



MGT REPORT

ESTABLISHING AN INTERNAL
AUDIT PROGRAM IN NORTH
CAROLINA'S STATE AGENCIES

FINAL REPORT

Submitted by MGT of America, Inc.
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INTRODUCTION

With the collapse of Enron, the prison sentence for key officials, and other corporate scandals, the public's trust has declined for accounting and reporting practices. In response, Congress passed the Sarbanes-Oxley Act of 2002 (Public Law No. 107-204, 116 Stat. 745). Some of the provisions created a public accounting oversight board, required public companies to evaluate and disclose the effectiveness of their internal controls, enhanced criminal civil penalties for fraudulent activities, and strengthened auditor independence provisions. These financial scandals in publicly traded companies has shaken trust in the accounting and auditing professions. Since Sarbanes-Oxley passed, there has been talk of it being applied to the public sector as well. A common expectation is that auditors ensure agencies are being run efficiently and effectively and that fraud and abuse are minimized. When the internal auditing function does not exist, the public cannot trust the efficiency and effectiveness of its government.

PROJECT BACKGROUND

In December 2006, the Government Performance Audit Committee (GPAC) issued a Request for Proposal (RFP) for a study to provide direction to the General Assembly in implementing the recommendations contained within the North Carolina State Auditor's September 2006 report *Internal Auditing in State Agencies and Institutions*. The State Auditor's study of internal audit functions within North Carolina state agencies, universities, and community colleges identified significant deficiencies with the state's internal audit activities, including but not limited to the following:

- * State agencies lack sufficient internal audit resources to complete audit procedures and produce audit reports.¹
- * Some internal auditors are not following any professional auditing standards and others lack policies and procedures.
- * Heads of some internal audit functions do not report to the highest management level within the state agency.
- * Some internal auditors are not creating or executing annual audit plans while others do not create the audit plans based on risk assessments.
- * Some state agencies assign internal auditors tasks unrelated to their primary job responsibilities.

¹ Note that for purposes of this report, MGT uses the term "state agencies" when referring to all entities supported fully or partially by state funding. This includes state departments, universities, community colleges, the General Assembly, and the Judicial Branch including the Administrative Office of the Courts.

Not having these protections leaves the state vulnerable to inefficient and ineffective management practices that result in wasted public funds. The lack of the internal audit function can also lead to fraud and abuse of state funds since there are few auditors reviewing internal control practices.

The General Assembly sought assistance to develop a plan to implement the State Auditor's recommendations. Since there was very little law regarding the state's internal audit function, the program covers every aspect of establishing and performing the function. The internal audit program in this report identifies how to assess areas of risk within an agency, how to determine what programs or units should be audited, the qualifications the internal auditors should possess, how to conduct an audit according to industry standards, how many internal auditors each agency needs, and roles and responsibilities for oversight bodies.

METHODOLOGY

To develop the audit program, MGT of America, Inc. (MGT) undertook a number of steps to collect and analyze data. At a high level, MGT:

- * Reviewed the State Auditor's recommendations.
- * Conducted research on industry best practices.
- * Interviewed staff in professional organizations and nonstate agencies.
- * Interviewed state agency heads and staff for those agencies with an internal audit function as well as those without.
- * Reviewed documents including budget documents and job classification documents.
- * Reviewed fiscal and staff classification data.
- * Vetted recommendations.

RECOMMENDED INTERNAL AUDIT PROGRAM

Based on the research conducted, MGT developed an Internal Audit Program for the state of North Carolina. It consists of the following:

- * A risk assessment tool that enables internal auditors to identify high-risk programs or units within an agency.
- * An audit planning methodology that uses the risk assessment analysis to identify which types and how many audits should be conducted in a fiscal year.
- * Standards by which audits should be performed.
- * Professional standards for the internal auditor.

- * Job classifications and descriptions that increase the current education requirements.
- * Career path that allows junior level entry into the internal audit classification scheme.
- * A pool of internal auditors who serve the smaller agencies, headed by a Director, who is only accountable to the Council of State members.
- * Authority to allow internal auditors unrestricted access to people, property, and data so that they can collect information to perform their responsibilities.
- * Identification of performance measures for which data should be collected and reported to assess value of the internal audit function.

MGT also created a cost estimate, drafted legislation to enact the program, and developed a plan to implement the recommendations. Each of those documents, along with the recommendations, are contained in appendices to this report.

INTRODUCTION

In August 2006, as a result of growth in North Carolina's economy and changes in the state government's budget expenditures and operations, the North Carolina General Assembly enacted S.L. 2006-248, Section 46 (The Studies Act of 2006). This Act tasked the General Assembly's Government Performance Audit Committee (GPAC II)—a successor committee to an earlier committee with the same name and objectives that operated in the 1990s—with the goals of evaluating the efficiency and effectiveness of State government and with identifying specific ways to make improvements to state agencies.

In September 2006, the State Auditor issued a report entitled, *Internal Auditing in State Agencies and Institutions* that evaluated the degree to which state agencies had an effective internal audit function. The general conclusion one can draw from the report is that there is not an established program with policies based on industry standards. Several agencies have functioning internal audit units; most do not. The State Auditor included a number of recommendations to correct this deficiency that leaves the state government vulnerable to costly activities.

In December 2006, GPAC II issued a RFP for a study to provide direction to the General Assembly in implementing the recommendations contained within the State Auditor's report. The State Auditor's study of internal audit functions within North Carolina state agencies, universities, and community colleges identified significant deficiencies with the state's internal audit activities, including but not limited to the following:

- * State agencies lack sufficient internal audit resources to complete audit procedures and produce audit reports.²
- * Some internal auditors are not following any professional auditing standards and others lack policies and procedures.
- * Heads of some internal audit functions do not report to the highest management level within the state agency.
- * Some internal auditors are not creating or executing annual audit plans while others do not create the audit plans based on risk assessments.
- * Some state agencies assign internal auditors tasks unrelated to their primary job responsibilities.

² Note that for purposes of this report, MGT uses the term "state agencies" when referring to all entities supported fully or partially by state funding. This includes state departments, universities, community colleges, the General Assembly, and the Judicial Branch including the Administrative Office of the Courts.

The GPAC II contracted with MGT to create recommendations, including proposed legislation and cost estimates, for improving the internal auditing function within state agencies. This report represents the results of MGT's work on behalf of the North Carolina General Assembly to help it institute an innovative, effective, and efficient internal audit program that complies with industry standards, as well as to provide the General Assembly with an approach to overseeing the state's internal audit function.

THE ROLE OF INTERNAL AUDITING IN STATE AGENCIES

The Institute of Internal Auditors (IIA)—an internationally recognized industry association—as part of its *Professional Practices Framework* has developed the globally accepted definition of internal auditing, which is:

Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Internal auditors assess risk exposures along a wide variety of the organization's governance, operations and information systems and evaluate the operations and activities of the agency. Internal auditors provide recommendations to management to make improvements in areas where opportunities or deficiencies are identified. These areas can include:

- * Effectiveness and efficiency of operations.
- * Reliability and integrity of financial and operational information.
- * Safeguarding of assets.
- * Compliance with laws, regulations, and contracts.

The internal audit function within an agency is an internal management resource tool. Internal auditing is another tool management can use to improve its delivery of services and also helps the state ensure that taxpayers' money is being used in the most efficient and effective manner possible. As such, management input is key in identifying the audits to perform.

THE VALUE OF INTERNAL AUDIT FUNCTIONS IN STATE AGENCIES

Implementing internal audit activities comes with added costs, mostly related to staffing the internal audit function with qualified individuals capable of carrying out the internal audit activities. However, the state can also expect to see benefits as the internal audit function is implemented

and strengthened in state agencies. A report by the National Association of Local Government Auditors identified three major benefits that result to government entities due to internal audit activities. They are:

- * Improvements in service delivery.
- * Cost savings and additional revenues.
- * Improved accountability.

There is no standard expected “benefit to cost” ratio to calculate a dollar value that the state can expect to derive from the internal audit activity. That is, there is no guarantee that the state will realize a particular dollar benefit for every dollar it spends on the internal audit function. Benefits resulting from internal audit activities can vary depending on the type and size of the agency served. Further, many internal audit activities provide benefits in future years, by offering training and technical assistance to agency staff that will prevent problems from arising. Quantifying the benefits of these services is difficult and subjective.

