Internal Audit Process

ACKNOWLEDGEMENTS

BACKGROUND

The Internal Audit Process Workgroup recommends that the Office of the State Comptroller (OSC) revise its Standards for Internal Control in New York State to specifically recognize the internal audit process as a supporting activity to agency management. The revised standards should set forth minimum requirements for the operation of an internal audit function within a New York State government entity and should, at a minimum, provide guidance in the four areas outlined in the following pages.

OBJECTIVES AND METHODOLOGY

The Internal Audit Process workgroup was charged to develop guidance and identify best practices in four areas: risk-based audit planning, reviewing internal controls, monitoring audit findings, and maintaining audit work papers. To accomplish these objectives, the workgroup analyzed the operational requirements imposed by the Internal Control Act, the Standards for Internal Control in New York State Government issued by the OSC and professional audit standards as they each relate to the four areas. The group also surveyed current internal audit practices within New York State and conducted follow-up discussions with audit staff from several agencies.

RESEARCH AND SURVEY RESULTS

Risk-Based Audit Planning

The workgroup's first objective was to provide internal audit units with tools to assist them both in assessing risk within their organizations and in developing an audit plan that focuses on the areas of highest risk. The group was also asked to identify best practices currently in place at individual agencies and to provide guidance on specific approaches to increase efficiency.

The Work Group found that some State agencies do not have a risk-based audit planning process, while others do not update their assessments of organizational risk at least annually. The group believes that these two elements are essential for the professional practice of internal auditing consistent with the Internal Control Act. The Work Group also agreed that all the practices itemized below are necessary for effective audit planning and should be part of each internal audit unit's planning process.

Reviewing Internal Controls

The workgroup's second objective was to provide internal audit units with guidance and tools to assist them in evaluating and monitoring the internal control systems within their entities. The group addressed this objective from two perspectives: the extent to which internal audit units should devote resources to examining internal control systems within their organizations, and the

extent to which internal controls need to be examined during the course of individual audit engagements.

The workgroup has concluded that the Standards for Internal Control in New York State Government issued by the OSC serve as the basis for evaluation of internal controls in State agencies and public authorities. Further, in making the Internal Control Act permanent in 1999, the Legislature highlighted the need for agency management to promote good internal controls and accountability in government in part by mandating that certain agencies maintain internal audit units while permitting others to evaluate the need for such units annually. In this context, the issue of whether internal audit units should devote some of their resources to examining control issues inside the organization or whether it is acceptable to only audit outside groups that conduct business with the organization (e.g. contractors, grantees, service providers) seems clear.

Internal audit units exist in major part in New York State due to the provisions of the Act, which focuses largely on control systems internal to the entity. In addition, the Act specifically requires that the internal audit function shall evaluate the agency's internal controls and operations. To fulfill this responsibility, the internal audit units created by the Act must devote resources to examining the internal activities.

However, it is important to note that the Act provides no criteria to evaluate the minimum level of resources that must be devoted to internal activities. In addition, we note that the Act also provides no expectation that all internal audit resources must be directed to internal activities. As such, the group concludes that this allocation is best determined as part of a larger analysis of risks facing the particular entity (i.e. the risk-based audit planning process).

Regarding the more focused issue of how internal controls should be addressed during an individual audit, Generally Accepted Government Audit Standards (GAGAS), which require auditors to have a sufficient understanding of relevant internal controls to plan an audit and determine what kinds of tests to perform in the audit. Auditing standards also require that sufficient, competent, relevant evidence is obtained to support the basis of their judgment about internal controls. In general, the group concluded that for routine audits of programs or operations, generally accepted audit standards (GAAS, GAGAS, and IIA Standards) already provide adequate direction and the auditor should refer to these authoritative sources.[1] For audits of internal control systems, once the internal audit unit has decided to examine the subject, it should then identify the specific objectives of that examination. It should consider examining the five elements of internal control: control environment, communication, assessing and

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[1] GAGAS refers to the standards and guidance contained in the G.A.O. Yellow Book, promulgated by the U.S. Comptroller General of the United States. GAAS is a set of 10 standards established by the AICPA. GAGAS incorporate, but go beyond GAAS. The Institute of Internal Auditors provides guidance in the form of Standards, which they refer to as *The International Standards for the Professional Practice of Internal Auditing*.

managing risk, control activities and monitoring. And, depending on the needs of the agency, the audit unit may need to expand the scope.

In addition, as part of its periodic assessment of organizational risk, the internal audit unit should review and test documentation, including management control self assessments, maintained by the agency's Internal Control Officer in support of the entity's annual certification. Depending on the test results, the internal audit unit can form a basis to either rely on the certification or set it aside and conduct its own separate review of internal controls.

