INTERAGENCY INTERNAL AUDIT AUTHORITY
INTERNAL AUDIT DIVISION
FREDERICK COUNTY, MARYLAND

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October 18, 2011

Richard A. Kaplan

From: Richard A. Kaplan
Director, Internal Audit Division

To: Privatization Advisory Committee

On October 3, 2011, you asked the Partnerships (Privatization) and Efficiencies Committee (PEC) to provide additional information before making a determination as to whether you would recommend to the BoCC to proceed with a Request for Proposal (RFP) for internal audit services. To answer certain questions you asked, we did additional research and have more information and comments for your consideration.

MONTGOMERY COUNTY

Montgomery County's Costs to Outsource Internal Audits Were Understated and Audit Coverage Has Been Reduced

In its September 28, 2011 memo to your committee, the PEC recommended to proceed with developing an RFP and obtaining bids to outsource internal audit services. The PEC stated that potential savings in outsourcing are unknown; however, Montgomery County reduced its costs when it outsourced internal audit services. They pointed out that Montgomery County decreased its staff from 12 full-time county employees to only one audit director on staff and reduced its costs of over $1 million to about $240,000. However, Montgomery County's Internal Audit Director stated that the PEC understated the outsourcing figure. The total funds dedicated to his office's internal audit costs in FY 2012 are actually between $423,510 and $473,510 when including $30,000 to $80,000 transferred in from other departments who request special audits and the Internal Audit Director's salary and benefits.

On October 3, 2011, a member of your committee said that the PEC had not determined whether Montgomery County's audit coverage had gone down as a result of outsourcing. Montgomery County has not had a staff of 12 for many years and no information is available to show the number of audits

that were conducted then. Since that time, Montgomery County operated with an internal audit staff of four, which was then reduced to three. Audits were performed by this staff and a contractor until the Internal Audit Director retired in FY 2009.

Montgomery County's audit coverage has gone down and funding for the contractor continues to be reduced, limiting audit coverage even further. In FY 2009, there were 12 audit reports issued when audits were last done by the in-house staff of three and the contractor with a budget of $922,000 which included funding for contracts. In FYs 2010 and 2011, the number of reports issued decreased to 5 and 3 as funding decreased from $665,000 to $441,000, respectively. Funding includes the salary and benefits of the Internal Audit Director. Six audits are planned in FY 2012, of which 2 audits are carried over from FY 2011. Therefore, the number of performance audits has decreased as a result of outsourcing and because the contracting budget decreased.

Montgomery County Has Several In-House Staffs that Also Conduct Audits

In its September 28, 2011 memo to your committee, the PEC stated that Montgomery County has and continues to use external audit services for significant portions of performance management audits with significant savings. While the PEC continues to focus on the fact that Montgomery County outsources its internal audit function, it has not taken into consideration that Montgomery County has three other in-house staffs that conduct internal audits. The contractor used by Montgomery County's Internal Audit Director does not audit non-County Executive Government agencies, the school system, or the community college. Only a small part of Montgomery County internal audits are outsourced. In fact, there are three other staffs with 11 employees that conduct internal audits at a cost of over $1.5 million. Montgomery County has an Inspector General with an in-house staff of four that perform audits and investigations of the entire County Government. In addition, there is a separate in-house staff of four that audits the Montgomery County Public School System and a staff of three that audits Montgomery College. As a result, Montgomery County does not solely rely on a contractor for its internal audit services.

The staffing and budget for Montgomery County's internal audit functions are shown on the following chart.

