

City of Cupertino
Audit Committee
Special Meeting
October 16, 2018

CALL TO ORDER

At 3:03p.m., Chairman Eno Schmidt called the meeting to order at Conference Room A, Cupertino City Hall, 10300 Torre Avenue, Cupertino CA 95014.

ROLL CALL

Committee Members Present: Chairman Eno Schmidt, Daisy Liang, Mayor Paul

City Staff Present: Amy Chan, Kristina Alfaro, Zach Korach,

Absent: Daisy Liang

Guests: Steve Morang (Frank Rimerman) and Kathy Lai and Matthew Geerdes (Crowe) via conference call.

ORAL COMMUNICATIONS

OLD BUSINESS

NEW BUSINESS

1. Finance Manager Korach gave a presentation on the debrief on the alleged embezzlement scheme by the City's former senior accountant.

Finance Manager Korach presented and explained the contents of the staff report by providing a timeline of events. City Manager Chan inquired about the deposit liability being reconciled to date and whether the initial deposits were/are intact. Committee Member Schmidt asked City Manager Chan to clarify and explain the process of the deposit liability. Finance Manager Korach emphasized that no expenditures were recorded in the general ledger, rather, they were directly reducing the deposit liability account. Committee Member Luther asked about the details in the current subledger and an estimate of how many vendors are charged or maintained in this detail. Finance Manager Korach estimated a few dozen "large" vendor deposits while noting there are many small customer deposits included as well. Committee Member Luther asked if it made sense to select a few of the larger vendors and confirm the deposit balances externally. Finance Manager Korach stated that the opportunity, relating to this alleged scheme, presented itself to Ms. Chang because she was solely responsible for maintaining the liability reconciliation and had the knowledge that many of these deposits were long-outstanding and the initial depositor/customer may or may not have known that they were entitled to the City's funds. Currently, the City experiences situations where staff are unable to reach customers with outstanding balances due to addresses changes etc. Committee Member Schmidt inquired about the reconciliation project that began in January 2018 and Finance Manager Korach stated the reconciliation had been completed in that the underlying supporting documents and the subledger activities associated with customer and developer deposits had been reconciled with the general ledger balances. City Manager Chan recommended the use

of 3rd party confirmations. Committee Member Schmidt inquired about the “2-pronged approach” and the concept of materiality and how it applies to this case. Steve Morang joined the meeting via conference call. Finance Manager Korach explained the “2-pronged approach” in more detail as referenced in the staff report. Steve Morang added additional information and clarification regarding the scope and procedures of the work to be performed. Committee Member Schmidt asked about an internal audit function and benchmarking the City’s control environment with other agencies, particularly in regards to the staffing comparisons. Steve Morang noted the difficulty and various factors involved in benchmarking/comparing. The work to be performed is specific to the City’s specific environment. Steve Morang also noted that the reason this happened is hard to determine, pinpoint or narrow down. Ultimately, the City had an employee with a defective moral compass that decided to act unethically. No internal control is going to stop that from happening, but the hope and goal is that having internal controls in place will either take away the opportunity and/or make it more difficult to do so. Committee Member Schmidt asked City staff and external auditors to weigh in on their thoughts on how this could have happened and the concept of materiality. Kathy Lai stated that segregation of duties were of the primary cause and discussed the procedures the external auditors have taken in fiscal year 2017-2018. Committee Member Schmidt inquired of the external auditors why or how this was not uncovered in the previous audit (FY 16-17). Kathy Lai stated that the municipal fraud spanned during a period outside (before) the scope of the audit in FY 16-17. Committee Member Luther stated that there should have been large debit balances sitting in the sub ledger accounts. Matt Geerdes stated that during the FY 16-17 audit, there were no debit balances existing. Finance Manager Korach reiterated that the checks that were paid against the liability account were debited against legitimate deposit balances. The Committee stated that the activities had to have “washed through” the income statement. Steve Morang discussed the deposit liability reconciliation spreadsheet and difficulties Ms. Chang was having attempting to reconcile it. Finance Manager Korach stated that it is not believed individual customer/developer deposit accounts were directly manipulated. Committee Member Schmidt inquired as to the communications with Ms. Chang and the progress of the investigation. Director Alfaro stated that the case is still pending and currently with the District Attorney’s Office. Steve Morang discussed the procedures that were performed in searching for additional transactions related to the alleged embezzlement scheme. Committee Member Luther further inquired about the nature of the scheme and concluded that the income statement was affected. Committee Member Schmidt inquired to Crowe as to any recommendations they had in regards to additional measures the City could take. Kathy Lai recommended increasing the scope of internal control testing. City Manager Chan inquired about the use of confirmations for the deposit liability by Crowe. Crowe has not used audit confirmations in either of the two years engaged to the independent audit. Finance Manager Korach stated that the use of confirmations, whether for the purpose of an audit or internally by management would be prudent on a periodic basis. It was also stated that the deposit liability and the related debits and credits did not appear to affect the income statement. Rather, Ms. Chang was aware that it was unlikely a customer/depositor would be calling upon

