OFFICE OF THE INSPECTOR GENERAL

MEMORANDUM

July 12, 2012

TO: Hon. Roger Berliner, President, County Council
Hon. Isiah Leggett, County Executive

FROM: Edward Blansitt
Inspector General

SUBJECT: Conclusion on Clifton Larson Allen Independence

Clifton Larson Allen LLP (CLA) audited the County's financial statements as of and for the year ended June 30, 2011 and issued their opinion thereon in March 2012. CLA also, using a different team of people who observed certain agreed-upon protocols, assisted the County in cleaning up its books of account which provided support for elements of those financial statements. We were asked to comment on this arrangement, particularly as to whether CLA's performing the additional work impaired the independence of the CLA audit team.

We decided to use an outside Certified Public Accountant to objectively review this matter. His report, which concludes that CLA did not, by doing such work, impair its staff members' or the firm's independence, is attached. We concur with his conclusion.

We previously provided a draft of this report to the County's Chief Administrative Officer for his review. He had no issues with the report.

If you have any questions about this report, please contact me at 240-777-8241.

Attachment

cc: County Council Members
Timothy Firestine, Chief Administrative Officer

Memorandum **June 27, 2012**

To: Edward L. Blansitt, Montgomery County Government Inspector General
From: Alan M Klein, CPA, Consultant
Subject: Clifton Larson Allen Independence in Performing Non-Audit Work

Objective

This memorandum responds to your request to determine whether the "safeguards" established for Clifton Larson Allen (CLA) to enable them to perform nonaudit service work as well as the annual financial statement audit were effective in ensuring CLA's auditor independence.

Scope and Methodology

The period for consideration is the Fiscal Year (FY) 2011 accounting period for the annual financial statement audit. CLA has a contract with the Montgomery County Government (MCG) to perform the annual financial statement audit, FYs 2008, 2009, 2010, and 2011. CLA issued its opinion on the FY 2011 MCG financial statements in March 2012.

We obtained an understanding of the MCG's Department of Finance (DOF) processes and requisite internal controls that were established for the CLA nonaudit services. We tested the key controls to ensure they were operating effectively and prevented CLA resources from impairing their or the firm's independence.

This evaluation was conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require planning and performing the evaluation to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our evaluation objectives. The evidence obtained is believed to provide a reasonable basis for my findings and conclusions.

Background

The MCG DOF performs work annually to close the County Government's books and to compile the annual financial statements. MCG DOF incurred challenges in closing the County Government's books for FY 2011. This was attributed to the July 2010 implementation of Oracle business software, the County Government's Enterprise Resource Planning (ERP) system, and because of staff turnover. These delays prevented the MCG DOF from compiling the County Government's annual financial statements on its normal timeframe.

As previously stated, CLA (previously Clifton Gunderson LLP) has been performing the annual financial statement audit of the County Government's financial statements mandated by the County Charter and County law for the past four years. FY 2011 was the final year of their four year contract. A new contractor will perform the annual financial statement audit in the future.

CLA performs this work under a contract with the County Council, and the Office of Legislative Oversight serves as the contract administrator. Among other issues, the delay in the closing of the County Government's books for FY 2011 prevented CLA from timely performing its final fieldwork on the audit of the County Government's FY 2011 financial statements. MCG decided to enlist the services of CLA to assist with the closing of the FY 2011 books. This added work was permissible under the contract, but certain measures would need to be taken since CLA would be performing the annual financial statement audit and this additional work, referred to as nonaudit services.

The Council's contract with CLA specifically states that the Council may amend the contract to add accounting services to the scope of work. Under Article I, Section B, Optional Work, the contract states:

> [T]he County's Department of Finance may request consulting services on specific financial reporting requirements. The County Council will amend the Contract to add optional work....Optional work may include, but is not limited to:
>
> (2) Accounting Services -The County may require professional accounting services from the Contractor to a) assist with the close of the County's books, b) assist with preparation of draft schedules to support each fund and draft financial statements, and c) provide other related professional services.

The MCG staff did not believe that this additional work by CLA created a conflict of interest. Under GAGAS an audit organization and an individual auditor must avoid "personal, external, and organizational impairments to independence, and must avoid the appearance of such impairments of independence…" Stated more simply, an auditor must avoid a conflict of interest in fact or appearance to maintain independence.