Montgomery County Internal Audit Functions

	FY2012 Budgeted In-house Staffing	FY2012 Budget	
		In-house	Contracted
Montgomery County Government			
Internal Audit Department (Executive Branch)	1	$159,510	$234,000
Transfers from other departments	N/A	N/A	$30,000 - $80,000
Subtotal	1	$159,510	$264,000 - $314,000
Montgomery County Office of Inspector General	4[1]	$655,510	N/A
Montgomery County Public Schools	4	$513,559	N/A
Montgomery College	3	$402,000	N/A
Subtotal	11	$1,571,069	N/A
Grand Totals	**12**	**$1,730,579**	**$264,000 - $314,000**

Montgomery County's internal audit functions are not comparable to our county's internal audit function. Unlike Montgomery County, Frederick County does not have an Inspector General's Office to conduct audits and investigations or other internal audit staffs to audit FCC or FCPS. Unlike Montgomery County, Frederick County's Internal Audit Division is solely responsible for conducting internal audits of the three entities. If Frederick County outsources its internal audit function, the BoCC, FCC Board of Trustees, and the Board of Education will be solely relying on a contractor to conduct internal audits.

On October 3, 2011, a member of your committee mentioned that the Internal Audit Division is a good example of "synergy" and inquired as to whether FCC and FCPS are onboard with outsourcing internal audit services. We found that there have been no formal talks with the FCC Board of Trustees and Board of Education on the County's consideration of outsourcing internal audit services or the potential affect on their budgets.

OTHER MARYLAND JURISDICTIONS WITH INTERNAL AUDIT FUNCTIONS

<u>With the Exception of Montgomery County, No Other Jurisdiction in the State Uses Contractors to Perform Internal Audits</u>

The PEC has not considered that nine jurisdictions in the state, including Montgomery County, continue to maintain in-house staffs to perform internal audits. The number of staff and budget for these jurisdictions, including Frederick County, is shown on the following chart:

[1] Staff conducts audits, investigations, and reviews.

Maryland Jurisdictions with Internal Audit Functions[2]

Jurisdiction	FY2012 Budgeted In-house Staffing	FY2012 Budget	
		In-house	Contracted
Anne Arundel	8	$1,012,180	
Baltimore City	36	$3,340,209	
Baltimore County	19	$1,606,258	
Frederick	5.5	$592,890[3]	
Harford	2	$254,619	
Howard	7	$680,000	
Montgomery	12	$1,730,579[4]	$264,000 - $314,000
Prince George's	17	$1,830,000	
Somerset	1	$118,669	
Wicomico	1	$82,800	

Harford County is increasing their oversight of county operations by recently establishing an Office of the County Auditor because of the following reasons:

"…The County Government has a great need for internal auditing capability in addition to the current contractual county auditor…All the other Charter Counties have an Independent Office of County Auditor to prepare various financial reports, internal financial reports, efficiency reports, performance audits and other similar tasks…The County Council and County Executive believe it is both beneficial and essential for the efficient operation of Government to create such an Office of County Auditor."

Also, as a result of "real and perceived ethics challenges facing local government," Prince George's County Executive established the Accountability, Compliance, and Integrity Advisory Board "to help the county Government provide transparent, open, and accountable services for its citizens." The Board strongly recommended creating an Inspector General for Prince George's County Government in addition to its internal audit staff.

While these counties are increasing their in-house oversight functions, Frederick County will be going in the opposite direction if they outsource internal audit services. In fact, if Frederick County outsources its internal audit function, it will be the only jurisdiction in the state to fully outsource its internal audit function.

[2] Carroll County has an internal audit function, but it has not been staffed for approximately 18 months since the retirement of the Internal Audit Director.

[3] The FY 12 budget of $692,890 is overstated by approximately $100,000. This is because the County eliminated one auditor position and the administrative coordinator position was changed to a part-time position. The $592,890 includes about $75,000 in salary and fringe benefits for a vacant position that has been placed on hold until a decision has been reached regarding outsourcing.

[4] This amount includes the Office of Inspector General's budget of $655,510 which is used to conduct audits, investigations, and reviews.

RISKS OF OUTSOURCING

According to an article on outsourcing and co-sourcing in the October 2011 Internal Auditor Magazine published by the Institute of Internal Auditors, outsourcing has risks. The most significant risk is the loss of control. "Losing control in audit engagements could mean uncertainty regarding whether the engagement is staffed appropriately, managed well, and supervised effectively." The article goes on to state "Engagement supervision can provide tremendous opportunities to improve the internal audit function. Hiring internal auditors with the right mix of skill sets, measuring their performance, and providing continuous development opportunities to improve their knowledge of the business, experience and credentials have been identified as key components of internal audit management."