Nonetheless, the need for internal audit activities in North Carolina’s state agencies is clear, especially given significant audit findings in recent years, such as the following:

- * The State Auditor’s April 2004 report on the North Carolina Division of Medical Assistance that identified misuse of more than \$1 billion in the Medicaid program.
- * The State Auditor’s April 2006 report on the North Carolina Northeast Partnership (a public agency established by state law to promote economic development in 16 counties in the state), which found a lack of oversight that led to questionable costs, including significant bonuses paid to the agency’s management and employees (totaling \$572,000 over a three-year period).
- * An audit of the Wake County School District’s Transportation Department resulted in a recovery of \$4.8 million in payments that had been made for fraudulent invoices and illegal kickbacks. Although this is not a state agency, it received public funding that was improperly used.

Implementing internal auditing activities does not provide an absolute guarantee that these problems would have been identified and prevented. However, it would have been a significant control and a means for agency management to identify risks and problems much earlier. Internal auditors are in a position to identify and possibly prevent some of these acts from occurring or from continuing until they reached the magnitude reported by the external auditors.

THE SERVICES PROVIDED BY INTERNAL AUDITORS

Internal auditors provide a wide variety of services to their agencies. The types of services that internal auditors may provide are:

- ✦ **Assurance Services (Audits and Reviews):** Objective examinations of evidence to provide an *independent assessment* on risk management, control, or governance processes for the agency. Types of assurance services are:
 - ✓ Efficiency or economy reviews to evaluate areas in need of improvement to help increase operating effectiveness, efficiency, or to realize economies.
 - ✓ Financial audits of the agency's accounting statements or methodologies.
 - ✓ Internal control reviews of the department's controls related to financial reporting.
 - ✓ Management or performance audits of the agency's units, programs, activities, or functions.
 - ✓ Compliance audits or reviews to assess compliance with laws and regulations.
 - ✓ Investigative or fraud audits to determine whether suspected illegal or inappropriate activities have occurred.
- ✦ **Consulting Services:** Advisory services to add value and improve an agency's governance, risk management, and control processes.

The types of audits performed by internal auditors in state agencies and the State Auditor's Office as well as other state organizations are similar. The difference is in the scope of the work as well as the independence of the individuals performing the audits or reviews. Internal auditors are limited to focusing on activities and processes within the organization (although they may conduct some work on outside entities if these entities receive partial or full funding from that state agency). External auditors, such as those in the Office of the State Auditor, are not limited to reviewing the activities of a single agency. For example, the audit of North Carolina state agencies internal audit function reviewed activities in many state agencies, not just one. Moreover, external auditors possess independence and objectivity that internal auditors, working as part of the state agency's organization, do not have simply because of who identifies the audit to be performed.

Table 1 identifies the different agencies and describes the types of reviews performed by the Office of State Auditor, agencies' internal auditors, and others, in North Carolina.

TABLE 1
TYPES OF AUDITS AND REVIEWS IN
NORTH CAROLINA STATE AGENCIES

AGENCY OR REVIEWER	TYPES OF AUDITS OR REVIEWS	WHAT THEY AUDIT OR REVIEW	WHO CAN REQUEST THE AUDIT OR REVIEW
<p>Office of the State Auditor</p>	<ul style="list-style-type: none"> • Financial and compliance audits • Economy and efficiency audits • Program results audits 	<p>All state agencies Any entity supported partially or fully by state funds.</p>	<p>General Assembly committees Governor State Agency (State Auditor has the final authority for prioritizing these requests)</p>
<p>State Agencies—Internal Audit Units</p>	<ul style="list-style-type: none"> • Financial and compliance audits • Economy and efficiency audits • Program results audits 	<p>State agency Subcontractors and sub-recipients</p>	<p>Head of the state agency State agency internal auditor</p>
<p>Office of the State Controller—Risk Mitigation Office</p>	<ul style="list-style-type: none"> • Internal control compliance reviews 	<p>State government agencies</p>	<p>State agency Office of the State Controller</p>
<p>Office of State Budget and Management (OSBM) —Management Section</p>	<ul style="list-style-type: none"> • Management analyses of organization, staffing, systems, processes, and delivery and quality of services 	<p>State government agencies</p>	<p>State Agency General Assembly OSBM</p>

It is not the purpose of internal audit functions within state agencies, nor is it the intent of the General Assembly in promoting these functions, to take away from the activities, audits, and reviews performed by other organizations within the state. To the extent that internal auditors can add value and help agency management improve their operational effectiveness and efficiency, and to the extent that other groups can use and rely on internal auditors' work, it will be to the benefit of all agencies and organizations.

SCOPE OF THE INTERNAL AUDIT STUDY

The GPAC II RFP issued to help the state develop its internal audit program and implement the State Auditor's recommendations required the contractor to undertake the following tasks:

1. Create recommendations for correcting the deficiencies identified in the State Auditor's performance audit.
2. Recommend how to assure that internal auditors conducting internal efficiency, economy and program results reviews do not limit the scope of internal audits to accounting and internal control issues.
3. Define outcome measures for effectiveness of an internal audit system within the state as a whole and for individual agencies and legislative oversight committees to gauge whether internal auditing is effective.
4. Recommend how an agency internal audit unit should be placed organizationally within the existing organizational structure of state agencies and state-supported institutions.
5. Review existing qualifications of internal auditors and recommend appropriate qualifications including education, certification, knowledge, skills and abilities for internal auditors. Include a recommended career path to allow internal audit professionals to advance in competence, responsibilities, and compensation without assuming managerial responsibilities.
6. Recommend appropriate professional standards for internal audit organizations.
7. Define how to measure outputs of internal audit units. The contractor will determine a reasonable productivity standard for use by the state in determining the number of internal auditors required for a given internal audit unit.
8. Define a process for measuring the cost of internal audit activities to allow comparison of unit costs of an agency internal audit unit with other state internal audit units or with comparable units in the private sector.

9. Recommend staffing increases if needed. If there are recommended staffing increases, the contractor must establish a methodology for rank ordering the internal audit positions recommended among and within state agencies to address highest risk agencies and highest risk activities within agencies first. Using that methodology the consultant will recommend where the General Assembly should allocate or reallocate internal audit positions and the number and costs of such positions.
10. Explore the feasibility, organizational location, and resources required of a system whereby smaller agencies could share the internal audit services of larger agencies that employ best practices or could receive shared services from a centralized, highly-skilled, and technology-oriented team.
11. Recommend an appropriate independent legislative and executive oversight structure to assure that internal audit units conform to legislative intent and professional standards as well as other requirements. Determine whether the State Auditor should perform this role.
12. Recommend an appropriate level of authority necessary for internal audit activities to carry out their required duties and responsibilities including access to records, people, and properties.

INTRODUCTION

In responding to the RFP, MGT divided each task into one of three main topic areas. These areas are described below:

- * **Planning:** how to ensure that internal auditors conduct efficiency, effectiveness, and program reviews in addition to fiscal and internal control reviews.
- * **Performance Measurement and Standards:** what standards should internal auditors follow in conducting their work, what qualifications should internal auditors possess; and how can the state measure internal audit performance.
- * **Governance:** what are the roles and responsibilities and who should be involved in conducting and overseeing internal audit activities.

MGT staff conducted a variety of research and interviews to develop the approach contained within this internal audit program. MGT's information gathering approach involved the following activities:

Reviewed State Auditor's Findings

MGT reviewed the State Auditor's September 2006 report to understand the issues it raises. The MGT team then interviewed the State Auditor's staff who evaluated the internal audit function in the state of North Carolina. The purpose of interviewing the State Auditor's staff was to obtain a more in-depth understanding of the issues raised in the State Auditor's report. The team also reviewed documents collected by the State Auditor's team during its review, and obtained contact information for those agencies or organizations the State Auditor staff had contacted during the review.

Interviewed Staff in Professional Organizations and Nonstate Agencies

To gain an understanding of best practices, industry standards, and requirements, MGT interviewed staff in several state and national organizations. These include the Institute of Internal Auditors; the American Institute of Certified Public Accountants; the National Association of State Auditors, Comptrollers, and Treasurers; the Government Accountability Office; and the North Carolina Board of Certified Public Accountant Examiners. MGT also contacted and interviewed staff in other states, including the New York Office of the State Controller. Questions raised of the professional organizations related mainly to the requirements or recommended practices that internal auditors working in a state government organization should follow. Contacts made in other states or local governments were mainly

made to identify the challenges and successes that they have found in implementing their internal audit functions.

Professional organizations were contacted to primarily:

- * Understand external peer review requirements including selecting auditors to perform the peer review.
- * Understand the process used to develop audit plans.
- * Obtain professional standards.
- * Obtain examples of data used to monitor the internal audit function (known as performance measures).
- * Understand oversight bodies' roles.
- * Gather staffing level standards.

