

A Report on

# Evaluating the Effectiveness of Internal Audit



**Office of the State Auditor**  
**Lawrence F. Alwin, CPA**

November 1994

Report No. 95-024



## OFFICE OF THE STATE AUDITOR

TWO COMMODORE PLAZA  
206 EAST NINTH ST., SUITE 1900  
AUSTIN, TEXAS 78701

MAILING: P.O. BOX 12067  
AUSTIN, TEXAS 78711-2067

PHONE: (512) 479-4700 FAX 479-4884

LAWRENCE F. ALWIN, CPA  
State Auditor

SHARON W. COBB, CPA  
First Assistant

November 11, 1994

### Members of the Legislative Audit Committee:

Overall, board members and agency heads indicate that their internal audit departments are effective. However, some improvements are needed to ensure the State continues to benefit from internal audit services, including:

- improving communication between internal audit departments and their governing boards
- reassessing resource allocation to internal audit to ensure cost effective audit coverage
- developing and using performance measures for internal audit
- complying with professional standards and the *Texas Internal Auditing Act*

Effective internal audit departments are needed to help ensure that agencies provide quality services at a reasonable cost.

Sincerely,

A handwritten signature in black ink, appearing to read "Lawrence F. Alwin".

Lawrence F. Alwin, CPA  
State Auditor

LFA/asc/rmn/enclosure

# Key Points Of Report

## A Report on Evaluating the Effectiveness of Internal Audit

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November 1994

### Key Findings

- Overall, board members and agency heads indicate that their internal audit departments are effective. More than 90 percent agreed they would have an internal audit department even if not required to by law. However, board members did not consider internal auditors as effective in communicating with them as agency heads did.
- A wide disparity exists in allocating resources to internal audit. Agencies should reassess allocation of resources to internal audit to ensure sufficient and cost-effective audit coverage.
- Most internal auditors did not submit performance measures. Agencies should develop and use performance measures to evaluate internal audit effectiveness.
- Some internal audit departments need to improve compliance with professional standards and the *Texas Internal Auditing Act*. These areas include independence, peer review, and audit scope.
- The State invested an estimated \$23 million in internal auditing during fiscal year 1994. Between fiscal years 1991 and 1993, internal auditors reported recommendations with a cumulative five-year fiscal impact of \$175 million. Other internal audit recommendations with little or no fiscal impact resulted in improved controls, which safeguard valuable assets.

### Contact:

Kay Wright Kotowski, CPA (512-479-4755)

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## Executive Summary

Overall, board members and agency heads indicate that their internal audit departments are effective. However, improved communication, reassessment of resource allocation, and the continued development of performance measures will increase internal audit effectiveness. Additionally, compliance with the *Standards for the Practice of Internal Auditing* and the *Texas Internal Auditing Act* will help ensure that audits are conducted in a professional manner. Internal auditors report that the State's investment in internal audit is producing positive results. They have made recommendations with millions of dollars in fiscal impact. They have reported other recommendations that promote internal controls which protect state assets.

### **Agency Management Values Internal Audit Efforts**

Overall, board members and agency heads we surveyed indicated that internal audit provides "value-added" to their organization. Most survey respondents expressed satisfaction with the accuracy and value of internal audit findings. They also indicated that they would elect to have an internal audit department even if not required to by state statute.

### **Some Areas Need Improvement To Increase Internal Audit Effectiveness**

Some internal audit departments should improve communication with their governing board to enhance audit services. Agency heads and board members consider internal auditors effective in communicating with them. However, board members were more likely than agency heads to disagree or have no opinion about communication with internal audit. Some board members indicated that internal auditors could do a better job of

alerting the board to potential problems before they occur and conduct more audits of high-risk areas. Thirty percent of the peer reviews also documented communication deficiencies.

Each agency should reassess resource allocation to internal audit to ensure cost effective coverage of major systems and controls on a periodic basis. A wide disparity of internal audit coverage exists, ranging from part-time contracted services to full-time internal audit departments. Reallocation should depend on such factors as agency appropriations, pass-through funds, sources of funds, staffing, number of control systems, major programs, and number of field offices. More board involvement in the agency risk analysis process will help to determine the optimum internal audit coverage for their agency.

More internal audit departments should establish and use performance measures to ensure that decision makers have the information to determine whether audit resources are used efficiently and effectively. Only 43 percent of the internal audit departments submitted performance measurement information for this review.

### **Some Internal Audit Departments Need To Improve Compliance With Professional Standards And The *Texas Internal Auditing Act***

Most internal audit departments comply with professional standards and the Act, however, others need to address compliance issues. Some internal audit departments need more independence and objectivity in order to perform impartial and unbiased audits. Some departments have not had a required peer review which could help them identify areas for improvement. Additionally, some internal auditors are not conducting all types of audits,

## Executive Summary

which may leave the agency susceptible to undetected errors, irregularities, fraud, waste, or abuse.

### **Internal Auditors Report That Texas' Investment In Internal Audit Is Producing Positive Results**

The State invests approximately \$23 million annually on internal audit services. Internal audit departments provide audit coverage to state entities which represent 92 percent of state appropriations and 89 percent of state employees. There are 79 internal audit departments in state agencies and universities (hereafter referred to as "agencies"). The internal audit departments employ 389 internal auditors and 54 administrative support staff.

Internal auditors have identified millions of dollars in fiscal impact. In fiscal year 1993, they reported recommendations with a five-year fiscal impact of \$100 million. Internal auditors have identified recommendations totaling \$175 million since they began reporting in 1991. Some audit recommendations, such as those addressing internal controls, protect valuable state assets but are difficult to quantify. Fiscal year 1994 information was not available prior to publication of this report.

Management implemented most internal audit recommendations. This high implementation rate demonstrates that management considers these recommendations to be accurate and valuable, an indicator of audit effectiveness. In fiscal year 1993, internal auditors reported an implementation rate of 91 percent.

### **Summary of Audit Objective And Scope**

The objective of this review was to evaluate the effectiveness of internal audit in accordance with the Government Code, Section 321.015.

