

Secretary of State **AUDIT REPORT**

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Follow-Up Review of Internal Auditing Functions in State Agencies



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Summary

PURPOSE

Internal auditing is one of the key mechanisms available to agency management to help ensure strong fiscal accountability over public funds. The objective of this review was to compare the status of internal auditing in state agencies during 2002 to the status described in our 1996 audit report *Review Of Internal Auditing Functions In State Agencies* (Report No. 96-53). We sought to identify improvements in state internal audit practice since 1996, and show areas of continuing need.

RESULTS IN BRIEF

During 2002, state agencies that had an internal audit function were implementing substantially more of the recommended practices described in our 1996 audit report. However, only three of 11 agencies with an internal audit function had implemented all of the recommended practices: the Judicial Department, the Oregon University System, and the Oregon Department of Transportation.

The Department of Administrative Services (DAS) has published recommended criteria for agencies to use in deciding whether or not to establish an internal audit function. Since the release of our 1996 report, two agencies had established new internal audit functions, but 11 of the state's larger agencies had not established an internal audit function, and another five agencies had no audit coverage

due to vacant internal auditor positions. Another seven agencies with budgeted internal audit positions had allowed vacancies to remain unfilled for six months or more. As a result, approximately one third of the state's budgeted resources are at increased risk of loss, waste, and misuse due to lack of internal audit coverage.

RECOMMENDATIONS

We recommend that:

- All agencies with an internal audit function should implement all of the recommended practices identified in this audit report, and focus on completing an external peer review if they have not yet received one.
- In line with management priorities, and as allowed by available resources, all agencies meeting Department of Administrative Services guidelines for establishing an internal audit function should budget for, fill, and fully support at least one fulltime internal auditor position so that internal auditing will be performed.

AGENCIES' RESPONSES

The agencies included in this report agreed with the findings and recommendations.

Introduction

Oregon state government operates through 89 different state agencies with biennial budgeted expenditures exceeding \$34 billion,¹ and more than 47,000 fulltime equivalent employees.² In 1991 the Executive Department (now the Department of Administrative Services), under authority of *Oregon Revised Statute* (ORS) 291.015, established central policy guidance regarding the use of internal auditors in state agencies.

The policy, included in the Oregon Accounting Manual (OAM), section 10.80.00.110.PR, recommends that state agencies strongly consider establishing, maintaining, and fully supporting a fulltime internal auditing function if they meet one or more of the following criteria: (1) total biennial expenditures exceed \$100 million, (2) the number of fulltime equivalent employees exceeds 400, or (3) cash items received and processed annually exceed \$10 million.

The 27 agencies included in this review either met OAM criteria for having an internal audit function, or had an internal audit function but were not to subject to the OAM.

Background

Areas of Concern in Prior Audit

In 1996, our audit (Report No. 96-53) noted that several large state agencies did not have an internal audit function. Also, most of the nine agencies reviewed that had a fulltime internal audit function had not implemented key practices recommended for the effective conduct of internal auditing.

Benefits of Internal Auditing

When organized and managed properly, internal auditing can provide agency management with an

¹ 2001-03 Legislatively Adopted Budget as of December 17, 2001 and Oregon Lottery Fiscal Year 2002-2003 Business Plan.

² Adjusted to include OUS FTE.

independent and objective assurance and consulting activity that adds value and improves agency operations. As a service to the agency, internal auditing should bring a systematic and disciplined approach to evaluating and improving risk management, control, and governance processes.³

Specifically, internal auditors can assist agency management by objectively:

- Identifying areas where organizational resources could be used more effectively and efficiently.
- Determining the extent to which programs are operating in compliance with legal requirements, and are achieving agency goals and objectives.
- Reporting on the reliability and integrity of operating and financial data.
- Identifying, assessing, and reducing risks to agency objectives, assets, or resources.
- Serving in a preemptive role in safeguarding assets and preventing or limiting fraud, waste and abuse.
- Participating in the development and review of information systems.

Recommended Practices

As part of our 1996 audit, and again for this audit, we compared the organization and work of state agency internal audit functions against practices recommended for the effective conduct of internal auditing. The following recommended practices appear among the standards, policies or guidelines published by the Institute of Internal Auditors, Inc., the U.S. General Accounting Office, and the Department of Administrative Services (DAS).

