

Strengthening the Internal Audit Functions of Sacramento County

Summary

The 2017-2018 Sacramento County Grand Jury conducted an investigation of Sacramento County's Internal Audit Process. We found that the county does not regularly perform independent operational audits, letting departments audit their own operations and processes. Independent outside operational audits can prevent waste, fraud and abuse. Based on our research, it is apparent that failing to properly exercise its oversight responsibility costs Sacramento County taxpayers' money.

Our focus was on 'best practices' which could be incorporated into Sacramento County operations. The grand jury study focused on auditor autonomy and independence, transparency, accountability, and a different method of audit selection based on a concept of 'risk' as discussed later in this report.

Interviews with local county and city officials gave the grand jury valuable information and insights regarding how the Internal Audit Unit (IAU) operates, where it fits within organizational structures and obstacles to the 'best practices' that were identified. These obstacles include issues such as staffing, policies and procedures, budgeting, and the priority, or lack thereof, that the County Board of Supervisors (Board) places on the IAU within the organizational structure.

The grand jury has outlined nine findings and recommendations which we believe can help Sacramento County as they build upon the foundation they have in place and as they move to optimum efficiency. Further, the grand jury believes that if the Board and county leadership are truly committed to improving their operations, the tools and opportunities are all there for them to become a success story and to be an example for others to follow.

Background

The issue of strengthening the internal audit functions of the County of Sacramento came to the attention of the 2016-2017 Grand Jury too late in the year to undertake an investigation, therefore, the matter was tabled for a future grand jury to pursue.

After reviewing practices in other jurisdictions, the 2017-2018 Grand Jury determined that this issue is significant enough to the taxpayers of the

County of Sacramento to warrant an investigation into what appear to be issues of a lack of transparency, independence, and accountability.

Methodology

What investigative techniques were used

- An informal review of the internal audit departments of the twelve largest cities and counties in California
- An in-depth review of the internal audit/auditor-controller operations of four of the most populous city and county governments in California was undertaken through research on the internet
- A number of formal interviews of City and County of Sacramento officials were conducted with staff representing the Internal Audit/Auditor-Controller divisions as well as executive management
- A review of numerous documents, both internal and external to the County of Sacramento, as well as review of nationally recommended auditing standards for governmental entities.

Internet Review

The internet research was valuable, as it portrayed the scope and depth of the different internal audit and auditor-controller functions among different jurisdictions. The grand jury was able to gain good insight into their operations and transparency of information provided to the public.

The website review was not a verifiable way to gain a proven understanding of how each internal audit department operated within the jurisdictions. However, the review was effective in terms of understanding how each city and county elected to provide relevant information. The individual websites are valuable portals for the public. The better websites were effective in portraying their internal audit departments as solid fiduciary custodians of how public dollars are utilized for governmental functions.

Review of Audit Practices in Other Jurisdictions

The review of other cities and counties allowed the grand jury to compare the County of Sacramento with many other organizations. We looked at the following:

- The quality and depth of the website and accessibility of information for the public
- Strength of independence of the internal auditing process
- The position of the Internal Auditor in the organization's overall hierarchy

Sacramento County Grand Jury 2017-2018

- Presence of an oversight committee or independent peer review function
- Internal Auditing Policies and Procedure document online
- Availability of completed internal audits on website
- Monthly status reports documenting the progress of the audits toward completion
- Availability of information on 'planned' audits for the next one or two years
- The availability of a whistleblower/fraud hotline and suggestion portal for the public's use.

Many of the more populous cities and counties were not necessarily better than the smaller organizations in providing public information for their internal audit function. We chose to review the following jurisdictions:

Orange County

Orange County appears to have a strong internal audit division and an informative website. The Auditor-Controller serves in an elected position and reports directly to the Board of Supervisors. Internal auditing is one of several functions that the auditor-controller supports. An oversight committee is in place and includes five 'private sector' members. The website includes strong mission and values statements and stresses that "Disclosure + Clarity = Transparency," as a fundamental way of communicating its functions, values and results to the public.

