

# Bankruptcy Controls – Going, Going, ...

## SUMMARY

The Board of Supervisors recently considered a proposal to return the Internal Audit Department to the Auditor-Controller's office – the same reporting structure held partially responsible for the County's 1994 bankruptcy. The 2007-2008 Grand Jury has concluded that the Orange County's Internal Audit Department (IAD) has the formal independence and procedures to meet both public and private internal audit standards.

The Grand Jury recommends that the Internal Audit Department remain independent and continue to report directly to the Board of Supervisors. The Grand Jury found that the current organizational reporting structure provides maximum auditor independence and reinforces Board accountability for the financial security of the County.

As a result of the bankruptcy, the Board in 1995 took steps to shield the Internal Audit Department from any potential management influence. Organizational independence of the Internal Auditor was established by having the IAD report directly to the Board and not to the Auditor-Controller.

Professional and governmental auditing standards require that internal audit organizations be free from personal, external and organizational impairments to independence in auditing matters. The office of County Counsel has concluded that the Internal Audit Department does not report to any department or office it audits. As such the IAD appears to satisfy the GAO [Government Accountability Office<sup>1</sup>] standards relating to organizational independence.

The Grand Jury also recommends that the Board of Supervisors add additional members to the Audit Oversight Committee representing primary stakeholders in the County Treasury, such as one appointed by the Orange County Board of Education to represent school districts and one appointed by the Orange County League of Cities to represent cities.

The failure of the audit function in 1994 contributed to a disaster which cost the taxpayers of Orange County hundreds of millions of dollars. This tragedy may not have occurred had there been an independent system of organizational checks and balances over Treasury operations<sup>2</sup>. The structure of Orange County government, prior to the Chapter 9 filing in December 1994, failed to provide the warning signs necessary to protect the County's solvency. We ignore the lessons learned from the bankruptcy at our own peril. The recent push to re-establish the audit structure existing prior to 1994 is unnecessary, untimely and unwise. The Internal Audit Department serves Orange County well and should not be tampered with.

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<sup>1</sup> Previously known as General Accounting Office

<sup>2</sup> The 1994-1995 Grand Jury Treasury Controls Study

## **REASON FOR THE INVESTIGATION**

The 2007-2008 Orange County Grand Jury received information that the County of Orange Board of Supervisors had considered the transfer of the Internal Audit Department to the Auditor-Controller's office. This would supersede the Board's 1994 resolution which established the independent Internal Audit Department reporting directly to the Board of Supervisors.

## **METHOD OF INVESTIGATION**

Interviews were conducted with the management and staff of the Internal Audit Department, the Auditor-Controller, the County Executive Office, County Counsel's office and the staff of the County of Riverside Internal Audit Department.

Various documents were reviewed including but not limited to the 1994-1995 Orange County Grand Jury Final Report, County Resolution 95-271, Internal Audit Department Charter adopted December 17, 2002, Orange County Board of Supervisors Minute Order dated February 6, 2007, including a proposal to return the Internal Audit Department to the Auditor-Controller's office, the Auditor-Controller Annual Report for 2007, the Internal Audit Department 2007 Business Plan and the External Quality Assessment of Orange County's Internal Audit Department (commonly referred to as a peer review).

Panel members also attended two Audit Oversight Committee meetings and reviewed AOC meeting minutes for 2006 and 2007.

## **BACKGROUND AND FACTS**

### **Establishment of the Internal Audit Department**

Following the County bankruptcy, the 1994-1995 Orange County Grand Jury<sup>3</sup> recommended that the Auditor-Controller office be separated into two functions because "combining both functions is a clear and significant violation of internal controls." It concluded that "the Auditor, whose role is to validate the integrity of financial results of various County operations, cannot report to the County's chief accounting official and remain independent. Independence is the key to an effective audit function."

According to the 1994-1995 Grand Jury, prior to the bankruptcy, the release of internal audit reports had been delayed when the internal audit function reported to the elected Auditor-Controller. As stated in its report, "the most recent internal controls review of the Treasurer's function was not released until approximately 20 months after completion of the field work. Meetings with the County Auditor revealed that the average delay for all audit report publication is 12 months." A delay of this magnitude does not allow for timely response to the information presented.