In the September 13, 2011 letter to the BoCC, the four public members of the Interagency Internal Audit Authority (IIAA), who are very knowledgeable of the Internal Audit Division's work, expressed the following concerns.

✓ Outsourcing the internal audit department will lead to a lack of dedicated resources that serve only our county. The staff of any firm engaged to provide outsourcing services will have other clients and competing priorities. Frederick County may have to fight for those resources when they are critical.

✓ We will have no ability to control the staff turnover at the outsourcing firm. An excessive amount of time could be spent training new staff assigned to our account leading to inefficiencies and additional costs. We will also have no control over the capabilities and competencies of the staff assigned to us.

✓ We will lack resources that truly know the county and its operations. It's difficult to place a price on the value of a well trained, knowledgeable, dedicated staff. The current internal audit staff has over 30 years experience auditing the County, FCC, and FCPS.

✓ We will lose a great training ground for future employees who can serve in other areas of our County's government and at our educational institutions.

✓ We will lose our independence, one of the primary reasons the IIAA was established in 1978.

✓ While complete internal audit outsourcing is a concern of ours, the same is not true of co-sourcing. Co-sourcing relies on a strong in-house internal audit department and usually uses external service providers only for non-routine services where special capabilities are needed. We have effectively been using a co-sourcing approach for many years now, utilizing the services of a contractor to assist in the evaluation of our testing of general computer and other information technology related matters.

Costs Will Increase by Outsourcing Internal Audit

In the September 28, 2011 memorandum from the PEC to the Privatization Advisory Committee, it was stated that "Potential savings in outsourcing are unknown until the results of a solicitation or request for proposals (RFP) for these services is completed." Actually, costs are known as the PEC is aware of the cost paid to the contractor used by Montgomery County. The costs are over 20 percent higher than the hourly rate of Frederick County's Internal Audit Division.

In its September 13, 2011 letter to the Commissioners, the four public members of the IIAA, who have many years of experience in public accounting and a detailed knowledge of audit costs, stated that "We will experience increased costs and administration of a third party (blended rates at most firms in our area are ranging from $130 to $140 an hour). This will lead to less audits being performed under the same budget." As a result, there will be less progress made in addressing the 150 high and medium-risk areas in the County, FCC, and FCPS that we have identified in our annual and long range audit plans. Reducing audit coverage will increase risks to the County and its taxpayers that fraud, waste, and abuse, will go undetected.

At the October 3, 2011 meeting, concerns were raised by members of your committee as to whether it was worth going through the extensive effort and costs of developing an RFP. We agree and believe that the cost of this effort should be identified before moving forward.

Using contractors to conduct performance audits does not necessarily mean lower costs and better quality. For example, in the November 2005 general election, the voters in the State of Washington approved Initiative 900 which authorized the separately elected State Auditor to conduct independent, comprehensive performance audits. Nearly all of the first audits were completed using contracts with accounting or consulting firms. By the end of 2009, the Washington State Auditor's Office Performance Audit Division transitioned to using in-house audit staff to conduct audits, with the occasional vendor contract for assistance with subject-matter expertise. According to the Assistant Director of the Washington State Auditor's Office Performance Audit Division, using in-house staff has resulted in the following benefits:

- ✓ The cost per audit has gone down from bringing the audit function in-house. The billing rate of the consulting firms used was generally between $175 and $350 per hour, which was well in excess of in-house costs.

- ✓ They are building capacity for conducting meaningful useful performance audits. Staff are more skilled at analyzing data, recognizing inefficiencies, and applying best practices from other states.

- ✓ Using state agency staff to audit other government agencies avoids the learning curve that private consulting firms have in understanding the government political process, authorizing environment and the lack of a profit motive.