The Auditor-Controller's office ensures that complicated documents like the Comprehensive Annual Financial Report (CAFR) are accompanied by a Citizens' Report that condenses the salient points of an often 250+ page document into an easily readable and understandable 10-12 page narration, reducing accounting terminology and legal jargon into plain English. Completed internal audits are online, awards are mentioned, and interested citizens can sign up for the departments 'e-newsletter' for updated information.

City of Sacramento

The internal auditor at the City of Sacramento serves in an elected position and reports directly to the City Council. There is a staff of six with diverse academic and work experience backgrounds. This is unlike many organizations that hire strictly individuals with financial or accounting backgrounds. The staff is directly engaged in a variety of

Sacramento County Grand Jury 2017-2018

financial and process audits and reports to and takes direction from the City Council.

The Internal Auditor has no connection to, or responsibilities on behalf of, the City's Finance department. This position operates independently of other city organizations. Internal audits are scheduled in advance, as the need arises, or at the request of the Sacramento City Council. A proposed scope of work for each audit is developed. The scope of work includes estimated savings to the taxpayer, as well as realized savings as independent milestones are met.

Completed internal audits are posted online and indicate a strong diversity of subject matter audited. The City has a comprehensive website, providing excellent transparency as to their vision, objectives and status of ongoing audit work and results. The City of Sacramento also maintains a Fraud Hotline with a link on their website.

City of San Jose

The City of San Jose has a solid internal audit program with a very well-developed website for communicating information to the public. The City Auditor is appointed by the City Council and has a staff of 15. The auditing section of the website has a strong mission statement, posts internal audits online and includes progress reports with potential financial savings. Work plans for the near future are also included, as well as internal audit work processes and standards.

A long list of awards is listed for past audit work. A video interview with the City Auditor is included on the website, allowing the public to gain an understanding of the department's purpose and direction.

Alameda County

Alameda County's elected Auditor-Controller has multiple functions apart from internal auditing. The Auditor reports to the County Administrator and the Board. Alameda County has a strong vision statement, job descriptions, and a good personnel contact list. Past CAFR's and Single Audit Reports are included online.

Discussion

Internal Auditing

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes." (Institute of Internal Auditors (IIA))

The responsibilities and duties of an internal auditor are to independently perform the following:

- Objectively review business processes
- Evaluate the risk management procedures that are currently in place
- Protect against fraud and theft of the agency and county assets
- Ensure that the agency is complying with relevant laws and statutes
- Make recommendations on how to improve internal controls, policies, and procedures.

Commonly Accepted Audit Standards

There are accepted standards for the practice of accounting within the government sector, covering strict financial auditing, as well as operational, or process audits. Government auditors conduct audits using a combination of Yellow Book and Red Book standards.

The Yellow Book

The U.S. Government Accountability Office, which issues the Yellow Book, is an independent, non-partisan agency that investigates how taxpayer dollars are spent. Their work includes auditing agency operations for efficiency and effectiveness and determining how well programs are meeting their objectives.

- The Yellow Book contains standards for financial audits, as well as performance audits. It does not, however, discuss overall audit planning strategy.
- Auditor independence is championed by the Yellow Book.
- The Yellow Book standards also clearly require that auditing staff must collectively have "adequate professional competence" and technical knowledge.

The Red Book

The Institute of Internal Auditors (IIA) issued the International Professional Practices Framework (IPPF) in 2009, known as the Red Book.

- The Red Book defines Internal Auditing as “an independent, objective assurance and consulting activity designed to add value to an organization’s operations.”
- The Red Book emphasizes auditor proficiency and competency. Internal auditors should possess skills, knowledge, and other competencies needed to perform their responsibilities.
- It emphasizes the concept of auditor independence.

