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## A Report on The Effectiveness of Internal Audit

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July 1997

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# Key Points of Report

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### Overall Conclusion

The internal audit function for the State's largest agencies is effective except for two agencies. Of the 12 state agencies reviewed, 10 have effective internal audit functions. The two agencies with ineffective internal audit functions, the Texas Education Agency and the Texas Workforce Commission, have made improvements since our review.

This audit was conducted to review the effectiveness of executive agency internal audit functions. Our review covered site visits and evaluations of 12 of the larger state agency internal audit departments. Based on 1995 data, the 12 agencies represented more than 77 percent of total state operating budgets and more than 71 percent of total state revenues. Also, the 12 agencies represent more than 95 percent of total contracting expenditures for the State. We did not include higher education in this review because our focus was on covering agencies with major contracting expenditures.

### Key Point

To enhance the effectiveness of the internal audit function, agencies should emphasize training management and administrative personnel to recognize the need for controls that ensure the proper and effective use of resources and protect physical assets. Each level of management should have responsibilities for identifying risk, designing procedures to minimize risk, monitoring how those procedures impact risk, and making needed adjustments to the procedures.

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*This audit was conducted in accordance with Government Code, Section 321.015.*

# Issues

Section 1:

## The Internal Audit Functions of the State's Largest Agencies Are Effective

We reviewed 12 of the larger state agency internal audit functions. Ten agency internal audit functions were effective and two were ineffective. The two agencies with ineffective internal audit functions, the Texas Education Agency and the Texas Workforce

Commission, have made changes to improve the function since our review. Other agencies have opportunities to make improvements in their internal audit functions.

The State Auditor's Office released a management letter report on each agency. If you are interested in receiving copies of these reports, please call Production Services at (512) 479-4740, or use the enclosed order form.

## Summary of Effectiveness of Internal Audit Functions by Agency

Agency (Arranged in General Appropriations Act Order) <sup>D</sup>	Overall Evaluation	Effectiveness Criteria <sup>A</sup>							
		Board/ Management Involvement	Managing Internal Audit Function	Assessing Risk	Audit Plan	Conducting Audits	Communicating Audit Results	Audit Standards	Follow-up
Comptroller of Public Accounts (304)	Effective	Can Improve	Effective	Can Improve	Can Improve	Effective	Effective	Effective	Effective
General Services Commission (303)	Effective	Effective	Can Improve	Effective	Effective	Effective	Effective	Effective	Effective
Texas Department of Health (501)	Effective	Effective	Effective	Can Improve	Can Improve	Effective	Effective	Effective	Effective
Texas Department of Human Services (324)	Effective	Effective	Effective	Effective	Effective	Effective	Effective	Effective	Effective
Texas Department of Mental Health and Mental Retardation (655)	Effective	Effective	Effective	Effective	Effective	Effective	Effective	Effective	Effective
Texas Department of Protective and Regulatory Services (530)	Inconclusive <sup>B</sup>	Effective	Effective	Effective	Effective	Note B	Note B	Effective	Note B
Texas Rehabilitation Commission (330)	Effective	Can Improve	Effective	Effective	Effective	Effective	Effective	Effective	Effective
Texas Education Agency (701)	Ineffective	Ineffective	Ineffective	Ineffective	Ineffective	Ineffective	Ineffective	Ineffective	Ineffective
Texas Department of Criminal Justice (696)	Effective	Can Improve	Can Improve	Can Improve	Can Improve	Effective	Can Improve	Can Improve	Effective
Texas Natural Resource Conservation Commission (582)	Effective	Effective	Effective	Effective	Effective	Effective	Effective	Effective	Effective
Texas Department of Transportation (601)	Effective	Can Improve	Effective	Effective	Can Improve	Effective	Effective	Can Improve	Effective
Texas Workforce Commission (322)	Ineffective	Note C	Ineffective	Ineffective	Note C	Ineffective	Ineffective	Ineffective	Ineffective

Note A: A list and broad definitions of the effectiveness criteria are included in Appendix 2. The term "Can Improve" denotes that the agency met minimum criteria but could improve.

Note B: The Texas Department of Protective and Regulatory Services was developing its internal audit function at the time of our review. Three criteria could not be evaluated because of the newness of the function.

Note C: Two criteria were not rated separately. The two criteria were included as parts of the other six criteria.

Note D: Individual agency reports cover fiscal years 1994 and 1995 and a portion of 1996. Reports contain findings, recommendations, and management's responses. Some agencies have implemented corrective actions since the writing of these reports.

Section 2:

### **Enhancing the Understanding of Responsibility for Controls Can Improve the Internal Audit Function**

An expectation gap exists between what agency management expects from the internal audit function, what oversight bodies want from the function, and what the internal audit profession views as the function's role. The expectation gap is further complicated because no universally accepted measures for the effectiveness of the internal audit function exist.

The expectations of the internal audit function vary within each organization and among the customers of the internal audit function. Some managers believe that the internal audit function is part of internal control. Other managers believe that the internal audit function is a special resource designed to assist management in assessing internal controls. Others believe that internal auditors should protect against fraud and abuse.

Professional auditing and accounting associations and the Federal Government have offered definitions of the roles and responsibilities of internal auditing.<sup>1</sup> However, the general nature of the definitions allows for flexible interpretations and the processes to implement accountability for controls are left to individual organizations.

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<sup>1</sup> American Institute of Certified Public Accountants Statement on Auditing Standards (SAS) Number 78, "Internal Control—Integrated Framework." Institute of Internal Auditors. *Codification of Standards for The Professional Practice of Internal Auditing*. Introduction. United States Office of Management and Budget (OMB), Circular Number A-123, June 1995. Federal Managers' Financial Integrity Act, Public Law 97-255.