³ Abridged from the Institute of Internal Auditors, Inc.: *Professional Practices Framework*.

- Establish an audit charter.
- Establish an independent audit committee.
- Perform a risk assessment of the organization each year.
- Report to an administrative level high enough to protect the independence of the audit function.⁴
- Formalize workpapers and issue written reports.
- Undergo an external peer review at least once every five years.
- Develop and perform internal assessment of the internal audit activity.
- Follow up on audit findings.
- Conduct or contract for information technology audits or audits with information technology components.

Audit Results

Status of Internal Auditing in 2002 Compared to 1996

Figure 1 shows that in 2002 considerably more state agencies with an internal audit function were implementing the recommended practices listed above.

⁴ According to the Institute of Internal Auditors, Inc., *Standards for the Practice of Internal Auditing*, "The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results."

Figure 1:
Implementation of Recommended Practices by Agencies with Internal Audit Function

Recommended Practices	Agencies in 1996	Agencies in 2002 ⁵
Has an Audit Charter	8 of 9	11 of 11
Has an Audit Committee	5 of 9	10 of 11
Performs Risk Assessments	6 of 9	10 of 11
Reports to Administrative Level High Enough to Protect Independence	7 of 9	11 of 11
Has Formal Workpapers and Issues Written Reports	4 of 9	11 of 11
Completed an External Peer Review in the Past Five Years	4 of 9	3 of 11
Follows Up on Findings	5 of 9	11 of 11
Performs Internal Assessment of the Internal Audit Activity	1 of 9	8 of 11
Conducts or Contracts for Information Technology Audits, or Audits with Such Components	4 of 9	11 of 11

The areas of greatest improvement since 1996 include the following: more agencies had formal work paper systems and issued written reports; more agencies followed up on internal audit findings; more agencies had performed internal assessments; and more agencies conducted or contracted for information technology audits, or conducted audits with information technology components.

Figure 2 provides a more detailed breakdown of each agency's implementation of the recommended practices.

⁵ As of November 2002.

Figure 2
Status of Recommended Practices at State Agencies with Internal Auditor(s)*

Agency	Charter	Audit Committee	Risk Assessment	Reports to Appropriate Level of Management	Formalized Workpapers and Reports	External Peer Review Within the Last Five Years	Follows Up on Findings	Performs Internal Assessment of the Internal Audit Activity	Information Technology Audits or Audits with Information Technology Components (7/1/01 - 11/1/02)	# of Reports Issued (7/1/01 - 11/1/02)
Department of Human Services	Y	Y	Y	Y	Y	N**	Y	N	Y	20
Department of Corrections	Y	N	Y	Y	Y	N**	Y	Y	Y	11
Judicial Department	Y	Y	Y	Y	Y	Y	Y	Y	Y	13
Department of Transportation	Y	Y	Y	Y	Y	Y	Y	Y	Y	16
Oregon University System	Y	Y	Y	Y	Y	Y	Y	Y	Y	43
Department of Consumer and Business Services	Y	Y	Y	Y	Y	N*** (Note 2)	Y	Y	Y	6
Employment Department	Y	Y	Y	Y	Y	N**	Y	Y	Y	1
Lottery	Y	Y	Y	Y	Y	N**	Y	Y	Y	25
Parks and Recreation	Y	Y	N/ In Process	Y	Y	N** (Note 2)	Y	N	Y	24
Public Employee Retirement System	Y	Y	Y	Y	Y	N**	Y	N	Y	2
State Treasury	Y	Y	Y	Y	Y	N**	Y	Y	Y	2 (Note 1)

Source: Agency internal auditor records.

Y = Agency internal auditor has implemented this recommended practice.

N = Agency internal auditor has not implemented this recommended practice.

N/ In Process = Agency internal auditor is in the process of implementing this recommended practice.

Note 1: The agency contracted with a private firm to perform audit work, and the contractor prepared two reports.

Note 2: Internal auditor position has existed for less than five years.

*We were unable to obtain internal auditor information from the Department of Administrative Services because all internal auditor positions were vacant at the time of our field work.

**Intends to participate in a peer review program that is currently being developed by the Salem Chapter of the Institute of Internal Auditors.

