

Table of Contents

Texas Department of Transportation Effectiveness of Internal Audit Engagement June 1997

Overall Conclusion	1
The Department Does Not Fully Comply With Rider 22 and the Texas Internal Auditing Act	2
Without Considering the Requirements of Rider 22, the Audit Office, While Effective in All Eight Criteria, Can Improve in Three Criteria	4
Preparation of the Audit Plan	4
Ensuring Compliance With Audit Standards	5
Management Involvement in the Audit Office	6
Excluding the Requirements of Rider 22, the Audit Office is Effective in Five Effectiveness Criteria	7
Appendix Objectives, Scope, and Methodology	9

Texas Department of Transportation

Detailed Issues and Recommendations

Overall Conclusion

The Texas Department of Transportation (Department) internal audit function may be impaired because it does not fully comply with statutes which require qualified internal auditors in each division and district. Internal Review Analysts (IRAs) in the districts and divisions, which constitute 72 percent of the audit staff, do not report to and are not fully supervised by either the Department's Director of Audits (appointed the internal auditor for the Department pursuant to the Texas Internal Auditing Act) or the Texas Transportation Commission (Commission), as required by statute.

- Prior to September 1, 1995, the Department did not consider the IRAs in the districts and divisions to be part of the headquarters internal audit function. The General Appropriations Act, Rider 22, required internal auditors to be located in the district and division offices.
- The Department has made or proposed the following changes:
 - The IRAs are submitting their reports to the Director of Audits.
 - The IRAs' contribution to the planning process began August 1996.
 - The Director of Audits meets annually with each IRA to address any limitations on review work or reporting.
 - An internal peer review process is being implemented for IRAs.
- The district engineers and division heads will continue to hire, supervise, and evaluate the IRAs.
- These changes will not meet the legislative intent for the IRAs to report to and be fully supervised by the Department's internal auditor or the Commission.
- Without consideration of the requirements of Rider 22, the Internal Audit Office would be effective in all eight effectiveness criteria.

**Texas Department of Transportation
General Appropriations Act,
74th Session
Appropriation Rider 22**

The Department of Transportation shall maintain an internal auditing program in compliance with the provisions the Texas Internal Auditing Act, which shall incorporate, at a minimum, the assignment of an internal auditor at each district office and within each division of the Department. Each internal auditor assigned pursuant to this provision shall report either directly to the Commissioners of the Department of Transportation or to the internal auditor appointed pursuant to Section 2102.006, Government Code.

An internal auditor whose duty station is assigned pursuant to this provision may consider suggestions from a District Engineer in developing proposals for the Department's annual audit plan.

As of September 1, 1995, Rider 22 increased the number of internal audit staff, including the IRAs and the Audit Office staff, to 61 auditors. Of this number, 44, or 72 percent, are IRAs. Audit coverage includes total revenue of \$1.8 billion, contract expenditures of \$1.9 billion, and more than 15,900 employees.

Texas Department of Transportation

Detailed Issues and Recommendations

Section 1:

The Department Does Not Fully Comply With Rider 22 and the Texas Internal Auditing Act

The Department's use of IRAs does not fully comply with laws because of the following:

- IRAs are responsible to the district engineers and the division heads; they are not fully supervised by the internal auditor or the Commission as required by statutes and audit standards.
- The IRAs operate independently from the central Audit Office's audit plan.
- While the IRAs, by agency policy, follow the Standards for the Professional Practice for Internal Auditing, they do not follow Government Auditing Standards (GAS).
- Only 7 of the 29 IRAs who responded to the survey meet the continuing educational requirements of GAS.
- The Texas Internal Auditing Act, GAS and the *Standards for the Professional Practice of Internal Auditing* require the work of the internal audit function to be subject to an external peer review. The IRAs' work has not been included in the periodic external peer reviews of the Audit Office.
- The Department has 19 divisions, and only 8 divisions have IRAs.

The current policy only requires the IRAs to submit their reports and audit plans to the Audit Office. Since the IRAs do not report directly to the internal auditor or the Commission, the IRAs' independence and objectivity are impaired. Also, the audit function is not coordinated throughout the Department. In addition, the IRAs may not be qualified to conduct internal audit engagements since their work does not follow auditing standards.

The Department has assured the Conference Committee in recorded testimony that they would comply with Rider 22 which became effective on September 1, 1995. As early as 1977, the Department's own administrative memos have stated that the IRAs should be part of the internal audit function. A 1985 Price Waterhouse report stated that the IRA audit contribution was impaired. Since the inception of the district internal review function at the Department, recommendations have been made to coordinate the district internal review function and the Department's internal audit function. The recommendations have been made in different external reviews and by separate audit organizations. Since fiscal year 1988, the Legislature has included a rider that appears to require the Department to coordinate and centrally manage the internal audit function.