Interviewed Staff in State Agencies

MGT also interviewed staff and management in thirteen North Carolina state agencies—including seven Council of State members--and three of the four co-chairs of GPAC II. MGT's objectives in interviewing state agency staff was to identify the challenges these agencies have faced in establishing internal audit activities (for those agencies with internal audit functions). Several chief internal auditors provided invaluable insight as well as their policies and procedures for conducting internal audits. (To the degree they were applicable and consistent with industry standards, the policies are incorporated into the internal audit program presented in this report.) The team also interviewed staff at state agencies that do not have an internal audit function to gain an understanding of why the agencies have not chosen to implement these activities.

The Council of State members shared their concerns with using the services of a pool of internal auditors. Most indicated a desire to use the pool to assure that the Council's internal audit function would remain cost effective. The team was sensitive to requiring the Council of State members to use the pool since they are elected officials. Like the agencies, the Council of State members wanted to ensure that the auditors assigned to the Council of State agency would be permanently assigned to that agency so that the auditor gained a deeper understanding of the agency's programs.

General Assembly members expressed the legislature's concerns about agencies not conducting a sufficient number and type of internal audits. Without this proactive identification of opportunities to increase efficiency and effectiveness, state agencies are not taking full advantage of the management tools that are available. As a result, it is likely agencies are not maximizing their services to North Carolina residents.

Conducted Best Practice Industry Research

To build an internal audit program that is credible, reasonable, and beneficial, the team determined the program must be based on the auditing industry's best practices. A number of internal audit organizations provided such guidance.

The Government Accountability Office (GAO), one of the team's resources, is a federal department that is as an independent congressional research organization. The *Government Auditing Standards* (known as Yellow Book), issued by the Comptroller General of the United States, provides requirements and guidance for financial, compliance, and performance audits of government entities. These are the primary standards the team used when developing the internal audit system in this report as Yellow Book standards are mandatory for auditors working in a government environment.

The IIA is an international professional association composed of internal auditors from around the world who work in both the public and private sectors. The IIA is recognized as the internal audit profession's leader in certification, education, research, and technological guidance. The IIA published guidelines on establishing an internal audit function from which the team drew many concepts. The MGT team considered IIA standards to be the secondary standards that formed the basis of the recommendations in this report because the IIA's standards are *recommended* but not *required* for all but Certified Internal Auditors. The IIA's standards for conducting internal audits and the individual auditor's professional standards were used by the team in developing the internal audit program except where these did not agree with GAO standards.

Reviewed Fiscal and Staff Classification Data

As part of this evaluation, MGT developed a methodology for calculating the estimated minimum level of internal audit expenditures that each state agency should spend (discussed further in **Appendix E** to this report). As part of developing this methodology, MGT obtained data on currently funded internal auditor positions in state agencies, as well as Office of State Personnel classification descriptions and salary ranges. MGT also obtained fiscal data (operating expenditures) for each state agency from staff in the General Assembly's Fiscal Research Division (who used the OSMB's annual reports as its resource). This information provided the basis for the projections of cost as well as identifying the minimal educational and experiential requirements internal auditors must possess.

Vetted Recommendations

While developing the recommendations, the team vetted the ideas with state department staff, General Assembly staff, the State Auditor and his staff, the State Controller and his staff, and seven Council of State members. Interviewees were asked to evaluate the reasonability of the

recommendations for North Carolina state government. To the extent that the team believed the input substantially affected the recommendation, the team revised the recommendation to respond to the issue.

Once the recommendations were finalized, the team developed an Implementation Plan that identified (1) what activities need to be undertaken, (2) the lead organization responsible for the activities, (3) the priorities of implementing the activities, and (4) the approximate cost of implementing the recommendations.

GUIDING ASSUMPTIONS

In developing the recommendations in this report, the MGT team made several assumptions based on discussions with General Assembly members and staff. These assumptions were made to recognize and incorporate the General Assembly's intent and vision into the internal audit function and plan. These assumptions are as follows:

- ✦ All state agencies need to perform some level of internal auditing.
- ✦ Internal auditing should not duplicate work performed by others.
- ✦ Internal auditing needs to encompass the entire spectrum of internal audit activities and cannot focus solely on financial or compliance audits.
- ✦ The internal audit program shall be based on industry best practices to the greatest degree possible.

These key assumptions were kept in the forefront as the MGT team developed the recommendations within this report. The rationale for making these assumptions reflects a commitment by the General Assembly and GPAC II to find ways for state agencies to make improvements and become more efficient and effective in providing state services, which in turn reflects the General Assembly's commitment to the public it serves and represents.

The emphasis on having all state agencies, large and small, perform at least some level of internal auditing, comes from the recognition by General Assembly members that internal auditing is a valuable resource for state agencies. Limiting this resource to only larger state agencies minimizes the benefit of these services. This is key because many of the smaller agencies, in terms of operating expenditures or number of staff, may in fact be overseeing complex or vital state programs. These organizations may not meet criteria that would enable them to be audited under the Single Audit guidelines and requirements, meaning that the state's liability for these services increases as inefficiencies are allowed to continue for long periods of time without being identified and resolved.

The second assumption—that internal auditors should only perform work prescribed by the professional standards—reflects the State Auditor's

finding that some state agencies have assigned non-audit activities to internal audit staff. Internal auditors are not, and should not be, the staff conducting program management, accounting, grant management, or other functions—that is a misuse of state funds and minimizes the value internal auditors can provide the agency. Internal auditors have specific tasks and a mission that does not allow for them to perform services that they could potentially be required to audit.

The third assumption speaks to the key operating principle of GPAC II. That is, internal audit activities are meant to encompass all aspects of the agency and all internal audit types. Internal auditing is much broader than cyclical, standardized financial testing reviews or internal control questionnaires. Internal auditors need to establish a rapport with the agency staff and be responsive to changes so that, as risks or situations change in the agency, the internal auditors understanding of and assessment of these risks also changes, and is reflected in their audit plan and activities. Conducting audits “by rote” is not an efficient or effective way to use internal auditors and adds minimal value to the organization.

Lastly, the assumption that the internal audit program be developed using industry best practices and standards is critical to ensure the products focus on the high-risk issues within the agency, are performed by qualified staff, are performed in a manner that is above reproach, and can be used by management to improve the efficiency and effectiveness of the services the agency provides.

INTRODUCTION

The internal audit program to implement the State Auditor's recommendations is presented in detail below. The team grouped the internal auditing issues into three overarching categories: planning, performance management and standards, and governance. It should be noted that the description below reflects a high-level presentation of MGT's recommended audit program. Detailed descriptions of activities and time lines are contained in the Implementation Plan and appendices that accompany this report.

To the left are the questions presented in the RFP. Following each question is a brief description of the recommendation. The text below describes in more detail the recommended approach.

PLANNING

How can the state ensure that internal auditors conduct efficiency, effectiveness, and program reviews in addition to accounting and internal control reviews?

Assess risk based on answering questions that identify high-risk programs or units. Use this risk assessment as the basis for developing the annual audit plan. The annual audit plan will then identify the number and type of audits for the agency.

How can the state ensure that internal auditors conduct efficiency, effectiveness, and program reviews in addition to accounting and internal control reviews?

The State Auditor found that there were many more financial reviews conducted than performance audits. As discussed in the introduction and background section of this report, internal auditors provide a variety of services and types of audits. Internal audit assurance activities can include efficiency and effectiveness reviews, financial audits, information technology assessments, or fraud investigations, among others. Unfortunately, lacking clear guidance on their roles, some internal auditors in state agencies may be limiting their work to financial or compliance work. Alternatively, agencies that lack an understanding of what an internal auditor's role is have assigned non-internal audit activities (such as program or grant management activities) to their internal audit staff, an issue highlighted in the State Auditor's September 2006 report. Internal auditing is broader than financial or compliance analyses; the full benefit of internal auditing is not realized unless the auditors can perform work beyond the financial or compliance analyses.

Best practice research and review of the IIA's *Professional Practices Framework* found that the way to ensure that internal auditors are maximizing their contribution to the state agency in which they work is by having structured audit planning activities. We recommend that internal auditors conduct their work based on annual audit work plans, which internal auditors should create as a result of a comprehensive, annual risk assessment. Following a risk-based approach to creating the plan ensures that the internal auditors' work reflects an assessment of the risks and issues of the agency as a whole, and is not limited to a specific area, such as the financial statements.

