclusions. Audit documentation should contain support for findings, conclusions and recommendations before auditors issue their report.

⁹ This is the same CPA firm that conducted the audit of the City's financial statements for every year since 1996.

Audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit. It appears that the CPA firm failed to develop sufficient documentation to fully comply with the audit documentation standard.

The CPA firm used audit programs that are part of a software package. The audit programs are categorized into balance sheet and income statement sections. There were 17 audit programs in the work papers that contained 290 audit program steps. We found that 195 steps (67 percent) included an appropriate level of documentation. However, the CPA firm's lack of documented conclusions for the remaining 95 audit program steps (33 percent) would not allow an experienced auditor who has had no previous connection with the audit to readily ascertain the evidence that supports the auditor's significant judgments and conclusions on the audited financial statements.

Analytical Review Procedures

To comply with GAGAS, sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit. Auditors should design the audit to provide reasonable assurance of detecting material misstatements that have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives.

Auditors are required to use analytical review procedures in the planning and overall review of financial statement audits. Analytical procedures performed during the planning of the audit can provide auditors with information to help them direct their audit efforts. The objective of the procedures is to identify such things as the existence of unusual transactions and events, and amounts, ratios and trends that might indicate matters that have financial statement and audit planning ramifications. The auditor should document and follow up on any significant unusual items identified during the course of the audit. If necessary, the auditor should modify the audit plan/program to address such items.

The CPA firm's work papers contained evidence that they performed analytical review procedures on various account balances. The CPA firm reviewed the trial balances of each fund and performed a preliminary analytical review based on the established materiality levels. With the help of the Treasurer's office, the CPA firm analyzed the variances noted to determine the causes. Through this review, the CPA firm determined that many variances were the result of posting errors in the accounting records.

After adjustments were made by the Treasurer's office, a final analytical review was performed by the CPA firm. The remaining variances were reviewed with the Treasurer's office, and the work papers indicate the CPA firm accepted the answers that were given to them by the Treasurer's office. The work papers also indicated that the CPA firm told the Treasurer's office that the Treasurer's office still had some work to do in the areas of taxes receivable, interfund receivables and payables, and the water and sewer funds. For example, the work papers indicate that the CPA firm informed the Treasurer's office that the Treasurer's office needed to analyze the interfund receivables and payables and water and sewer fund receivables to determine if any adjustments were needed.

It does not appear as though the CPA firm followed up to ensure that the Treasurer's office did additional analysis. Furthermore, the CPA firm did not conduct any additional audit testing either. If the CPA firm performed additional tests, rather than rely on the Treasurer's office to perform the work, they would likely have found the significant discrepancies in the accounting records. Therefore, it is our opinion that the CPA firm did not properly design and conduct the audit in a manner to afford a reasonable assurance of detecting material misstatements.

Audit Supervision

According to GAGAS, audit work is to be adequately planned, and assistants, if any, are to be properly supervised. Audit supervision involves providing sufficient guidance and direction to staff assigned to the audit and reviewing the work performed.

We question whether the audit was properly supervised, as we found errors and inconsistencies in the engagement letter, financial statements, work papers and management letter. If the audit supervisor reviewed these documents more thoroughly, he may have easily discovered the errors:

- In the notes to the audited financial statements, Note 1 states: "Modified Accrual Basis – Under this basis of accounting, revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the City considers revenues to be available if they are collected within 60 days of the end of the current fiscal period. Revenues from federal, State or other grants designated for specific City expenditure are recognized when the related expenditures are incurred." However, the CPA firm did not test for compliance with this revenue recognition rule when they audited the City's financial statements. The Treasurer's office understated deferred revenues – an account that is used

to recognize revenue that is not collected within 60 days after the close of the fiscal year – in the general, water and sewer funds as of December 31, 2012, as noted in our prior audit,¹⁰ and the CPA firm did not recommend any adjustments to these accounts.

- In the notes to the financial statements, Note 17 states: “Fund balances at January 1, 2012 have been restated to reflect the corrected allocation of interfund cash balances.” However, the supervising partner told us that, “This note was erroneously carried forward from a previous year. The ending fund balances for 2011 do in fact match the beginning fund balances for 2012.” The Treasurer’s office failed to note this error as well.