The scope of the review included consideration of the following:

- audit findings and recommendations
- compliance with the *Texas Internal Auditing Act* and the *Standards for the Professional Practice of Internal Auditing*
- professional services provided by internal audit departments
- communication of potential problems to agency management
- communications between the agency's governing board, management, and the internal audit department
- internal auditor qualifications
- independence, objectivity, and fairness in conducting audits
- management support for the internal audit department
- adequacy of internal audit department resources

We compiled information primarily through surveys of board members, agency heads, and internal audit directors. Additionally, we reviewed supplemental information, including peer review results, internal audit department budgets, and charters. This review was not conducted in accordance with generally accepted governmental auditing standards because verification of information submitted was not performed.

Section 1:

## Agency Management Values Internal Audit Efforts

Survey results indicate that, overall, internal audit departments are effectively assisting board members and agency/university (hereafter referred to as agency) management in discharging their responsibilities. The *Standards for the Professional Practice of Internal Auditing* defines assistance to members of the organization in the effective discharge of their responsibilities as the objective of internal audit. In addition, the *Texas Internal Auditing Act* requires internal auditors to report directly to the agency's governing board or commission. Therefore, their perceptions are important to evaluate internal audit effectiveness.

We surveyed 228 board members, agency heads, and internal audit directors. These groups returned 175 surveys for an overall response rate of 77 percent. Individual response rates were 90 percent for internal audit directors, 62 percent for board/commission chairs, and 72 percent for agency heads. (See Appendix 1.)

Most board members and agency heads agreed with the following statements:

- Internal audit is effective in providing accurate findings.

<u>SURVEY</u>	<u>AGREE</u>	<u>DISAGREE</u>	<u>NO OPINION</u>
Board/Commission	83.9%	3.2%	12.9%
Agency Head	95.6%	1.5%	2.9%

- Internal audit is effective in providing valuable recommendations.

<u>SURVEY</u>	<u>AGREE</u>	<u>DISAGREE</u>	<u>NO OPINION</u>
Board/Commission	93.6%	6.4%	0.0%
Agency Head	92.7%	2.9%	4.4%

- Internal audit is effective in providing professional services.

<u>SURVEY</u>	<u>AGREE</u>	<u>DISAGREE</u>	<u>NO OPINION</u>
Board/Commission	83.9%	9.7%	6.4%
Agency Head	94.2%	2.9%	2.9%

Additionally, 90 percent of the board members and agency heads responded:

- They would have an internal audit function even if they were not required to by the *Texas Internal Auditing Act*.
- Internal audit provides "value-added" to their organization.

Likewise, over 80 percent of the internal audit directors reported complete or generally good support from the governing board and top management. An effective internal audit program depends heavily on the involvement and support of the governing board and executive management.

Section 2:

## Some Areas Need Improvement To Increase Internal Audit Effectiveness

While most survey responses are positive, some indicate room for improvement. Some internal audit departments should enhance communication with their governing boards. This would enable board members to fully recognize the benefits of internal audit. Agencies should reassess resource allocation to internal audit to ensure cost effective coverage of high-risk areas. In addition, internal audit departments need to develop or improve performance measures. This would ensure that the decision makers have the information to determine whether internal audit is providing useful and cost-effective audit services.

Section 2-A:

### Internal Audit Departments Should Improve Communication With Board Members

Some internal audit departments should improve communication with board members to strengthen internal audit effectiveness. Agency heads and board members consider internal auditors effective in communicating with them. However, board members were more likely than agency heads to disagree with this assessment or have no opinion.

Communication between internal auditors and agency decision makers must be clear, concise, and timely to be effective. Survey responses to statements related to the effectiveness of communications between the internal auditors and the board members and agency head follow.

- Internal audit effectively communicates with the board/agency management.

<u>SURVEY</u>	<u>AGREE</u>	<u>DISAGREE</u>	<u>NO OPINION</u>
Board/Commission	77.4%	6.4%	16.2%
Agency Head	95.6%	4.4%	0%

- Internal audit is effective in providing clear audit reports.

<u>SURVEY</u>	<u>AGREE</u>	<u>DISAGREE</u>	<u>NO OPINION</u>
Board/Commission	80.7%	6.4%	12.9%
Agency Head	97.0%	1.5%	1.5%

- Internal audit is effective in providing timely audit reports.

<u>SURVEY</u>	<u>AGREE</u>	<u>DISAGREE</u>	<u>NO OPINION</u>
Board/Commission	80.6%	6.4%	13.0%
Agency Head	86.8%	7.4%	5.8

Some internal auditors are not looking at areas their boards consider high risk. Based on responses to the following two questions, these auditors should ensure that board members are given the opportunity to provide input into the audit plan.

- Internal audit uses its resources performing audits in the high-risk areas of the organization.

<u>SURVEY</u>	<u>AGREE</u>	<u>DISAGREE</u>	<u>NO OPINION</u>
Board/Commission	74.2%	9.7%	16.1%
Agency Head	91.2%	4.4%	4.4%

- Internal audit does an effective job of alerting board/agency management to potential problems before they occur.

<u>SURVEY</u>	<u>AGREE</u>	<u>DISAGREE</u>	<u>NO OPINION</u>
Board/Commission	61.3%	13.0%	25.7%
Agency Head	83.8%	11.8%	4.4%

Thirty percent of the peer review examinations performed on internal audit departments had findings related to the need to improve communications. Communication deficiencies noted in peer reviews include:

- audit reports which are not timely, poorly organized, and poorly communicated
- too few or, in some cases, no meetings between internal audit and the board
- no formalized audit committee structure
- audit reports which do not convey the significance of conclusions reached
- not providing management or the board with an opportunity to provide input in the audit plan

Few internal audit departments responding to our survey, however, reported problems communicating with members of the board or executive management. Almost all indicated that they have meetings with the highest organizational level. Additionally, 87 percent of the internal audit directors agreed that board and agency management effectively communicate with them.

**Recommendation:**

Internal audit departments should work with the governing board to increase the frequency and effectiveness of their communications as needed. Internal auditors should examine the clarity and timeliness of their reports to alert the board to potential problems as early as possible. In addition, some boards may need to become more involved in the internal audit risk assessment process and audit selection.

