



# **Assessment of the Internal Audit Division**

## **February 18, 2021**

**Office of Retirement Services – Internal Audit**

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## Background

The Boards of the Office of Retirement Services (ORS) adopted an Internal Audit Charter (charter) on August 15, 2019. The charter requires that the Internal Audit Division (IAD) maintain a quality assurance and improvement program that covers all aspects of the internal audit activity, including an evaluation of the internal audit activity's conformance with Standards for the Professional Practice of Internal Audit including the Codes of Ethics and Core Principles established by the Institute of Internal Auditors (IIA Standards).

In addition, the charter requires the IAD to communicate the following to management and the Board:

- Results of both the continual internal assessments and periodic external evaluation of an independent third party at least once every five years.
- Confirmation to the Boards through the Audit Committee, at least annually, the organizational independence of the internal audit activity.<sup>1</sup>

This memorandum documents the required internal assessment and recommended corrective actions as of January 2021.

## *Why use auditing standards?*

According to the Institute of Internal Auditors (IIA), the mission of an internal audit function is to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight. IIA Standards provide a framework that is designed to help achieve this mission, evaluate internal audit performance, and foster improved organizational processes and operations. The IIA's code of ethics requires internal auditors to perform internal auditing services in accordance with the IIA Standards.

## *Methodology*

To assess compliance with IIA Standards, the IAD used the Association of Local Government Auditors' guide for assessing conformance with the IIA Standards. The guide required validating that the IAD's charter, policies and procedures, work products, and organizational attributes met the IIA Standards. The IAD also surveyed other internal audit functions to compare its current and past practices in selected areas with benchmark agencies.

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<sup>1</sup> The IIA Standards require independence and objectivity of the IAD and its work, respectively. Independence is the freedom from conditions that threaten the ability of the IAD to carry out internal audit responsibilities in an unbiased manner. Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made.

## Results

As required by the IIA Standards, a charter defines the purpose, authority, and responsibility of the IAD. Consistent with the charter, starting in 2019, the IAD issued a risk-based, five-year audit plan and issued several audit reports with audit findings and recommendations. Most of the audit reports included a response from management regarding ORS's disposition on the audit findings and recommendations.

### Benchmarking

Comparisons of the IAD with benchmark audit functions, shown in the Exhibit, suggest that the reporting structure of the IAD is generally consistent with other agencies and in compliance with requirements for organizational independence under the IIA Standards. However, unlike other agencies, the IAD has not had an external assessment (peer review) and does not cite whether it conforms with the IIA Standards in its audit reports. The IAD's charter and the IIA Standards require an external assessment at least once every five years to determine whether the IAD's work meets the IIA Standards. The benchmarking results also show opportunities for improvement in organizational independence. For example, the IAD does not have an independent budget and unlike most surveyed audit functions, ORS's CEO is responsible for the hiring, performance appraisals, and remuneration of the CAE.<sup>2,3</sup>

### Exhibit: Benchmarking Results

Question	ORS	ACERA	LACERA	OCERS	SDCERS
1. Who does the Chief Audit Executive (CAE) report to primarily?	<b>Audit Committee</b>	Board	Audit Committee	Audit Committee	Audit Committee
2. Who does the hiring, performance appraisals, remuneration, etc. for the CAE?	<b>CEO</b>	CEO <sup>3</sup>	Audit Committee	Audit Committee	Audit Committee
3. When was your last external assessment (peer review) and its result?	<b>Not Done</b>	2019 – Pass <sup>3</sup>	2016 - Pass	2019 - Pass	2019 - Pass
4. How many Internal Audit FTEs do you have?	<b>1 FTE</b>	3 FTE	11 FTE	2 FTE	1 FTE
5. Does Internal Audit have an independent budget? If so, who approves it?	<b>No</b>	Y/Board	Y/Board	Y/Board	Y/Board
6. Do you include a conformance statement in your audit reports?	<b>No</b>	Yes	Yes	Yes	Yes

**Notes:** ACERA: Alameda County Employees' Retirement Association; CAE: Chief Audit Executive; CEO: Chief Executive Officer; LACERA: Los Angeles County Employees Retirement System; OCERS: Orange County Employees Retirement System; SDCERS: San Diego City Employees' Retirement System

<sup>2</sup> The IIA defines the Chief Audit Executive (CAE) as a person in a senior position responsible for effectively managing the internal audit activity in accordance with the internal audit charter and the mandatory elements of the IIA Standards. At ORS, the senior auditor is effectively the CAE.

<sup>3</sup> The external assessment team stated that in the future they would take a stricter approach in assessing whether the CEO's role in hiring, performance appraisals, and remuneration of the CAE threatens the CAE's independence.