More importantly, the CPA firm’s work papers demonstrate that lax supervision failed to detect the weakness in the audit design, which relied too much on analytical review, to provide guidance to perform additional substantive testing and to follow up on the additional analysis the Treasurer’s office was supposed to perform. Overall, the audited financial statements depict the City’s financial position as being more promising than it actually was. In reality, the City was in fiscal stress. For example, as indicated in our December 2013 audit report, sewer rents receivable were overstated by approximately \$322,000 and refuse fees receivable were overstated by \$354,000. When these two accounts are adjusted to reflect actual balances, fund balance would be significantly reduced.

The external auditor has an important role to play in reporting the City’s finances to the Council, City officials, taxpayers and other interested parties. Auditing standards require the external auditor to design the audit to provide reasonable assurance of detecting material misstatements in the City’s financial statements. The CPA firm should have included more information in the work papers to help demonstrate they fully complied with auditing standards. If the CPA firm exercised sound professional judgment and due professional care when they audited the City’s accounting records, they would likely have identified problems with the City’s accounting records and the City’s fiscal stress. While the Treasurer’s office is ultimately responsible for ensuring that the City’s accounting records are accurate, complete and timely and fairly present financial activity, that office clearly failed to provide reliable financial information. City officials should be able to rely on an external audit to assess and report on the fairness of the presentations in the financial statements.

¹⁰ Refer to the OSC report titled *City of Lockport Fiscal Stress* (2013M-330)

In our opinion, the CPA firm failed to provide information needed for effective oversight of the City's fiscal operations.

Recommendations

5. The Council should ensure that the audit committee, when established, oversees the City's independent audit.
6. The Treasurer should ensure that the City's accounting records are accurate, complete and timely and fairly present financial activity.

APPENDIX A

GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS (GAGAS)

The Government Accountability Office of the United States promulgates generally accepted government auditing standards. The “Yellow Book,” issued by the Comptroller General, contains guidelines for the conduct of financial statement audits that pertain to auditors’ professional qualifications, the quality of audit effort and the characteristics of professional and meaningful audit reports. The Yellow Book incorporates the standards of the American Institute of Certified Public Accountants (AICPA) and adds additional requirements for government audits. The Yellow Book standards are outlined below.

Government Auditing Standards — 2011 Revision (Yellow Book)
(Effective for financial audits of periods ending on or after December 15, 2011)

General Standards

These general standards apply to all audit organizations, government and non-government (i.e., public accounting firms and consulting firms) conducting audits of government organizations, programs, activities and functions, and of government assistance received by non-government organizations.

Generally accepted government auditing standards (GAGAS) require the following:

1. In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent.
2. Auditors must use professional judgment in planning and performing audits and in reporting the results. Using professional judgment is important in determining the required level of the audit subject matter and related circumstances. Professional judgment does not mean eliminating all possible limitations or weaknesses associated with a specific audit, but rather identifying, considering, minimizing, mitigating and explaining them.
3. The staff assigned to perform the audit must collectively possess the adequate professional competence needed to address the audit objectives and perform the work in accordance with GAGAS. Each auditor performing work in accordance with GAGAS should complete, every two years, at least 24 hours of continuing professional education (CPE) that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates. Auditors who are involved in any amount of planning, directing, or reporting on GAGAS audits also should obtain at least an additional 56 hours of CPE (for a total of 80 hours of CPE in every two-year period) that enhances the auditor’s professional proficiency to perform audits.
4. Each audit organization performing audits in accordance with GAGAS must establish and maintain a system of quality control that is designed to provide that the audit organization

and its personnel comply with professional standards and applicable legal and regulatory requirements and have an external peer review at least once every three years.

Standards for Financial Audits

For financial statement audits, GAGAS incorporates the AICPA's Statements of Auditing Standards (SAS) and establishes additional requirements for performing financial audits when citing GAGAS in the auditor's report.

