OC Internal Audit

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Summary

This white paper provides the background and justification to return the audit function to its mandated role as part of an independent Auditor-Controller's department. The plan will improve operations, add safeguards, retain the oversight committees and make the process more accessible and transparent to the benefit of the County Board of Supervisors and Orange County taxpayers. It will remove any actual or perceived conflict of interest between the Board of Supervisors and Internal Audit. It will not change the authority of the Board of Supervisors to retain outside auditors to provide audit services at the direction of the Board or to review the work of the independent Auditor-Controller. It will reduce costs by consolidating duplicative efforts, streamlining accounting functions and increasing fiscal control.

This proposal is not to return exactly to the governance of Internal Audit that was in place before Orange County's bankruptcy. Rather, drawing on the experience since the bankruptcy, we propose a new the governance structure that is transparent, creates the greatest value for the taxpayers and allows the Auditor-Controller to fulfill the legally mandated duties.

History

According to California Government Code Section 26881, the County Auditor-Controller is the Chief Accounting Officer for the county. In most counties, the Auditor-Controller is an independent, nonpartisan elected official responsible for budget control, disbursements and receipts, and financial reporting. In all California counties, *except* Orange, the Auditor-Controller's office is responsible for independent audits of certain agencies within the county.

Bankruptcy

Following the county bankruptcy in December 1994, in order to refinance the county's debt, the Board of Supervisors needed to demonstrate to Wall Street that those responsible for the bankruptcy were no longer in charge. By early 1995, Treasurer-Tax Collector Robert Citron had resigned and admitted to criminal wrongdoing. To demonstrate to Wall Street that sufficient changes were in place the County Executive Officer made a deal with the sitting Auditor-Controller to create the Internal Audit structure we currently have.

Post-Bankruptcy

The net result was the elected Auditor-Controller was left with basic bookkeeping and check writing responsibilities and unable to perform the office's mandated oversight, effectively turning the County Auditor-Controller into simply the County Controller. The policy was never intended to be a long-term solution and was not a long-term policy decision. In fact, while it solved a temporary crisis, it created several inherent conflicts:

- Internal Audit was no longer independent from the Board of Supervisors.
- A majority vote is required to authorize an audit. In cases where the Board is split on an issue, the minority board members are unable to request an audit or hire outside auditors.
- Without true independence, any audit could be viewed as influenced by the Board, as they hire/fire the Internal Auditor.
- Ironically, by State law, the Auditor-Controller is still responsible for quarterly and annual audits of the County Treasurer's investment pool.

Auditor-Controller's Current Duties

Currently, the elected County Auditor-Controller only has oversight for part of the duties mandated to the office. Orange County is the only county in California that bifurcates these critical functions.

This puts the County's Auditor-Controller at a distinct disadvantage in fulfilling the auditor function, therefore leaving the County's finances in a weakened condition.

- The current Internal Audit structure bifurcates two functions that should be working together – internal control and compliance. Currently the Auditor-Controller does not know the effectiveness of the internal control structure because the compliance function which is the internal audit department is not an integrated part of the Auditor-Controller's office.
- The Auditor-Controller may create internal control safeguards but has no way to determine compliance or effectiveness.
- Internal control compliance and effectiveness is the service of a properly functioning internal audit department in order to safeguard County assets.
- Internal audit oversight strengthens the oversight and transparency of the County's finances.

Benefits of Reinstating Mandated Auditor-Controller Functions

Returning the Internal Audit function to the office of Auditor-Controller achieves the following:

1. **Establishes mandated independence for the county's chief auditing office**. The Internal Auditor will once again be fully independent of the Board of Supervisors and County Departments/managers, placed under the people's elected Auditor.

2. **Streamlines county accounting functions.** Reduces redundant accounting/audit functions and streamlines operations by placing all accounting/audit professionals within a single independent department. Will reduce costs.

3. **Preserves Board of Supervisor's options to retain outside accounting/audit firms**. By a simple majority, the Board of Supervisors can retain outside accounting or audit firms to perform audits it deems necessary.

4. **Preserves oversight options for minority supervisors.** When controversial situations occur, Supervisors lacking majority support on the board may still approach the independent Auditor-Controller and request a review. Under the current structure, minority supervisors can neither retain outside accounting services nor use Internal Audit.

5. **Better operational response from internal audit**. With the Internal Audit function reporting to a single elected official with financial and auditing expertise, the response time to sensitive audits will be quicker and more accountable.

6. **Better training and development of auditors and rotation of audit staff.** Having the Internal Audit function overseen by the elected Auditor-Controller would create more opportunities for auditor rotation, mirroring the Best Practices promoted for public companies by Sarbanes-Oxley, the new auditing rules enacted for public companies after the Enron scandal. This would help guarantee that there is no auditor or audit management fatigue or complacency when conducting audits.