*Organizational independence could be enhanced*

The IAD is currently staffed with a single senior auditor, who is the Chief Audit Executive (CAE), as defined under the IIA Standards. Although the CAE currently reports functionally to the Boards, the following aspects of the IAD's reporting structure are inconsistent with the IIA Standards for achieving independence:

- ORS management is responsible for hiring the CAE and approving the CAE's salary. This could present a conflict of interest for management. Management may not have an interest in hiring and properly compensating a highly qualified CAE whose mandate is to provide the Audit Committee and public with objective and independent audit findings and conclusions about management's operations.
- ORS management is responsible for conducting performance appraisals of the CAE. This could bias the CAE in how and whether he/she reports audit findings and conclusions to the Audit Committee. For example, the CAE may have to balance his/her mandate to provide objective information to the Audit Committee with the potential for a negative performance evaluation from management if there is disagreement on audit findings and recommendations.
- The IAD does not have an independent budget and resource plan that is approved by the Boards. This could prevent the CAE from purchasing audit tools, resources, and/or outside expertise needed to complete audits and maintain professional certifications that are not a high priority for management.

Any changes to the current reporting structure of the IAD may require coordination with the City's Human Resources Department and could require changes to the current CAE's job classification or hiring of a new CAE into a different job classification. Such changes may incur additional costs to the ORS. In addition, City rules and regulations may limit the ORS's ability to implement changes to the reporting structure for the IAD and the approval process for its budget and resource plan.

*Formal process to monitor management's actions not established*

The IAD has not implemented a system to track the status of audit recommendations to ensure that ORS management is accountable for implementing audit recommendations or accepting the risk of not taking action. The IIA Standards require the CAE to establish and maintain a system to monitor the disposition of audit results communicated to management. The IAD is currently working to meet this requirement.

*Policies and procedures should be established for the IAD*

The IAD does not yet have policies and procedures, workpaper templates, or a standardized audit documentation system. The IIA Standards require that the CAE

establish policies and procedures to guide the internal audit activity. This requirement is important to ensure:

- Audit work is appropriately planned to meet audit objectives in an efficient and effective manner (e.g., the scope of an audit should include relevant, high-risk areas, including the risk of fraud, and leverage technology-based and data analytic techniques).
- Audit work complies with the IIA Standards (i.e., to show that audit conclusions and recommendations are based on sufficient, appropriate evidence)
- Institutional knowledge is retained, especially when there is turnover of staff in a small audit shop. In addition, policies and procedures should serve to memorialize decisions about how to properly scale audit steps and procedures to serve ORS's needs while meeting the IIA Standards.
- The IAD can provide professionally prepared audit records in response to public records requests or legal mandates.

*The IAD must evaluate ethics and information technology governance*

The IAD has not done work to assess governance in the areas of ethics and information technology. The IIA standards require the IAD to assess and make recommendations to improve the ORS's governance processes. In addition to strategic, operational, risk management, and control risks, the IAD must evaluate ethics-related risks and whether information technology governance supports the ORS's strategies and objectives. The IAD is currently working to meet this requirement.

*Formal conformance with the IIA Standards will require an external review*

The audit reports issued by the IAD to date have not cited conformance with the IIA Standards. Audit reports that are done in accordance with the IIA Standards should include a conformance statement (i.e., "Conforms with the International Standards for the Professional Practice of Internal Auditing"). Use of the conformance statement requires that the results of both internal and external assessments of the IAD demonstrate compliance with the IIA Standards. This document presents the IAD's first internal assessment and shows areas of nonconformance that should be addressed. In addition, the IIA Standards require external assessments of the IAD at least once every five years by a qualified, independent assessor or assessment team from outside of the organization. Should the ORS Boards prefer that the IAD prioritize demonstrating full compliance with the IIA Standards and use of the conformance statement in audit reports, the IAD will need to contract for an external assessment sooner.

*The staffing of the IAD may not be sufficient to complete scheduled audits and comply with the IIA Standards*

Achieving compliance with the IIA Standards will require additional allocation of the IAD's existing resources, which currently consists of one senior auditor FTE. Creating and implementing the various internal audit functions mandated by the IIA Standards (e.g., monitoring management's actions on audit recommendations)

and creation of policies and procedures and audit templates will compete with the existing work priorities of the IAD, as defined in the five-year work plan approved by the Boards in 2019. The IIA standards require that the CAE ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved work plan. Due to turnover in the office, the IAD has recently resumed work on audits that were originally anticipated for completion as part of the Fiscal Year 2019/2020 work plan. Completing the IAD's existing five-year work plan in a timely manner may require additional staffing, especially if the work is to be completed in compliance with the mandated IIA Standards.

## **Corrective Action Plan**

1. At its discretion, to achieve organizational independence for the IAD, the ORS Boards should consider working with the ORS director and the Human Resources Department to explore:
  - Options to assign the responsibility of hiring, evaluating, and compensating the CAE to the Boards or Audit Committees of the Boards.
  - Providing an independent budget, approved by the Boards, to the IAD.
2. The IAD should establish a process to monitor the status of ORS management's responses and actions to address audit recommendations. (IAD Target Date: February 2021)
3. The IAD should establish a process to periodically evaluate ethics and information technology governance at ORS. (IAD Target Date: February 2021)
4. The IAD should establish policies and procedures, workpaper templates, and a standardized audit documentation system to guide the internal audit activity. (IAD Target Date: January 2023)
5. After demonstrating compliance with the IIA Standards through internal assessments, contract for an external review of the IAD. (IAD Target Date: August 2024 or sooner if the ORS Boards prefer that the IAD demonstrate full conformance with the IIA Standards and use a conformance statement in audit reports)