The proposed risk assessment tool provides a structured process to break down agency operations into “auditable units” and assessing the agency’s and each auditable unit’s relative liability (risks) related to a wide variety of topic areas. These topic areas, or risk categories, were selected using best practices recommendations and practices that consider many facets of each unit’s and each agency’s operations. Taken as a whole, the identification of risks directs internal auditors to develop an audit plan that results in the internal auditors spending the majority of their activities on areas where the agency’s exposure due to financial loss, program failure, or public exposure is greatest.

Table 2 below lists and describes the risk categories that internal auditors should consider in developing annual audit plans. A risk assessment tool with specific areas the internal auditor should evaluate is contained in **Appendix B—Audit Methodology**.

**Table 2
Risk Categories**

Risk Category	Description of Risk
Financial	The risk that financial reporting is inaccurate, incomplete, or untimely due to a variety of factors, including errors, changes in accounting standards, or the pressure on management to meet financial expectations.
Operational	The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events. This risk addresses barriers to the timeliness, accuracy, authorization, and completeness of these processing activities.
Criticality to the Agency	The importance of the unit to the agency’s ability to continue to function and carry out its primary mission.
Legal or Compliance	The risk of direct or indirect loss resulting from failure to follow statutes, regulations, and directives. This includes loss due to loss of funding or increased expenditures from fines and/or penalties by external oversight agencies.
Technology	This risk considers the level of use, sophistication, complexity, robustness, ease of use and speed, and accuracy of recovery/replacement of systems. Addresses the overall importance of technology within the organization and the availability and quality of information the organization can access to support decision making, as well as the security around key information.
Fraud	The risk of loss due to intentional misappropriation of assets or intentional misstatement of financial reporting.

Risk Category	Description of Risk
Public or Political Sensitivity	The sensitivity of the unit to public exposure of any internal issues and the level of public embarrassment that could be caused to the agency as a whole.
Strategic	The risk that work performed is no longer justified. Or if justified, the risk that business objectives will not be achieved because business strategies are poorly defined and communicated, or the organization is unable to execute these strategies due to inadequate organizational structure, infrastructure, or alignment. Strategic risk is managed by appropriate organizational governance. Failure to adequately plan and execute against organizational goals may result in significant damage to the organization’s reputation.

The risks clearly identify more than financial or accounting risks. Thus, when the audit plan is based on a completed risk assessment, it will represent those areas of highest risk to the agency and as a result will identify the appropriate type of audit that should be conducted to evaluate that issue.

Conducting a risk assessment and creating annual audit plans involves several steps. The methodology to create an audit plan should include the following steps, at a minimum:

1. Define the agency’s “auditable units.” An auditable unit is the smallest unit or program within the agency that merits auditing.
2. Conduct interviews to gather information about the unit.
3. Document key information on the auditable unit.
4. Answer the questions in the risk assessment tool based on collected information.
5. Quantify each auditable unit’s risk.
6. Calculate the weighted risk for each auditable unit.
7. Prioritize internal audit tasks by calculated weighted risk and create the audit plan.

The annual audit plan must be comprehensive and meaningful. To ensure that the staff responsible for approving the plan possess the sufficient competency and experience (professional judgment) to maximize the value provided by this activity, we recommend therefore that final development and approval of the audit plan be performed by no less than an Internal Audit Manager. (Please refer to **Appendix C** for recommended new internal auditor job classifications.) Typically, internal audit plans are distributed within the agency. However, because the state

PERFORMANCE MEASUREMENT AND STANDARDS

What are the professional standards for internal audit organizations?

The standards that government auditors must use are the Government Auditing Standards issued by the Comptroller General of the United States—commonly known as “Yellow Book”.

The IIA has also published standards and guidance for internal auditors to follow that are contained in its Professional Practices Framework.

If the two sets of standards conflict, Yellow Book standards prevail.

needs a means of evaluating the progress of the implementation of internal auditing in the state, every agency should expect that these plans may be requested and assessed by agencies or groups, such as the State Auditor, OSMB, or the General Assembly’s Fiscal Research Division.

Appendix B contains a detailed recommended audit planning methodology, including detailed instructions on how to assess risk, and the risk assessment tool.

What standards should internal auditors follow in conducting their work, what qualifications should internal auditors possess, and how can the state measure internal audit performance?

To ensure successful implementation of the recommendations in the State Auditor’s report, many of the GPAC’s RFP requirements related to the area of performance management and standards. That is, what are the fundamental rules and practices that exist for internal auditors to follow? What qualifications should internal auditors possess? How can the state measure the performance and value added by internal auditors? In this section, MGT presents its recommendations for each of these areas.

What are the professional standards for internal audit organizations?

A key finding in the State Auditor’s report was that internal auditors lacked guidance on the professional standards they should follow when performing their work. Professional standards provide guidance on how internal auditors should conduct all aspects of their work, including planning, supervising, and reporting. Professional standards provide guidance to help internal auditors ensure that they are maintaining independence and objectivity during their work. This adds value to the function and credibility in the public’s eye to the work produced by the auditors.

Several organizations exist that have issued standards. However, the prevailing standards that internal auditors in state government should follow are the *Government Auditing Standards* issued by the Comptroller General of the United States—commonly known as “Yellow Book”. Yellow Book standards are **mandatory** for government auditors. Yellow Book standards address:

- * Application of GAGAS.
- * Ethical principles in government auditing.
- * General standards.
- * Fieldwork standards for financial audits.

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- * Reporting standards for financial audits.
- * General, fieldwork, and reporting standards for attestation engagements.
- * Fieldwork standards for performance audits.
- * Reporting standards for performance audits.

The IIA has also published standards and guidance for internal auditors to follow that are contained in its *Professional Practices Framework*, which includes *Standards for the Professional Practice of Internal Auditing*. The IIA's standards are mandatory for Certified Internal Auditors (CIA's) and recommended for all others. The IIAs' *Professional Practices Framework* consists of the IIA's:

- * Definition of internal auditing.
- * Code of Ethics.
- * Standards for the Professional Practice of Internal Auditing.
- * Other guidance, such as practice advisories that were created to provide guidance to internal auditors on how to implement the standards.

The IIA's *Professional Practices Framework* complements the guidance provided by Yellow Book standards. When IIA standards conflict with Yellow Book requirements, the auditor should use Yellow Book as the prevailing standard. **Appendix A** of this report presents further guidance on the standards and also contains references to where the standards are published by their respective organizations.

To address the findings in the State Auditor's report, MGT recommends that the General Assembly enact legislation that requires internal auditors in state agencies to comply with Yellow Book and IIA standards. This draft legislation is presented in **Appendix G** of this report.

What professional qualifications should internal auditors possess?

According to the IIA's publication, *Establishing an Internal Audit Activity*, one of the most significant challenges agencies face in establishing internal audit functions is to attract, develop, and retain highly specialized and qualified staff. To address this need and to provide guidance for North Carolina to assist the state in staffing the internal audit function within state agencies, MGT developed a recommended internal auditor career path. The proposed career path includes recommendations related to creating job classifications within the state's personnel system that meet best practice recommendations for minimum professional standards.

In reviewing existing internal auditor classifications, MGT found several issues with the current structure. These issues are as follows:

What professional qualifications should internal auditors possess?

We recommend a change in the education requirement such that all internal auditors have at least a four-year degree from an accredited university or college.

We also recommend that the degree be from an expanded universe of degree types and not limited to financial or accounting degrees.

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What professional qualifications should internal auditors possess? (continued)

Finally, we recommend a career path that allows for junior level staff to enter the internal auditing career in the state.

- ✦ **No entry level classification.** The current classification allows internal auditors to enter into the pathway only after having a minimum number of years experience in conducting financial accounting or auditing. This does not allow for the development of internal auditors throughout the spectrum of their full career path.
- ✦ **Heavily weighted for finance or accounting candidates.** North Carolina's job classifications for internal auditors, which are weighted heavily towards accounting candidates, may preclude qualified individuals from entering the internal auditing field. Best practices research indicates that there is value in having internal audit candidates that have education and experience in fields other than accounting or finance, such as tax, law, public policy, environmental affairs, or economics.
- ✦ **Education levels are insufficient.** The current structure allows entry into the internal audit field for candidates with two-year (associate's) degrees in accounting. This does not comply with best practice recommendations, which indicate that, at a minimum, internal audit candidates should possess at least a four-year degree from an accredited college or university. The two-year degree is too focused on accounting and bookkeeping and does not expose the candidate to a wide variety of topics and classes that result in a sufficiently well-rounded candidate possessing the requisite knowledge and education needed to perform the internal audit function.

