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DAVID E. SUNDSTROM, CPA
AUDITOR-CONTROLLER

October 13, 2005

Supervisor Bill Campbell, Chairman
Board of Supervisors, Third District
10 Civic Center Plaza
Santa Ana, CA 92701

Enclosed is the proposal we discussed on October 3, 2005, that would allow me to reassume direct responsibility for my statutory audit mandates. In order to avoid misunderstandings that could result from this type of proposal, I am sharing it with you now far in advance of any potential implementation.

Although I continue to have every confidence in the integrity, objectivity, and skills of the Internal Audit Department, I believe that a different audit perspective, one which directly represents my statutory responsibilities, would be in the best interests of the county. In my view, this is not a proposal to merely change from one outsource provider to another (i.e., from Internal Audit to an external CPA firm) as the Treasury Oversight Committee elected when deciding how to best satisfy its statutory audit requirement. This proposal represents my desire to directly satisfy my legal mandates.

A new Treasurer will likely be assuming office on January 1, 2007. In order to play a significant role in the transition of the office, I am proposing the shifting of direct responsibility for the conduct of the Quarterly Treasury Cash Counts to my office be effective July 1, 2006. This proposal needs to be vetted now for it to be considered in the Auditor-Controller's segment of the County's strategic financial plan, as well as in the preparation of our annual business plan.

As a next step, I propose that this be placed on the agenda for the next Audit Oversight Committee meeting. If you have any questions or further concerns, please call. Thank you for your consideration.

Sincerely,

for David E. Sundstrom, ~~CPA~~
Auditor-Controller

DES:lr

cc: Supervisor Thomas Wilson, Vice Chairman, Fifth District
Supervisor Lou Correa, First District
Supervisor James Silva, Second District
Supervisor, Chris Norby, Fourth District
Thomas Mauk, County Executive Officer
John Moorlach, Treasurer-Tax Collector
Dr. Peter Hughes, Director, Internal Audit Department
David Carlson, Member, Audit Oversight Committee

Proposal for the Reestablishment of a Limited Internal Audit Function within the Auditor-Controller Department

David E. Sundstrom, CPA – Auditor Controller

October 12, 2005

Summary

This is a modest proposal to reestablish a limited internal audit function within the Auditor-Controller. The proposal would require the addition of two positions to perform the Auditor-Controller's mandates of quarterly treasury cash counts and the biennial audit of the Probation Department. The proposal does not change the Board's ability to have its internal auditor perform audits. The proposal allows the Auditor-Controller to directly satisfy his legal mandates, adds no additional costs and provides significant operational enhancements.

Proposal

Background. The internal audit function was separated from the Auditor-Controller Department following the County's bankruptcy. Although this action had some merits at the time, ten years of practice have surfaced several factors that warrant its reconsideration. The following is a brief discussion of these factors and the benefits that could be achieved through reestablishment of a limited internal audit function within the Auditor-Controller Department. The primary purpose of this reestablished division will be to fulfill the Auditor-Controller's legislated audit mandates. In no way is this proposal intended to abridge or otherwise limit the scope of the Board's Internal Auditor, although if this proposal is adopted, the Board may desire to modify its methods for supervising the treasury function.

Current scope of internal audit responsibilities. Currently, the Auditor-Controller employs two staff positions to perform internal audits of some County operations. One is located in the Housing and Community Services Department Accounting Unit and performs regular reviews of grant sub-recipients. Another is located in the Health Care Agency Accounting Unit and performs audits of the host agency's cash handling practices. The Auditor-Controller also "contracts" with the Internal Audit Department to satisfy his mandates to review the treasurer's statement of assets in the county treasury (GC §26920) and biennial audits of the books and accounts of the Probation Department (Welfare and Institutions Code §275). Approximately two additional positions would need to be transferred to the Auditor-Controller's Office to perform these audits. In addition, there is a regular need for ad-hoc reports and analyses. This includes the fiscal analyses of ballot measures (Election Code §9160), requests of the Board of Supervisors to review collective bargaining agreements, requests from the CEO to perform special studies (such as the financial problems facing the Planning Department) and other matters requiring auditing and analysis as determined by the County Auditor.