Control Self Assessment

With regard to the objective of obtaining evidence from agency staff, the group concludes that Control Self Assessment process of the Institute of Internal Auditors' is a "best practice" that can provide the auditors with the best evidence from which to draw a conclusion about the control environment and preliminary indicators of how adequate the agency's risk assessment, control activities, information and communication systems, and monitoring processes are. However, it should also be understood that auditors should perform other tests and evaluations to draw conclusions about these four other components of internal controls, as well as being constantly aware of other control environment evidence gained by the auditors' interaction with management.

Once the decision has been made to conduct a Control Self Assessment survey, the audit director should contact management to discuss the following items:

- The auditors will be collecting evidence on the five elements of internal controls, with particular emphasis on assessing the control environment.

- Using the organization chart, and other input from management as necessary, the auditors will schedule meetings with all staff involved in the area under audit to get their input about internal controls. When scheduling the meetings with staff, the auditors should ensure that their supervisors are not in the same meetings.

- Once the survey is complete, the auditors will analyze the results and meet with area management to discuss the preliminary results.

- After discussing results with area management, the auditors will prepare a preliminary report for internal audit review and approval. Once approved internally, the preliminary report should be forwarded to area management for their review prior to the meeting with them.

A sample Control Self Assessment survey questionnaire is being provided as a best practice and should be tailored by the auditor to the area under review as necessary. The auditor should identify manager(s) by name and title in the survey since the instrument makes specific statements about management's ethics and integrity. This is necessary to avoid any confusion for the employees filling out the survey. Alternatively, the auditor may decide that the survey should be anonymous, in which case they can eliminate the identifying information from the survey, or still collect the information but keep it confidential. This document is intended as a guide and therefore, the auditor may decide to also consider integrating its content with all or parts of other best practices available to them.

Monitoring Audit Findings

The workgroup's third objective was to provide agencies with guidance for establishing a system to monitor the implementation of their audit recommendations through a formal system of follow-up. The group's conclusions are based upon analysis of the Act and applicable audit standards, as well as information provided by State agencies in response to our survey.

As previously noted, the Act specifies that the internal audit function shall evaluate the agency's internal controls and operations. Further, the internal audit function is also directed to identify internal control weaknesses that have not been corrected and make recommendations to correct those weaknesses. The Work Group concludes that each internal audit unit must therefore have a process to follow up on audit findings if it is to identify weaknesses that remain uncorrected. This interpretation is supported by an analysis of IIA standards, which require in part that:

- The chief audit executive should establish and maintain a system to monitor the disposition of results communicated to management

- The chief audit executive should establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action

- The internal audit activity should monitor the disposition of results of consulting engagements to the extent agreed upon with the client

Our survey showed that most State agency internal audit units do have a system in place to monitor audit findings. In most cases, audit units reported using a manual system. The following survey responses indicate that State agencies follow-up on audit recommendations based on various circumstances, such as:

- Every six months on internal audits, as needed on external audits;

- 90 days - similar to OSC's process for final reports;

- Significant outstanding findings reviewed annually;

- Depends on audit;

- Based on significance of the issues;

- Depends on recommendation.

The survey responses also highlighted how internal audit units use different criteria to determine which audits to follow up on, including:

- Follow up on major recommendations;

- Impact on operation audited;

- High priorities main concern, too much control activities can cause resistance;

- Formal follow up on material issues, informal follow up on others;

- Corrective action taken immediately; and

- Based on materiality and relative risk, not all audits warrant a follow up.

Maintaining Audit Documentation

This workgroup's final objective was to identify best practices and establish minimum standards for audit documentation to be retained in support of internal audit activities. As part of this effort, the group also addressed issues related to electronic work papers and other non-traditional forms of work paper documentation. Thirty-two agencies responded to our survey. The overall results indicated that internal audit units are successful in managing the following:

- Maintaining work papers for each audit engagement;

- Using an electronic format such as Word and/or Excel;

- Including standard elements in the work papers such as source, purpose, conclusion and scope; and

- Utilizing proper work paper techniques such as cross referencing and work paper review.

Although many of the agencies' internal audit units seem to have some good procedures established, we found that there are a small percentage of agencies that are lacking in these procedures. Therefore, our recommendation for baseline requirements are intended to reach those internal audit units that are showing a need for improvement, as well as to focus on creating some standardization among the units and address improving automation and efficiency.

The recommendations included in this report will provide all State agencies a better under-standing of the requirements under the New York State Internal Control Act, as well as the Internal Auditing Standards defined by the Institute of Internal Auditors as they pertain to audit

documentation. In addition, they serve to highlight some methodologies that can be classified as a "best practice" within the internal audit function.

RECOMMENDATIONS

The following baseline practices this Work Group is recommending were modified slightly from the International Standards for the Professional Practice of Internal Auditing (IIA Standards) to make them more applicable to State agencies.