The question of whether a conflict of interest would arise if CLA were to provide staff to the MCG DOF under this contract amendment stems from the fact that CLA would be performing work to help compile the County Government's financial statements and subsequently CLA staff would then perform an audit of those financial statements.

The MCG DOF and CLA discussed at length the steps that would need to be taken to ensure that the work under this contract amendment would not jeopardize CLA's independence. The following are the safeguards that MCG DOF and CLA believed would ensure CLA's auditors' independence:

- The CLA staff members working in the MCG DOF would not be the same CLA staff members that perform the audit of the County Government's financial statements.
- The CLA staff members working in the MCG DOF would work under the authority of a CLA partner who is not associated with CLA's audit work for the County Government.
- The CLA staff members working in the MCG DOF would be supervised by and receive direction directly from MCG DOF staff, not CLA supervisors.

- The CLA staff members working in the MCG DOF and the staff members performing the audit work would be instructed to never speak with each other.
- CLA would make its best effort to have the staff members working in the MCG DOF come from a different office than the staff members performing the audit work.
- The CLA staff members working in the MCG DOF would not be allowed to enter any information into or change information in the County Government's financial software.
- The CLA staff members working in the MCG DOF would not have any authority to make any management-type decisions.

The MCG DOF and the CLA lead partner believed that these safeguards created a sufficient "firewall" between the CLA audit work and the CLA nonaudit services that would allow CLA to maintain its independence.

Internal Controls

At the onset of agreeing to have CLA do nonaudit work as well as the annual financial statement audit, CLA and MCG DOF assessed the potential independence ramifications and concluded that with proper internal controls (safeguards) the nonaudit work could be performed.

A key area of concern for potential impairments was the decision process and the generating and inputting of data (transactions) into the MCG's Oracle accounting system, especially Adjusting Journal Entries (AJE) and management of the CLA staff work. Due to the issues with closing the FY 2011 books, almost 200 AJEs were generated. The process was that MCG DOF staff were fully responsible for generating and posting AJEs to the accounting system. There were automated internal controls whereby only MCG DOF staff with authorization were permitted access to the accounting system to input or change data. The CLA staff had permissions for the accounting system that allowed them "view only" of accounting system data and reports. Limited testing of internal controls for access to the system showed that only those staff members with access permission and authorization to input or change data could do so and those with access but without authorization could not. We tested one MCG DOF staff that had permission and found that this person was able to get on the system and have full access, and tested one CLA staff member who logged onto the system but was limited to read and view access only.

The internal controls over AJEs also required that the appropriate MCG DOF prepare the AJE and another staff member, generally a supervisor, sign off on all AJEs. We tested 30 AJEs and found that they were posted properly.

CLA Staffing and Process for Tasks

In providing the nonaudit services CLA used seven staff ranging from Associate to Manager.

David Crow - Senior Manager, Calverton
Leeann Ahern – Manager, Timonium
John Homan – Manager, Arlington

Maggie Huang - Senior Associate, Calverton
Jillian Barnhill – Associate, Calverton
Lisa Hamer – Associate, Calverton
Katherine Jackson – Associate, Calverton

To perform the annual audit, CLA used seven different staff ranging from Associate to Senior Manager with a Partner assigned. This met one of the key "safeguards" to avoid impairment.

The process for CLA's nonaudit work was that MCG DOF staff would identify tasks, such as performing a reconciliation or extracting a report, which was communicated via an email to CLA. A CLA staff person would perform the task and provide the feedback and results to the MCG DOF requester. CLA maintained binders of the work they performed. This process was not documented but was consistently followed. The process would be improved by MCG DOF documenting the process and ensuring that all current and future MCG DOF staff involved with this work understand and follow the process.

Conclusion

The only contract stipulation that was not fully met was the one whereby staff members on the nonaudit work were to be from a different CLA office. Due to CLA resource availability and the tight timeframe to do the nonaudit work, this stipulation was not fully met.

Further, the safeguard that CLA staff members were not supposed to communicate with each other was not possible to test. Nevertheless, I conclude that the internal controls (safeguards) that were established by MCG DOF were effective in ensuring that CLA did not impair its staff members' or the firm's independence.