Proposed scope of internal audit responsibilities and division organization. I propose that an Internal Audit Division reporting directly to the Auditor-Controller be established. At a minimum, the unit should be staffed by four positions that would be exclusively responsible for internal audit work. The Auditor-Controller Department currently has two of the four required positions in the Satellite Accounting Division. Two additional positions to perform the Auditor's mandates would need to be added through the budget process. In addition, three professional positions already in the Auditor-Controller's Staff Services Unit could be added to the Division in order to enhance scheduling flexibility. These positions are periodically loaned to other units to fill short-term staffing needs.

Independence, Governance and the Audit Oversight Committee

Independence would be enhanced by reestablishment of a limited function. Independence would be enhanced because the elected Auditor-Controller has only limited countywide administrative powers that are specified by legislation or that are delegated by the Board. In contrast, the Board has direct responsibility for the treasury's investment pool as well as the Internal Audit Department. Independence would be further assured by submitting our mandated audits to the Board and the Audit Oversight Committee and conducting triennial peer reviews of the internal audit function.

Orange County is the only county in the state which has Internal Audit report outside of the Auditor-Controller's office. It took special legislation to allow this structure. No other county in the ten-plus years since inception of this separate reporting structure has opted to mimic Orange County.

Reestablishment of a limited function would provide the Board with an alternative method for conducting special investigations or examinations. Instances arise where it could be more advantageous to direct the County Auditor Controller to perform a review. Because the Board has both executive and legislative authority over all appointed offices, public perception would be enhanced if the Board were to direct certain special investigations to an office that is directly elected by the people. Government Code §26883 gives the board *"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 on whose funds are kept in the county treasury."* Audits may be directed by the Board through formal resolutions, minute orders, or memos to the Auditor-Controller.

Reestablishment will not adversely affect the Board's audit function. According to Government Code §25250, the Board is required to biennially *"examine and audit, or cause to be audited, the financial accounts and records of all officers having responsibility for the care, management, collection, or disbursement of money belonging to the county or money received or disbursed by them under authority of law."* This would include internal control reviews, information technology audits and investment policy reviews of the Treasurer's Office. In addition, Government Code §26915 allows the Board to *also* direct other county employees to perform the required audits of the Auditor-Controller. Accordingly, the Board can elect to have its internal auditor duplicate the work of the Auditor-Controller, or to review the work of the Auditor-Controller to ensure that its needs are satisfied. Accordingly, adoption of this proposal does not affect the Board's continued direct presence in the Treasurer's Office.

Administration and Other Considerations

Reestablishment would assist in recruiting and the development of staff. The primary question that I am asked during our on-campus recruiting efforts is "how can I become a CPA in your organization?" In addition to passing a rigorous examination, the certification process requires several years of qualifying experience. Reestablishment of this audit function would provide a significant path toward achieving the professional experience necessary to become a

CPA. Additionally, internal audit training builds organizational and documentation skills, written and oral communication skills, and analytical skills.

Reestablishment would better support the development of future county fiscal managers. The reestablishment of an internal audit function will allow a valuable synergy to develop that existed prior to April 1995. The analytic skills taught and refined through an audit function are invaluable. There are currently many County managers who "graduated" from the previous Internal Audit Division of the Auditor-Controller Department and they are actively supporting the County's mission and vision scattered throughout the County. This group includes two department/agency heads, a past CEO and County CFO, a past acting CFO, and two other executive managers, all of whom were once assigned to the internal audit function of the Auditor-Controller. The effects of losing this cadre of financial management talent will become apparent as these individuals retire from county service.

Reestablishment would not result in increased costs. According to the Internal Audit Department's progress reports to the Audit Oversight Committee, we can anticipate spending annually, on the average, approximately 2,900 staff hours in auditing the treasury and probation mandated audits. Our plan would include hiring one Admin Manager I and one Senior I to conduct the mandated audits. We do not anticipate adding any other overhead to administer the audit function. Clerical and administrative support would be absorbed by current staff.

Timing. In order to ensure a reasonable transition, I am recommending that the function be reestablished for the 2006-07 fiscal year

Conclusion. The system of checks and balances is greatly enhanced by restoring the independently elected Auditor-Controller's ability to perform audits for which he is responsible. The public deserves a structure that protects the public interests. The Auditor-Controller is totally independent of those functions for which he is legally required to audit. In this highly charged political environment, we must make every effort to ensure that our audit function protects the public's interest. I believe that personally directing the mandates required of me best protects the public while providing organization benefits to the County as a whole.