Texas Department of Transportation

Detailed Issues and Recommendations

Recommendation:

We recommend that the Department comply with the requirements of Rider 22 and the Texas Internal Auditing Act. The rider requires an internal auditor in each district and division.

The Department should adopt policies requiring the IRAs to comply with the Government Auditing Standards in addition to the Standards for the Professional Practice of Internal Auditing.

Management's Response:

*We believe that our current process (described in our August 1996 Internal Audit Manual and apparently mentioned as "the new policy" in your report) does comply with the intent of Rider 22. We reviewed Texas Department of Transportation's (TxDOT) testimony before a Conference Committee of the 74th session before our current planning and reporting processes were developed, and again upon receipt of this report -- and still come to the conclusion that they address the concerns expressed by that Conference Committee. Both processes were designed to provide full visibility of all audit planning and performance to the Audit Director and the Transportation Commission -- regardless of the scope of the work, or the physical location of the auditor's duty station. The processes also provide every district and division IRA direct contact with TxDOT's Audit Director, including **at least** an annual private discussion with the Audit Director. Audit plans are coordinated on an annual basis.*

*TxDOT is committed to a strong internal auditing function serving management's needs **throughout** the department. In 1971 the department started an independent internal review function which reported to the agency head. Based on the effectiveness of this, a second tier was established in 1975 to broaden internal audit coverage more to fully meet district and division level needs. This second tier is an essential management tool at the local level, and also provides valuable input at the central level. We do not believe it was the intent of the rider that we reduce our audit coverage and deprive local management of this valuable tool.*

As stated in the report, TxDOT policy expects all internal auditors (Audit Office and IRAs) to comply with the Standards for the Professional Practice of Internal Auditing - the standards specifically named in the Internal Auditing Act. We adopted these standards, long before passage of the Internal Auditing Act, as the most comprehensive professional standards relevant to an internal audit function, and were pleased to see the Act also recognize that. We are aware of no benefit to be gained by making the policy change recommended. We did, after the passage of Rider 22, develop a peer review program for IRAs. This is currently being implemented and is expected to enhance compliance with internal audit standards and increase effectiveness.

Texas Department of Transportation

Detailed Issues and Recommendations

Auditor Follow-Up Comment:

The Department cannot comply with Rider 22 by simply designating IRAs in the districts and divisions as internal auditors. The IRAs are not fully supervised by the internal auditor or the Commission. The IRAs continue to work under the direction of the district engineers and division heads. This condition compromises the ability of the IRAs to conduct independent reviews. Not all divisions have IRAs. If the Department wants to use IRAs for the internal audit function, the IRAs must meet all internal auditing standards and Government Auditing Standards.

Currently, Department auditing policies do not require compliance with government auditing standards. The Texas Internal Auditing Act requires compliance with both *Standards for the Professional Practice of Internal Auditing* and generally accepted governmental auditing standards. Generally accepted government auditing standards are promulgated by the Comptroller General of the United States.

Section 2:

Without Considering the Requirements of Rider 22, the Audit Office, While Effective in All Eight Criteria, Can Improve in Three Criteria

Section 2-A:

Preparation of the Audit Plan

Although Audit Office's audit plans were substantially complete for the past three years, the Audit Office does not estimate budget hours on the risk assessment or the audit plan. Without estimates of budget hours, executive management does not have information to determine if the internal audit resources are sufficient to address risk.

Also, about one-third of the total available internal audit hours have been used to address special projects. The type of unanticipated work done by the Audit Office was not subjected to the same risk assessment as the audit plan. Thus, internal audit resources may not have been applied to the most risky areas. The audit hours used for special projects is high, which suggests that the risk assessment and audit plan may not be identifying the areas management considers the highest risks in the Department.

Recommendation:

We recommend that the Office include estimated audit hours for auditable units in the risk assessment. The Office can project the number of hours necessary to perform the planned reviews. The plan can allocate time for special projects. The information could also be used to perform a staffing analysis to determine if there are adequate resources in the Audit Office to review the highest risk areas. This process would

Texas Department of Transportation

Detailed Issues and Recommendations

allow the Audit Office's limited resources to be directed at the areas management considers the highest risk. The percentage completion of the audit plan could be used as a performance measure.