Section 2-B:

**Agencies Need To Reevaluate Resource Allocation To Internal Audit For Cost-Effective Coverage Of High-Risk Areas**

Agencies need to address the allocation of resources to internal audit. A wide disparity exists in size and type of internal audit services, ranging from part-time contracted services to full-time internal audit departments.

Too many or too few resources can result in inefficient or inadequate audit coverage. There are no specific guidelines; however, internal audit staffing levels should ensure that all major systems and controls are periodically reviewed to meet requirements of the *Texas Internal Auditing Act*.

Agencies may need to reallocate resources to internal audit for more cost effective coverage. For example, 4 of the 11 one-person internal audit department respondents had appropriations and/or revenues greater than \$100 million. Agencies in this range had an average of 5.9 internal auditors.

Factors relevant to internal audit resource needs include:

- appropriations
- amount of pass-through funds
- sources of funds
- agency staffing patterns
- number of control systems
- number of major programs
- number of field offices

A large number of respondents disagreed or had no opinion when responding to whether internal audit has adequate resources to ensure that all major systems and controls are reviewed on a periodic basis. For example, 42 percent of the board members, 32 percent of the agency heads, and 45 percent of the internal audit directors either disagreed or had no opinion in response to this survey statement. In addition, 24 percent of the peer reviews contained comments relating to the inadequacy of internal audit resources.

It was also noted that survey respondents within most agencies were not in internal agreement on this issue. Only 2 agencies of the 60 agencies with multiple survey responses collectively agreed that internal audit resources are inadequate. This is

another indicator of the need for improved communications between internal audit, the board, and management.

Survey results also indicate the following:

- For agencies with \$10 million to \$30 million in appropriations, the number of internal auditors varied from contracted services to three staff members, with an average of 1.2 internal auditors per department.
- For agencies with \$30 million to \$100 million in appropriations, the number of internal auditors varied from contracted services to seven staff members, with an average of 2.5 internal auditors per department.
- For agencies with \$100 million to \$500 million in appropriations, the number of internal auditors varied from contracted services to 19 staff members, with an average of 5.9 internal auditors per department.
- For agencies with \$500 million (or more) in appropriations, the number of internal auditors varied from 3 to 23, with an average of 13.1 internal auditors per department.

There are no established standards for internal audit department expenditures. However, we noted that most agencies and universities spend less than one half of one percent of their appropriations on internal audit. Budgets reported for internal audit ranged from 0.01 percent to 1.14 percent of agency appropriations.

A comparison of internal audit resources based on agency appropriations and staff size is shown in Figure 1.

**Figure 1**

COMPARISON OF INTERNAL AUDIT RESOURCES				
Appropriations*	Internal Audit Budgets as a Percentage of Agency Appropriations	Average Internal Audit FTEs	Internal Audit FTEs as a Percentage of Agency FTEs	Reported Range of Fiscal Impact for Audit Recommendations
\$10 - \$30 Million	0.321 %	1.2	0.33 %	\$0 - \$7.9 (Million)
\$30 - \$100 Million	0.193 %	2.5	0.27 %	\$0 - \$4.7 (Million)
\$100 - \$500 Million	0.139 %	5.9	0.25 %	\$0 - \$19 (Million)
\$500 Million & Up	0.030 %	13.1	0.12 %	\$0 - \$22 (Million)

\* Appropriations were substituted with revenues or current fund revenues where those items were greater than appropriations.

Each agency should ensure adequate coverage of its major systems and controls when it considers contracting for internal audit services. Some agencies contract for part-time internal audit services instead of maintaining an in-house internal audit department. For example, three of the seven agencies which contract for internal audit services have appropriations or revenues greater than \$70 million. These agencies may want to reconsider whether this alternative sufficiently meets their needs.

**Recommendations:**

Agency boards need to reevaluate the adequacy of the current allocation of resources to internal audit and decide whether additions or reductions are warranted. Each agency should consider the factors relevant to internal audit resource needs in assessing sufficiency of coverage for major programs and high-risk areas.

- More board involvement in the agency risk analysis process may be needed to determine the optimum internal audit coverage for their agency.
- Agency use of performance measures will help to evaluate the adequacy of internal audit resources. (See discussion below.)

Section 2-C:

**More Agencies Should Implement Or Improve Performance Measures For Internal Audit**

Most agencies do not use performance measures or need additional measures to ensure that decision makers have appropriate information to determine whether their internal audit resources are used efficiently and effectively. Fifty-seven percent of the internal audit directors responding to our survey either did not submit evidence of measures or indicated that they had no measures. Only 43 percent of the respondents submitted evidence that they had established at least some measures.

Respondents identified common elements of internal audit performance to be measured. Most of the responses on elements important to measure fit into the following categories:

- communication and coordination with agency personnel
- timeliness and accuracy of reports
- ability to anticipate and resolve problems
- technical competence

Respondents identified more performance measures for the above elements than in the past, an indicator that performance measurement is evolving. They submitted several commonly used performance measures, including:

- rating on auditee satisfaction (usually via surveys)
- percent of audits completed within budget

- percent of time spent in direct audit work
- percent of audit plan completed
- percent of recommendations implemented
- rating on external quality assurance (peer) review

**Recommendation:**

Internal audit departments should identify and implement performance measures. They should work with their governing boards and agency heads in this process.

Internal audit directors should include the following steps in implementing their performance measures:

- Identify what to measure.
- Define the performance measures.
- Design and construct a system to capture data and report the measures.
- Set performance goals or targets.
- Produce information from the system for management to evaluate and adjust performance goals.

Internal auditors can obtain more information on performance measures from literature. The Institute of Internal Auditors publication, *Evaluating the Effectiveness of Internal Audit Departments*, provides specific information about internal auditing performance measurement. A new publication, *Developing Productivity in Quality Measurement Systems for Internal Auditing Departments*, offers additional information on this subject.