Difference Between Yellow and Red Books

Where the two differ substantially is in the nature of audit planning. The Red Book states that overall audit planning for an organization “must establish risk-based plans to determine the priorities of the internal audit activity” (Section 2010). Further, the plan must be based on a documented risk assessment done on an annual basis. As mentioned before, the Yellow Book does not address this issue.

Types of Internal Audits

- Financial Audits seek to ensure an organization is using accepted accounting procedures to create and manage financial information through the review of financial statements.
- Compliance Audits are used to evaluate an agency’s compliance with applicable laws, regulations, policies and procedures.
- Performance Audits assess whether an agency is meeting the goals and objectives set forth by the policy makers. If the agency is not meeting its stated goals, the internal auditor will identify process shortfalls and make suggestions for improvement to the policy makers.
- Operational/Process Audits assess the overall efficiency and reliability of an agency’s control mechanisms. It is an objective review of the way an agency uses resources.

The Job of the Internal Auditor and the Scope of internal audits

There are four common techniques which make up the internal auditing process and allow auditors to collect information and evidence, analyze the collected data and report back with suggestions for improvement as needed:

Sacramento County Grand Jury 2017-2018

- Observing the agency operations and environment
- Inspecting the specific risk management, financial reporting and productivity strategies that are currently in place
- Inquiring or asking questions of management personnel related to the effectiveness of the current internal controls
- Confirming whether the goals and objectives of the business are being met.

Auditors apply their professional judgment to determine the standards by which agency activities are measured. This involves:

- Conducting special studies
- Analyzing business policies, processes and procedures
- Defining audit objectives
- Deciding the nature and extent of the audit procedure
- Stating final opinions and conclusions
- Reporting and distributing findings to the board and management.

One of the most important aspects of an internal auditor's job is the ability to perform an objective evaluation of an agency's activities. If agency politics prevent the internal auditing department from performing its job with autonomy and independence, the agency will not receive the benefits that are associated with an honest internal audit such as increased efficiency and productivity, decreased waste, potential savings of taxpayers' dollars and legal compliance.

Risk Assessment Modeling

Risk Assessment is a process to identify and quantify "risks" inherent in the organization and the quality of its controls over those risks. Establishing a model to schedule reviews is simply not enough, there must be a robust independent review and analysis of an operation to ensure that work is done efficiently, economically, and correctly. Simply put, the greater the risk, the greater the need for review.

The Risk Assessment approach to performance auditing has several advantages:

- It goes beyond simple compliance to established practices and identifies areas most in need of improvement
- It can eliminate archaic practices that no longer serve a necessary purpose
- It can eliminate redundant processes
- It can improve cross departmental practices and processes

Sacramento County Grand Jury 2017-2018

- It can optimize the use of existing resources
- It can identify wasteful and possibly illegal practices
- It can save taxpayer money.

It is difficult to attribute actual amounts of savings derived from performance audits, as each is different in scope and nature. However, our internet research and our interviews revealed that it is possible to achieve estimated savings of \$3.00 for every \$1.00 invested when jurisdictions conduct performance and operational audits. That would be considered an excellent return on investment for any organization.

To this point, we have been discussing general internal accounting practices, as well as practices in other jurisdictions in order to establish a basis of comparison to Sacramento County.

Sacramento County Current Auditing Practices

The County of Sacramento performs annual financial reviews of cash management and procurement cards. Some reviews are in the annual audit plan and some are requested by county agencies or departments. In both instances, auditors and agencies mutually agree on what is to be audited and how much will be spent on the audit. The agencies requesting reviews must pay for them out of their agency budget.

It appears that the county does not conduct independent, outside performance or operational audits. Performance or operational audits normally have been performed by the same unit or section that is being audited. Simply put, units are auditing their own work products!

Independent outside performance or operational audits can provide a more accurate assessment of the efficiency and effectiveness of an agency's operation. Such audits help to identify deficiencies and issue findings with corresponding recommendations for improvement.