*** Intends to contract for an external peer review.

Figure 2 shows that in 2002 the following agencies implemented all of the recommended practices: the Judicial Department, Oregon University System, and Department of Transportation. It is noteworthy that each of these agencies had

undergone a recent external peer review and was found to be organized and operating in compliance with applicable professional standards.

Of the eight other agencies with an active internal audit function, none

had undergone an external peer review within the past five years. The majority of agency internal auditors cited high costs associated with a peer review as the reason for not having undergone one. However, internal auditors at seven

agencies reported that they would be participating in an inter-agency external peer review effort being developed by members of the Salem Chapter of the Institute of Internal Auditors. Another agency planned to hire a private contractor to perform an external peer review.

Recommendation

All agencies with an internal audit function should implement all of the recommended practices identified in this audit report, and focus on completing an external peer review if they have not yet received one.

Internal Auditing Results

Our review of state agency internal audits found many examples in which internal auditors supplied management with valuable information and recommendations. Between July 1, 2001 and November 1, 2002, state internal auditors issued 163 written reports. The reports typically included recommendations for improving:

- Controls over cash and credit cards,
- Financial management,
- Information systems,

- General program management,
- Contracting,
- Internal controls,
- Agency compliance with legal requirements, and
- General operations.

Internal auditors made positive impacts on agencies they serve. The following are examples of significant audit findings included in written internal audit reports.

- A Department of Consumer and Business Services internal auditor found errors in a feasibility analysis of a records storage project. The project cost was originally estimated at \$343,565, but the audit showed that total costs were underestimated by \$1.3 million. The department discontinued the project pending a reevaluation of systems that might more economically meet storage needs.
- Internal auditors at the Oregon Department of Transportation concluded that the state may have paid \$2.5 million more than necessary by awarding highway construction contracts in 16

cases in which only one contractor bid on individual jobs.

- Department of Corrections internal auditors found that profits from prison canteen operations totaling \$594,000 had not been properly transferred to the department’s Inmate Welfare Fund. No loss occurred. The funds have since been transferred and procedures changed to prevent reoccurrence.
- The Judicial Department internal auditors found an instance in which a contract defense attorney over-billed the state by \$62,000. The attorney reportedly has faced professional disciplinary action and is repaying the state.

State Resources Potentially at Risk Due to Insufficient Internal Audit Coverage

Figure 3 shows that approximately one third of state resources, or \$11.9 billion, is at increased risk because of a lack of internal audit coverage. This lack of coverage is occurring at agencies that have not established any internal auditor positions and at agencies where every internal auditor position is vacant.

FIGURE 3

Percentage of State Expenditures At Agencies With and Without Active Internal Auditing Functions