7. **Development and retention of our future line managers.** In California's other 57 counties, the Internal Audit office is the training ground for the County's future financial managers and leaders because the auditors who rotate through Internal Audit receive a very detailed and analytical view of divergent County departments. This provides an exceptional insight into how the County functions and operates. Unfortunately, Orange County's fragmented audit function does not provide for maximum retention of institutional knowledge across departments on a countywide basis. The current internal audit department is top heavy with Administrative Manager positions–a very unique structure not often replicated in other counties, CPA firms, or private companies. The structure of most audit

departments within government and public accounting firms are based on mentoring and apprenticeship with greater auditor rotation and better succession planning. “Journey level” auditors would perform the field work while the mentors would manage the audit process. As audit managers move on to other financial management positions within the County, the field auditors move into the ranks of the audit managers ensuring that the County’s internal audits will continue to be fresh, with less complacency while still retaining our institutional memory.

8. **Edge in recruiting new employees**. Many accounting graduates want to work for diverse organizations or CPA firms out of college so that they can earn their CPA licenses through the training they receive in a variety of assignments. To further challenge our recruiting efforts, Baby Boomers will continue to retire over the next 10-15 years, and many critical vacancies within the County will be created. The Generation X’ers will fill up many of these vacancies left by the Baby Boomers, and the need to attract and retain Millennials will be critical for the County to maintain a skilled work force to provide services to the public. Once the Auditor-Controller oversees all Internal Audit functions, there will be a path for accounting graduates.

9. **Reduced costs and overhead**. The current Internal Audit department is very small but still incurs significant overhead. By absorbing the Internal Audit department into the Auditor-Controller’s office, the related overhead costs of having such a small department will be eliminated. Orange County has a greater proportion of administrative support for its Internal Audit staff than any other California county. The proposed structure brings financial savings over the current structure. The mix of field auditors and audit managers costs significantly less than the current structure of highly compensated Administrative Manager positions. Depending on the audit needs, the number of auditors could be increased for the same cost or the overall cost of conducting internal audits could be reduced.

10. **Broader scope and coverage of audits because of the Auditor-Controller’s focus on the county’s processes**. Under the Auditor-Controller, Internal Audits will focus more on how to safeguard the County’s assets by strengthening the internal control structure. The audits of controls will be based on a countywide basis, and then focused on a specific county department. The ultimate goal of Internal Audits will be internal control compliance and enhancement. The Auditor-Controller’s office is charged with the creation and maintenance of the County’s internal control structure that would be the focus of the Internal Audit function overseen by the Auditor-Controller. With a broader scope under the Auditor-Controller’s office, systemic problems plaguing multiple County departments would be more easily uncovered.

Proposed Structure for Internal Audit under Auditor-Controller

The current staffing of the Internal Audit department suffers from too many Administrative Managers and not enough line employees. That has led to high costs and stagnation. In a private sector structure, audit staff naturally rotates through departments as they advance in their careers. This creates an opportunity for staff rotation and fresh eyes that bring new ideas and observations to the internal audit process. Over time, the Auditor-Controller will create a structure similar to a private CPA firm and to other County Departments that is a balance of field auditors and senior auditors managed by audit managers. This streamlined structure will result in savings and efficiencies, as outlined above under "Benefits to Reinstating Mandated Auditor-Controller Functions."

"Audit Team" Structure

The current Internal Audit department, including personnel and budget, will be placed under the direction of the elected Auditor-Controller. However, the operation will be restructured into teams. This will create the balance needed to retain institutional memory and skill from experienced managers with fresh viewpoints from new field auditors. There will be more flexibility as audit managers rotate because staff can be moved from audit team to audit team, and whole teams can be moved from manager to manager if the need arises. Using staff at differing stages of their careers will "build a bench" within the department. Currently, the department is vulnerable to turnover because many of the staff is close to retirement age, and there are not enough junior level managers ready to move up in the ranks. This new approach saves money while providing the County with a streamlined service, more continuity, and more opportunities to strengthen County finances by creating employees with a board base of knowledge of how the County operates. This will be critical for the County as the Baby Boomers continue to retire, and the need to attract and retain new employees becomes essential.

- Each audit team will have three to four field auditors overseen by a senior auditor.
- Two or three audit teams will be assigned to an audit manager.
- The audit managers will report to the Director of Internal Audit, who will report directly to the elected Auditor-Controller.

Whistleblower Hotline

A whistleblower or fraud hotline is a critical component to creation and maintenance of any internal control system. It is the ultimate safety valve for the public or county employees to report waste or non-compliance to the internal auditor. While nothing prohibits another County department from operating its own hotline, California Government Code Section 53087.6 explicitly gives the Auditor-Controller the power to operate a "whistleblower hotline to receive calls from persons who have information regarding fraud, waste, or abuse by local government employees." Because this is a part of the integrity of internal auditing and a mandate to the Auditor-Controller, a fully integrated whistleblower hotline will be a key component to the Auditor-Controller's internal audit function.

Retain Audit Oversight and Treasury Oversight Committees

The current structure of the Audit Oversight and Treasury Oversight Committees will be kept in place to facilitate input and transparency from the public and the Board of Supervisors into the Auditor-Controller's operation.