COUNTY OF ORANGE
INTERNAL AUDIT DEPARTMENT
Recipient of the Institute of Internal Auditors Award for Excellence
Integrity • Objectivity • Independence

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October 28, 2005

Supervisor Bill Campbell, Chairman
Board of Supervisors, Third District
10 Civic Center Plaza
Santa Ana, CA 92701

As requested by several Board Members, I have prepared the following observations regarding the merits of Auditor-Controller David Sundstrom's request in his memo addressed to the Chair of the Board of Supervisors, Bill Campbell, dated October 13, 2005, in which Mr. Sundstrom asked Board authorization and funding to:

1) establish by Board resolution, in addition to the Board's independent Internal Audit Department, a new and duplicative internal audit division with competing County-wide audit authority and scope reporting solely to the Auditor-Controller, and

2) to personally direct his newly proposed internal audit division to perform the State mandated audit of the Treasurer's cash and investment holdings totaling over $5.8 billion, instead of continuing to use the Board's independent Internal Audit Department to do so.

I have framed my observations under the following six categories detailed below in response to the major components of the Auditor-Controller's request. I've indicated these categories by highlighting in bold my observations with supporting detail and discussion.

In viewing the Auditor-Controller request from the perspective of the United States Government Accountability Office, the Institute of Internal Auditors and the American Institute of Certified Public Accountants, our research has revealed that all relevant professional standards indicate that the Auditor-Controller lacks the requisite independence to conduct any governmental audits including the Treasury Funds Audits because of his extensive County Controllership duties.

In addition, the Auditor-Controller's request to fund a second and redundant internal audit division will significantly increase and unnecessarily duplicate costs to the County which we estimate will be approximately $500,000 to $900,000.

Sincerely,

Peter Hughes

Dr. Peter Hughes, CPA
Director, Internal Audit Department

cc: Supervisor Thomas Wilson, Vice Chairman, Fifth District
Supervisor Lou Correa, First District
Supervisor James Silva, Second District
Supervisor Chris Norby, Fourth District
Thomas Mauk, County Executive Officer
John Moorlach, Treasurer-Tax Collector
David Sundstrom, Auditor-Controller
David Carlson, Member, Audit Oversight Committee

Review of the Request for the
Creation of An Additional County Internal Audit Division
Reporting Directly to the Auditor-Controller

Introduction

As requested by several Board Members, I have prepared the following observations regarding the merits of Auditor-Controller David Sundstrom's request in his memo addressed to the Chair of the Board of Supervisors, Bill Campbell, dated October 13, 2005, in which Mr. Sundstrom asked Board authorization and funding to:

1) Establish by Board resolution, in addition to the Board's independent Internal Audit Department, a new and duplicative internal audit division with competing County-wide audit authority and scope reporting solely to the Auditor-Controller; and

2) Personally direct his newly proposed internal audit division to perform the State mandated audit of the Treasurer's cash and investment holdings totaling over $5.8 billion, instead of continuing to use the Board's independent Internal Audit Department to do so.

I have framed my observations under the following six categories detailed below in response to the major components of the Auditor-Controller's request. I have indicated these categories by highlighting in bold my observations with supporting detail and discussion.

Historical Perspective

By State statue G.C. Section 25250, only the Board has the authority to conduct internal audits on a County-wide basis. By resolutions as far back as 1947 many County Boards have delegated the internal audit responsibility to the elected County Auditor. Furthermore, some of the limited duties prescribed to the County Auditor date back to 1883. Since that time many Boards have also delegated to the County Auditor the duties of their Head Bookkeeper or Chief Accounting Officer for the County. Orange County did just this by resolution 59-415 on April 8, 1959.

Specifically, the California Government Code Section 26880 states "the board of supervisors may create the office of controller. The office of county controller shall be held ex officio by the county auditor." Furthermore, G.C. Section 26885 states the board of supervisors by adoption of a resolution passed by three-fifth vote, may repeal the controllership duties assigned to the county auditor.

Much, however, has changed since 1883 and 1959 in the accounting and auditing world. Current developments in the American Institute of Certified Public Accountants (AICAP), the Institute of Internal Auditors (IIA), the US Government Accountability Office (GAO) and the National Association of Local Governmental Auditors (NALGA) all now unanimously demand greater audit independence than previously accepted. In simple terms the County's Internal Audit function cannot report to the County Controller and maintain its required independence to conduct governmental audits or perform attest (audit) services in accordance with the professional auditing standards.

