Independent Auditing within Ventura County Government

Background

Recent instances of national failure in the auditing process have caused the Comptroller General of the United States to issue new government standards for the independence of audit agencies. This guidance was in the form of a revision of Government Auditing Standards Amendment No. 3 *Independence* (Amendment No. 3). This standard will apply for all audits for periods beginning on or after January 1, 2003. The Grand Jury was motivated by this change to review this new policy and assess the impact on the Ventura County audit processes. There are three kinds of audits: financial, attestation engagements and performance audits. These are described in Appendix A.

Internal auditing is key to sound government operations. Internal auditing involves attestation engagements and performance auditing. It reviews the reliability and integrity of information, compliance with policies and regulations, the safeguarding of assets, the economical and efficient use of resources, and established operational goals and objectives. Internal audits encompass financial activities and operations including systems, administration, program implementation and human resources. A key dimension of internal auditing is the evaluation of departmental internal controls. This is discussed in Appendix B.

Methodology

The Grand Jury reviewed the audit policy published in the County administrative manual as well as the organization for auditing within the County. It reviewed the internal control and audit process as well as the status of ten audits each of which took from one to two years to produce a final report. It reviewed past Grand Jury reports on the audit process. It met with the Auditor-Controller and senior County management. It met individually with current and past members of the audit staff. It reviewed portions of the California Code and Auditing Standards with respect to audits and internal control. With the help of the office of the Clerk of the Board it reviewed the Board of Supervisors agenda items associated with audits for the past fifteen years. It held meetings with agencies responsible for internal audit in Santa Barbara and Orange Counties. The Grand Jury assessed the impact of the new Comptroller General of the United States policy on the County audit process.

Findings

F-1. The Board of Supervisors has the fiduciary responsibility for all County government.

F-2. The County Executive Officer is the Board of Supervisors' agent in implementing the County's internal control system.

F-3. The Auditor-Controller is the Board of Supervisors' agent for implementing an independent audit. This is discussed in Appendix C.

F-4. With respect to the new auditing standard the Board of Supervisors is the head of County Government. Appendix D.

F-5. In the California Government Code, the Legislature has found that it is essential to establish audit procedures that conform to Federal standards of independence and quality.

F-6. In terms of full time employees, auditors represent a small fraction of the employees of the Office of the Auditor-Controller.

F-7. Some of the other important business and accounting functions of the Auditor-Controller are:

- Claims and Disbursing
- Payroll
- General Ledger
- Reconciliation of Accounts
- Invoices/Billing
- Collections/Accounts Receivable
- Accounting for Fixed Assets
- Preparing the Comprehensive Annual Financial Report
- Maintaining and developing the County's Accounting System
- Overhead Allocations and Cost Studies
- Accounts Payable

F-8. In 1981 there were 17 auditors. By 1989 there were about a dozen auditors. Currently there are six auditors.

F-9. In Fiscal Year (FY) 1981-1982 the audit department performed 55 audits. In Calendar Year (CY) 1989, 35 audits were on the agenda of the Board of Supervisors. In CY 2000, seven audits were on the agenda of the Board of Supervisors.

F-10. The majority of areas that internal audit would normally address are in the Auditor-Controller's operations or areas where the Auditor-Controller sets accounting policy.

F-11. The current structure places the Auditor-Controller in a conflicting situation when there are differences between the Controller staff and the Audit staff.

F-12. The current audit policy was last issued in 1991 and revised in 1997. It supports a collegial approach to performing the auditing process and states “.audit reports will be discussed with the auditee staff and management. At this point, the focus will be on improving operations and correcting noted deficiencies in a mutually agreed upon manner. The auditee will be given the opportunity to initiate corrective actions on any noted weaknesses."

F-13. On some audits the attitude engendered by the current collegial policy has led to excessive delays between the issuance of a preliminary report and a final report.

F-14. Past Boards of Supervisors had members participating in an Audit Advisory Board. For the current Board of Supervisors, visibility into the audit process has been limited to the end product.

F-15. The value to the Board of Supervisors of some audits is limited due to the excessive time taken to complete the audits.

F-16. Current policy has led to the auditee having too strong an influence over the content of a final audit report.

F-17. Recent attempts to increase size and expertise of the audit staff have been minimally successful.

F-18. The audit staff, in the recent past, was seen by County agencies as not possessing the depth of expertise necessary to do performance auditing of technical functions.

F-19. There is no policy associated with a required response time to draft audits by audited departments. This deficiency has resulted in an inordinate time frame to complete some audits.

F-20. The County administrative manual contains a number of topics associated with internal controls but no explicit internal control policy and no review mechanism.

F-21. Each department, by the nature of its activities, has a unique set of internal controls.