Based on best practice research, we recommend an internal auditor career path will do the following:

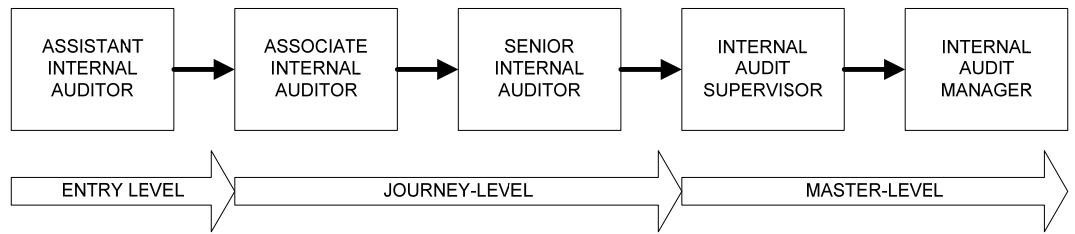
- ✦ Align North Carolina's scope of internal audit activities and staff skills with that envisioned by IIA.
- ✦ Facilitate entry to the career path of internal auditing by creating an entry-level apprentice position available to candidates working toward a four-year degree from an accredited university or college.
- ✦ Enhance, encourage, and promote the flow of valuable experience from outside the state system into the IIA career path by removing barriers to entry for outside candidates at all levels of the career path.

Figure 3 below identifies the proposed classifications and the existing classifications.

PERFORMANCE MEASUREMENT AND STANDARDS

Figure 3

Proposed North Carolina's Internal Auditor Job Classifications and Career Path



North Carolina's Current Internal Auditor Job Classifications and Career Path



Generally, the following represents our recommendations regarding the internal auditor's minimum requirements.

- * **Education:** Four-year (bachelor's) degree in one of many areas from an accredited college or university for all but entry-level positions.
- * **Experience:** Increases as auditor progresses through classification scheme.
- * **Graduate Degree:** Not required but can be substituted for one year of experience.
- * **Certifications:** Typically not required but can be substituted for one year of experience.

Appendix C in this report contains the specific education and experience recommendations for each of the job classifications identified in **Figure 3** above.

How can state agencies assess the performance of internal auditors and the internal audit function?

The General Assembly's RFP posed several questions about how to measure internal auditor performance levels. Identifying performance is vital for the General Assembly and state agencies to be able to understand the value internal auditing is bringing to state agencies. Identifying performance levels leads to a determination of what activities are working well, and what activities need to be modified.

Performance measures enable managers in state agencies to evaluate what resources went into the effort, how much work is being produced, how well an activity is being performed, how efficiently the work is being done, the quality of the work, and the length of time it takes to perform the work. When performance is measured, attention is drawn to that

How can state agencies assess the performance of internal auditors and the internal audit function?

The audit program shall require the collection of data for mandatory output, outcome, and efficiency performance measures.

A few quantifiable and relevant performance measures should be required. Managers are encouraged to establish additional performance measures.

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How can state agencies assess the performance of internal auditors and the internal audit function? (continued)

Collected data should be reported to the OSBM and Management and the legislature annually.

performance. The purpose of drawing attention to the performance is to increase opportunities to improve the performance being evaluated.

Managers use these measures to evaluate the performance of a unit—the internal auditing function in this case. Knowing how well the unit performed against expectations enables managers to make decisions about allocation of resources and direction of the activity. Collecting and analyzing data for each performance measure and then taking appropriate action to improve performance is a management responsibility.

Generally, performance measures should be:

- * Meaningful—reflect points of common understanding or interest on the part of stakeholders.
- * Measurable—quantifiable indicators; systems in place to measure.
- * Manageable—a limited number of measures that capture the breadth of program activity.

If performance measures are not meaningful, they do not provide the information needed by the decision-makers although the information may be interesting. If the performance measure cannot be measured for any reason, it does not enable the decision-makers to make a determination based on it. Lastly, if there are too many performance measures, the focus for the organization is lost—everything becomes a number one priority. Having fewer performance measures forces the organization to prioritize those areas that are of highest importance.

There are many different types of performance measures available to managers. These can include the following shown in **Table 4** below:

**Table 4
Types of Performance Measures**

Type	Answers the question	Example
Input	“How many resources were consumed by this activity?”	Number of personnel years expended.
Output	“What is the level of internal audit activity?”	Percent of audits identified as high risk in the audit plan that were completed. Percent of total available hours spent on unanticipated and/or unscheduled activities.
Outcome	“What changed as a result of the internal audit function?”	Percent of recommendations implemented within one year.

Type	Answers the question	Example
		Value of internal audit function to agency Director.
Efficiency	“How many resources did it consume per unit of product?”	Number of audits conducted per staff member. Average number of hours consumed per audit type.
Quality	“What is the level of quality of the product or service?”	Rating given by consumer.
Process	“How long did this activity take to perform?”	Number of months to conduct original work during an audit.

Performance measures are a relatively new concept for the public sector. Historically, performance measures have not been widely used to determine the value a governmental service provides. As a result, there are no best practices for performance measures as they specifically relate to internal auditing. However, performance measures can be used by any program to assess a program or service.

Based on research, interviews, and experience developing performance measures for public sector programs, MGT developed recommendations for state agencies to collect data and report on three types of performance measures: output, outcome, and efficiency. Output measures quantify the amount of work completed; for example, the number of audit findings developed. Outcome measures identify the effect internal auditing has had on the agency. For example, an outcome measure might describe how cash management has changed as a result of a finding of lack of segregation of duties. Lastly, efficiency measures quantify the number of resources consumed per unit produced. This could take the form of number of hours per audit.

Moreover, MGT recommends that internal auditors and state agencies identify targets and deadlines for each of the performance measures as a step in developing the annual audit plan. Targets establish the numerical expectation of performance for a period of time. For example, an output target may be three performance audits and two financial compliance audits for fiscal year 07-08. The purpose of establishing targets is to establish performance expectations—not to “punish” state agencies that cannot meet the targets. Performance measures without targets simply become a list of accomplishments. Without evaluating performance against expectations, an agency cannot determine whether the internal audit function met or exceeded its expectations. Targets need to be achievable and feasible given the agency’s resources. The General Assembly’s expectations in reviewing internal auditor performance in

PERFORMANCE MEASUREMENT AND STANDARDS

How many internal auditors does each agency need?

The methodology calculates staffing levels based on operating expenditures.

relation to established targets is to identify where improvements are required and where additional resources may be necessary.

Appendix D of this report identifies specific performance measures, describes how to establish targets, and identifies the data required to evaluate performance against the target.

How many internal auditors does each agency need?

The internal audit function can be an incredible tool for the state agency to make improvements to agency operations. However, it is key for the internal audit function to be staffed at a sufficient level to allow for the necessary resources to carry out the work. Too often, internal audit functions are understaffed, as reported by the North Carolina State Auditor in his September 2006 report, *Internal Auditing in North Carolina Agencies and Institutions*.

Unfortunately, there is little information available on how to calculate internal audit staffing levels. Neither the American Institute of Certified Public Accountants (AICPA), the Internal Auditors Association (IAA), nor GAO have published metrics on how to calculate the optimal number of internal auditors needed by an agency. Studies performed by other states, such as New York for its Internal Control Task Force, as well as within North Carolina, such as the September 2006 State Auditor's Report, have also experienced similar difficulties in identifying staffing metrics.

MGT utilized a variety of data and sources in creating its methodology presented in **Appendix E** of this report. However, because of the limited data and benchmark comparison sources available, this methodology resulted in an estimate of the minimum expected levels of internal audit activity for each agency. This methodology is designed to give the General Assembly and state agencies a starting point in their discussions of what resources they will ultimately need to use in carrying out these activities. One of the strategies to reduce the staffing expenses is to create a pool of internal auditors that would staff the smaller agencies. (This issue is presented below.) If the internal audit function is fully staffed according to the methodology in this report, we calculate that annual expenditures on internal auditors are approximately \$16 million for those auditors in the agency and those in the pool. If the state converts noncritical positions that have been vacant more than six months to perform the internal audit function, the funding necessary to fully staff the internal audit function is approximately \$3.8 million. (Please see **Appendix E—Staffing Methodology** for the calculations.)

GOVERNANCE

Should internal audit services be provided by a central service provider for smaller agencies?

The OIA shall be established and staffed with internal auditors who comply with the newly established professional qualifications.

Smaller agencies shall use OIA. Council of State member agencies are not required, but are encouraged, to use the Office's services.