The wisdom of the California Legislature and the Board of Supervisors in repealing the Internal Audit duties from the Orange County Auditor-Controller has been validated by the accounting and auditing profession. The Board by Resolution 95-271, dated April 25, 1995, unanimously created a truly independent and professional Internal Audit Department reporting directly to the Board instead of the Auditor-Controller. This was 10 years ahead and now is in complete compliance with the AICPA, GAO, IIA and NALGA standards. This has served as a model example for the rest of the California counties.

Presently, the Auditor-Controller already has several members of his staff that "double check" the work of his accountants as part of providing ongoing supervision as does every other Department and Agency in the County. He as well as any other County executives can continue to do this without seeking a Board resolution. The proposal by the Auditor-Controller seeks authorization to go beyond this internal process and asks for authorization to create an internal audit division to conduct "audits" County-wide.

Summary

In viewing the Auditor-Controller request from the perspective of the United States Government Accountability Office (GAO), the Institute of Internal Auditors (IIA) and the American Institute of Certified Public Accountants (AICPA), our research has revealed that all relevant professional standards indicate that the Auditor-Controller lacks the requisite independence to conduct any governmental audits including the Treasury Funds Audits because of his extensive County Controllership duties.

Lacking this requisite independence, the stated intention of the Auditor-Controller to "personally direct" the Treasury audits would fail to achieve his stated desire "to directly satisfy my legal mandates." In addition, the Auditor-Controller's request to fund a second and redundant internal audit division with County-wide authority and scope under his direct control will significantly increase and unnecessarily duplicate costs to the County.

It will also restrict the range and scope of audit coverage currently provided by the Board's independent (validated as such by two separate nationally recognized CPA firms) Internal Audit Department. Furthermore, we estimate the cost to fund a duplicate County internal audit division to be approximately $500,000 to $900,000.

In response to the Auditor-Controller's assertions in his request, we noted the following:

I. The creation of a redundant internal audit division with County-wide scope and authority reporting directly to the Auditor-Controller would not be independent. The assignment of these audit duties will be a conflict of interest where the Auditor-Controller is auditing himself due to his extensive County-wide accounting responsibilities. In addition, his accountants prepare a critical reconciliation of the Treasurer's cash investment accounts which is an important focus of the mandated Treasury audits the Auditor-Controller is proposing to conduct himself.

II. Creation of a redundant internal audit division will cost an amount estimated to be between $500,000 and $900,000. This additional cost for the support of another County internal audit division is coming at a time when the County is considering eliminating audit positions within the current Board's independent Internal Audit Department.

III. The Board of Supervisors is already completely fulfilling the California Government Code that requires audits of the Treasurer's Assets by having their independent Internal Auditors conduct these audits over the past seven years. As such, the Auditor-Controller does not need his own internal audit division to satisfy this statute, nor does this legislative mandate require the Auditor-Controller to conduct these audits himself.

IV. Creation of a redundant internal audit division is not necessary to certify the Auditor-Controller's staff because the Auditor-Controller can already do so without having to have an internal audit division given the 2004 revisions to the California Board of Accountancy's Standards.

V. Creation of a redundant internal audit division is not necessary to support the development of future County fiscal managers. The Board has already invested in the training and development of its fiscal managers and has a ready pool of highly trained CPA's in its Internal Audit Department to facilitate this objective.

VI. Creation of a redundant internal audit division with County-wide scope and authority would, by its very nature, create confusion throughout the County regarding the competing internal audit departments' scopes and authorities. In addition, it would divert funding away from the Board's independent Internal Auditors and redirect them to the Auditor-Controller's internal auditor division at a time when the Board's Internal Auditor may lose one or more positions due to budget cuts and it would also reduce the range and scope of audit coverage currently possessed by the Board's independent Internal Auditors.

Detailed Observations

1. The United States Government Accountability Office (GAO), the American Institute of Certified Public Accountants (AICPA) and the National Association of Local Government Auditors (NALGA) maintain that the position of Auditor-Controller lacks the requisite independence to run an Internal Audit division and to conduct the specific Treasury audits he is proposing to perform.

The wisdom of the California Legislature and the Board of Supervisors in establishing by Board Resolution 95-271, dated April 25, 1995, a truly independent and professional Internal Audit Department reporting directly to the Board instead of the Auditor-Controller was ten years ahead of the recent and publicly supported advances made in the audit profession's quest for greater independence of its audit divisions.

In 1995, the Orange County Grand Jury stated in their final report that:

- "Independence is the key to an effective audit function."
- "Combining both functions under the Auditor-Controller is a clear and significant violation of internal controls."
- "The County's Auditor function should be separated from the Controller."
- "The Auditor, whose role is to validate the integrity of financial results of various operations, cannot report to the County's chief accounting official and remain independent."