Section 3:

**Some Internal Audit Departments Need To Improve Compliance With Professional Standards And The *Texas Internal Auditing Act***

Overall, compliance with the *Texas Internal Auditing Act* and the *Standards for the Professional Practice of Internal Auditing* has increased, but some internal audit departments need to improve. For example, our analysis of peer reviews indicates that some internal auditing departments:

- Need more independence and objectivity to perform impartial and unbiased audits.
- Need a required peer review which could help them identify areas for improvement. (Note: A peer review is a review of the department's compliance with the *Standards for the Professional Practice of Internal Auditing* and the *Texas Internal Auditing Act*. An independent and objective auditor external to the organization should perform the review.)

- Need to cover all types of audits as required by internal auditing standards to reduce the risk of undetected errors, irregularities, fraud, abuse, or illegal acts. (Note: The *Standards for the Professional Practice of Internal Auditing* require auditors to perform work in five audit areas: reliability of information, compliance with laws, safeguarding of assets, economy and efficiency, and program results/effectiveness.)

Based on survey responses and additional information collected, 95 percent of qualifying executive agencies have established internal audit programs. Most internal audit departments comply with the *Standards for the Professional Practice of Internal Auditing* and the *Texas Internal Auditing Act*.

Based on our review of surveys and peer review results, at least 85 percent of the internal audit departments:

- Use documented risk assessments in preparing a formal annual audit plan, which is approved by the highest organizational level or its designee.
- Have a certified internal auditor or a certified public accountant as director.
- Submit written reports of audit work to the highest organizational level.
- Comply with the *Standards for the Professional Practice of Internal Auditing*.
- Provide adequate coverage of the following scope areas:
  - reliability and integrity of information
  - compliance with policies, plans, procedures, laws, and regulations
  - safeguarding of assets

Section 3-A:

### **More Internal Audit Departments Should Be Objective And Independent**

Some internal audit departments lack the independence and objectivity needed to conduct unbiased audits. While agency heads and board survey respondents agreed that internal audit performs its work in an independent, objective, and fair manner, peer reviews and internal audit director surveys were not as positive. For example:

- Fourteen percent of the peer reviews received comment on potential or actual problems with independence or objectivity.
- Eighteen percent of the internal audit directors are not appointed/removed by the highest level in the organization.

- Twenty-two percent of the internal audit directors responding indicate that their internal audit staff performs some duties in addition to their internal audit functions.
- Twenty-one percent of the internal audit charters submitted for review do not require the internal audit directors to functionally report to the highest organizational level.

The *Standards for the Professional Practice of Internal Auditing* require that internal auditors be independent of the activities they audit. The *Standards* recommend that each internal audit department define its purpose, authority, and responsibility in a formal written document, or charter, and have the document accepted by the board. The *Texas Internal Auditing Act* further requires the internal audit director to report to the highest organizational level.

Professional guidelines warn against potential and actual conflicts of interest, assuming operating responsibilities, and designing, installing, and operating systems. The short-term benefit of management using internal audit resources for operational duties obscures the long-term consequence of the loss of internal audit objectivity.

**Recommendation:**

Governing boards and agency heads should work with their internal audit departments to ensure compliance with each of the standards and legislative mandates for independence and objectivity. Currently, new board members receive information about internal auditing in state government as part of their orientation to state service. Additional information and assistance is available from the State Auditor's Office, the State Agency Internal Audit Forum, and the Texas Association of College and University Auditors.

Section 3-B:

**Some Internal Audit Departments Need Required Peer Review**

Twenty-one percent of internal audit departments have not had a required peer review which could help them identify areas for improvement. Seventy-three percent, as compared to 53 percent two years ago, have had peer reviews. The remaining six percent of internal audit departments have not been in existence long enough to require peer review.

Professional standards and the *Texas Internal Auditing Act* require peer reviews to provide agency management and boards with assurance that audit recommendations result from sound auditing practices. These reviews, as part of a quality assurance program, provide reasonable assurance that internal auditors' work meets industry-recognized professional standards.

Professional guidelines state that "external reviews of the internal auditing department should be performed to appraise the quality of the department's operations. These reviews should be performed by qualified persons who are independent of the organization . . . [and] should be conducted at least once every three years, . . . [unless] circumstances justify a different interval" (IIA, 87).

At least one instance of reciprocal peer review in which two internal audit departments reviewed each other has occurred. Agencies should avoid similar situations in the future.

**Recommendation:**

Unless a non-compliant agency has a specific reason to delay, it should arrange a peer review immediately. The Texas Association of College and University Auditors and the State Agency Internal Audit Forum offer cooperative peer review programs. Agencies could also contract for peer reviews with professionals from private practice or governmental entities in other states.

Section 3-C:

**Internal Audit Departments Should Reassess The Types Of Audits Performed**

Twenty-nine percent of the internal auditors had no opinion or responded that they are not adequately conducting all types of audits, which may leave the agency susceptible to undetected errors, irregularities, fraud, waste, or abuse. The *Standards for the Professional Practice of Internal Auditing* identify five required scope areas, or types of audit work, that internal audit departments should conduct:

- reliability and integrity of information
- compliance with policies, plans, procedures, laws, and regulations
- safeguarding of assets
- economical and efficient use of resources
- accomplishment of established objectives and goals for operations or programs (program effectiveness)

Adequate emphasis in economy/efficiency and program effectiveness can determine whether the agency is achieving its intended mission in the most cost-effective way. Internal auditors continue to place less emphasis in these areas than in the more traditional scope areas of reliability of information, compliance, and safeguarding of assets. Several peer reviews also noted the need to increase audit work in these areas.

The *Texas Internal Auditing Act* also requires internal audit departments to perform audits of electronic data processing (EDP) systems and controls. Seventy-two percent of the responding internal audit directors agree that they adequately review automated systems and controls.

Without adequate EDP audit coverage, agency decision makers risk using inaccurate information. Emphasis in EDP auditing helps ensure that the agency's automated systems accurately control processing and access to the agency's information so that it will remain accurate, reliable, timely, and complete.