A Director of the Office shall be appointed by the Council of State members, excepting the State Auditor, for a five year term.

The OIA will be housed in OSBM for administrative support purposes only.

What are the roles and responsibilities and who should be involved in conducting and overseeing internal audit activities?

Determining who is responsible for each facet of internal auditing is a crucial component of the internal audit program presented in this report. Clearly identifying roles and responsibilities and ensuring decision-making without undue influence is a basic tenet in internal auditing. That is, who is responsible for performing versus overseeing the internal audit activities? What responsibilities and duties should be expected of the various stakeholders and staff? How does the General Assembly gain assurance that state agencies are using internal audit services and that these services are adding value to the state? In this section, MGT presents its recommendations to address governance in the internal audit program.

Should internal audit services be provided by a central service provider for smaller agencies?

When developing the internal audit program in this report it was important that it is effective without being fiscally burdensome, especially to the smaller agencies. To minimize costs to smaller agencies, we propose establishing a pool of qualified internal auditors that are available to perform internal audits for smaller agencies. These auditors would be assigned to specific agencies so that the auditors develop a deep understanding of these agency's programs through the years. Since most smaller agencies do not have a need for full-time auditors, one auditor may serve several agencies concurrently. These auditors have the same responsibilities and privileges as internal auditors hired by an agency.

We recommend that this pool of auditors, which we are calling the Office of Internal Audits (OIA), be sited within OSBM. The OSBM's sole purpose with regard to OIA is to provide administrative support (for example, payroll).

The services of the OIA shall be used by smaller agencies. Council of State members are not required to use the services of OIA for their agencies, but are encouraged to do so to achieve the financial benefit this option offers.

There shall be a Director of OIA who leads the pool of internal auditors. The Director shall be selected and terminated by a majority vote of the Council of State members, excepting the State Auditor. To retain the independence of the Office of the State Auditor, the State Auditor is not a voting member of the Council when selecting or terminating the Director. A majority of the Council is defined to be those members who constitute the Council excepting the State Auditor, whether or not they are all in attendance. The Director will serve a five-year term, at which time the Council of State members will determine whether to request the continuation of his/her services or select another Director. The Director of OIA does not report to the Director of OSBM.

GOVERNANCE

Where should the internal audit function be placed within state agencies?

The head of internal audits shall report directly to the head of the agency.

Internal auditors must not be responsible for managerial or program responsibilities within an agency other than auditing.

What authority should be conferred upon internal auditors?

Auditors shall have unrestricted access to people, property, and information.

The only purpose for which the Director of OIA should receive copies of audits issued by the staff within the Office is to assess performance of the internal auditors working for the Office. It is not the OIA Director's responsibility to address the audit findings. That is the responsibility of the Director of the state agency for whom the audit was performed.

Appendix F describes the organization structure of OIA in greater detail.

Where should the internal audit function be placed within state agencies?

One of the most important tenets to auditing is to remain independent and objective. To facilitate this, professional standards recommend that the head of the internal audit function report directly to the agency head. The head of internal audits shall not report to another manager within the agency.

Additionally, the Internal Audit Manager must not have managerial or operational responsibilities for any aspect of the agency other than internal auditing. Having managerial or operational responsibility would immediately create a conflict for the internal auditors as they would eventually be auditing their own unit.

Since auditors from OIA have the same responsibilities and privileges as auditors hired by an agency, the auditors from OIA also report directly to the agency head. If, for any reason, an auditor from the OIA is asked to report to anyone other than the agency head, the internal auditor shall report that to the Director of OIA. The Director then shall discuss with the agency head the necessity of the direct reporting.

What authority should be conferred upon internal auditors?

To ensure internal auditors have the authority they need to perform their functions, internal auditors shall have unrestricted and unannounced access to people, records, and property. Having unrestricted access ensures auditors are able to acquire all the information they deem necessary to complete their work. Since auditors are to remain independent and objective, they must have the ability to acquire any information they deem necessary to perform their job.

Access to people includes state employees, contractors, subcontractors, and any entity receiving state funds for a service or product. Access to information is not differentiated by whether it is on paper or only available electronically. Access to property means having physical access to any and all assets purchased with government funds.

GOVERNANCE

What legislative and executive oversight bodies should review state agencies' implementation of professional standards and development of internal audit plans?

The legislature has a responsibility to the residents of North Carolina to perform third-party oversight of the Executive Branch's functions. The Executive Branch has a fiduciary responsibility to ensure that the function is at an optimal functioning level.

What legislative and executive oversight bodies should review state agencies' implementation of professional standards and development of internal audit plans?

As with most government functions, it is important that oversight be performed. The legislature has a responsibility to the residents of North Carolina to perform third-party oversight of the Executive Branch's functions. The Executive Branch has a fiduciary responsibility to ensure that the function is at an optimal functioning level. For this particular function, oversight should be performed in both the executive and legislative branches. That oversight can be performed by existing entities or separate bodies can be created to perform the oversight. Having a separate body perform the oversight calls additional attention to the internal audit function. It may be that the legislature wants to call attention to the function at least until agencies have a fully functioning internal audit unit that is performing to standards. Not doing so can result in the function being a lesser priority for agencies, as it appears to have been in the recent past.

The OSBM has responsibility for evaluating budget requests from state agencies. We recommend that OSBM evaluate state agencies' progress in implementing the internal audit function through evaluation of each agency's performance measures. The OSBM should work with state agencies to identify whether budget issues are hampering an agency's ability to perform the audits identified in its audit plan, and if so to provide the resources necessary for the program.

Similarly, the legislature has existing fiscal and oversight committees that should annually analyze each agency's performance measurement data to determine the degree to which the internal audit function has been implemented, and how well the agency is performing against its expectations. The performance measures will indicate the number of audits performed and should identify the type of audit (for example, efficiency and economy, fiscal, fraud, etc.) Thus, the legislature will be able to determine if the agencies are spending sufficient time identifying potential cost savings for the state.

To the degree that either OSBM or the legislature believes insufficient attention has been paid to the internal audit function, these bodies can and should ask the agency to report on its internal auditing activities, including describing reasons why the auditors could not perform all the audits identified in the annual audit plan or did not conduct a sufficient type of audit (for example, efficiency and economy audits). Depending upon the discussion, the OSBM or legislature may want to hold hearings to gain a deeper understanding of the barriers and/or take action on the agency's budget as needed.

LEGISLATION

Which recommendations require new statutes?

Draft legislation includes:

- ✓ *Requirement to conduct internal audits.*
- ✓ *Auditors must follow industry standards for performing audits.*
- ✓ *Professional qualifications for internal auditors.*
- ✓ *Establish the Office of Internal Audits.*
- ✓ *The Council of State members hire and terminate Director of the Office of Internal Audits.*
- ✓ *Auditors have unrestricted access to people, records, and property.*
- ✓ *Agencies use an Internal Audit Manager.*
- ✓ *Internal Audit Manager has direct access to agency head.*
- ✓ *Annual audit plan required assessment.*
- ✓ *External peer reviews required.*

Which recommendations require new statutes?

To ensure every agency implements the internal audit program found in this report, some of the requirements should be in statute. The degree to which policy is set in statute is dependent upon the needs of the state. In this instance, since the state has not historically embraced internal auditing in the recent past, we recommend that the following policies be set in statute:

- ✧ All state agencies must conduct internal audits.
- ✧ Auditors must follow industry standards for performing audits.
- ✧ There are minimum professional qualifications for the state's internal auditors.
- ✧ Establish OIA, housed within OSBM, to provide internal auditing services to smaller agencies.
- ✧ The Council of State members hire and terminate Director of OIA.
- ✧ State Internal Auditors have unrestricted access to people, records, and property to perform their duties.
- ✧ State agencies that are performing internal audits with their own staff must have an Internal Audit Manager on staff.
- ✧ Internal Audit Manager has direct access to agency head.
- ✧ Every agency must develop an annual audit plan based on a risk assessment.
- ✧ Agencies must seek external peer reviews per industry best practices.

The draft legislative language can be found in **Appendix G**.

IMPLEMENTATION PLAN



Implementation Plan

Below is a plan to implement the recommendations in the report. The responsible party for leading the effort for a particular activity is listed at the head of each section. The left most column identifies the activity/recommendation that needs to be implemented. The following columns are the fiscal years (FYs) in which the activity should occur as well as the estimated cost of the activity. Annual ongoing expenses after year one are in each column. The costs reported are the total costs required for the specific activities. Some agencies have existing internal audit staff, but the existing staff costs are not included as part of the cost estimates shown below. To the extent that agencies convert staff in existing internal audit classifications to the new internal audit classifications presented in **Appendix C** or choose to redirect existing non-critical vacant positions that have been vacant for more than six months, there would not be a new cost to hiring the internal auditors.