Management's Response:

We appreciate the acknowledgment that the preparation of our annual audit plan is effective - even though it may not be done as some literature and other offices describe. Executive management has significant other information available upon which to base allocations of resources. The current audit planning process focuses available audit resources at the highest perceived risk areas, and makes it possible for those resources to respond to changing conditions in a timely manner. We do not feel that adding estimated hours to the annual risk assessment process would improve the result.

Auditor Follow-Up Comment:

Without using budget hours estimated for projects, executive management does not have information necessary to determine if the internal audit resources are sufficient to address the high-risk areas in the Department. *Standards for the Professional Practice of Internal Auditing*, Section 520.04 (c), states that audit work schedules should include the estimated time required for the auditable activity. While this is a guideline, it describes a suitable means of addressing the standard. Also, this condition was documented in the Audit Office's 1994 Peer Review.

Section 2-B:

Ensuring Compliance With Audit Standards

The Audit Office does not document compliance with Government Auditing Standards. The Audit Office does have an effective quality assurance process that complies with the *Standards for the Professional Practice of Internal Auditing*. However, statutes require that state agency internal audit functions also comply with Government Auditing Standards.

Recommendation:

We recommend that the Audit Office:

- Incorporate Government Auditing Standards into division policies.
- Track continuing professional education according to Government Auditing Standards.
- Disclose in audit reports that the work conducted was in accordance with Government Auditing Standards.

Texas Department of Transportation

Detailed Issues and Recommendations

- Monitor changes to the standards and make timely changes to policies.

Management's Response:

As stated in the report, the Internal Audit section has an effective quality assurance process that complies with the Standards for the Professional Practice of Internal Auditing. Internal Audit management is knowledgeable of Government Audit Standards, and we do not find that the two sets of standards are in conflict. No substantive matters of non-compliance were brought to our attention during the audit. We do currently track continuing professional education in a manner consistent with Government Auditing Standards. No changes are planned based on this recommendation.

Auditor's Follow-Up Comment:

Statutes require compliance with both the *Standards for the Professional Practice of Internal Auditing* and Government Auditing Standards. The most significant non-compliance issue is that the Department does not disclose in audit reports that the work conducted was in accordance with Government Auditing Standards. Also, Government Auditing Standards require specific amounts of training in governmental topics. The Audit Office does not maintain a record of which courses relate to the governmental environment.

Section 2-C:

Management Involvement in the Audit Office

The Commissioners have limited their involvement in the Audit Office. The Commissioners have delegated responsibilities to the Executive Director to approve the annual audit plan and to perform the annual evaluation of the Director of Audits. Executive management is actively involved in the internal audit process. Although the Commission can delegate, the action limits the Commission's knowledge of the Department's operations. Also, management does not use performance measures to evaluate the performance of the Audit Office.

Recommendation:

We recommend the Commissioners increase the involvement with the Audit Office by actively monitoring and evaluating the Office's performance. The Commissioners, with input from the Audit Office, should develop written measures, goals, and objectives to evaluate the Audit Office. Status reports should include the progress of the Audit Office in performance against the established measures. This will help to ensure the Audit Office is meeting the needs of the Commission and management.

Texas Department of Transportation

Detailed Issues and Recommendations

Management's Response:

The Commission currently receives a detailed audit plan for the Audit Office, along with a summary of audit plans for district and division IRAs, before each plan is implemented. At that time, and at anytime throughout the year, commissioners are free to express any areas of concern not already in the plan, and those concerns are addressed. Commissioners currently receive monthly status reports of all internal audit work, along with a summary of district and division IRA reports. The Audit Office director does meet with individual commissioners. We feel that these tools are adequate to ensure the Audit Office is meeting the needs of the Commission, and plan no changes based on this recommendation.

Auditor's Follow-Up Comment:

A critical element of achieving accountability and an effective control environment is the oversight by Commissioners. The Commissioners' oversight is necessary because the internal audit function reviews operations of executive management. The Commissioners serve as a means of reducing the risk of management override of key elements of the internal control system. The Commissioners' participation can be improved by implementing our recommendations.