The additional requirements for performing financial audits are the following:

1. Auditors should communicate pertinent information that, in the auditors' professional judgment, needs to be communicated to individuals contracting for or requesting the audit.
2. Auditors should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements or other financial data significant to the audit objectives.
3. Auditors should extend the AICPA's requirements pertaining to the auditor's responsibilities for laws and regulations to also apply consideration of compliance with provisions of contracts or grant agreements.
4. Audit findings may involve deficiencies in internal control; noncompliance with provisions of laws, regulations, contracts or grant agreements; fraud or abuse. When auditors identify findings, auditors should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. The elements of an audit finding include: (a) criteria, (b) condition, (c) cause and (d) effect or potential effect.
5. In addition to the AICPA requirements for audit documentation, auditors should (a) document supervisory review of the evidence that supports the findings, conclusions and recommendations contained in the auditors' report and (b) document any departures from the GAGAS requirements and the impact on the audit and on the auditors' conclusions.

For financial statement audits, GAGAS incorporate the AICPA's requirements for reporting and establishes additional requirements when citing GAGAS in the auditor's report.

The additional requirements for reporting on financial audits are the following:

1. Audit reports should include a statement that the audit was performed in accordance with GAGAS.
2. When providing an opinion or a disclaimer on financial statements, auditors should also report on internal controls over financial reporting and on compliance with provisions of laws, regulations, contracts or grant agreements that have a material effect on the financial statements. Auditors should include either, in the same or in separate report(s), a description of the scope of the auditors' testing of internal control over financial reporting and of compliance with provisions of laws, regulations, contracts or grant agreements. Auditors should also state in the

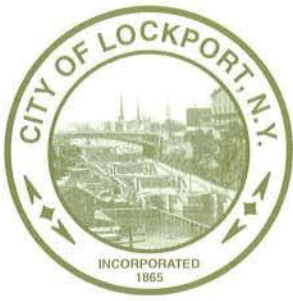
reports whether the tests they performed provided sufficient, appropriate evidence to support opinions. If the auditor reports separately, they should include a reference to the separate report and state that the separate report is an integral part of a GAGAS audit in considering the audited entity's internal controls over financial reporting and compliance.

3. Auditors should communicate in the report on internal controls over financial reporting and compliance, based upon the audit work performed (1) significant deficiencies and material weaknesses in internal control; (2) instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the audit and other instances that warrant the attention of those charged with governance; (3) noncompliance with provisions of contracts or grant agreements that has a material effect on the audit; and (4) abuse that has a material effect on the audit. In some circumstances, auditors should report known or likely fraud; noncompliance with provisions of laws, regulations, contracts or grant agreements; or abuse directly to parties external to the audited entity.
4. If the auditors' report discloses deficiencies in internal control; fraud; noncompliance with provisions of laws, regulations, contracts or grant agreements; or abuse, auditors should obtain and report the views of responsible officials of the audited entity concerning the findings, conclusions, and recommendations as well as planned corrective actions.
5. If certain pertinent information is prohibited from public disclosure or is excluded from a report due to the confidential or sensitive nature of the information, auditors should disclose in the report that certain information has been omitted and the reason or other circumstances that make the omission necessary.
6. Audit organizations in government entities should distribute auditors' reports to those charged with governance, to the appropriate audited entity officials, and to the appropriate oversight bodies or organizations requiring or arranging for the audits. As appropriate, auditors should also distribute copies of the reports to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports.

APPENDIX B

RESPONSE FROM LOCAL OFFICIALS

The City officials' response to this audit can be found on the following pages.



Office of the Mayor

Anne E. McCaffrey, Mayor



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November 3, 2014

Mr. Robert Meller, Chief Examiner
Office of the NYS Comptroller
Division of Local Government and
School Accountability
295 Main Street, Suite 1032
Buffalo, NY 14203-2510

Re: Independent Audit Services Response and Corrective Action Plan

Unit Name: City of Lockport
Audit Report Title: "Independent Audit Services"
Audit Report Number: 2014M-238

Dear Mr. Meller:

Officials from the City of Lockport have received and reviewed the Report of Examination entitled, "Independent Audit Services." In addition, city officials met with OSC representatives to review the findings on October 9, 2014.

This letter shall serve as the City of Lockport's Combined Response to the audit as it also contains the city's Corrective Action Plan. The Mayor and Common Council share the NYS Comptroller's goal of managing municipal resources efficiently and effectively and providing accountability for the tax dollars spent on governmental operations. Over the course of the past eight months, the Mayor and Common Council have strived to improve business operations and strengthen controls.