Activity	FY 2007-08 Year 1	FY 2008-09 Year 2	FY 2009-10 Year 3	FY 2010 – 11 Year 4	FY 2011 – 12 Year 5
Council of State Members					
Hire Director of the Office of Internal Audits.	\$124,815	\$124,815	\$124,815	\$124,815	\$124,815
Office of Internal Audits					
Hire internal auditors and support staff. Estimates are based on the methodology described in Appendix E–Internal Audit Staffing , and represent approximately twelve internal auditors and several support staff. These estimates reflect partial year implementation efforts. See Appendix E, Figure E-10 for details.	\$652,179	\$1,302,602	\$1,302,602	\$1,302,602	\$1,302,602
Adopt policies and procedures for conducting audits in accordance with professional standards. Refine the policies and procedures as new standards are promulgated.	X	X	X	X	X

IMPLEMENTATION PLAN
NORTH CAROLINA INTERNAL AUDIT PROGRAM

Activity	FY 2007-08 Year 1	FY 2008-09 Year 2	FY 2009-10 Year 3	FY 2010 – 11 Year 4	FY 2011 – 12 Year 5
Office of Internal Audits (continued)					
Perform risk assessment for the ten agencies identified by the General Assembly as the highest-risk agencies (except for those that establish their own internal audit function).	X	X	X	X	X
Develop an annual audit plan for the ten agencies for which a risk assessment was conducted.	X	X	X	X	X
Conduct audits of the ten highest-risk agencies per the annual audit plans.		X	X	X	X
Report on progress with completing annual audit plan activities to the agencies.			X	X	X
Adjust estimates for number of internal auditor positions needed within the Office based on risk assessments and audit plans developed in prior years. Factor in the degree to which agencies are choosing to use the Office services.			X		
Establish process and tools to collect data on performance measures.		X			
Collect data on performance measures.		X	X	X	X
Report performance measures to agencies.			X	X	X
Collect best practices, professional development and training opportunities, and external peer review resources and make this information available via Internet to all state agencies.		X	X	X	X
Seek external peer reviewers for audits conducted on behalf of agencies.					X
State Agencies					
Determine whether to use internal auditors from the Office or hire internal auditors to establish own internal audit function. Make intention known to the Office.	X				

IMPLEMENTATION PLAN
NORTH CAROLINA INTERNAL AUDIT PROGRAM

Activity	FY 2007-08 Year 1	FY 2008-09 Year 2	FY 2009-10 Year 3	FY 2010 – 11 Year 4	FY 2011 – 12 Year 5
State Agencies (continued)					
For those agencies that will be establishing internal audit function, hire staff. (This may take the form of converting existing non-essential vacant positions—that have been vacant more than six months—to Internal Audit personnel classifications).	X	X			
For those agencies with existing staff, evaluate whether the staff’s current job classification levels are sufficient to meet the expectations and requirements established in the draft legislation. To the extent that these are not sufficient, consider converting the positions to ensure staff possesses sufficient proficiency, competency, and knowledge to carry out the audit work. See discussion in Appendix E for costs less anticipated “existing” funded positions, which could drop this total to about \$3.8 million.	\$15,491,188 (cost of all Internal Audit staff, does not account for existing positions that are currently funded)	\$14,840,765	\$14,840,765	\$14,840,765	\$14,840,765
Identify performance measures for which agency will collect data	X				
All agencies assess risk and develop Audit Plan per methodology. The agencies can use the Office or internal auditors within agency.	X	X	X	X	X
All departments must begin conducting internal audits in accordance with their annual audit plan.		X	X	X	X
Update risk assessment and audit plan.		X	X	X	X
Establish data collection methodology and reporting process for performance measures and for following up on audit recommendations and findings.		X			
Collect performance measure data and track		X	X	X	X

IMPLEMENTATION PLAN
 NORTH CAROLINA INTERNAL AUDIT PROGRAM

Activity	FY 2007-08 Year 1	FY 2008-09 Year 2	FY 2009-10 Year 3	FY 2010 – 11 Year 4	FY 2011 – 12 Year 5
agency's progress in implementing recommendations.					
Adjust estimates of needed internal audit positions based on risk assessments and audit plans conducted in prior years.				X	
Office of State Personnel and State Personnel Commission					
Convert existing internal audit positions to new classifications.	X				
General Assembly					
Approve legislation to require agencies to perform the internal audit function.	X				
Require each department to report performance measures during budget hearings.		X	X	X	X
Refine statutes as needed.					X
TOTAL, ALL RECOMMENDATIONS	\$16,143,367	\$16,143,367	\$16,143,367	\$16,143,367	\$16,143,367



APPENDIX A

PROFESSIONAL STANDARDS



**APPENDIX A
ESTABLISHING PROFESSIONAL STANDARDS
FOR STATE AGENCIES**

Introduction

The General Assembly requested assistance in identifying professional standards for internal auditors in state agencies (state departments, universities, community colleges, the judiciary, commissions, boards, and branches). Professional standards ensure the audit program is operating in a professional and ethical manner, adding quality and value to the state agencies it serves. The need to establish professional standards with regard to how internal auditors perform their work was identified in the State Auditor’s September 2006 review of the state’s internal audit function. The State Auditor generally found that (1) auditors did not follow any professional auditing standards when performing audits, (2) audit plans were not being developed to guide the auditor’s work, (3) if audit plans were developed, they were not based on the agency’s risk, (4) internal auditors were tasked with duties unrelated to auditing, and (5) had not implemented quality control measures (external peer review) required in the standards. In short, the internal audit function was being misused and mismanaged in the state thereby minimizing the value it can bring to the state. Audits should be performed independently, objectively, and in compliance with industry standards. Not complying with these basic tenets of auditing eviscerates the audit function.

Professional Standards

The Comptroller General of the United States published *Government Auditing Standards*, which are the primary standards for government internal auditors. The Institute of Internal Auditors (IIA) published standards in its *Professional Practices Framework*. The Comptroller’s standards are the prevailing professional standards while the IIA’s standards complement the Comptroller’s standards. Auditors are required to use the Comptroller General’s *Government Auditing Standards*. Certified Internal Auditors (a subset of internal auditors) are required to use the IIA’s *Standards for the Professional Practice of Internal Auditing*.

This appendix further explains the benefits of complying with these standards. An accompanying compact disc (CD) contains both prevailing professional standards: the *Government Auditing Standards* and the *Professional Practices Framework*. The table below answers frequently asked questions about the use of professional standards.

**Table A-1
General Guidance on Professional Standards**

Question	Response
What professional standards (guiding principles) should internal auditors adhere to so that the state’s internal audit functions are operating in a professional and	<p><i>Government Auditing Standards</i> issued by the Comptroller General of the United States—commonly known as “Yellow Book” is the primary standard that all internal auditors in state governments must follow. <i>Yellow Book standards are mandatory for government auditors.</i></p> <p>The IIA has also published standards and guidance for internal auditors to follow in the IIA’s <i>Professional Practices Framework</i>, which includes <i>Standards for the Professional Practice of Internal Auditing</i>. The IIA standards are mandatory for Certified Internal</p>

APPENDIX A: PROFESSIONAL STANDARDS
NORTH CAROLINA INTERNAL AUDIT IMPLEMENTATION PLAN

Question	Response
ethical manner, adding quality and value to the state agencies they serve?	Auditors (CIA's) and recommended for all others. The IIA's <i>Professional Practices Framework</i> complements the guidance provided by Yellow Book standards. When IIA standards conflict with Yellow Book requirements, the auditor should use Yellow Book as the prevailing standard.
What guidance does Yellow Book provide to auditors?	The Yellow Book, which outlines Generally Accepted Government Auditing Standards (GAGAS), contains professional requirements and related guidance in the form of explanatory material. These standards are designed to ensure audit work leads to improved government management, better decision making and oversight, effective and efficient operations, and accountability for resources and results.
Does Yellow Book provide more than just "financial audit" related guidance?	Yes. Because Yellow Book contains professional requirements and related guidance for a variety of types of audits, financial audits are just one subset of Yellow Book. Although this includes financial and compliance audits, it also includes internal audit guidance and performance audit guidance.
Do internal auditors have to apply all portions of Yellow Book to their work?	Auditors have a responsibility to consider the entire text of Yellow Book in carrying out their work and in understanding and applying the professional requirements. However, not every paragraph of Yellow Book carries a professional requirement that auditors and audit organizations are expected to fulfill. Rather, the professional requirements are identified through use of specific language (for example, "shall" or "must").
Who must adhere to Government Auditing Standards?	<ul style="list-style-type: none"> • Auditors of government agencies (including internal auditors in state government). • Auditors of agencies that receive government awards. • Audit organizations performing Generally Accepted Government Auditing Standards (GAGAS)-compliant audits.
What is included in the Yellow Book?	The <i>Government Auditing Standards</i> consist of eight chapters: <ul style="list-style-type: none"> • Application of GAGAS. • Ethical principles in government auditing. • General standards. • Field work standards for financial audits. • Reporting standards for financial audits. • General, field work, and reporting standards for attestation engagements. • Field work standards for performance audits. • Reporting standards for performance audits.
Do other standards apply for internal auditors in state government agencies?	Yellow Book states that internal auditors may use Yellow Book in conjunction with professional standards issued by other authoritative bodies. However, if the auditor is citing compliance with Yellow Book and inconsistencies exist between Yellow Book and other standards cited, the auditor should use Yellow Book as the prevailing standard