these long-outstanding amounts. Additionally, the process and interdepartmental communications in which these transactions were tracked was limited if not lacking in the City's former system. Finally, it is speculated that Ms. Chang was likely reluctant to initiate transactions affecting the income statement, as the revenues and expenditures were of the primary purview by department heads, Councilmembers, etc. Committee Member Paul inquired about the historical reconciliation difficulties with the City's deposit liability and wondered if these had been addressed sooner, would this alleged embezzlement also have been uncovered sooner. Committee Member Paul also inquired about the policies and procedures necessary to prevent this from happening again. Committee Member Luther recommended starting at the point of the auditors' recommendations. City Manager Chan spoke to management oversight within Finance, Audit Committee, and the City Council and the idea that staff should bring management's responses to Council on an annual basis. Director Alfaro spoke to the effects of the implementation of the new system in 2014/15 and the additional challenges that were inherent to performing a city-wide system implementation. Director Alfaro also spoke to the FY 15-16 auditor's comments and the presentation staff provided to Council regarding the subject matter in an open forum. Committee Member Paul recommended establishing a sub-committee to meet and confer with the District Attorney's office to obtain additional information regarding the case. City Manager Chan recommended that this meeting take place subsequent to the investigation's conclusion. Committee Member Schmidt recommended taking full advantage of the situation we're in; in that we have an opportunity with the forensic accountants to improve the controls in place for the better. If the issues are pertaining to staffing resources, then acquire additional staffing. Committee Member Schmidt reminded the Committee that it was the current staff that found the alleged embezzlement. He and City Manager Chan agreed that an action item to the public at the conclusion of the auditors' reports would be prudent. Committee Member Schmidt continued to urge that additional staffing is necessary due to what he's seen over the years as well as an internal audit function. Committee Member Paul inquired as to the issues discussed around implementation in 2014/15 and wondering what we could have done to expedite the clean-up/reconciliation process. City Manager Chan stated that it is management's responsibility to communicate the needs and establish a level of accountability. Committee Member Luther further recommended determining where the "debit" went in the deposit liability reductions. Finance Manager Korach clarified that the activities did not appear to "wash through" the income statement and that only the deposit liability and cash accounts were affected. Additionally, the records and underlying information pertaining to the liability reductions were not directly associated with customer accounts. As a result, staff is unable to discern which, if any, developers/customers had balances affected. Committee Member Schmidt recommended items for follow-up as noted below:

Actions/agenda items for the subsequent Audit Committee meeting slated for December 11, 2018 are to include a clarifying analysis and discussion of the aforementioned. Specifically as to how this alleged scheme took place as well as the

procedures/practices in place to reasonably ensure something like this does not occur in the future.

2. ADJOURNMENT

Chairman Schmidt moved to adjourn the meeting, Mayor Paul seconded, adjourned the meeting at 4:57pm.

Zach Korach
Recording Secretary