According to the Assistant Director of the Washington State Auditor's Office Performance Audit Division, "the results of audits conducted over the past two years have been especially striking, both in terms of dollars saved and legislative action."

It is Unknown Whether the Quality of Audits Will Improve

The PEC is assuming that the quality of work will improve by using contractors. However, on October 3, 2011 a member of your committee pointed out that the PEC had not indicated any problems with the quality of work by the Internal Audit Division. In fact, the IIAA and Association of Local Government Auditors (ALGA) have attested to the quality of our work.

In its September 13, 2011 letter to the Commissioners, the four public members of the IIAA stated that they have been very pleased with the quality of work and recommend that the BoCC evaluate how it can strengthen the internal audit function instead of outsourcing. "…By focusing on performance audits in the past several years, there are numerous examples where the audits have resulted in more effective and efficient management, actual cost recoveries, and savings. We believe that the success of an internal audit department cannot be measured by the number of reports it issues, but rather by recommendations that have been accepted by management that have resulted in positive change."

Additionally, we have attached a letter prepared by ALGA's Advocacy Committee Chair encouraging you to retain our in-house independent performance audit function. ALGA has conducted five peer reviews of our office since 1998, including the most recent peer review in April. The Advocacy Committee Chair stated that, "While outsourcing for audit resources makes sense when specialized skills are required, in-house functions provide many advantages over outsourcing including: Lower costs per audit hour, greater familiarity with internal operations, continuity of review and oversight, and quicker response to audit requests." The Chair also stated that the last two peer reviews identified several areas where we have excelled including our quality control system used to ensure compliance with *Government Auditing Standards*, our competent and qualified staff, and our audit reports are concise and well written.

"Buy What You Need When You Need It" Is Unrealistic

The PEC's sole basis for using a contractor for internal audit services is that the County can "buy what you need, when you need it," and therefore, the County would save money. Several members of your committee questioned this method on October 3, 2011 because they did not understand it. In a small organization where maintaining an internal audit staff full-time would be cost prohibitive, "buying what you need when you need it" may be sufficient. However, "buying what you need when you need it" is not appropriate in a County that has over 100 high and medium-risk auditable areas and the remaining 50 high and medium-risk auditable areas split about equally among FCC and FCPS. As stated in our October 3, 2011 memorandum, audit needs are identified as we conduct an annual risk assessment and prepare an annual audit plan and a 5-Year plan. These plans are approved by the IIAA. Buying "what you need when you need it" would reduce audit coverage and oversight of operations at the County, FCC, and FCPS by only starting an audit after there is a recognized problem. Additionally, the question of who determines "what you need…?" raises the independence issue because only the IIAA has

the responsibility of determining audit needs.

Montgomery County does not use this method. In fact, they did a risk assessment as the first major audit of the new contractor about 2 years ago. The risk assessment contains a proposed 3 year audit guide and audits are generally selected from this guide with the highest risk audit first. Sometimes they depart from the plan due to emergencies and other needs or if a department requests that they do an audit.

Maintaining an in-house internal audit staff serves as a critical defense against the threat of fraud by periodically assessing and monitoring internal controls designed to prevent and detect fraud. The Internal Audit Division assesses internal controls on every audit and identifies risks, including the risks of fraud. To wait until an audit is needed may be too late.

OTHER COMMENTS

Performance Audits Are Vastly Different from Financial Audits and Require Additional Skills

While the PEC has stated that the hourly rate should not be the sole consideration of overall costs, it is assuming that a contractor can conduct the same performance audits in less time than the current internal audit staff which will offset the more expensive hourly rate. We continue to believe that it would be very unlikely that a firm could reduce the number of hours used by the Internal Audit Division without the extensive performance audit experience and knowledge of County operations. In addition, it is not feasible to determine whether a performance audit can be done cheaper by a contractor than by in-house staff because the time it takes to conduct an audit depends on many factors. These factors include the experience of the staff and the specific audit objectives, scope, and specific audit tests which are not determined until the completion of the planning phase of the audit which includes an assessment of risks.