The Mayor and Common Council agree with the findings included in this audit. As indicated in the audit, several problems were identified that contributed to the city's fiscal stress. It was noted that if the city had sought a Request for Proposal (RFP) and engaged a different CPA firm to perform independent audit services, city officials may have been informed at an earlier date that the city's accounting records were in poor condition and that the city was experiencing fiscal stress.

It was determined by OSC that the City of Lockport engaged the independent CPA firm in 1996 and kept the firm, without issuing any RFPs or seeking any other proposals for CPA services, until 2013. The City of Lockport ended its relationship with the former firm in 2013 and issued an RFP at that time and subsequently

engaged the services of a new CPA firm. Current city officials are keenly aware of the problems that resulted from having the same CPA firm for 17 years. Current city officials understand that periodically seeking competition for professional auditing services is a best practice and will serve the best interest of safeguarding municipal assets.

In addition, OSC has determined that while the CPA firm's work met many of the auditing standards, the audit work papers were deficient in certain key areas including audit documentation, testing and supervision. This resulted in the audit inappropriately concluding that the financial statements were fairly presented. OSC determined that the CPA firm lacked the appropriate level of documentation in 33 percent of the audit program steps. OSC indicated that the CPA firm informed the Treasurer's office of the need to analyze interfund receivables and payables and the need to analyze water and sewer fund receivables to determine if any adjustments were needed. It does not appear that the CPA firm followed up to ensure that the Treasurer's office performed the additional analysis. Nor did the CPA firm conduct additional audit testing. If the CPA firm performed additional tests, rather than rely on the City to perform the work, they would likely have found the significant discrepancies in the accounting records. OSC's conclusion is that the CPA firm did not properly design and conduct the audit in a manner to afford a reasonable assurance of detecting material misstatements. OSC found errors and inconsistencies in the engagement letter, financial statements and management letter.

Current city officials concur that had the independent audit been effective, the CPA firm could have warned the city that it was heading toward or was in fact in the midst of financial stress. In addition, current city officials believe that the CPA firm has the responsibility of reviewing the financial work performed by the Treasurer's office and informing the Mayor and/or Common Council of material misstatements in the City's financial statements and problems in the City's accounting records. This was not done.

CORRECTIVE ACTION PLAN

PROCUREMENT OF AUDIT SERVICES

Audit Recommendation #1

The Council should revise the City's procurement policy to require the use of RFPs when obtaining independent audit services.

Implementation Plan of Action

The Council will review the City's procurement policy and insert a revision that will require the use of an RFP every 3 years when obtaining independent audit services.

Implementation Date

The Council will pass a resolution approving this revision to the policy by 12/31/14.

Person(s) Responsible for Implementation

Mayor Anne McCaffrey and Common Council President Joe Kibler

Audit Recommendation #2

The Council should periodically seek RFPS for independent audit services to ensure it is receiving the desired services at a competitive price.

Implementation Plan of Action (Already Occurred in 2013)

When the Common Council became aware of the City's fiscal stress in the Fall of 2013 and had grave concerns over the quality of its previous independent audits, it immediately issued an RFP for a new independent CPA audit firm to perform the City's independent audit. At this time, the Mayor and Common Council ended the City's relationship with the former CPA firm. Two firms submitted proposals in response to the RFP. The Common Council authorized the Mayor to enter into a contract with [REDACTED] on January 15 2014.

Implementation Date

January 2014

Person(s) Responsible for Implementation

Common Council

Audit Recommendation #3

The Council should develop a process to be used in reviewing and rating the proposals for independent audit services to ensure all requirements set forth in the RFP process are met.

Implementation Plan of Action

The Council, Corporation Counsel, and Audit Committee will develop a ratings criteria to ensure that all requirements set forth in the RFP for independent audit services are met.

Implementation Date

12/31/14

Person Responsible for Implementation

Corporation Counsel John Ottaviano

Audit Recommendation #4

The Council should establish an audit committee to oversee the City's independent audit.

Implementation Plan of Action

The Mayor and Common Council will establish an audit committee and appoint community members with financial knowledge, education and/or experience to oversee the City's independent audit. The Mayor and Common Council Finance Chairman will also sit on the Audit Committee.

