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An Audit Report on the Effectiveness of Internal Audit Functions with Four or Fewer Staff Members

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Members of the Legislative Audit Committee:

Overall, small internal audit functions were effective. We found that 26 of the 33 small internal audit functions were covering high-risk areas, important strategies, and key control systems (see attachment for a list of small internal audit functions reviewed). Governing boards and management followed through on over 90 percent of the significant recommendations made by the auditors. The 33 internal audit functions we reviewed cost \$3.4 million at agencies that were appropriated \$13.7 billion in fiscal year 1997.

Internal audit functions that were not effective (21 percent) generally did not cover high-risk areas. These functions spent \$600,000 during fiscal year 1997. We provided these entities input to improve their functions and increase their effectiveness. We did not identify any issues that required legislative action.

Management and governing boards should use the criteria in this report as guidelines to improve their internal audit functions.

Our objective was to make an overall assessment of the State's small internal audit functions; we are not reporting the individual assessment for each function. Therefore, we did not include individual management responses. The audit was conducted in accordance with Government Auditing Standards.

We would like to thank the board members and management of all the entities we reviewed. Special thanks are given to the internal audit directors and contractors for providing all of the requested information.

We have attached a more detailed discussion on the effectiveness of small internal audit functions. Please contact Susan Riley, Audit Manager, at 479-4700 if you have any questions about this report.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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Attachment

Objective, Scope and Methodology

The objective of this audit was to evaluate the effectiveness of small internal audit functions. The scope of this audit included:

- Evaluating the effectiveness of internal audit departments with four or fewer staff members and internal audit services provided by contractors at 33 state agencies and universities
- Surveying internal audit directors, agency directors, university presidents, and board chairs to obtain their opinions regarding the effectiveness of internal audit functions

We performed our audit by developing criteria, obtaining information from each of the 33 entities selected for review, analyzing the information received, performing site visits, and evaluating the data against our criteria.

SAO Report No. 99-011

Are Small Internal Audit Functions Effective?

Overall, small internal audit functions were effective. We found that 79 percent of the 33 small internal audit functions (identified on page 6) were effective. Auditors at the effective functions reviewed high-risk areas, important strategies, and key control systems. Governing boards and management followed through on over 90 percent of the recommendations made by the auditors. Together these actions help to make sure that each entity's mission, goals, and objectives are met. The effective internal audit functions spent \$2.8 million in fiscal year 1997.

An internal audit function has three key components:

- Internal Auditors
- Management
- Governing Board

However, we found 21 percent of the small internal audit functions did not do at least one of the following:

- Cover important strategies, control systems, or high-risk areas
- Provide information that was used by their governing boards and management

The ineffective functions spent \$600,000 during fiscal year 1997.

Section 1:

Did Internal Auditors Adequately Cover Risk?

Overall, small internal audit functions effectively covered the risks to their entities. Twenty-eight of the 33 internal audit functions covered sufficient risk. Risk is defined as the chance that conditions could occur that may prevent the entity from meeting its mission, goals, or objectives.

The internal audit function's role is to provide information to the governing board and management about the entity's operations in managing these risks. The governing board and management can use this information to determine whether the business of the entity is being conducted as planned or if adjustments need to be made.

We reviewed coverage of risk in terms of (1) strategies, (2) key control systems, and (3) self-assessed risk to the entity. By reviewing these three areas of risk, we obtained a comprehensive assessment of each internal audit function's coverage of appropriations, management systems and processes, and unique entity risks.

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Section 1-A:

Coverage of Appropriation Strategies

Over a three-year period, effective internal audit functions covered an average of 91 percent of their strategies. Ineffective internal audit functions covered 81 percent.

Coverage of appropriation strategies was an area of concern for small internal audit functions. Only 20 of the 33 entities received enough coverage of their strategies from internal and external audits. Sufficient coverage occurs when audits are conducted in strategies that make up at least 90 percent of the entity's appropriated funds over three years.

An entity's strategies usually relate to its major programs. It is important to have current information on whether the significant programs meet the goals and objectives that are set by management. This enables management to determine whether the entity is achieving its mission.