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<sup>3</sup> The 1994-1995 Grand Jury was assisted in its review of the activities of the Treasury function of the County by the consulting firm of Kroll and Associates, Inc. and the resulting report was adopted by the Grand Jury as its own.

On April 25, 1995, the Internal Audit Department was established as a separate independent department and removed from the Auditor-Controller by County Resolution 95-271. According to the IAD Charter adopted on December 17, 2002, the Board of Supervisors established the IAD to optimize auditor independence. The organizational reporting structure defined in the IAD Charter directs that it shall report directly to the Board of Supervisors and be advised by an Audit Oversight Committee designated by the Board. Again, the charter states, “The purpose and intent of this reporting relationship is to clearly establish auditor independence by reporting directly to the Board” instead of to the Auditor-Controller.

County Resolution 95-271 defines an organizational structure that is in compliance with the U.S. Government Accountability Office which demands audit independence. County Counsel’s office has concluded GAO rules relating to government auditors are applicable to the Internal Audit Department since the work performed is exclusively for the County of Orange. The American Institute of Certified Public Accountants Code of Professional Conduct, as defined by Rule 101 of the code, addresses private auditing firms and is not applicable to government audit.

According to this opinion, “The GAO is the government auditing regulatory authority that promulgates standards commonly referred to as the ‘Yellow Book.’ These standards apply to local governments and, as such, the provisions relating to government auditors and independence requirements are applicable to the situation at hand. Standard 3.22 provides that government auditors can be presumed to be free from organizational impairments to independence when reporting externally to third parties if their audit organization is organizationally independent from the audited entity.”

This legal opinion also refers to GAO Standard 3.24 which provides that “if the audit organization’s head is appointed by a legislative body, is subject to removal by the legislative body, and reports the audits to and is accountable to a legislative body, the government audit organization can be presumed to be organizationally independent. Standard 3.30 further provides that ‘the audit organization’s independence is enhanced when it also reports regularly to the entity’s independent audit committee and/or the appropriate government oversight body.’”

To further promote independence and relieve the Internal Audit Department from inappropriate management influence, Resolution 95-271 provides that the Director of Internal Audit is appointed by the Board of Supervisors and is subject to removal by the Board of Supervisors. County Counsel concluded that “the Internal Audit Department does not report to any department or office that it audits. As such Internal Audit appears to satisfy the GAO standards relating to organizational independence.”

## **Audit Oversight Committee**

The County of Orange Audit Oversight Committee (AOC) was established in conjunction with the creation of the Internal Audit Department. The AOC is charged with IAD oversight and serves as an advisory committee to the Board of Supervisors. This committee oversees the quality of financial reporting activities and reviews audit results of County programs over which the Board of Supervisors has authority. Procedurally the Audit Plan is developed by the Internal Audit Department based upon a countywide risk assessment including such factors as financial volume and activity, prior audit coverage, external audit coverage and meetings with the Board of Supervisors and the County Executive Office. The Audit Plan is submitted, discussed and approved at the beginning of each fiscal year by the AOC.

Membership of this oversight committee presently consists of the following: The Chairman and Vice-Chairman of the Board of Supervisors, the Auditor-Controller, the County Executive Officer, the Treasurer-Tax Collector as a non-voting member, and one member from the private sector appointed by the Board.

One of the primary audit responsibilities of the County is the mandated quarterly and annual audits of the Treasury. Audit Oversight Committee membership does not include representatives from two of the primary stakeholders in the County Investment Pool: the county's cities and school districts.

## **AOC Requested Research of Other Internal Audit Functions**

Orange County's organization model was unique when it was established. It was created after a financial crisis resulting from an operational failure. At present, Orange County is the only county in California in which the internal audit function reports to the Board of Supervisors. Since the various private industry failures which led to the Sarbanes-Oxley Act of 2002, there has been a pronounced shift towards increased auditor independence in government structure.

The Audit Oversight Committee recently asked the Internal Audit Department to identify other counties and cities throughout the United States that have an independent internal audit function similar to Orange County's where the IAD reports directly to the elected county supervisors or city councils and has no management duties.<sup>4</sup> The IAD report summary states that "An average of 50% of the largest Cities and Counties in the U.S. have established an internal audit department similar to Orange County that reports directly to either the elected County Supervisors or elected City Council and performs no management duties."

