

CONTROL ENVIRONMENT ASSESSMENT AND MANAGEMENT REPRESENTATIONS UPDATE

EXECUTIVE SUMMARY

This report provides the Audit Committee the annual update on the control environment, including matters with respect to financial reporting, within The City and information on the management representation letter process.

ADMINISTRATION RECOMMENDATION(S)

That the Audit Committee receives this report for information.

PREVIOUS COUNCIL DIRECTION / POLICY

The Audit Committee's Terms of Reference (AC2008-13 received by Council, 2008 November 03) state that regarding Internal Control, it "receives an annual report from Administration on the control framework within The City and how that framework serves to prevent fraud and error and ensure safeguarding of City assets."

At the 2013 April 18 Audit Committee meeting, Administration provided an annual Control Environment Assessment and management representations (AC2013-0332), which was received for information.

Audit Committee updated their terms of reference on 2011 November 07, which was approved by Council on 2012 November 05 (AC2012-0726) and became a bylaw 2013 October 21. Audit Committee's responsibilities regarding internal controls are outlined in these Terms of Reference.

BACKGROUND

Administration has provided an annual control environment assessment and management representation since 2009. Since 2009, Administration has reported that the overall control environment over The City's financial reporting is strong. In certain cases where internal controls continue to be updated, for example, in Tangible Capital Assets (TCA), Administration is committed to ongoing continuous improvement.

On June 20, 2013 the City of Calgary experienced a major flood event that caused significant damage to The City's Tangible Capital Assets ("TCA"). Due to this emergency, a State of Local Emergency (SOLE) was declared. While The City has completed a substantial portion of the work to restore conditions to pre-flood, it is expected that remediation and mitigation efforts will continue into 2014 and beyond. Eligible costs are expected to be claimed through insurance and The Province of Alberta through the Disaster Recovery Program. The City has estimated the total cost of capital spend related to the flood to be approximately \$445 million which includes repairs, replacements, and mitigation strategies. In addition, The City incurred approximately \$43 million for emergency operating and recovery costs. Appropriate controls and management oversight were put in place to ensure flood expenditures were tracked separately (see Attachment 1 for further information).

INVESTIGATION: ALTERNATIVES AND ANALYSIS

The annual assessment of the control environment is based on the integrated internal control framework of the Committee of Sponsoring Organizations of the Treadway Commission (i.e.,

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the COSO Internal Control – Integrated Framework). This comprehensive framework for evaluating internal controls is required for Sarbanes-Oxley Act (SOX) compliance and is the model of choice in other jurisdictions, including Canada.

The COSO integrated framework is comprised of five inter-related components: control environment, risk assessment, control activities, information and communication, and monitoring. These components can be described as:

“The *control environment* provides an atmosphere in which people conduct their activities and carry out their responsibilities. ...Within this environment, management assesses *risks* to the achievement of specified objectives. *Control activities* are implemented to help ensure that management directives to address risks are carried out. Meanwhile, relevant *information* is captured and *communicated* throughout the organization. The entire process is *monitored* and modified as conditions warrant.” (Internal Control – Integrated Framework, COSO, 1994 July, p. 17).

For internal controls to be deemed effective, all five components must be present and functioning as intended.

Based on the review (see Attachment 1), Administration's overall conclusion is that the control environment over The City's financial reporting is strong. Administration is committed to ongoing continuous improvement of internal control processes and appropriate resources are being assigned as required. A risk-based approach and culture are being embedded amongst the staff through Administration training initiatives. In certain cases where internal controls continue to be updated, for example in Tangible Capital Assets (TCA), and therefore were not fully in place and weaknesses existed, adequate and appropriate compensating controls were put in place to ensure an overall strong control environment for The City. Administration has developed and is tracking business unit and departmental-specific TCA sustainment plans to complement the corporate plan and ensure that appropriate internal control activities are embedded within TCA activities. Additional details are provided in Attachment 1.

Administration continues to keep on top of current developments in internal control and to implement 'best practice' for municipalities, where appropriate.