Implementation Date

The Common Council will appoint an Audit Committee no later than 12/31/14.

Person(s) Responsible for Implementation

Mayor Anne McCaffrey and Common Council President Joe Kibler

EFFECTIVENESS OF AUDIT SERVICES**Audit Recommendation #5**

The Council should ensure that the audit committee, when established, oversees the City's independent audit.

Implementation Plan of Action

The Common Council will ensure that an audit committee is established and that the Audit Committee will oversee the City's independent audit.

Implementation Date

The Audit Committee will have its first meeting during the month of January 2015.

Person(s) Responsible for Implementation

Mayor Anne McCaffrey and Common Council Finance Chairman Ken Genewick

Audit Recommendation #6

The Treasurer should ensure that the City's accounting records are accurate, complete and timely and fairly present financial activity.

Implementation Plan of Action

The Mayor and Common Council have determined that it would serve the City well to hire a Director of Finance with knowledge of municipal accounting to perform financial analysis, monitor the budget and ensure accuracy, thoroughness and timeliness of accounting records. This position will be budgeted for in the 2015 budget.

Implementation Date

The inclusion of the position in the budget will occur during budget development in November 2014. The position will be filled by January 2015.

Person Responsible for Implementation

Mayor Anne McCaffrey and Council President Joe Kibler

Thank you for your assistance as the City of Lockport begins to implement measures that will decrease its fiscal stress and also to put in place measures that will ensure greater competence in its independent audit services as well as accounting.

Sincerely,

Anne E. McCaffrey
Mayor

Joseph Kibler
Common Council President

October 14, 2014

Mr. Jeffrey D. Mazula
Chief Examiner of Local Government
and School Accountability
Office of State Comptroller
110 State Street
Albany, NY 12236

Dear Mr. Mazula:

In response to your recent audit results, we provide the following information.

Workpapers were prepared in accordance with *Generally Accepted Audit Principles*. As such, each workpaper is designed to obtain self-sufficient evidentiary matter to support the financial statement transaction or balance.

Workpapers are designed to accomplish the audit objectives as determined by the audit program. The audit programs themselves are prepared to design the procedures necessary to verify transactions and balances.

The initial phase in preparing an audit program is a preliminary analytical review of trial balance amounts to previous year balances and budgetary amounts. This information is then used to adapt standard commercially available audit programs to determine expected balances for each transition class. The standard audit programs are purchased from Practitioners Publishing Corporation and CCH and are widely used throughout the profession.

As part of the planning process, a materiality limit is determined to provide guidelines as to which accounts will be regarded as significant audit areas to plan the amount of test work necessary for that area. Factors included in deciding the significant audit areas are the change in balance from year to year, the expertise of the client accounting personnel and the expected variations of balance sheet and income statement items.

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The audit program is modified throughout the audit field work based upon the actual results of test work as compared with the expected results. The audit program is designed specifically for each client including modifications as noted above.

Conclusions regarding the results of the test work are recorded on the audit workpapers or the audit program itself depending on whether an adjustment to the accounts is required.

The audit program for the City of Lockport recognized the need for an emphasis upon verifying the City's cash balances. At the time of the audit, the cash balances on the City's financial records had not been reconciled with the bank statements for 18 months. At that time, the city did not have an accurate record of the cash balances in its name at financial institutions. This included approximately 23 separate bank accounts dispersed over 14 funds. This was clearly a significant audit area and many hours were spend during the audit to assist the City Accountant in determining accurate cash transactions and verifying cash balances.

The audit program was also modified to augment the testing of interfund receivables and payables, which was also established as a significant audit area. Throughout the year, various funds would lend money to other funds to overcome cash shortages as certain times. This situation was exacerbated by the lack of cash controls as previously stated. For the year, cash transfers were made from fund to fund, but not recorded in the General Ledger. This led to a condition where the interfund balances were out of balance by an amount in excess of one million dollars.

A substantial amount of time was spent during the audit to ascertain the correct balances and adjust them on the financial records. Subsequent to the adjustment the City was advised to investigate the balances and take the necessary steps to make repayments.