**Recommendation:**

Agencies should review their emphasis in the various scope areas and adjust priorities and resources to provide adequate audit coverage. Internal auditors should continue initiatives in this area, including:

- sharing expertise and information between internal audit departments via the State Agency Internal Audit Forum EDP auditing user group
- performing audits which address economy/efficiency and program effectiveness issues

Section 4:

## **Internal Auditors Report That Texas' Investment In Internal Audit Is Producing Positive Results**

The State's estimated \$23 million annual investment in 389 internal auditors and 54 support staff is producing positive results. [Note: Investment in internal audit is based on internal audit department budgets submitted. Figures are adjusted for overhead (12 percent) and fringe benefits (27.7 percent) for agencies not submitting this information. Staffing information is based on internal audit departments surveys.] Internal auditors have identified a cumulative fiscal impact of \$175 million projected over a five-year period. In addition, internal audit recommendations with little or no fiscal impact result in improved controls which safeguard valuable state assets. Internal auditors report that most recommendations have been implemented.

Section 4-A:

### **Internal Audit Cost The State An Estimated \$23 Million In Fiscal Year 1994**

A total of \$23 million was estimated as the fiscal year 1994 cost of internal audit based on budgets submitted by internal audit departments. This figure represents an increase of \$7 million since 1992. A small portion of this amount can be attributed to rising salaries and additional staff. However, the majority of this increase is due to the availability of more comprehensive budget data than in years past. The information submitted for this fiscal period included more complete details for items such as auditor and support staff salaries and overhead. The addition of this detail permitted a more reasonable estimate of the cost of internal audit.

Section 4-B:

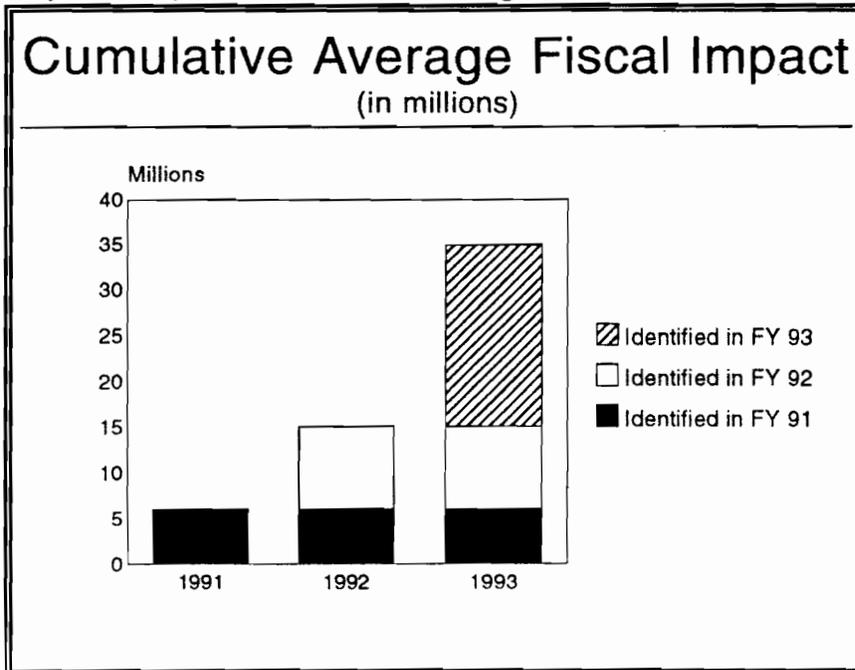
**Internal Audit Identified A Cumulative Five-Year Fiscal Impact Of \$175 Million Since Fiscal Year 1991**

During fiscal years 1991, 1992, and 1993, internal auditors have reported recommendations with a cumulative five-year fiscal impact of \$175 million. As Figures 2 and 3 illustrate, internal auditors have reported an increased fiscal impact over this three-year period. The *Texas Internal Auditing Act* requires internal audit departments to annually report (by November 1) the five-year fiscal impact of their recommendations. Fiscal year 1994 estimates were not available prior to publication of this report.

**Figure 2**  
Five-Year Fiscal Impact Projections Reported by Internal Auditors  
From Fiscal Year 1991 through Fiscal Year 1993

FIVE YEAR FISCAL IMPACT PROJECTIONS				
FY 1991	FY 1992	FY 1993	FY 1994	Total
\$30 Million	\$45 Million	\$100 Million	Data Unavailable	\$175 Million

**Figure 3**  
The Cumulative Annualized Effect of the Fiscal Impact  
Projected by Internal Auditors through Fiscal Year 1993



Many controls recommended by internal audit may not result in direct cost savings. Internal auditors reported 111 recommendations during fiscal year 1993 that did not have a quantifiable dollar impact. Although not all internal audit recommendations can be quantified in terms of dollars, they provide valuable assistance to management in other ways. For example, the recommended controls safeguard millions of dollars in state assets, increase the accuracy and reliability of data, or promote operational efficiency.

Section 4-C:

### **Agency Management Has Implemented Most Internal Audit Recommendations**

Internal auditors reported that their management either implemented or was in the process of implementing 91 percent of their recommendations during fiscal year 1993. Agency management implementation rates have remained at a high level, beginning in fiscal year 1991. We believe this is an indication of internal audit effectiveness, an indicator that management views internal audit as accurate and valuable.

**Figure 4**  
Management Response To Internal  
Audit Recommendations

Fiscal Year	Percent of Implementation
1991	83 %
1992	92 %
1993	91 %

## Objective, Scope, and Methodology

### Objective

The objective of our review was to evaluate the effectiveness of the State's internal audit departments. This biennial review is required by Texas Government Code, Chapter 321, Section 321.015.

In order to evaluate internal audit's effectiveness, we focused on determining if internal audit departments were meeting the key objectives of internal auditing.

The following are the objectives of internal auditing from the *Texas Internal Auditing Act* (Government Code, Chapter 2102) and the *Statement of Responsibilities of Internal Auditing*, published by the Institute of Internal Auditors.

#### *Texas Internal Auditing Act*

Internal audit is to assist agency administrators by furnishing independent analysis, appraisals, and recommendations concerning the adequacy and effectiveness of an agency's systems of internal control policies and procedures as well as the quality of performance in carrying out assigned responsibilities.