The GAO, which is the government auditing regulatory authority overseeing governmental audits and publishes the authoritative standards commonly referred to as the "Yellow Book", now precludes the internal auditors working for Auditor-Controllers from conducting "governmental audits" due to the obvious lack of independence in having the "County Controller" audit the County's accounting records and transactions. This point needs to be underscored: It is a conflict of interest to have the Controller audit how well he keeps his books. Specifically, the United States Government Auditing Standards state "Auditors should not audit their own work."

Two independent and nationally recognized CPA firms have determined in separate reviews that the Board's independent Internal Audit Department has all the requisite independence required to conduct governmental audits and AICPA reviews. Specifically they noted that in all matters related to the audit work, the audit organization and the individual auditors, the Board's Internal Audit Department is free both in fact and appearance from personal, external and organizational impairments to their independence. Specifically, they noted the following:

i) The audit director and his department are free from County accounting, business, operational and management responsibilities that would conflict with their ability to maintain both objectivity and the appearance of independence in auditing any county operations;

ii) The Director is held directly accountable and reports directly to the Board of Supervisors who is the highest authority in the County; and

iii) All direction provided by the Board to the Director of Internal Audit and his department is done in public board meetings, subject to public scrutiny and comment as required by the Brown Act. This practice underscores the Board's commitment to transparency and their support of their Internal Auditors independence from any internal or external pressures that may compromise their objectivity.

In contrast, the Auditor-Controller has direct line authority over accounting, financial, and managerial responsibilities for County-wide operations, is not the highest authority as regards the County; and unlike the Board, directs his internal audits outside the scrutiny of the Board's public meetings and to the exclusion of the Brown Act. As cited by the United States Government Accountability Office's Audit Standards, the Auditor-Controller as the County Controller is in a position, in fact and in appearance, to exert pressure on his internal auditors by interfering with the assignment, appointment, and promotion of audit personnel; possesses the authority to overrule or to inappropriately influence the auditor's judgment as to the appropriate content of the report; and improperly influence the scope, content or release of an audit or audit report.

The Auditor-Controller for Orange County has been assigned the duties as the County's "Chief Accounting Officer" per Board Resolution 82-162, dated February 2, 1982, titled: "Duties and Responsibilities of Auditor-Controller." And, as such he has County-wide authority and responsibility for extensive and critical business and accounting systems. His staff of over 400 professionals performs accounting and financial reporting for the County. They are stationed throughout the County and are accountants only, not auditors by contract, for SSA, IWMD, RDMD, HCA, JWA, and HCS, to name just the largest departments that use the Controller's staff as their accountants. The Auditor-Controller establishes all accounting policies and practices for the entire County including all elected officials. The Auditor-Controller directly runs payroll, makes all disbursements including payments to vendors for services and supplies, manages accounts receivable, allocates all tax apportionments, maintains the general ledger, and prepares the County's financial reports, i.e. the CAFR, and runs cost accounting to name just some of the accounting and business functions the Auditor-Controller directs.

Given that the majority of internal audits conducted of any County operation evaluates the accounting and business processes run directly by the Auditor-Controller, and the adherence to County accounting polices established and enforced by the Auditor-Controller; the auditing profession has determined that the internal audit division can not report to this position and "remain independent."

A September 2004 Peer Review conducted by an independent and nationally recognized CPA firm selected and hired by the Audit Oversight Committee determined that the Board's Internal Audit Department was independent and could conduct all and any required governmental audits for the County of Orange including all audits of the Treasurer's office.

In contrast, the Auditor-Controller's independence is directly compromised as evident below:

- First, in addition to the County-wide accounting and managerial duties, there is an additional conflict in that the Auditor-Controller is a permanent voting member of the legislatively mandated Treasury Oversight Committee (TOC). In his TOC role, the Auditor-Controller is responsible for "reviewing and monitoring" the Treasurer's investment policies. Such an influential role creates, in fact and in appearance, an obvious conflict-of-interest in his "personally directing" audits of the Treasurer's office as he proposes.

- Secondly, the Auditor Controller's accountants are directly involved in preparing a critical reconciliation of the Treasurer's investment accounts. Specifically, his staff prepares the critical monthly reconciliations between the cash and investments recorded on the Treasurer's Office subsidiary records and the cash and investments recorded on the Auditor-Controller's general ledger for over <u>700</u> individual funds totaling over $3.12 billion dollars. Further, any differences for each fund are investigated and resolved by the Auditor-Controller's General Ledger staff.