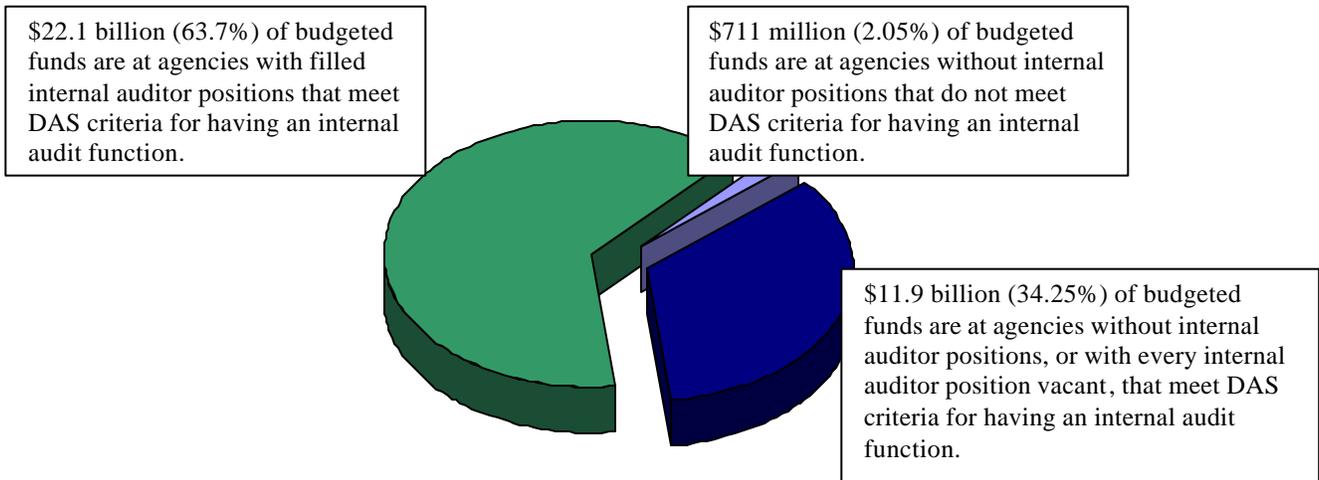


FIGURE 4
Status of Internal Auditing Functions at
State Agencies With Internal Auditors (IA) and State Agencies Meeting DAS/OAM Criteria

Agency Name	2001-2003 Legislatively Adopted Budget	2001-2003 Budgeted FTE Positions	FY 2002 Total Payroll Expenses for Internal Auditor Positions	FY 2002 Budgeted Internal Auditor FTE Positions	FY 2002 Filled Internal Auditor Positions ¹	Vacant Internal Auditor Positions (As of 11/01/02)	FY 2002 Internal Auditor Positions Vacant for 6 Months or More (As of 11/01/02)
Department of Administrative Services	\$ 485,591,296	936.39	\$185,172	3	2	3	1
Department of Agriculture	76,860,884	432.88		0			
Department of Community Colleges and Workforce Development	604,991,615	43.40		0			
Department of Consumer and Business Services	472,434,990	1,102.51	85,666	1	1		
Department of Corrections	1,013,338,960	3,812.44	230,459	4	2.83	1	1
Oregon Economic and Community Development Department	473,134,391	149.00		0			
Department of Education	6,289,857,701	462.90		0			
Employment Department ²	1,690,233,023	1,448.65	83,463	1	1		
Office of Energy	165,368,002	77.94		0			
Department of Environmental Quality	304,195,824	865.71		0			
Oregon Department of Fish and Wildlife	213,583,924	1,056.12		0			
Oregon Department of Forestry	222,368,762	944.24		1		1	1
Housing and Community Services Department	931,958,069	139.21		0			
Department of Human Services	8,561,297,958	8,870.48	593,701	10	9.15		
Oregon Judicial Department	427,457,766	1,824.24	236,371	3	3	1	
Oregon Department of Justice	221,368,733	1,173.04		0			
Oregon State Lottery ³	510,036,000	460.00	223,419	3	2.87	1	
State Parks and Recreation Department ⁴	130,926,824	509.62	54,000	1	1		
Department of State Police	398,330,192	1,444.31		0			
Public Employees Retirement System	3,663,077,843	216.08	105,307	2	1.33		
Department of Revenue	138,692,816	959.72		1		1	1
Oregon Student Assistance Commission	110,396,076	92.21		0			
Department of Transportation	1,836,871,921	4,724.89	413,709	6	5.90	1	
Treasurer of State	22,744,473	78.00	151,085	2	1.79		
Oregon University System	3,798,487,642	11,911.43	624,807	8	6.31	1	1
Department of Veteran's Affairs	990,595,245	165.00		1		1	1
Oregon Youth Authority	270,086,615	1,279.96		1		1	1
Totals	\$34,024,287,545	45,180.37	\$2,987,159	48	38.18	12	7

Source: 2001-2003 Legislatively Adopted Budget, Detailed Analysis and Appendix B: Summary of Expenditures (December 17, 2001, prior to any legislative special sessions), internal auditor interviews, and the Oregon State Payroll System.

¹ FTE calculations based on number of months each position was filled during FY 2002.

² Internal auditor position is federally mandated and funded.

³ Oregon Lottery budget obtained from the Oregon Lottery Fiscal Year 2002-2003 Business Plan.

⁴ Internal auditor position is filled by a Program Technician 1.

More State Agencies Should Have an Internal Audit Function

Internal auditing is a critical component of an agency's control environment, and most of the directors we interviewed shared this view. Auditors can lower risks by preemptively identifying and correcting weaknesses in control and information systems. All the directors of agencies with internal audit functions reported satisfaction with the value of contributions made by their internal auditors.