Another area of emphasis resulting from the audit plan was in the budgeting process. The City had adopted a budget which made aggressive assumptions regarding estimated revenues. Additional emphasis was given to revenue recognition versus the budged amount and expenditures versus the budged amount. Overestimation of budgeted revenues was a contributing factor to the City's cash flow problems.

Some areas such as deferred revenues and water and sewer rents receivable and the related revenues did not exceed the materiality limits of the analytical review and were not considered a significant audit area during the audit. However, the City Accountant indicated that a comprehensive analysis and adjustment to the accounts would be made when time permitted. The resulting reclassification of deferred revenues was made after the audit. Water and sewer rents receivable were similarly adjusted.

Each of the areas addressed in the audit plan were discussed with the City Accountant, City Treasurer and Mayor acting in lieu of an official audit committee.

Most of the short comings in the City's financial records resulted from inadequate staffing in the accounting department. Delays in hiring the City Accountant, combined with the reluctance to pay overtime to update records and budget cuts generally hindered the City's ability to generate meaningful financial information to determine its financial condition. This, and the lack of a responsible budget, rather than the prior year external audit report contributed greatly to the City's distressed financial condition.

Errors made in the footnotes to the external financial statements were generated from a standard reporting package. These errors had no bearing on the financial condition of the City and were subsequently corrected.

At the conclusion of our audit, our firm was informed by a letter from the Mayor that our audit services were not required for the ensuing fiscal year. Consequently, we were unable to determine if the City has taken follow-up measures to respond to the various financial issues. We anticipate that this process will be performed by the continuing auditors.

We believe that our audit was conducted with the best information that was available from the City.

Our emphasis during the audit, based upon the needs of the City, was placed upon the areas which could best assist the City in developing fiscal stability.

Our approach regarding workpapers, supporting documentation and workpapers conclusions was one which has been subject to professional peer reviews for the past 18 years. Each peer review has resulted in an unqualified opinion.

Areas which were reviewed included audit workpapers, documentation, professional education, audit programs, supervision and review, audit approach as well as many more.

Each staff member assigned to an audit receives in excess of 40 hours per year in continuing professional education relating to governmental accounting and audits.

In the case of the audit in question our firm spent over 214 hours in conducting the audit including 71 hours of supervision and review by managerial level personnel.

Sincerely,

Amato, Fox & Company, P.C.

APPENDIX C

AUDIT METHODOLOGY AND STANDARDS

The Office of the State Comptroller's Fiscal Stress Monitoring System evaluates local governments based on both financial and environmental indicators. These indicators are calculated using the local government's annual update document (AUD)¹¹ and information from the United States Census Bureau, the New York State Department of Labor and the New York State Education Department, among other sources. The City demonstrated signs of fiscal stress in several areas. Due in part to these fiscal stress indicators, we conducted audits of the City in 2013 and 2014. The results of those audits can be found at:

- <http://www.osc.state.ny.us/localgov/audits/cities/2013/lockport.pdf>
- <http://www.osc.state.ny.us/localgov/audits/cities/2014/lockport.pdf>

During these audits we found that the City's accounting records were in such poor condition that the Council and City officials were unaware of the severity of the City's fiscal stress. As such, we determined that an audit of the City's procurement of audit services was warranted. To accomplish the objective of this audit, our procedures included the following steps and procedures:

- We reviewed the City's purchasing policies and procedures.
- We interviewed City officials and key personnel.
- We interviewed representatives from the City's CPA firm.
- We evaluated the process by which the City procured audit services.
- We used Audit Program Checklists based on the GAGAS general standards, GAGAS financial statement audits, relevant AICPA audit standards and Government Auditing Standards from the United States Government Accountability Office (GAO) to assist in conducting our audit.
- We considered the requirements under GAGAS concerning independence, planning the audit, obtaining evidence and reporting on matters found during the audit. The procedures used to carry out the latter part of our audit included, but were not limited to, meeting with the CPA firm, reviewing the CPA firm's policies and procedures and reviewing City-specific audit work papers.

We conducted this performance audit in accordance with GAGAS. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

¹¹ Required to be submitted annually by the City to the Office of the State Comptroller

APPENDIX D

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DIVISION OF LOCAL GOVERNMENT
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Gabriel F. Deyo, Deputy Comptroller
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