#### *Statement of Responsibilities of Internal Auditing*

The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To do this, internal audit furnishes them with analysis, appraisals, recommendations, counsel, and information concerning the activities reviewed.

To determine if internal audit departments were meeting these key objectives, our evaluation focused on answering the following questions:

- Does management and the board consider internal audit findings and recommendations to be meaningful?
- Are internal audit departments in compliance with the *Texas Internal Auditing Act* and the *Standards for the Professional Practice of Internal Auditing*?
- Are internal audit departments adequately informing agency management of potential problems?
- Are communications adequate between the agency's governing board, management, and the internal audit department?
- Do internal auditors have appropriate qualifications?
- Are internal audits being conducted independently, objectively, and fairly?

- Are internal audit departments receiving top management support?
- Do internal audit departments have adequate resources?

## Scope

Eighty-three executive branch agencies and universities were included in the scope of this review in accordance with Texas Government Code, Chapter 321, Section 321.015.

The consideration of audit findings and recommendations included a review of:

- information obtained from surveys of board chairs and agency heads
- findings and recommendations from internal audit department's annual reports

The consideration of compliance with the *Texas Internal Auditing Act* and the *Standards for the Professional Practice of Internal Auditing* included a review of:

- internal audit department peer reviews
- survey of internal audit departments

The consideration of adequately informing agency management of potential problems included a review of:

- information obtained from surveys of board chairs and agency heads

The consideration of adequate communications between the agency's governing board, management, and the internal audit department included a review of:

- information obtained from surveys of board chairs, agency heads, and internal audit departments

The consideration of internal auditor qualifications included a review of:

- information obtained from a survey of internal audit departments

The consideration of independence, objectivity, and fairness in conducting audits included a review of:

- information obtained from a survey of board chairs and agency heads

The consideration of top management support for the internal audit department included a review of:

- information obtained from a survey of internal audit departments

The consideration of adequacy of internal audit department resources included a review of:

- internal audit department budget information
- staffing information obtained from a survey of internal audit departments

## **Methodology**

The methodology used on this audit consisted of collecting and analyzing information and evaluating the information against pre-established criteria.

Information collected to accomplish our objectives included the following:

- surveys of governing board chairs
- surveys of agency heads
- surveys of internal audit departments
- codification of *Statements for the Professional Practice of Internal Auditing*
- *Texas Internal Auditing Act*
- documentary evidence including:
  - agency findings and recommendations
  - descriptions of management actions taken in response to audit findings and recommendations
  - fiscal impact of audit recommendations
  - external peer reviews of internal audit departments
  - internal audit department budgets
  - internal audit department charters
  - internal audit department performance measures

Procedures conducted:

We surveyed 228 board members, agency heads, and internal audit directors. There were 175 surveys returned for an overall response rate of 77 percent. Internal audit directors returned 76 of 84 surveys sent. Board or commission chairs returned 31 of 50 surveys sent. Agency heads returned 68 of 94 surveys sent. The number of surveys sent to the three groups varied depending on the organizational structure of the agency or university. The response rates for the three groups were:

- 90 percent for internal audit directors
- 62 percent for board/commission chairs
- 72 percent for agency heads

Analysis techniques used:

- review of performance measures
- comparison of survey responses
- comparison of internal audit department budgets and staffing to agency budgets and staffing

Criteria used:

- effectiveness criteria from *Measuring the Effectiveness of Internal Audit Departments*, published by the Institute of Internal Auditors
- Requirements of the *Texas Internal Auditing Act*
- *Codification of Standards for the Professional Practice of Internal Auditing*

Fieldwork was conducted from August 1, 1994, to September 30, 1994.

We compiled information primarily through surveys of board members, agency heads, and internal audit directors. Additionally, we reviewed supplemental information, including peer review results, internal audit department budgets, and charters. This review was not conducted in accordance with generally accepted government auditing standards because verification of information submitted was not performed.

This review was performed by the following members of the State Auditor's staff:

- William D. Hastings, CPA (Project Manager)
- Terry E. Hazel, CIA
- Christina D. Hurr, MPA
- Dennis D. O'Neal, CIA
- Carol A. Noble, CISA
- Kay Wright Kotowski, CPA (Audit Manager)
- Craig Kinton, CPA (Director)

## Internal Audit Background Information

For fiscal year 1994, agency and university appropriations were greater than \$35 billion, making Texas government comparable in size to a Fortune 500 company. The internal audit function has become a mechanism for the efficient and effective management of state resources.

Internal audit departments provide audit coverage to state agencies which represent 92 percent of state appropriations and 89 percent of state employees. There are 79 internal audit departments in state agencies and universities. These departments employ 389 internal auditors and 54 administrative support staff. The total estimated cost to the State is \$23 million annually.

In fiscal year 1993, internal auditors reported a five-year fiscal impact of \$100 million. Since 1991, the overall reported fiscal impact totals \$175 million. Fiscal year 1994 information was not available prior to publication of this report. Other internal audit recommendations with little or no fiscal impact result in improved controls which safeguard valuable state assets.

The *Texas Internal Auditing Act* requires agencies which meet any one of the following three criteria to have a "full-time program of internal auditing":

- has an operating budget exceeding \$10 million annually
- has a staff of more than 300 employees
- receives and processes cash items in excess of \$10 million annually

(See Appendix 4.1 for the text of the *Texas Internal Auditing Act*.)

## Reference List

The books, articles, reports, etc., listed below are relevant to *Evaluating the Effectiveness of Internal Audit*:

Albrecht, W. Steve, Keith Howe, Dennis Schueler, and Kevin Stocks. *Evaluating the Effectiveness of Internal Audit Departments*, Altamonte Springs, FL: The Institute of Internal Auditors, 1988.

Governmental Accounting Standards Board. *Service Efforts and Accomplishments Reporting: Its Time Has Come*, 1990.

Institute of Internal Auditors. *Codification of Standards for the Professional Practice of Internal Auditing*, Altamonte Springs, FL: 1993.