The audit of the accuracy of this critical reconciliation is a key component of the State mandated quarterly Treasury Funds Audits. The Auditor-Controller's assertion in his memo to the Chair that "the Auditor-Controller is totally independent of those (Treasury) functions for which he is legally required to audit" does not comport with the fact that the Auditor-Controller's own accountants prepare and review this critical reconciliation. These facts violate the AICPA and US GAO requisite independence requirements of an auditor and, as such, preclude him from conducting this audit himself.

Both the United States Government Accountability Office and the National Association of Local Government Auditors have determined that an audit function reporting to an Auditor-Controller does not have the requisite independence to perform any governmental audit is a point that should be strongly noted. At least three California County Grand Juries have reached this conclusion as well and recommended Orange County's Internal Audit structure to their respective Boards. In addition, several other California Auditor-Controllers have acknowledged that they do not possess the requisite independence required to conduct these Treasury Fund Audits themselves. As a result, we noted that one County is now outsourcing this Treasury Fund Audit, two others have qualified their opinions by declaring to the reader of their reports that they are not independent as required by auditing standards and two more County's stated they have postponed these required audits due to their concerns over their independence.

Given that both the appearance and fact of independence is the foundation of the value and trustworthiness of the audit profession, the County of Orange's Board of Supervisors and the California Legislature in creating the Board's independent Internal Audit Department acted in exactly the right manner and in complete accord with both the United States Government Accountability Office and National Association of Local Government Auditors.

Presently any Auditor-Controller who disregards the US Government Accountability Office Auditing Standards regarding independence must qualify their opinion and warn the reader in their report of their lack of independence.

Additional Support Regarding the Auditor Controller's Lack of Independence to Conduct the Treasury Funds Audits

The California Government Code Section 26920 requires that the auditor, at least annually perform or cause to be performed an audit and quarterly reviews that are in accordance with the Auditing Standards and the Statement on Standards for Accounting and Review Services (SSARS), both issued by the American Institute of Certified Public Accountants (AICPA).

The California Government Code Section 26920 (a)(3) requires that the review/audit include verifying that the records of the county treasurer and auditor are reconciled pursuant to G.C. Section 26905. G.C. Section 26905 requires that once a month the auditor reconciles the cash and investment accounts stated in the auditor's books with that in the treasurer's books. (See D below.)

The SSARS require that the review report reference that the review was done in accordance with SSARS issued by the AICPA.

To issue an independent auditor's opinion on audited financial statements, the independent auditor must follow the Auditing Standards issued by the AICPA. The Auditing Standards require that the audit report reference that the audit was conducted in accordance with generally accepted auditing standards (Section AU 508.08, d.) and the financial statements are presented fairly and in accordance with generally accepted accounting principles (Section AU 508.08, h.).

The Standards for both the audit and the reviews requires that the auditor be independent. Auditing Standard AU Section 220.02 states "This standard requires that the auditor be independent," also, the SSARS in Section AR 100.44 states "An accountant is precluded from issuing a report on the financial statements of an entity with respect to which he is not independent." Both Standards state that in making a judgment about whether the accountant (auditor) is independent, the auditor should be guided by the AICPA Code of Professional Conduct.

The AICPA Code of Professional Conduct ET Section 101 - Independence, 101-3-Interpretation of Rule 101. Independence shall be considered to be impaired if:

- During the period covered by the financial statements or during the period of the professional engagement, a firm, or partner or professional employee of the firm was simultaneously associated with the client as a director, officer, or employee, or in any capacity equivalent to that of a member of management.

Also, Section 101-3—Performance of non-audit (accounting task) services states that independence would be impaired if the following non-audit services were performed:

- Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. Authorize or approve transactions. Prepare source documents.

The following accounting duties conducted by the Auditor-Controller office related to the Treasurer's office would impair the Auditor-Controller's independence to conduct the audit or review of the Treasurer's financial statements, and should preclude him from conducting these audits in accordance with the AICPA Auditing Standards and the AICPA Standards for Accounting and Review Services.