F-22. Efficient audits of a particular activity require an objective statement of internal controls. Such objective statements are not in evidence for some departments. This deficiency can lead to disputes between auditors and management that adversely impacts the timely completion of audits.

F-23. Given the small size of the audit office the standard practice in the office is relatively inefficient in the following ways.

A. Generally auditors work as individuals not as a team.

B. There is no guidance or support provided to working auditors at the beginning of an audit.
C. Feedback by middle management to the audit staff seems only to be provided after substantial effort has been expended.
D. Training is limited.

F-24. Some audit personnel consider the integrity of their efforts compromised by multiple negotiations engendered by the "collegial" approach.

F-25. Other Accounting Standards identify the critical need of the internal audit organization to report to the audit committee of an organization and not to the Auditor-Controller. Appendix E.

F-26. The Benchmarking and Best Practices Survey of the National Association of Local Government Auditors (NALGA) for the year 2000 determined that internal auditing activities returned savings averaging $3.36 per $1.00 spent in internal audit costs. Also, the City of San Jose determined that, from May 1985 through June 2001, $7.00 was returned for each $1.00 of internal audit costs.

Conclusions

C-1.The Board of Supervisors has the fiduciary responsibility to ensure the proper operation of County Government. This responsibility rests on two legs. The first leg is the development and operation of a system of internal controls. The second leg is an effective independent audit process to insure that the system of internal controls is effective. (F-1, F-2, F-3, F-4)

C-2. The current structure of independent audit does not meet the independence criteria of Government Auditing Standards Amendment No. 3. There is an inherent conflict between Auditor and Controller responsibilities. (F-5, F-6, F-7, F-10, F-11, F-25)

C-3. Past administrations have allowed the auditing capability to deteriorate significantly yet the size, complexity and technology of County government have increased significantly over the past ten years. (F-8, F-9, F-17, F-18)

C-4. The existing internal control policies, procedures and practices and audit policies, procedures and practices need to be revised in light of the new policy on independence from the Comptroller General of the United States. (F-5, F-12, F-13, F-14, F-15, F-16, F-19, F-23)

C-5. The perceived independence of the audit process has been eroded due to the current collegial policy. (F-13, F-24)

C-6. There is no clear, focused policy on internal controls within the County government. (F-20, F-21, F-22)

C-7. There is deficiency in oversight by the Board of Supervisors over both internal controls and independent audits. (F-14, F-15, F-17, F-20)

C-8. Internal audit functions can more than pay for themselves. (F-26)

Recommendations

R-1. In order to insure that the County meets the newer standards for independent audit the Board of Supervisors establish an effective oversight mechanism to insure adequate audit resources and independence.

R-2. The Grand Jury recommends the establishment of an Audit Oversight Committee reporting to the Board of Supervisors. This committee would be charged with responsibility for oversight of internal controls and independent audits within the County. It would be composed of a Chair, a Co-Chair, The Chief Executive Officer, the Auditor-Controller, the Treasurer–Tax collector as a non-voting member, and one outside member from the private sector appointed by the Board of Supervisors. The Purpose of this committee would be:

A. Oversee the establishment and maintenance of the County's internal control structure.
B. Oversee the quality of financial reporting activities.
C. Oversee and monitor County compliance with internal controls, pertinent laws, regulations and standards.
D. Oversee the resources allocated to the internal control and internal audit functions.
E. Receive regular briefings from the internal audit staff on all planned and in-process audits.
F. Study the Orange County paradigm to internal audits with a view to avoiding potential audit weaknesses.
G. Review the possibility of separation of the duties of Auditor-Controller. The Auditor responsibilities would return to its elected status while the Controller responsibility would report to the CEO.

R-3. That the Board of Supervisors take active responsibility for internal audit resources including annual budget, staffing size, salaries and position classification. This responsibility would consider the recommendations of the Audit Oversight Committee.

R-4. That, considering the current budget difficulties, the Board of Supervisors be committed to a long term process to turn around a deteriorating situation with respect to independent audits. This effort should include the following:

A. Accept the responsibility for the hiring and termination of the head of the internal audit function. This position should be filled through a nation-wide competitive process. To insure integrity, this position should have a severance package associated with it.

B. All the positions of the internal audit function should be budgeted at the senior level. The actual placement of individuals can be at a lesser level.

C. Develop a plan to improve the quality and effectiveness of the audit function through external recruitment, internal training or in contracting of outside capability.

R-5. That auditing policy be reviewed and revised to focus on the timeliness of audits. At a minimum the revision should require no more than a sixty day time limit for an audited department to respond to all draft audits.

R-6. That draft audit findings be released to the audited organization as quickly as possible without waiting for the completion of the draft report.