Internal Audit Unit (IAU)

"The IAU is responsible for the audit functions of Sacramento County. This includes performing financial and compliance audits for County departments, special districts, Federal and State grants, joint power authorities, trust funds and other districts whose funds are deposited in the County Treasury. Reviews are performed of the Comprehensive Online Management Personnel and Accounting (COMPASS) for Sacramento County, and how various departments utilize COMPASS and the established internal controls. The IAU also conducts

compliance audits and reviews of transient occupancy tax, utility tax and concessionaires doing business within the County, and investigates any cash or property losses occurring within the county" (Sacramento County Website: Internal Audits).

According to the current County of Sacramento Organizational chart, the IAU is under the Assistant Controller-Auditor, who is under the Director of the Department of Finance (DOF), who is under the Deputy County Executive for Administration, who is under the Assistant County Executive, who reports to the County Executive, who reports to the Board. It is important to note that there are four (4) levels of supervision between the IAU and the County Executive and five (5) levels between the IAU and the County Board. These many layers of reporting diminish accuracy, effectiveness and accountability.

Accounting Database System

The County, as well as the IAU, uses an antiquated financial database called the Comprehensive Online Management Personnel and Accounting system (COMPASS) which was established sometime in the early '90's and it is updated annually by the vendor. One individual the grand jury interviewed discussed the complexity of the system and how it is challenging to use. It requires specific training to learn the system and additional training and usage to gain efficiency. In addition, they have to purchase ancillary software as needed which is then integrated into COMPASS to address needed changes, upgrades or improvements. There is a COMPASS Steering Committee which meets to discuss changes, planning and resources. IAU staff attends COMPASS meetings occasionally but are not regular members of the committee.

Current Budget Process

The IAU prepares annual audit plans and apportions staff hours to each audit with corresponding dollar values for which they must budget. Additional revenue is collected by the IAU from agencies who request reviews of their agency or any part thereof because those agencies must pay out of their own budget. The problem with this arrangement appears to be that agencies may opt not to request audits/reviews because of budgetary restrictions. Given IAU's staff limitations, agencies may not be audited for multiple years. According to audit plans provided by the IAU for the past three years, there are some county agencies that have not been audited for several years and some agencies that have never been audited.

Budget Process Change

The County is implementing a change in the budget process regarding internal audits.

One witness told the grand jury “this change will involve a three-month process for risk assessment and produce a ‘heat map’ plotted to show high and low risk by county department, which would result in a ‘template’ to work with for the next five years and an audit plan developed for high risk priority. The difference with the new budget process is that they will have an audit plan which will remove the budgetary issue and problems with departments saying they don’t want to pay, for example, for a cash review.”

Audit Committee

Audit Committees are often created to review and approve audit plans, review audit reports, and generally provide oversight for internal and external audits, the CAFR and to provide advice to the Board. Sacramento County recently revived their Audit Committee.

Several witnesses within County government were asked about the composition of the current audit committee and whether they saw any benefit to having a board member on the committee in an advisory capacity. They stated that discussions have been held regarding the “pluses and minuses” of having board members present at their committee meetings, but no decision has been made. Witnesses were asked about having someone from the outside or non-government representative as an audit committee member. One individual stated that this is happening in other counties and believes that they would embrace it if it happens.

Independence – Change in Organizational Structure?

It is interesting to note that 47 of the 58 counties in California have elected Auditor Controllers, insuring the independence of the position (this data was taken directly from the State Controller’s office. Interestingly, Sacramento County is annotated as having an elected Auditor Controller, although this has not been the case for many years).

Witnesses were asked if it would be helpful if the IAU had a more direct connection to the Board. One response was, “other counties have that method. We can report to the board now but not necessarily a direct communication.”

Transparency

The IAU website is not user friendly. The county's website did not reflect the 45 audits performed annually.