Lampe, James C. and Steve G. Sutton. *Developing Productivity in Quality Measurement Systems for Internal Auditing Departments*. Altamonte Springs, FL: Institute of Internal Auditors, 1994.

State of Texas, Office of the State Auditor. *Spotlight on Internal Auditing, Fiscal Year 1993*. SAO Report No. 94-013.

\_\_\_\_\_, Office of the State Auditor. *Internal Auditing in State Agencies: 1992 Progress Report*. SAO Report No. 93-024.

## **The Texas Internal Auditing Act**

Government Code, Chapter 2102

### **Section 2102.001. Short Title.**

This chapter may be cited as the Texas Internal Auditing Act.

### **Section 2102.002. Purpose.**

The purpose of this chapter is to establish guidelines for a program of internal auditing to assist agency administrators by furnishing independent analyses, appraisals, and recommendations about the adequacy and effectiveness of an agency's systems of internal control policies and procedures and the quality of performance in carrying out assigned responsibilities.

### **Section 2102.003. Definitions.**

In this chapter:

- (1) "Administrator" means the executive head of a state agency.
- (2) "Audit" means:
  - (A) a financial audit described by Section 321.0131;
  - (B) a compliance audit described by Section 321.0132;
  - (C) an economy and efficiency audit described by Section 321.0133;
  - (D) an effectiveness audit described by Section 321.0134; or
  - (E) an investigation described by Section 321.0136.
- (3) "State agency" includes a department, board, bureau, institution, commission, or other agency of the state.

### **Section 2102.004. Applicability.**

This chapter applies only to a state agency that:

- (1) has an operating budget exceeding \$10 million annually;
- (2) has a staff of more than 300 employees;
- (3) receives and processes cash items in excess of \$10 million annually.

### **Section 2102.005. Internal Auditing Required.**

A state agency shall conduct a full-time program of internal auditing that includes:

- (1) an annual audit plan that is prepared using risk assessment techniques and that identifies the individual audits to be conducted during the year; and
- (2) periodic audits of the agency's major systems and controls, including:
  - (A) accounting systems and controls;
  - (B) administrative systems and controls; and
  - (C) electronic data processing systems and controls.

### **Section 2102.006. Internal Auditor; Staff.**

- (a) The governing board of an agency or its designee, or the administrator of an agency without a governing board, shall appoint an internal auditor.
- (b) An internal auditor must:
  - (1) be a certified public accountant or a certified internal auditor; and
  - (2) have at least three years of auditing experience.

- (c) The state agency shall employ additional professional and support staff the administrator determines necessary to implement an effective program of internal auditing.

**Section 2102.007. Duties of Internal Auditor.**

- (a) The internal auditor shall:
  - (1) report directly to the state agency's governing board;
  - (2) develop an annual audit plan;
  - (3) conduct audits as specified in the audit plan and document deviations;
  - (4) prepare audit reports;
  - (5) conduct quality assurance reviews in accordance with professional standards and periodically take part in a comprehensive external peer review; and
  - (6) conduct economy and efficiency audits and program results audits as directed by the state agency's governing board.
- (b) The program of internal auditing conducted by a state agency must provide for the auditor to:
  - (1) have access to the administrator; and
  - (2) be free of all operational and management responsibilities that would impair the auditor's ability to review independently all aspects of the state agency's operation.

**Section 2102.008. Approval of Audit Plan and Audit Report.**

The annual audit plan developed by the internal auditor must be approved by the state agency's governing board or its designee, or by the administrator of a state agency without a governing board. Audit reports must be reviewed by the state agency's governing board and the administrator.

**Section 2102.009. Annual Report.**

- (a) The internal auditor shall prepare an annual report and submit the report before November 1 of each year to the governor, the Legislative Budget Board, the Sunset Advisory Commission, the state auditor, the state agency's governing board, and the administrator.
- (b) The report must contain:
  - (1) a copy of the annual audit plan;
  - (2) a list of the audits completed;
  - (3) an explanation of any deviation from the approved annual audit plan;
  - (4) a narrative description of the most significant findings and recommendations for each audit;
  - (5) a narrative description of the management actions taken in response to the audit findings and recommendations;
  - (6) a table listing the auditor's audit recommendations and the five-year fiscal impact for each recommendation;
  - (7) a table of the audit recommendations from the previous fiscal year's report and an explanation of the status of each recommendation; and
  - (8) a statement of the last date on which an external peer review of the agency's internal audit program was conducted.
- (c) Each recommendation must show whether:
  - (1) the recommendation has been implemented;

- (2) the recommendation is in the process of implementation;
  - (3) action on implementation of the recommendation has been delayed; or
  - (4) the agency does not intend to take action on the recommendation.
- (d) The report must emphasize the findings in important areas that are difficult to quantify, including weaknesses in management controls or quality of services.

**Section 2102.010. Consultations.**

An internal auditor may consult with the state agency's governing board, the governor's office, the state auditor, and legislative agencies or committees about matters affecting duties or responsibilities under this chapter.

**Section 2102.011. Internal Audit Standards.**

The internal audit program shall conform to the *Standards for the Professional Practice of Internal Auditing*, generally accepted governmental auditing standards, the Certified Internal Auditor Code of Professional Ethics, and the Statement of Responsibilities of Internal Auditing of the Institute of Internal Auditors.

**Section 2102.012. Professional Development.**

(a) The state auditor shall make available and shall coordinate a program of training and technical assistance to ensure that state agency internal auditors have access to current information about internal audit techniques, policies, and procedures and to provide general technical and audit assistance to agency internal auditors upon request.

(b) The state auditor is entitled to reimbursement for costs associated with providing the services under the terms of interagency cooperation contracts negotiated between the state auditor and each agency. The costs may not exceed those allowed by the General Appropriations Act.