We found that the number of strategies at an entity did not influence the effectiveness of the internal audit function. Ten out of the 11 entities with more than 15 strategies had effective internal audit functions.

We recommend that internal audit functions include appropriation strategies in the development of their annual risk assessments. They also need to perform audits in strategies that make up 90 percent of their funding over three years.

Section 1-B:

Coverage of Key Control Systems

Over a three-year period, effective internal audit functions covered an average of 100 percent of their key control systems. Ineffective internal audit functions covered 81 percent.

Twenty-six of 33 agencies received enough coverage of their key control systems from internal audit. Key control systems are the processes that management puts into place to ensure the achievement of the entity's mission, goals, and objectives. The 12 key control systems are:

- Assets
- Automation
- Compliance with Laws and Regulations
- Effectiveness and Efficiency of Operations
- Expenditures
- Human Resources and Organizational Structure
- Information Flow and Communication
- Liabilities
- Performance Measurement Systems
- Planning and Budgeting
- Policies and Procedures
- Revenues

We recommend that internal audit functions include key control systems when they plan each audit. They should review at least 90 percent of the key control systems every three years.

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Section 1-C:

Risk Assessment

Almost all internal audit functions had adequate processes for assessing risk. Management was usually involved in this process. Risk assessments provide assurance that all major risks to the entity are identified. Audit plans, which list all of the audits to be performed each year, were then developed based on the risk assessments.

Most of the effective internal audit functions performed a majority of their work in high-risk areas. Only four out of seven ineffective internal audit functions did a majority of their work in high-risk areas.

We recommend that governing boards and management make sure that a majority of the audits are performed in high-risk areas identified by their risk assessment. Because high-risk areas are generally related to strategies and key controls, performing high-risk audits can assure governing boards and management that they are getting sufficient coverage in these areas.

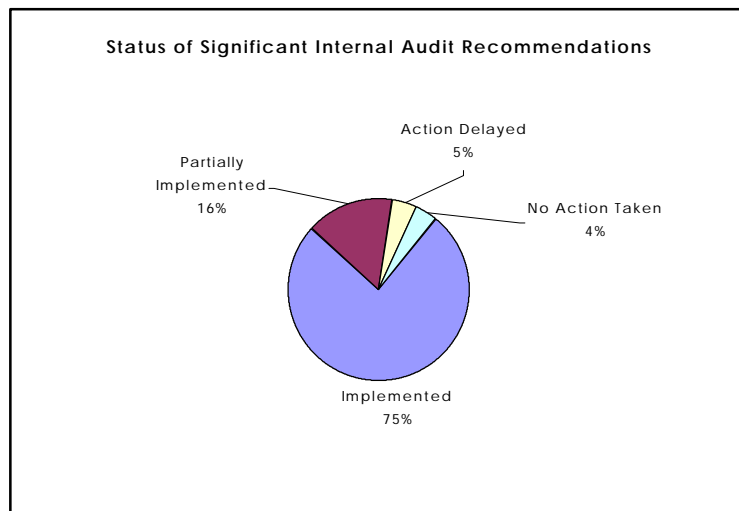
Section 2:

Is Internal Audit Useful to Governing Boards and Management?

Overall, governing boards and management stated that their internal audit functions were useful. Specifically, 82 percent of the entities:

- Recognized the value of internal audit services and would maintain this function even if not required by law (based on feedback from management and governing boards)
- Followed through on at least 90 percent of significant recommendations made by internal audit

In the survey information collected, governing boards and management noted the value of internal audit's ability to:



Source: Annual Internal Audit Reports and Supplemental Information from Internal Audit Directors

- Provide independent reviews
- Identify problems before they occurred

It is internal auditors' responsibility to develop feasible recommendations that address the identified problems. It is management's responsibility to correct the problems. Internal auditors at the 33 entities made more than 1,800 significant recommendations during fiscal years 1995-1997. Management took at least some action on over 90 percent of these recommendations.

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Are There Other Areas of Improvement for Internal Auditors?

There were two areas of improvement that require attention from internal auditors, management, and governing boards:

- Some internal audit functions need to improve their quality control procedures.
- Internal auditors need to ensure that they meet the continuing education requirements set by Government Auditing Standards.