The City Manager, Chief Financial Officer (CFO), General Managers (GMs), Directors, the City Treasurer and other senior management sign the Management Representation Letters (MRLs) as part of the annual financial reporting process. The annual MRLs are management's declarations indicating that the financial statements are fairly presented in all material respects, and in accordance with Generally Accepted Accounting Principles (GAAP). Administration's representations are also relied upon by the external auditor during the annual audit process. The City Manager, CFO and City Treasurer sign the overall MRL representing that to the best of their knowledge and belief, the financial statements are accurate and represent the financial position and activities of The City. They rely in part on the representations made within each business unit (i.e., the cascading representations). Individuals in the business units are responsible for those items that they should have reasonably been aware of, given their position and responsibilities. These MRLs will be completed prior to the presentation of the financial statements to the April meeting of the Audit Committee.

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In accordance with historical practice, information and guidance is provided to those individuals required to sign the MRLs to ensure they fully understand their responsibilities and accountabilities when providing their representations.

Recent Developments

A new COSO Framework was released in May 2013. For organizations that must comply with SOX (not required for Municipalities), The 1992 Framework may be used until December 15, 2014. The new framework, which, in substance, is essentially the same as the 1992 version, includes the following changes:

- The existing five components of internal control are expanded to include 17 formal principles (see Attachment 2), these 17 principles were implicit in the narrative of the 1992 framework
- In addition to financial reporting controls, there is an emphasis on compliance and operational controls
- The new framework reflects the increased relevance of technology and has an increased emphasis on risk and fraud

The City will assess when to transition the Control Environment Assessment Report to the new framework (TBD). There is no significant risk for not transitioning to the new framework as The City is not required to comply with SOX. In addition, we consulted with 8 Canadian Municipalities on whether they evaluate their internal control environment on an annual basis and found that none conduct this annual assessment.

Stakeholder Engagement, Research and Communication

The contents and recommendations of this report are developed using a process of gathering information from various business units. The process relies on the information provided by the business unit's respective Finance Managers and Directors and the management representations made within each business unit (i.e., the cascading representations). Individuals in the business units are responsible for those items that they should have reasonably been aware of, given their position and responsibilities. Upon request, detailed information on items included in Attachment 1 is available from the respective areas.

In addition, the contents, attachments and recommendations of this report have been reviewed with the City Auditor, The City's Integrated Risk Management staff, Human Resources staff and Environmental Health and Safety staff.

Strategic Alignment

Strong internal controls are embedded in the financial reporting processes within The City. These internal controls, along with the annual management representations, align with Council's Fiscal Plan objective of becoming a more effective and disciplined organization.

Social, Environmental, Economic (External)

No implications have been identified with this report.

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Financial Capacity

Current and Future Operating Budget:

There are no budget implications for this report. The ongoing management and monitoring of internal control is included within the existing operating budget.

Current and Future Capital Budget:

No implications have been identified with this report.

Risk Assessment

The City has maintained its excellent credit rating of AA+ from Standard & Poors and R-1 (High) and AA (High) from Dominion Bond Rating Service confirming that The City is well-managed and financially stable. The City's 2012 Annual Report received the Canadian Award for Financial Reporting from the Government Finance Officers Association (GFOA) in recognition of excellence in government accounting and financial reporting. The City will apply for the 2013 award and will endeavour to ensure that all requirements are met.

The City's rating and reputation could be at risk if a significant breakdown in internal controls over financial reporting impacted The City's ability to achieve its financial reporting objectives. The presence of an appropriate governance structure will allow management to provide reasonable (but not absolute) assurance of The City's ability to achieve its objectives. As such, The City's voluntary compliance with the spirit of the SOX legislation provides greater confidence to the citizens of Calgary.

REASON(S) FOR RECOMMENDATION(S):

As a component of overall Corporate governance practice, this annual control environment assessment and management representations ensures that Audit Committee is informed on the processes to gather information regarding the effective functioning of internal controls and to report those areas where internal controls are effective and those areas where effective internal controls are evolving.

ATTACHMENT(S)

Attachment 1: Control Environment Assessment

Attachment 2: Principles of Effective Internal Control