The CAFR and the Single Audit Reports are on the website. These reports are written by accountants and meet reporting requirements but are not easily readable or understandable by the general public.

The grand jury learned that the DOF currently does not have an Information Technology (IT) Specialist to maintain the website and it is updated by IAU staff as time permits. Only one IT tech is assigned to the Finance Department, helping to resolve desktop issues for 179 employees. His responsibilities do not include website updating or maintenance.

The grand jury believes that transparency of information is evident when:

- The overall website and the internal auditor section is well designed and inviting to the reader
- The internal auditor section has a strong vision statement
- An organization chart is provided with a comprehensive description of the staff, their training, duties and roles in the department
- An indication of the reporting relationships between the internal auditor within the organization and whether that individual is a division chief, department head or executive manager
- There is an oversight committee that drives direction of the internal audit function
- Completed audits over the last several years are included on the website
- An audit work plan for the coming year or two is included
- A monthly status report on milestones completed for each audit that is carried out
- A cost-benefit structure is incorporated that identifies estimated cost savings of each audit, once completed, and actual dollars saved as each audit recommendation is carried out by the affected department/function
- A method exists for the public to make suggestions regarding perceived operational problems and to make voluntary, anonymous reports of fraud and abuse.

Staffing

The grand jury learned that the IAU's staffing is budgeted to include 7 professional auditors. However, there have been two positions which have not been filled for some time. It was mentioned by at least one witness that some of the IAU's staff also do "all sorts of other things in the department of finance". Retention issues were mentioned and attributed to two factors: 1) the loss of staff to private industry, 2) The loss of employees to other County agencies, either to direct promotion or transfer to an agency with better and more defined promotional opportunities. There was a general concurrence that the unit could use more employees. It was noted that most, if not all of the IAU staff, are accountants.

Looking to the Future

The County has been studying the best practices of other governmental organizations and is considering using all or parts of the Red Book, for both financial and operational audits. In 2017, the County Department of Finance determined that they needed to develop and implement a risk assessment approach to internal auditing of county agencies.

In August of 2017, the County issued a Request for Proposal (RFP), inviting proposals "for conducting a risk assessment study and developing a risk-based model which will be used to prioritize audits/reviews to be performed". Under a section called Scope of Work, the County's main expectations were:

- Extensive Departmental background information to be obtained
- Identification of risk factors to both operational and financial processes and internal controls
- High, medium, and low risk profiles
- A means of updating profiles, under changing conditions and changes in identifiable risk factors.

In response to the RFP, a proposal was accepted by the County in December 2017 and a completed report is expected to be delivered to the county by May 30, 2018. The following components were also identified:

- Identifying and cataloging auditable activities, and to assess those activities on a yearly basis, using, but not limited to the following criteria:
 - An overall numeric score
 - An overview of operation

Sacramento County Grand Jury 2017-2018

- Key operating objectives
- Potential near-term significant risks
- Recommending quantitative and qualitative evaluation method
- Providing a user-friendly tool to prioritize audits based on risk level
- Establishing a three to five-year audit plan.

The discussion on risk assessment echoes what the grand jury heard and reported above. It is an understanding of how actions expose the entity to risk, either through direct loss, inefficiency, or lack of effectiveness. Ultimately, the goal is to find optimal efficiency and effectiveness, eliminate redundancy, and move beyond mere compliance with established procedures and processes.

Two important areas of concern are conspicuously absent from both the RFP and from the accepted proposal:

- There is no mention of auditor independence nor is there any mention of audit unit composition. As discussed above, there are many approaches to the concept of internal controls (operational audits), but there is one consistent requirement: the independence of the auditor. The auditor must be free to pursue issues where the data leads.
- Noticeably missing is any mention of a diverse auditing team, bringing together broad academic and professional experiences, fostering a wider approach to operational audits.