R-7. That the Auditor-Controller review and benchmark current audit activities against the Best Practices identified by NALGA. That a team approach be utilized for complex audits to improve the timeliness of audits. This should include peer reviews of planned and in-process audits as well as a “lessons learned” on all completed audits.

R-8. That the County Executive Officer develop a focused policy on internal controls which would act as the enabling policy for all County departments and that the Auditor-Controller provide the technical support and training to implement this policy. This policy would include, after an initial review, a staggered tri-annual review by the County Executive Officer of the internal controls in every County department.

Responses Required

Board of Supervisors (R-1, R-2, R-3, R-4)
Auditor-Controller (R-2, R-5, R-6, R-7, R-8)
Chief Executive Officer (R-2, R-8)

Appendix A

Types of Audits

There are three types of governmental audits.

Financial audits are any audits covered under Generally Accepted Auditing Standards (GAAS) and financial statements.

Attestation engagements relate to such activities as:

- Internal Control
- Compliance
- Allowability and reasonableness of proposed contract fees
- Final contract cost
- Reliability of performance measures

Performance audits are independent assessment of performance and management of an entity, program, service, or activity against objective criteria. Performance audit objectives include:

- Program effectiveness and results
- Economy and efficiency
- Internal control
- Compliance

Appendix B

Internal Auditing and Internal Controls

Evaluating internal controls is one of internal audits primary responsibilities. Internal auditing is an independent appraisal function established within an organization to examine and evaluate the adequacy and effectiveness of the organization's internal control system and its overall quality of performance. Internal auditing furnishes top management with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed.

The purpose of internal controls is to:

- Protect the County's assets
- Ensure records are accurate
- Promote operational efficiency
- Encourage adherence to policies

Generally, internal controls are of two types:

Preventative Controls --- are designed to discourage errors or irregularities from occurring. *Examples are: Processing vouchers only after signatures have been obtained from appropriate personnel. A computer application which checks validity prevents the entry of an invalid account number.*

Detective Controls --- are designed to find errors or irregularities after they have occurred. *Examples are: Reviewing departmental phone bills for personal calls. A comparison of validated Cash Receipt Vouchers to monthly financial statements will detect deposits posted to erroneous accounts*

Ultimately, it is County management's responsibility, not the auditors, to ensure that controls are in place. That responsibility should be delegated to each area of operation. Every employee should have some responsibility for making this internal control system function.

Appendix C

Applicable California Government Code

26880. The board of supervisors may create the office of controller. The office of County controller shall be held ex officio by the County auditor.

26881. The County auditor, or in counties that have the office of controller, the auditor-controller shall be the chief accounting officer of the County.

26883. In addition to the power now possessed by the board of supervisors to enter into contracts for audits the board shall have the power to require that the County auditor-controller shall audit the accounts and records of any department, office, board or institution under its control and of any district whose funds are kept in the County treasury.

26884. In the event the board of supervisors elects to require that the County auditor-controller perform the additional services authorized by this chapter it shall have the power and it shall be its duty to provide by proper appropriations for any additional personnel, equipment, supplies or expenses made necessary thereby.

Appendix D

Elements of Amendment No. 3 of the Federal Government Auditing Standards

The following are elements of Amendment No. 3 of the Federal Governmental Standards:

1. The standard for non audit services is based on two over-arching principles:
    a. Auditors should not perform management functions or make management decisions.
    b. Auditors should not audit their own work or provide non-audit services in situations where the amounts or services involved are significant/material to the subject matter of the audit.

2. The internal audit function is independent when all three of the following criteria are met:
    a. The independent audit function is accountable to the head or deputy head of the governmental entity.
    b. The independent audit function is required to report the results of its work to the head or deputy head of the governmental entity.
    c. The independent audit function is located organizationally outside the staff or line management function of the unit under audit.

3. The audit organization's independence is enhanced when it reports regularly to the entity's independent audit committee and/or the appropriate government oversight body.

Appendix E

Other standards

Elements of the Institute of Internal Auditors (IIA) Standards

Government Code 1236 requires the County to follow internal auditing standards promulgated by the IIA. The IIA standards, Section 1110, states that “The Chief Audit Executive (CAE) should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities.” The IIA issues Practice Advisory 1110-2, dated 3 December 2002 states, “The functional reporting line for the internal audit function is the ultimate source of its independence and authority.” As such, the IIA recommends that the CAE report functionally to the audit committee, board of directors or other appropriate governing authority.

Elements of Government Auditing Standards (GAS) and American Institute of Certified Public Accountants (AICPA)

For audits of federal and state monies, the auditors must follow GAS. For financial opinion audits and other attest audits (such as the annual treasury audit) the auditors must follow the AICPA standards.