Performance audits are vastly different from financial audits. When conducting financial audits, auditors test compliance with generally accepted accounting principles (GAAP). However, when conducting a performance audit to assess whether a program is effective, there are often little or no criteria to audit against. The auditor has to determine whether best practices exist and can be used as criteria. The auditor has to assess the auditee's goals and benchmarks, and develop an audit methodology to assess whether a program is effective. This takes time and it is imperative that the auditor understands how the auditee evaluates program effectiveness and has an agreement with management on the criteria to use in the audit. The auditor has to test internal controls and assess risks before gathering evidence and conducting extensive analyses to answer specific audit objectives. After audit tests are conducted, an auditor must be skilled in writing a detailed audit report in a clear and concise manner which has findings and recommendations. Financial auditors rarely have this skill as they are not involved in writing extensive audit reports. Instead, they write financial reports which contain standard language.

If the BoCC does decide to proceed with an RFP to obtain and evaluate bids, it is essential that bidders be evaluated on their demonstrated success in conducting performance audits in a government environment.

The Affect on Operating the County's Fraud Hotline Should Be Considered

Another consideration in proceeding with outsourcing and reducing the staff to one is the potential affect on the Internal Audit Division's ability to conduct timely investigations of complaints made through its operation of the County's Fraud Hotline. This function should not be outsourced to a contractor given the confidentiality of complaints. In recent years, staff have been used to investigate and report on such complaints. Without staff, such investigations may be delayed. The Fraud Hotline offers County employees a way to report their concerns regarding fraud, waste, and abuse within the County Government confidentially and anonymously. Employees should use the Hotline to report apparent unlawful or wasteful acts committed by County employees or acts of others, such as vendors, contractors, or other parties against the good of the County. The Fraud Hotline is meant to be used for instances when a County employee has reasonable suspicions of fraud, misuse of property or theft. These matters may include illegal acts, such as theft, fraud, kickbacks, price fixing, or conflict of interest by County employees and its vendors/contractors; misuse or abuse of County property, including County buildings, vehicles, equipment or County time by County employees, and gross misconduct, incompetence, or inefficiency by County employees.

CONCLUSION

We believe that your committee should reconsider the PEC recommendation to the BoCC to move forward with developing and evaluating bids from contractors due to the reasons stated and because of the expense and effort involved.

First, there is no doubt that the cost of using contractors for internal audit services would be higher than maintaining the current internal audit staff. As stated, Montgomery County pays its contractor over 20 percent more than our hourly cost and the PEC has no evidence that contractors can conduct the same audits in less time especially given the extensive governmental audit experience and institutional knowledge of our staff.

Second, "Buy What You Need When You Need it" is inappropriate given that there are over 100 high and medium-risk auditable areas in the County and about 50 more split about equally between FCC and FCPS. Maintaining an in-house internal audit staff serves as a critical defense against the threat of fraud and periodically assesses and monitors internal controls designed to prevent and detect fraud and reduce inefficiencies. The Internal Audit Division assesses internal controls on every audit and identifies risks, including the risks of fraud. Waiting until an audit is needed may be too late.

Third, outsourcing internal audit services will result in the BoCC, FCC, and FCPS losing an independent dedicated staff that conducts quality audits that have improved operations of the County, FCC, and FCPS and saved taxpayers money. The quality of our work has been proven through on-going IIAA oversight and ALGA peer reviews. Solely relying on a contractor for independent oversight of operations of the three entities, where the quantity of work will be reduced and the quality of work is unknown, has a significant risk to the County and its taxpayers.

Fourth, as stated by the four public members of the IIAA in its September 13, 2011 letter to the BoCC, a better option is co-sourcing which relies on a strong in-house internal audit department and usually uses external service providers only for non-routine services where special capabilities are needed. We have effectively been using a co-sourcing approach for many years now, utilizing the services of a contractor to assist in the evaluation of our testing of information technology related matters, and believe this is the best method of providing internal audit services.

Attachments