Conclusion

Sacramento County is in the first steps of transforming their audit process from financial reviews to include independent performance and operational reviews. The grand jury recognizes that Sacramento County is taking this initial step, but it will require hard work, diligence and a significant change from “everyday” procedures to ensure the success of this shift. The grand jury recognizes that the transition from current practices to the ‘optimal’ practices, outlined in this report and in the consultant’s proposal, will be a multi-year process. It is critical that the elected officials of the County of Sacramento continually review the process and take the necessary steps to ensure its success.

Sacramento County Grand Jury 2017-2018

The grand jury identified the following findings and offers the following recommendations:

Findings

- F1. The Sacramento County Internal Audit Unit lacks the necessary independence to perform operational audits and report their findings directly to the Board of Supervisors. Currently, there are five separate levels of supervision between the unit and the Board. As stated earlier, the grand jury believes that these multiple layers of reporting can diminish accuracy, effectiveness, and accountability.
- F2. Sacramento County lacks a process for independent outside operational audits. The current practice is for departments to perform operational audits from within, using an operational audit team composed of members of that department. This approach reinforces long standing practices, and does not lend itself to innovation, efficiency and streamlining.
- F3. There is a lack of public transparency in the current audit process. Websites are disorganized and confusing. It is not easy to find a current schedule of audits or past audits. There are no clear mission statements or objectives shown for the Department of Finance or its sections.
- F4. Current staffing levels are not at maximum strength and are not sufficient to undertake an increased role in performing internal operational audits.
- F5. Sacramento County currently lacks staff in the audit section with the breadth of experience or broader education to also process operational audits, in addition to financial audits.
- F6. Audit Reports that are available to the public are often written to address specific accounting and legal needs and are not readily understandable to the public. Reports conform to financial standards, requiring some degree of experience on behalf of the reader.
- F7. The Audit Committee is comprised of department heads. Other governments that have established audit committees have included decision-makers (elected officials) and members of the public to assist the Board and the Auditor in fulfilling oversight responsibilities.

- F8. The Internal Audit Unit, as well as the Department of Finance as a whole, are understaffed in IT Support. Maintaining transparency of operations to the public is difficult, if not impossible, without adequate IT support.
- F9. The Internal Auditor has infrequent, irregular input to the COMPASS Steering Committee.

Recommendations

- R1. Create an elected position of County Auditor. Remove the Internal Audit Unit from the Department of Finance, eliminating unnecessary levels of supervision.
- R2. Emphasize independent operational audits to review processes and procedures. Emphasize Risk Assessment Modeling to develop operational audits and scheduling.
- R3. Establish a strong mission statement and objectives for the Internal Audit Unit. In order to ensure increased transparency, the County should work to improve its website and to support it, using a dedicated individual, either from the Department of Finance or from the County's Information Technology support staff.
- R4. Staffing increases are necessary to also undertake operational audit workloads.
- R5. Hire and retain staff with a wide breadth of education and experience that they can bring to operational and process audits.
- R6. Make all reports more transparent to the public, particularly the readability and accessibility of completed operational and performance audits.
- R7. Maintain and expand the Audit Committee to include one or two members of the Board of Supervisors. The Board should also consider appointing members of the Public to the Audit Committee
- R8. Improve Information Technology support for the Internal Audit Unit and for the Department of Finance.
- R9. The Auditor should be a permanent member of the COMPASS Steering Committee.

Request for Response

Penal Code sections 933 and 933.05 require that the following officials submit specific responses to the findings and recommendations in this report to the Presiding Judge of the Sacramento Superior Court by Sept. 30, 2018.

County Board of Supervisors

All Findings and Recommendations

County Executive

All Findings and Recommendations

Mail or hand-deliver a hard copy of the response to:

David De Alba
Presiding Judge
Sacramento County Superior Court
720 9th Street, Dept. 47
Sacramento, CA 95814

In addition, email the response to:

Becky Castaneda, Grand Jury Coordinator @castanb@saccourt.com