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<sup>4</sup>Results of Research Requested by the OC Audit Oversight Committee Regarding the Prevalence of the OC Internal Audit Department Model Report No. 2702-A, dated November 2, 2007. AOC Meeting 11/7/07, Item 5.

## **State Law Supports Independence of Internal Audit**

Senate Bill 1452 was signed by the governor on September 25, 2006. Section 1 states that: Section 1236 of the Government Code, is amended to read: “All city, county, city and county, and district employees that conduct audit activities of those respective agencies shall conduct their work under the general and specific standards prescribed by the Institute of Internal Auditors or the Government Auditing Standards issued by the Comptroller General of the United States.” The standards specifically provide that auditors should be independent of the activities they audit.

Under this law, Part 3.5, Section 13887 states that in order to achieve independence and objectivity, the chief internal auditor and the internal audit operation shall be accountable to the head of the agency and be organizationally outside the staff or line management function of the unit under audit. The chief internal auditor shall also be accountable to the audit committee of the governing body and report audit findings and recommendations to the audit committee.

The Orange County’s Internal Audit Department currently reports to the Board of Supervisors which acts as the head of the county or “agency.” As such, the IAD is outside of the line management of any unit under audit and is in compliance with the requirements of SB 1452.

## **Regulation Summary**

Current standards are evolving with recent changes in the field of auditing standards. The most rigid of these are the Government Accountability Office Standards which emphasize that audit organizations must be free from organizational impairments to independence with respect to the entities they audit. Such impairments can result when the audit function is organizationally located within the reporting line of the areas under audit.

## **Qualifications of Existing Internal Audit Department**

Establishing the Internal Audit Department as a separate specialized unit has facilitated the professional development of the Orange County IAD. It is the only IAD of a large county in the nation whose entire audit staff possesses a Certified Public Accountant (CPA) designation, and 80% of the staff has earned multiple certifications. The 14 professional staff currently holds the following certifications:

Certified Public Accountant	(CPA)	14
Certified Compliance and Ethics Professional	(CCEP)	1
Certified Internal Auditor	(CIA)	9
Certification in Control Self-Assessment	(CCSA)	3
Certified Fraud Examiner	(CFE)	3
Certified Fraud Specialist	(CFS)	1
Certified Information Systems Auditor	(CISA)	5
Certified Information Tech. Professional	(CITP)	1
Certified Government Financial Manager	(CGFM)	1

The County's Internal Audit Department follows the professional standards of the Institute of Internal Auditors, the U.S. Government Accountability Office and the American Institute of Certified Public Accountants.

### **External Quality Assessment of Internal Audit Department**

The Institute of Internal Auditors (IIA) and the Government Accountability Office auditing standards require that internal audit functions obtain external quality assessments to assess compliance with standards and to appraise the quality of their operations (called a peer review). Recently, the Director of Internal Audit requested a quality assessment for the Orange County Internal Audit Department in accordance with the IIA Professional Practices Framework and as required by California Government Code, Section 1236. This assessment was performed from July 30 to August 1, 2007, for the prior three-year period. The peer review was performed by the County of Riverside Office of the Auditor-Controller and found that "Orange County's IA activity *fully complies* with the Institute of Internal Auditor's *International Standards for the Professional Practice of Internal Auditing*. This opinion means policies, procedures and practices are in place to implement the standards and requirements necessary for ensuring independence, objectivity and proficiency of the IA function." [*Italics were present in original text.*]

### **INTERNAL CONTROLS – Going once...**

#### **Additional Internal Audit Division lacks structural independence**

The Auditor-Controller has established a new Internal Audit Unit to perform audits mandated by Government Code Section 25250. This code requires the Auditor-Controller to perform certain mandated audits. Initially the Auditor-Controller chose to contract with the Internal Audit Department for the performance of mandated audits. As of Fiscal Year 2007, the Auditor-Controller has chosen to discontinue the contract with the Internal Audit Department to perform these audits, specifically the biennial audits of the Probation Department (Welfare and Institutions Code Section 275), and the quarterly verifications of assets in the County Treasury (Government Code Section 26920).