One way agencies can close this expectation gap is to implement the concepts that evolved from the Treadway Commission following the saving and loan failures of the 1980s. The Treadway Commission was appointed by the Federal Government to study control systems. The Committee of Sponsoring Organizations (COSO) of the Treadway Commission developed control concepts, including the Control Self-Assessment Program. COSO emphasizes training management and administrative personnel to recognize the need for controls to ensure the proper and effective use of resources and to protect physical assets. COSO was composed of accounting and auditing professionals from public accounting firms and professional accounting and auditing organizations.

COSO developed a framework for evaluating internal controls by focusing on the accomplishment of management's goals and objectives. The framework defined internal control as a process effected by people to provide reasonable assurance of achieving objectives. The Commission developed a systematic method of analyzing key processes or controls critical to achieving management's objectives.

Implementing the COSO concepts and the Control Self-Assessment Program would expand management's understanding of controls, provide more knowledgeable people to assist in controlling resources, improving accountability for controls throughout the organization, and expand the utility of the internal audit function.

When agency management chooses to implement this type of program, it sets a strong "tone from the top" on the importance of strong control systems. This helps to reduce the expectation gap between management and the internal auditing profession. Internal audit departments could assist by facilitating, teaching, coaching, and

advising management on the implementation of the concepts. Internal audit departments

would also evaluate the effectiveness of the controls that are being implemented.

# Appendices

Appendix 1:

## **Objectives, Scope, and Methodology**

### **Objectives**

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 assisting agency administrators in carrying out their assigned responsibilities.

### **Scope**

The scope of the audit included:

- Evaluating the effectiveness of 12 of the larger state agency 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 then compiling the results

### **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

### 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 were developed from the Texas Internal Auditing Act. See Appendix 2 for broad explanations of the criteria.

### **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

## Appendices

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

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# Appendices

Appendix 2:

## Effectiveness Criteria

Criteria used to evaluate the effectiveness of internal audit functions was developed from the Texas Internal Auditing Act, the *Codification of Standards for The Professional Practice of Internal Auditing*, and *Government Auditing Standards* (1994 Revision).

Effectiveness or ineffectiveness is based on a series of actions or outcomes for each criteria. The degree of participation or outcome is also a key element of effectiveness. Explanations of the eight basic effectiveness criteria are as follows:

- **Board/Management Involvement in Internal Audit Function** - The agency's board, commissioners, 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.

Both the oversight body and management have responsibilities under the Texas Internal Auditing Act. They are charged with:

- Identifying the internal audit function's objectives and needs
- Appointing the director of internal audit
- Approving the internal audit charter
- Monitoring actions on audit reports
- Approving the internal audit department's budget and audit plan

Whether the oversight body and the executive management of the organization believed that the internal audit function was effective was a significant element in our evaluation.

- **Organizing and Managing the Internal Audit Function** - The internal audit director is effective in managing and organizing the internal audit department, based on administrative and organizational tasks.

The director's primary responsibilities are to develop policies and administer procedures for the operation of the internal audit function.

Methodologies should be established to:

- Guide the allocation of internal audit resources.
- Develop risk assessment.
- Prepare an audit plan.
- Complete field work.
- Perform quality assurance reviews.
- Participate in peer reviews.

Administration should also cover how reports are distributed and what actions are taken to implement recommendations.

- **Assessing Entity Risks** - A risk assessment is used in the audit planning process, and all agency risks are identified and appropriately ranked.

The methodology used to perform risk assessment should include input from oversight bodies such as boards, commissions, or elected officials; executive management; and staff.

The process for identifying risk factors and assigning values (including a definition of the value), as well as the level of management participation, is important. The process should provide assurance that all significant risks to the business of the agency have been identified and defined.



- **Preparation of the Audit Plan** - The audit plan includes those areas identified as high risk, and resources are available to complete the plan.

In our review, consideration was given to whether long-range audit plans were developed based on risk assessments. In addition, administrative information was evaluated for documentation on the following:

- How budget estimates were developed
- The portion of the audit plan completed
- How special project demands impacted the audit plan
- The disposition of audits not completed

Approval of deviations from the audit plan were also reviewed.

- **Planning and Conducting Audits** - Audit projects are properly planned, and due professional care is used in performing audits.

Data supporting reports was reviewed for compliance with industry audit standards, specifically:

- Whether the evidence supported the published reports
- Whether issues were properly resolved in working papers
- Whether working paper fundamentals were observed

- **Communicating Audit Results** - The results of audits are appropriately communicated in written format to the proper level to ensure corrective action is taken.

Consideration was given to:

- How the reports were distributed
- To whom the reports were distributed
- How corrective action was monitored
- Whether reports were written or oral
- Whether exit conferences were held
- Whether the audits met stated purpose, scope, and objectives

- **Ensuring Compliance With Audit Standards** - The internal audit department takes steps to ensure work conforms to audit standards, which include *Standards for The Professional Practice of Internal Auditing* and *Government Auditing Standards*.

These processes for the following were evaluated:

- Supervision of audit staff
- Quality assurance review procedures (establishment and maintenance)
- Adherence to professional ethics

Also, the frequency of peer reviews was reviewed for compliance with standards.

- **Follow-Up Audit Recommendations** - The internal audit department follows-up recommendations in audit reports from prior periods.

The review included determining whether:

- Management responses to audit findings were received
- Management responses were appropriate and adequate
- The internal audit function scheduled and conducted follow-up work