### Table of Executive Branch Survey Responses

Agency #	Agency Name	Board Survey Received	Agency Head Survey Received	Internal Audit Director Survey Received	Internal Audit Budget Submitted
301	Governor, Office of the		N	Y	Y
302	Attorney General, Office of the		Y	Y	Y
303	General Services Commission, State	Y	Y	Y	Y
304	Comptroller of Public Accounts		N	Y	Y
305	Land Office and Veterans' Land Board, General		Y (2)	Y	Y
306	Library and Archives Commission	Y	N	Y	Y
307	Secretary of State		Y	N	N
310	Treasury Department		Y	Y	Y
312	Securities Board		Y (2)	N	N
313	Information Resources, Department of (1)				
318	Blind, Commission for the	N	Y	Y	Y
322	Employment Commission, Texas	Y	Y	Y	Y
323	Teacher Retirement System	Y	Y	Y	Y
324	Human Services, Department of	Y	Y	Y	Y
327	Employees Retirement System	Y	Y	Y	Y
329	Real Estate Commission (1)				
330	Rehabilitation Commission	N	Y	Y	Y
332	Housing and Community Affairs, Department of	N	Y	Y	Y
340	Aging, Department on	N	Y	Y	Y
350	National Research Laboratory Commission	Y	Y	Y	

Agency #	Agency Name	Board Survey Received	Agency Head Survey Received	Internal Audit Director Survey Received	Internal Audit Budget Submitted
401	Adjutant General's Department		Y	Y	N
405	Safety, Department of Public	N	Y	Y	Y
406	Armory Board, National Guard (1)				
409	Jail Standards, Commission on	N	Y	Y	Y
451	Banking, Department of		N	Y	Y
453	Workers' Compensation Commission	N	Y	Y	Y
454	Insurance, Department of		N	Y	Y
455	Railroad Commission	N	N	Y	Y
457	Accountancy, Board of Public	Y	Y	Y	Y
458	Alcoholic Beverage Commission	Y	Y	Y	Y
465	Commerce, Department of	Y	Y	Y	Y
473	Utility Commission, Public	Y	Y	Y	Y
501	Health, Department of	Y	Y	Y	Y
503	Medical Examiners, Board of (1)				
506	The University of Texas M.D. Anderson Cancer Center		Y	Y	Y
517	Alcohol and Drug Abuse, Commission on	Y	Y	Y	Y
529	Health and Human Services Commission			Y	Y
530	Protective and Regulatory Services, Department of	Y	N	Y	Y
551	Agriculture, Department of		Y	Y	Y
554	Animal Health Commission	Y (2)	Y	Y	Y
580	Water Development Board	N	Y	Y	Y

Agency #	Agency Name	Board Survey Received	Agency Head Survey Received	Internal Audit Director Survey Received	Internal Audit Budget Submitted
582	Natural Resources Conservation Commission	Y	Y	Y	Y
601	Transportation, Department of	Y	Y	Y	Y
655	Mental Health and Mental Retardation, Department of	N	Y	Y	Y
665	Probation Commission, Juvenile	Y	N	Y	Y
694	Youth Commission	N	N	Y	Y
696	Criminal Justice, Department of	Y	N	N	Y
701	Central Education Agency	Y	N	Y	Y
710	TX A&M University System: Administrative and General Offices	Y	Y	Y	N
711	TX A&M University	N	N	Y	Y
714	The University of Texas at Arlington		Y	Y	Y
717	Texas Southern University	N	Y	Y	Y
719	Texas State Technical College System	Y	Y	Y	Y
720	The University of Texas System: System Administration	Y	Y	Y	Y
721	The University of Texas at Austin		Y	Y	Y
723	The University of Texas Medical Branch at Galveston		N	Y	Y
724	The University of Texas at El Paso		Y	N	N
729	The University of Texas Southwestern Medical Center at Dallas		Y	Y	Y
731	TX Woman's University	N	Y	Y	Y

Agency #	Agency Name	Board Survey Received	Agency Head Survey Received	Internal Audit Director Survey Received	Internal Audit Budget Submitted
733	Texas Tech University	Y	Y	Y	Y
735	Midwestern State University	Y	Y	Y	Y
736	The University of Texas - Pan American		Y	Y	Y
737	Angelo State University		N	Y	Y
738	The University of Texas at Dallas		Y	Y	Y
743	The University of Texas at San Antonio		N	Y	Y
744	The University of Texas Health Science Center at Houston		Y	Y	Y
745	The University of Texas Health Science Center at San Antonio		Y	Y	Y
747	The University of Texas at Brownsville		Y	N	N
750	The University of Texas at Tyler		Y	Y	Y
751	East Texas State University	Y	Y	Y	Y
752	University Of North Texas	Y	N	Y	Y
753	Sam Houston State University		N	Y	Y
754	Southwest Texas State University		Y	Y	Y
755	Stephen F. Austin State University	N	Y	Y	Y
756	Sul Ross State University		Y	N	N
758	Texas State University System	N			
763	University of North Texas Health Science Center at Fort Worth	Y	Y	Y	Y
771	School for the Blind and Visually Impaired		Y	N	N
772	School for the Deaf	N	N	N	N

Agency #	Agency Name	Board Survey Received	Agency Head Survey Received	Internal Audit Director Survey Received	Internal Audit Budget Submitted
781	Higher Education Coordinating Board	Y	Y	Y	Y
783	University of Houston System: System Administration	N	Y	Y	Y
785	The University of Texas Health Center at Tyler		Y	Y	Y
786	Lamar University System: System Office	Y	Y	Y	Y
802	Parks and Wildlife Department	N	Y	Y	Y

NOTES:

1. Agency does not have an internal audit program as required by the *Texas Internal Auditing Act*.
2. Survey not returned in time to be included in results.

Copies of this report have been distributed to the following:

## **Legislative Audit Committee**

Honorable James E. "Pete" Laney, Speaker of the House, Chair  
Honorable Bob Bullock, Lieutenant Governor, Vice Chair  
Senator John Montford, Chair, Senate Finance Committee  
Senator Kenneth Armbrister, Chair, Senate State Affairs Committee  
Representative Robert Junell, Chair, House Appropriations Committee  
Representative Tom Craddick, Chair, House Ways and Means Committee

## **Governor of Texas**

Honorable Ann W. Richards

## **Legislative Budget Board**

## **Sunset Advisory Commission**

**Chief Executive Officers, Board Members,  
and Internal Auditors of the entities  
included in this report**