While the Auditor-Controller has statutory authority to conduct these audits, the creation of this separate unit under the Auditor-Controller's office erodes the post-bankruptcy controls recommended by the 1994-1995 Grand Jury and implemented by County Resolution 95-271. This separate unit is estimated to cost the county approximately \$500,000 in additional salaries. This does not include the cost of training and certifying inexperienced auditors or the cost to obtain a peer review every three years. These mandates have been successfully performed by the Internal Audit Department at the Auditor-Controller's request since 1996 (Treasury Funds) and 1997 (Probation Department). The Auditor-Controller has always been complimentary of the work performed by the IAD.

As stated earlier, Government Accountability Office (GAO) standards require that audit organizations must be free from organizational impairments to independence with respect to the entities they audit. Optimum organizational independence requires that the audit function be located outside the reporting line of the areas under audit. As such, by GAO standards, the Auditor-Controller lacks the requisite independence to operate an independent Internal Audit Unit.

The Auditor-Controller is the County's Chief Accounting Officer per Board Resolution 82-162, dated February 2, 1982. The County Executive Office response to the 1994-1995 Grand Jury report stated that "the Board of Supervisors established an Internal Audit Department, reporting directly to the Board of Supervisors. This action, in essence, has separated the audit function from the Auditor-Controller's office, which now functions primarily as a Controller."

The Auditor-Controller is responsible for all accounting and financial reporting for the County. Among the many duties of the Auditor-Controller is the preparation of the Treasurer's investment account reconciliation between cash and investments. The American Institute of Certified Public Accountants states that independence shall be considered impaired if during the period covered by the financial statements the auditor is simultaneously associated with the client. More simply stated, an auditor cannot audit his own work and be considered independent. The Auditor-Controller's staff prepares the Treasurer's investment account reconciliation as well as investigates and resolves any variances for each of the funds controlled by the Treasurer's Office. Therefore, the Auditor-Controller's Internal Audit Unit is performing a self-audit.

### **No Independent Internal Audit of the Treasury**

The Auditor-Controller sits on the Treasury Oversight Committee, prepares the Treasurer's investment account reconciliations and now performs the Treasury Fund audits. Only the Board of Supervisors is authorized by California Government Code Section 2700.3 to invest surplus cash for the county. (Currently delegated to the Treasurer pursuant to Section 53607 on an annual basis) Now that the Auditor-Controller is performing the audit of the Treasury Funds, the Board of Supervisors' independent Internal Audit Department has no audit presence in the Treasurer's Office.

### **INTERNAL CONTROLS – Going twice...**

On February 6, 2007, the Board of Supervisors considered a resolution to "re-establish an Internal Audit Unit within the office of the Auditor-Controller," superseding Board Resolution 95-271. The proposed Board resolution directed that:

- The Director of Internal Audit be appointed by the Auditor-Controller and report directly to the Auditor-Controller
- The Auditor-Controller shall have sole authority to direct the Director of Internal Audits, or any staff person within the IAD
- The Auditor-Controller shall have sole authority to assign employees of the Auditor-Controller to any function within the IAD or within any other department of the Auditor-Controller

The proposal failed to pass, with two votes for and two against and one seat vacant at the time.

The resolution would have given the Auditor-Controller sole discretion regarding the operation of the department including the appointment of the Internal Audit Director. This is a clear violation of audit independence as the Internal Auditor would have reported to the same department head as the operations under audit. The Institute of Internal Auditors Standards are similar to those set forth in the “Yellow Book” [Generally Accepted Government Auditing Standards] and clearly state that Internal Auditors should be independent of the activities they audit, including organizational status and objectivity.

The Board’s proposal contained an “ethical curtain” where all functions except Internal Audit report to the Assistant Auditor-Controller. This proposed organizational structure does not negate the fact that the Internal Auditor would have reported to the same department head as the operations under audit. The Government Accountability Office disqualifies internal auditors working for Auditor-Controllers from conducting “governmental audits” due to the lack of independence. Currently the County Auditor-Controller is the Chief Accounting Officer of the county and is responsible for all the accounting forms and methods, departments/agencies, institutions and districts under the control of the Board of Supervisors.

The 2007-2008 Grand Jury found the Board’s proposal also eliminated public review of the Audit Plan. If the Auditor-Controller is able to direct the internal audit unit outside the scrutiny of the Board of Supervisors or an Audit Oversight Committee, both of which conduct public meetings, the Auditor-Controller would be in a position to influence internal auditors through appointment and promotion. These factors could influence the scope, content or release of an audit.