A. In the testing of the demand accounts to determine if the Treasurer's demand (bank) account balances are fairly stated in the financial statements, the internal auditor must test the Treasurer's staff reconciliations of the Treasurer's records to the bank's records. This audit step requires the testing of individual reconciling transactions that have been initiated, approved, and posted by the Auditor-Controller's staff. Billions of dollars in transactions are recorded through these bank accounts each year.

B. The Treasurer's Fund Accounting System (FAST) is maintained on the County's IBM mainframe. The Auditor-Controller CAPS System automatically downloads transactions into FAST. These transactions consist of Deposit Orders (including Deposit Orders for wire transfers), Journal Vouchers, Cash Transactions, Payment

Vouchers (which include payroll) and tax apportionments. As part of the audit/reviews, Board's independent Internal Audit Department tests the Treasurer's office reconciliation of the Treasurer's general ledger (Quantum System) to FAST. Billons of dollars a year in transactions are processed in the Quantum and FAST Systems. In the testing of these reconciliations, internal the auditor has to determine whether reconciling transactions generated by the Auditor-Controller's office are adequately supported, i.e. valid transactions.

C. The internal auditor also has to test the Treasurer's office reconciliation of the Treasurer's Specific Investments balance to the Auditor-Controller Cash and Treasurer's Investment Balance Report.

D. The internal auditor must test the reconciliation performed monthly by the Auditor-Controller's General Ledger Unit between cash recorded on the Treasurer's subsidiary records and cash recorded on the Auditor-Controller's general ledger for over 700 individual funds totaling over $3.12 billion dollars. Differences for each fund are investigated and resolved by the Auditor-Controller's General Ledger staff.

2. Creating Another County Internal Audit Division Unnecessarily Duplicates and Increases the County's Cost for Internal Auditing Services.

Duplication

The Board already has created through a unanimously approved Board Resolution No. 95-271, titled: "Establishment of an Internal Audit Unit Independent from the Auditor-Controller Reporting Directly to the Board of Supervisors" and funds a highly professional Internal Audit Department that has just been awarded by the Institute of Internal Auditors (the worldwide association for internal auditors) recognition as one of the top internal audit departments in the world. The Board's independent Internal Audit Department is fully staffed and has surpassed the expectations of three Peer Reviews conducted by independent and nationally recognized CPA firms. The Internal Audit Department conducts over one hundred audits and projects a year, has met all deadlines, stayed within its budget and completed its annual audit plan six years in a row.

In addition, the Internal Audit Department reports monthly to the Board and quarterly to the AOC, which is comprised of the Chair and Vice Chair of the Board of Supervisors, the CEO, the Auditor-Controller and a public member. The AOC has repeatedly complimented the Internal Audit Department for doing an outstanding job for the County. The Board's independent Internal Audit Department already has policies and procedures, By-Laws and Administrative Rules already developed, approved and implemented. In addition, it has trained managers, auditors and administrative support staff already in place. To create and fund another and competing internal audit division would be inefficient in that it wouldn't have the economies of scale already enjoyed by the Board's independent Internal Audit Department. Overall, we have estimated the cost of funding a redundant internal audit division in the Auditor-Controller's office would be approximately $500,000 to $900,000.

Costs to the County

A "full costing" approach that captures both efficiencies and economies of scale as well as direct costs has been applied to the Auditor-Controller's proposal. Some items pertain to productivity, efficiency, and start-up costs commonly weighted when considering duplicating a well-established operation while other costs are the more traditional budget items. Certainly the estimated amounts are subject to revision depending upon one's underlying assumptions but our rough estimate is that approximately $500,000 to $900,000 of County funds will be required to fund this request.

1) The Auditor-Controller states that he needs funding to hire **two** additional positions to establish his internal audit division. The approximate cost of the level of staffing he is proposing is about $70,000 per position per year which will result in a **net increase** to the County of about **$140,000** a year.

2) The Auditor-Controller proposes taking **three** full time employees that are currently being used in his staff services unit and reassigning them to his new internal audit division. This suggests that either these positions are unnecessary and as such could be eliminated and their salaries saved, or that he will need to eventually refill these three positions. In both of these instances, the result is a cost to the County that is estimated to be over **$210,000** in salaries and benefits.

3) The Auditor-Controller plans to include in his internal audit division two staff members from HCA Accounting and HCSD Accounting. It is estimated that these two positions would cost approximately $70,000 per position with a cost to the County of about **$140,000** a year.