Section 3:

Excluding the Requirements of Rider 22, the Audit Office is Effective in Five Effectiveness Criteria

- **Assessing Entity Risks** - The Office conducts a formal risk assessment process. All major areas of the Department are considered in the risk assessment. Both the Audit Office staff and Department management are involved in evaluating the Department's risks. The Audit Office uses the risk assessment to develop its annual audit plan.
- **Organizing and Managing the Audit Office** - The Audit Office is independent of operational and management responsibilities. The audit staff uses due professional care in conducting audit assignments. The audit staff has the necessary skills, educational backgrounds, professional certifications, and experience to carry out the applicable audit responsibilities.
- **Planning and Conducting Audits** - The Audit Office includes each of the five audit objectives in the *Standards for the professional Practice of Internal Auditing* in each audit reviewed. The audit work meets the stated objectives and scope for each audit. The auditors use due professional care in performing the audits. The auditors are aware of the potential for fraud. They include steps in the audit programs to evaluate the risks that fraud may have been committed. The evidence in the working papers supports the findings. The

Texas Department of Transportation

Detailed Issues and Recommendations

auditors carry the findings to the report. The Audit Office distributes the reports to the appropriate Department officials.

- **Communicating Internal Audit Office Results** - The results of the audits are appropriately communicated, in written format, to the proper level to ensure corrective action is taken. The audit reports follow an appropriate format. The reports include an introduction, which is followed by the scope and the opinion. The reports provide a summary of findings, the detailed findings and the recommendations, which include managements' responses.
- **Follow-Up on Recommendations** - The Audit Office performs follow-up reviews on recommendations from prior audit reports. The Audit Office requires written reports on the results of the follow-up reviews. In these reports, the Audit Office determines whether management has taken appropriate corrective action. Ultimately, senior management assumes the risk for the decision, which is documented in follow-up reviews.

Objectives, Scope, and Methodology

Objective

The objectives of Evaluating the Effectiveness of Internal Audit were to:

- Evaluate the effectiveness of the State's internal audit departments.
- Determine whether internal audit departments were meeting the key objectives of internal auditing and assist agency administrators in carrying out their assigned responsibilities.

Scope

The scope of the audit included:

- Evaluating the effectiveness of 12 of the larger state agencies' internal audit departments
- Surveying the board chairs, elected officials, audit committee chairs, and internal audit department directors of the 79 agencies and universities with internal audit departments to obtain their opinions and comments on the effectiveness of internal auditing, and compiling the results of the survey

Methodology

The methodology used on this engagement consisted of developing criteria, obtaining information on each of the 12 agencies selected for review, analyzing the information, and evaluating the information against the criteria.

Information collected to accomplish the audit objective included the following:

- Interviews with management of oversight agencies
- Interviews with management and staff of individual agencies
- Documentary evidence, including:
 - State statutes
 - Internal auditing standards
 - Government Auditing Standards
 - Agency documents including plans, policies, procedures, manuals, reports, memoranda, and other written communications
 - Internal audit reports

Objectives, Scope, and Methodology

Procedures and tests conducted:

Internal audit function information collected in the current fiscal year and the last two completed fiscal years was evaluated against criteria developed from the Texas Internal Auditing Act.

Criteria used:

- Criteria developed from the Texas Internal Auditing Act

The following are the eight basic effectiveness criteria and a brief definition of each:

- **Board/Management Involvement in Internal Audit Function** - The agency's board or elected official and executive management are adequately involved in the internal audit function and in completing their responsibilities under the Texas Internal Auditing Act
- **Organizing and Managing the Internal Audit Function** - The internal audit director is effective in managing and organizing the internal audit department.
- **Assessing Entity Risks** - A risk assessment is used in the audit planning process and all agency risks are identified and appropriately ranked.
- **Preparation of the Audit Plan** - The audit plan includes those areas identified as high risk, and resources are available to complete the plan.
- **Planning and Conducting Audits** - Audit projects are properly planned, and due professional care is used in performing the audits.
- **Communicating Audit Results** - The results of audits are appropriately communicated in written format to the proper level to ensure corrective action is taken.
- **Ensuring Compliance With Audit Standards** - The internal audit department takes steps to ensure work conforms to audit standards.
- **Follow-Up on Audit Recommendations** - The internal audit department follows-up recommendations in audit reports from prior periods.

Objectives, Scope, and Methodology

Other Information

Fieldwork was conducted from April to September 1996. The audit was conducted in accordance with applicable professional standards, including:

- Generally Accepted Government Auditing Standards
- Generally Accepted Auditing Standards

The audit work was performed by the following members of the State Auditor's staff:

- Scotty Killingsworth, CIA (Team Leader)
- Arthur B. Arispe
- Michelle A. Duncan
- Larry Vinyard, CPA, CIA (Project Manager)
- Linda C. Lansdowne, CPA (Quality Control Reviewer)
- Charlie Hrcir, CPA (Audit Manager)
- Deborah Kerr, Ph.D. (Audit Director)