Justification for the Board’s proposal to relocate and restructure the Internal Audit Department included additional training opportunities for employees through rotation of personnel. The rotation of assignments between accounting line or field assignments and the auditing structure of Internal Audit could increase effectiveness of both functions. This rotation could provide future line managers a better appreciation for internal controls and give auditors operational perspective gained from line experience. However, co-mingling the functions would undermine the ability of auditors to maintain objectivity and the appearance of independence. Future job assignments and/or promotions could impact the impartiality of the field work despite a proposed two-year delay before transfers to areas that had been audited. Since cross-training and certification qualifying experience for retention or recruitment could be accomplished through coordinated training programs and staff development initiatives, as suggested by the Director of Internal Audit, there is no need to transfer the Internal Audit Department to the Auditor-Controller’s department.



## **FINDINGS**

In accordance with California Penal Code sections 933 and 933.05, each finding will be responded to by the government entity to which it is addressed. The responses are to be submitted to the Presiding Judge of the Superior Court. The 2007-2008 Orange County Grand Jury has arrived at the following findings:

- F-1 The current organizational structure of the Internal Audit Department satisfies the most rigid of requirements for independence and objectivity required by the U.S. Government Accountability Office and the Institute of Internal Auditors. These organizations specifically state that audit organizations must be free from organizational impairments to independence with respect to the entities they audit.
- F-2 The Audit Oversight Committee structure lacks representation from two of the primary stakeholders of the County Investment Pool: the educational institutions and other governmental entities in Orange County.
- F-3 After a resolution to revoke County Resolution 95-271 and return the Internal Audit Department to the Auditor Controller's office failed to pass, the Auditor-Controller refused to renew the existing contract with IAD to perform audits mandated by state statute.
  - F.3.1 Although the Auditor Controller's office has statutory authority to conduct certain mandated audits, the creation of a separate IAD within the Auditor Controller's office to perform such audits erodes some of the post bankruptcy controls.

**Responses to Findings F-1 through F-3 are required from the Board of Supervisors**

## **RECOMMENDATIONS**

In accordance with California Penal Code sections 933 and 933.05, each recommendation will be responded to by the government entity to which it is addressed. The responses are to be submitted to the Presiding Judge of the Superior Court. Based on the findings of this report, the 2007-2008 Orange County Grand Jury makes the following recommendations:

- R-1 Preserve the current organizational structure of the Internal Audit Department. This is defined in Resolution 95-271 as a separate independent department removed from the Auditor-Controller and reporting directly to the Board of Supervisors.
- R-2 Add additional members to the Audit Oversight Committee such as one appointed by the Orange County Board of Education to represent school districts and one appointed by the Orange County League of Cities to represent cities.
- R-3 Authorize the Internal Audit Department to perform separate Quarterly Audits of the Statements of Assets held by the County Treasury for the Board of Supervisors to re-establish the Board's independent audit presence in the Treasurer's Office, even though the Auditor-Controller has statutory authority to conduct these mandated audits

**Responses to Recommendation R-1 through R-3 are required from the Board of Supervisors**

## **REQUIRED RESPONSES:**

The California Penal Code specifies the required permissible responses to the findings and recommendations contained in this report. The specific sections are quoted below:

### §933.05

- (a) For purposes of subdivision (b) of Section 933, as to each grand jury finding, the responding person or entity shall indicate one of the following:
  - (1) The respondent agrees with the finding.
  - (2) The respondent disagrees wholly or partially with the finding, in which case the response shall specify the portion of the finding that is disputed and shall include an explanation of the reasons therefore.
- (b) For purposes of subdivision (b) of Section 933, as to each grand jury recommendation, the responding person or entity shall report one of the following actions:
  - (1) The recommendation has been implemented, with a summary regarding the implemented action.
  - (2) The recommendation has not yet been implemented, but will be implemented in the future, with a timeframe for implementation.
  - (3) The recommendation requires further analysis, with an explanation and the scope and parameters of an analysis or study, and a timeframe for the matter to be prepared for discussion by the officer or head of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This timeframe shall not exceed six months from the date of publication of the grand jury report.
  - (4) The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation therefore.