4) The cost of training and certifying inexperienced auditors is estimated by the audit profession to be one-fifth of their annual salaries for three years before they are fully productive. Given that the Auditor-Controller is proposing to have **seven auditors** in his new internal audit department, the cost associated with developing this number of staff over the next three years would cost over **$300,000** in productivity costs as they learn the profession, develop audit expertise and develop and organize their new organization.

5) There is a cost involved in providing professional administrative oversight, supervision and training that is generally assessed to vary between ten to fifteen percent of the auditors' salary, which conservatively is estimated at **$50,000** a year.

6) The Auditor-Controller states that he would obtain a Peer Reviewer to audit his internal audit division every three years. The Peer Review conducted of the Board's Internal Audit Department this past April cost over **$50,000**.

3. **The Legislated Audit Mandate pertaining to the Audit of the Treasury Fund Accounts is Already Completely Fulfilled**.

   The Auditor-Controller per the California Government Code Section 26920 "shall, at least annually, perform or cause to be performed an audit of the assets on the County Treasury and express an opinion." There is **no** requirement that only the Auditor-Controller can personally conduct these audits himself which is why the Board of Supervisors with the full support of the Audit Oversight Committee and the Auditor-Controller, has had its independent Internal Audit Department perform those 28 quarterly and annual audits for the past seven years.

   On the contrary, the California Government Code Section 26915 explicitly authorizes the County of Orange's Board of Supervisors to direct its own independent internal auditors to perform these mandated audits. In doing so, the Board has already completely fulfilled the requirements of the legislation.

   All of the audits conducted by the Board's independent Internal Audit Department have fully complied with and exceeded all professional auditing standards. This fact was cited by two different nationally recognized CPA firms who have performed three extensive Peer Reviews of the department over the past five years. These Peer Reviewers were hired as a way to independently assure the Board that their Internal Audit Department is both independent and professionally managed.

   In addition, it should be noted that this may not be a good time to replace the Board's experienced and independent Internal Auditors with inexperienced auditors as proposed by the Auditor-Controller. Next year, two new County Supervisors and a new Treasurer will be elected. Experienced auditors are a highly valuable resource due to their corporate memory and proven expertise in conducting these audits. The Board may want to take this factor into consideration when deciding whether or not to support the Auditor-Controller's request.

4. **The Auditor-Controller Can Already Certify New Staff as CPAs Without Having to Create a New and Duplicate County Internal Audit Division.**

   Recent changes by the audit profession now enable the Auditor-Controller to certify his staff as CPA's given the variety of duties and tasks that are already present in his office. He does not need an internal audit division to achieve this. The California Accountancy Act, Chapter 7, and Article 5, titled: Certificates, Information and Records, Section 5093, subsection (d) specifically speaks to this in the January 2004 revision. Furthermore, the Board's independent Internal Audit Department is willing to assist the Auditor-Controller's accountants in obtaining the requisite work experience to qualify for certification whenever possible.

5. **Creation of a Redundant County Internal Audit Division is Not Necessary for the Development of Future County Fiscal Managers.**

The Board of Supervisors has already invested funds to train and develop its independent Internal Audit Department professionals in accounting, budgeting, auditing and management. Presently, the Board's independent Internal Audit Department has 16 Certified Public Accountants (CPA's) who are familiar with County policies, processes, and business objectives, all of whom are willing and able to assume key managerial promotional opportunities throughout the County. It is encouraging to see that the Auditor-Controller is not only supportive but insistent that Internal Auditors are placed in such important managerial positions when such openings occur. In addition, several auditors graduated from the County Leadership Academy sponsored by the County Executive Office and as such, are in a prime position to advance within the County's executive and managerial ranks.

6. **Creation of a Redundant County Internal Audit Division reporting to the Auditor-Controller Would Reduce the Current Scope and Authority of the Board's Current Independent Internal Audit Department.**

Creation of a redundant internal audit division with County-wide scope and authority would, by its very nature, create confusion throughout the County regarding the competing audit departments' scope and authority. Additionally, it would drain funding away from the Board's independent Internal Auditors and redirect them to the Controller's internal auditors at a time when the Board's Internal Auditor may lose one or more audit positions due to possible budget cuts. It also would reduce the range and scope of audit coverage currently possessed by the Board's independent Internal Auditors.

In the past three years, the Board's independent Internal Audit Department has successfully and timely responded to over a dozen audit requests from the Board involving critical areas and issues. If there is an area that the Board and any County official believes needs to be audited, the Board's independent Internal Audit Department stands ready and able as it has demonstrated in the past to conduct those audits with professionalism in a timely manner.