1. The DIA in each State agency should periodically develop a risk-based audit plan to determine the priorities of the internal audit activity, consistent with the organization's goals.

2. The internal audit activity's plan of engagements should be primarily based on a risk assessment, updated at least annually. The input of senior management and the board (if applicable) should be considered in the process.

3. In developing the audit plan, the DIA should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

4. The DIA should communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and to the board for review and approval. The DIA should also communicate the impact of resource limitations.

5. The DIA should ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

6. The DIA should establish policies and procedures to guide the internal audit activity.

7. The DIA should establish and maintain a system to monitor the disposition of audit recommendations communicated timely to management.

8. The DIA should document the rationale in deciding which audit recommendations should be followed up on and when, as opposed to recommendations where no follow-up is needed.

9. The DIA should follow up with management to document that either audit recommendations have been effectively implemented, or that senior management has accepted the risk of not implementing the recommendations.

10. The DIA should monitor the disposition of recommendations of consulting engagements to the extent agreed upon with the client.

11. The DIA should establish a written policy for security and control of audit work papers. Work paper policies should address four areas:

Physical Control: Work papers are the auditors' property and should be kept under their control. The auditors should know exactly where manual work papers and supporting documents are during the conduct of the audit. When not in use, they should be kept in a locked file or otherwise secured so they are not readily available to persons unauthorized to use them. Access to electronic work papers should be controlled via electronic data processing security controls (passwords, shared file controls, etc.).

Storage: The most recent set of work papers for each project should be kept in the Department's *secured* central files. The current electronic work paper files should be maintained in a directory of active audits. Prior work papers may be filed in a centralized record retention. A designated individual should be assigned to maintain a list of work papers sent to record storage. A destruction date should be placed on each carton sent to storage.

Retention: Work papers should be retained for a minimum of seven years (depending on industry, regulatory constraints, etc.) after the date of the report.

Release to Internal and External Parties: Approval from senior management and/or legal counsel should be obtained prior to releasing work papers and reports to external parties, as appropriate.

12. Internal audit units should maintain work paper documentation for each audit and follow-up. The IIA Standards require internal auditors to record relevant information to support the conclusions and engagement results under IIA Practice Standard 2330. In addition, Government Auditing Standards, Section 4.22 require that each Internal Audit function maintain documentation related to planning, conducting and reporting on the audit. This documentation should contain sufficient information to enable an experienced auditor who has no previous connection with the audit to ascertain from the audit documentation the evidence that supports the auditors' significant judgments and conclusions.

13. Internal audit units should establish a written policy governing work paper review and approval. Our survey revealed that 7 out of the 32 respondents (22 percent) are currently not having their work papers reviewed by someone other than the auditor who prepared them. The policy should clearly delineate who is responsible for reviewing audit work papers prepared by various staff levels and when that review should occur. Audit units should also consider adopting a standard work paper review checklist as a best practice for managing this important quality assurance function.

14. The ICTF should develop a mechanism for internal audit units to create and share standard work paper elements to meet minimum requirements and incorporate best practices. This is needed to address our initiative of establishing consistency and efficiency. A total of 38 percent of the internal audit units responding to our survey indicate that they do not currently utilize standard templates or checklists while creating work papers. Examples of what should be included in the guide are explanations of the qualities of good work papers (e.g., relevance and completeness), descriptions of good work paper techniques (e.g., tick-marks, cross-referencing and standard templates), and examples of standardized work papers that could be utilized by others (e.g., planning documents, schedules and analyses).

15. The ICTF should explore licensing an electronic work paper package (such as TeamMate®) on a statewide basis for use by all agencies. Our survey revealed that 78 percent of the internal audit units would be interested in learning more about electronic audit packages. Our workgroup participated in a demonstration of one such product (TeamMate®) which is licensed and utilized by the Office of the State Comptroller for all of its audit assignments. We found this product directly addresses many of the issues presented in our recommendations. However, the group concluded that this product would be cost prohibitive for most organizations given the small size of their audit units. The ICTF should investigate the possibility of licensing this product on a broader, statewide basis so that smaller agencies could take advantage of the product at a more affordable incremental cost.

ADDITIONAL OBSERVATIONS

As the Internal Audit Process Work Group compiled our recommendations for the Task Force, we realized that additional information is needed in several areas to assist Internal Audit Units, Internal Control Officers and management in fulfilling their responsibilities. Many of these areas will likely be addressed by the Task Force. The Group recommends that the Task Force establish a process for developing and maintaining a resource repository that can be accessed by internal audit personnel, Internal Control Officers and management as a principal place of reference. This resource repository might include such items as a standardized internal audit manual, standard audit programs, internal control programs and examples of other documents that promote best practices in these areas of responsibility.