Section 3-A:

Quality Control Processes Need to Be Improved

Fourteen of 33 of internal audit functions did not have adequate internal quality control practices in place. Nine of these 14 functions were one-person departments. Six of these functions took steps to reduce this weakness. For example, they used a quality control checklist or contacted other auditors for input.

External reviews are also an important part of quality control. Thirty of the 33 internal audit functions had an external review in the last three years as required by internal auditing standards.

Internal auditing standards require that internal audit directors maintain a quality control program to provide assurance that audit work meets professional standards. A good quality control program includes supervision as well as internal and external reviews.

We realize that one-person internal audit functions will have difficulty in meeting this standard. Therefore, we recommend that these functions obtain reciprocal quality control services with other internal audit departments. Internal audit functions with more than one staff should ensure that adequate internal reviews occur so that audit work complies with internal auditing standards.

Section 3-B:

Auditors Should Ensure They Meet Continuing Education Requirements

Nine of the 33 internal audit functions reviewed did not meet the continuing education requirements set by Government Auditing Standards:

- Auditors are required to complete at least 80 hours of training every two years. At least 20 of these hours should be completed in one year.
- Auditors that do a significant amount of government audit work should receive at least 24 hours of training in government-related subjects.

- The audit function is required to have a program that ensures auditors meet these requirements.

By not receiving sufficient amounts of training, there is increased likelihood that auditors may not have sufficient skills and training to perform their duties.

We recommend that auditors review their system for tracking education and training. They should make sure the system identifies auditors who have not received enough training. Once identified, these auditors should ensure that they receive sufficient training to meet these standards.

Objective, Scope, and Methodology

The objective of this audit was to evaluate the effectiveness of small internal audit functions. The scope of this audit included:

- Evaluating the effectiveness of internal audit departments with four or fewer staff members and internal audit services provided by contractors at 33 state agencies and universities (identified below)
- Surveying internal audit directors, agency directors, university presidents, and board chairs to obtain their opinions regarding the effectiveness of internal audit functions.

We performed our audit by developing criteria, obtaining information from each of the 33 agencies selected for review, analyzing the information received, performing site visits, and evaluating the data against our criteria.

The criteria developed by the State Auditor's Office included whether:

- Internal audit sufficiently covered risk in terms of strategies, key controls systems, and self-assessed risk to the entity. Sufficient coverage of strategies and key control systems occurs when over 90 percent of the appropriated funds and control systems are covered over three years (60 percent in two years, or 30 percent in one year, as applicable).
- Governing boards and management took some action on at least 90 percent of the significant recommendations made by internal audit and believed that internal audit was useful. Usefulness of internal audit was also based on communication between internal audit, governing boards, and management.

We also determined whether internal auditors complied with aspects of Government Auditing Standards and internal auditing standards.

Our audit work was performed from April through October 1998. The audit was conducted in accordance with Government Auditing Standards.

Agencies and Universities Reviewed

- Adjutant General's Department*
- Advisory Commission on State Emergency Communications*
- Alcoholic Beverage Commission
- Angelo State University
- Animal Health Commission
- Commission for the Blind*
- Department of Agriculture*
- Department of Banking*
- Department of Economic Development*
- Department of Housing and Community Affairs
- Department of Information Resources*

- Department of Public Safety
- Department on Aging*
- Employees Retirement System
- General Land Office and Veterans' Land Board*
- Higher Education Coordinating Board
- Interagency Council on Early Childhood Intervention*
- Juvenile Probation Commission*
- Lamar University - Beaumont, Institute of Technology, Orange, and Port Arthur*
- Library and Archives Commission*
- Midwestern State University
- Office of the Governor
- Parks and Wildlife Department*
- Railroad Commission
- School for the Blind and Visually Impaired
- Secretary of State*
- State Securities Board*
- Southwest Texas State University*
- Stephen F. Austin State University*
- Texas Education Agency
- Texas Lottery Commission*
- Texas State Technical College System, Harlingen, Sweetwater, and Waco
- University of North Texas Health Science Center – Fort Worth

* Selected for site visit to verify information submitted by internal auditors.