At the time of our audit, 27 state agencies met the OAM recommended criteria for establishing, maintaining and supporting a fulltime internal audit function. Eleven of the 27 agencies, however, did not have an internal audit function. Figure 4 shows that included among the 11 agencies are the Department of Education (\$6.3 billion biennial budget), Oregon Housing and Community Services Department (\$932 million biennial budget), and Oregon Economic and Community Development Department (\$473 million biennial budget).

For the 2001-03 biennium, the 11 agencies without an internal audit function had budgeted expenditures of \$9.8 billion, with 5,937 fulltime equivalent employees.

We spoke with senior managers at the 11 agencies. The majority reported that, because of budget constraints, creating new internal auditor positions had not been a top priority. Nevertheless, most recognized internal auditing as a valuable service and expressed a desire to have an internal audit function. However, managers of three agencies said that they believed that appropriate controls were in place to adequately reduce risk, therefore minimizing the need for an internal auditor.

A manager at DAS explained that over the last several budget cycles

no additional resources were made available specifically for new internal auditor positions. To fund a new auditor position, the agency must be willing to give up another existing position. When required to choose between program positions and internal auditing positions, most agencies have chosen to fund programs.

Need to Fill Vacant Internal Auditor Positions in a Timely Manner

Most vacant internal auditor positions were not being filled in a timely manner. As of November 1, 2002, state agencies had 48 budgeted internal auditor positions; 12 of those positions (25 percent) were vacant. As a result, five agencies with budgeted internal auditor positions were operating with no internal audit coverage. For the 2001-03 biennium, these five agencies had budgeted expenditures of \$2 billion, with 4,285 fulltime equivalent employees.

Of the 12 vacant positions, five had been vacant for less than six months. These positions were vacant due to normal turnover; however, agencies were not actively recruiting for three of these positions.

Seven of the 12 positions had been vacant longer than six months and, as of November 1, 2002, no recruitment efforts were underway. Three of these vacant positions had never been filled.

Spokespersons for these agencies said that the positions had been vacant for more than six months because of ongoing budget constraints and uncertainties, or because of a state employee-hiring freeze.

Recommendation

In line with management priorities, and as allowed by available resources, all agencies meeting Department of Administrative Services guidelines for establishing

an internal audit function should budget for, fill, and fully support at least one fulltime internal auditor position so that internal auditing will be performed.

Agencies' Responses

We received written or verbal responses regarding this audit report from 10 of the 27 agencies included in this report. The agencies agreed with the findings and recommendations of the report.

Objectives, Scope and Methodology

The purpose of this review was to compare the current status of internal auditing in state agencies to the status described in our 1996 audit report *Review Of Internal Auditing Functions In State Agencies* (Report No. 96-53). We sought to identify improvements in state internal auditing since 1996, and review the results of recent internal audit work. We sought to evaluate agencies' utilization of budgeted internal audit positions, and identify any agencies with clearly insufficient internal audit coverage.

As in our 1996 audit, we compared the organization and work of state agency internal audit functions against a chosen set of practices recommended for the effective conduct of internal auditing. The recommended practices appear among the standards, policies or guidelines published by the Institute of Internal Auditors, Inc., the U.S. General Accounting Office, and the Department of Administrative Services.

To accomplish our objectives, we interviewed agency directors, deputy directors, managing internal auditors, and senior internal auditors. We reviewed state internal audit reports issued between July 1, 2001 and November 1, 2002. We reviewed state rules, and agency policies and procedures that

pertained to internal auditing. If an external peer review had been conducted of an internal audit function within the past five years, we reviewed the written conclusions of the external reviewers.

We obtained and analyzed budget, expenditure, and position information pertaining to the agencies and internal audit functions reviewed.

We conducted our audit in accordance with generally accepted government auditing standards.

This report, which is a public record, is intended to promote the best possible management of public resources. Copies may be obtained by mail at Oregon Audits Division, Public Service Building, Salem, Oregon 97310, by phone at 503-986-2255 and 800-336-8218 (hotline), or internet at Audits.Hotline@state.or.us and <http://www.sos.state.or.us/audits/audithp.htm>.

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The courtesies and cooperation extended by the officials and staff of all the agencies audited were commendable and much appreciated.

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