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NORTH CAROLINA INTERNAL AUDIT IMPLEMENTATION PLAN

Question	Response
	for conducting the audit and reporting the results.
What guidance do the IIA's Standards provide to auditors?	The IIAs' <i>Professional Practices Framework</i> provides guidance for internal auditors to use in conducting their functions. The framework consists of: <ul style="list-style-type: none"> • The IIA's definition of internal auditing. • The Code of Ethics. • The Standards for the Professional Practice of Internal Auditing. • Practice advisories that were created to provide guidance to internal auditors on how to implement the standards.
Are the IIA Standards mandatory?	Adherence to the IIA's <i>Professional Practices Framework</i> is mandatory for Certified Internal Auditors (CIAs) and recommended (but not mandatory) for others.
What is included in the IIA's Standards?	The Standards consist of three components: <ul style="list-style-type: none"> • Attribute Standards address the attributes of organizations and individuals performing internal auditing services. • Performance Standards describe the nature of internal auditing services and provide quality criteria against which the performance of these services can be measured. • Implementation Standards expand upon the Attribute and Performance Standards, providing guidance applicable in specific types of engagements. These standards may be expanded to ultimately address industry-specific, regional, or specialty types of audits.
Where are the standards located?	The Comptroller General of the United States publishes <i>Government Auditing Standards</i> on the Internet at http://www.gao.gov/govaud/ybk01.htm . The Institute of Internal Auditors has published the <i>Standards for the Professional Practice of Internal Auditing</i> on the Internet at http://www.theiia.org . Both sets of standards are also included electronically in this guidebook on a CD.
What are the quality assurance requirements in either Yellow Book or the <i>Professional Practices Framework</i> ?	Professional standards require audit organizations performing audits in accordance with Yellow Book to have an appropriate internal quality control system in place, and to undergo an external peer review at least once every three years by reviewers independent of the audit organization being reviewed. There are a wide variety of sources on the Web related to external peer review requirements, including manuals from the Office of Inspector General for federal agencies at http://www.ignet.gov/pande/faec1.html . <ul style="list-style-type: none"> • MGT has recommended that the General Assembly consider legislation that would create a shared pool of internal auditors (the Office of Internal Audits) as part of the Office of State Budget and Management (OSBM).¹ The Office of Internal Audits and the OSBM would need to be considered separately for purposes of

¹ The Office of Internal Audits is discussed in greater detail in **Appendix F** of this report.

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Question	Response
	<p>the external peer review. In other words, to the extent that OSBM has its own internal audit function, it will need to have an external peer review for that internal audit function that is separate from the review performed for the Office of Internal Audits.</p> <ul style="list-style-type: none"> • A state agency that exclusively uses the Office of Internal Audits and does not otherwise have an internal audit function, can rely on the Office of Internal Audits' quality assurance program and peer reviews as being indicative of its internal audit quality.
<p>Who can be an external peer reviewer?</p>	<p>External peer reviewers must come from outside the state agency under review, but do not have to be external to the state's general government, university, or community college system.</p> <ul style="list-style-type: none"> • Example One: the Department of Health and Human Services may use as external peer reviewers internal auditors from another state agency, such as the Department of Correction, or internal auditors from the North Carolina university system. • Example Two: the North Carolina State University may use as external peer reviewers internal auditors from the state's community college system or a state department in general government but should not use as an external reviewer another internal auditor from within the North Carolina University system, such as East Carolina State University. <p>Because they provide services to a wide variety of state agencies and their office is considered a statewide resource, internal auditors within the Office of Internal Audits <i>should not</i> serve as peer reviewers as this would place them in the position of possibly having to audit or review their own work.</p>
<p>How does the internal auditor maintain independence in performing internal audit activities?</p>	<p>Professional standards recognize that internal auditors in state governments may be subject to administrative direction from persons involved in the agency's management process. These auditors will not be able to maintain organizational independence in the same way that auditors external to the state agency do.</p> <p>However, under Yellow Book, a government internal audit function is presumed to be free from organizational impairments to independence if the head of the audit organization meets all of the following criteria:</p> <ul style="list-style-type: none"> • Is accountable to the head or deputy head of the government agency or to those charged with governance. • Reports the audit results both to the head or deputy head of the government agency and to those charged with governance. • Is located organizationally outside the staff or line-management function of the unit under audit (that is, never in the position of having to audit or review their own work or decisions). • Has access to those charged with governance. • Is sufficiently removed from political pressures to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisal.

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	<p>For state agencies with their own internal audit functions, the head of the internal audit function needs to be part of the executive management team, reporting to the head of the state agency. Therefore, the job classification for the head of the internal audit function should never be lower than “Internal Audit Supervisor,” and preferably should be at the “Internal Audit Manager” level. Further, the head of internal audits should never report to an agency controller, deputy director of finance or accounting, or any official having responsibility over transactions that the internal auditor could audit.</p> <p>It should also be noted that these requirements preclude state agencies from designating existing executive management positions as the “head of the internal audit” function in addition to their other duties. This is because the internal auditor can not be in a position where he or she will or may have to review or audit their own work or the work of their subordinates.</p> <p>For state agencies using the Office of Internal Audits, the contracted auditor must report directly to the head of the state agency and to those charged with governance.</p>
What are the responsibilities of an agency’s head of internal auditing with regard to planning the audits?	<p>The Internal Audit Manager for each agency must develop annual audit plans based on a documented risk assessment. At the beginning of each fiscal year, the Internal Audit Manager shall submit a one- to five-year audit plan to the agency head for review and comment. The audit plan shall include the proposed plan for auditing any aspect of the agency for the period. This plan may be amended during the period after review with the agency head. Additionally, the Internal Audit Manager may spontaneously initiate and conduct any other audit deemed necessary. A copy of the approved annual audit plan shall be available upon request to the state and/or legislative auditor or any other appropriate external auditor.</p>
How does a state agency determine who “those charged with governance” are?	<p>Yellow Book standards mirror standards issued by the American Institute of Certified Public Accountants (AICPA) in Statements on Auditing Standards Number 114. These state that those charged with governance are those with the duty of overseeing the strategic direction of the agency and obligations related to the accountability of the agency. This includes overseeing the financial reporting process, subject matter, or program under audit including related internal controls.</p> <p>In general, the head of the state agency (such as the Secretary of State or the State Controller for their respective agencies) is both the “head of the agency” as well as “those charged with governance”. State agencies, such as universities, with a board of trustees, will have a dual reporting authority in that the head of the agency is the Chancellor; “those charged with governance” is the Board of Trustees.</p> <p>Because the governance structures of government agencies and organizations can vary widely, it may not always be clearly evident who is charged with key governance functions. In these situations, those responsible for organizational placement of the internal audit</p>

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Question	Response
	function should evaluate the organizational structure for directing and controlling operations to achieve the agency's objectives and document their conclusions in writing.

APPENDIX B

AUDIT PLANNING METHDODOLOGY

**APPENDIX B
AUDIT PLANNING METHODOLOGY
(AUDIT PLANNING ACTIVITIES FOR STATE AGENCIES)**

Introduction

The proposed North Carolina Internal Audit Act of 2007, Article 143, Section 740, requires each state agency (all state governmental agencies supported partially or fully by state funds, including universities and community colleges), to annually create or update agency internal audit plans for the coming fiscal year.¹

This methodology is designed to provide practical guidance and templates for state agencies to use in creating annual internal audit plans based on risk. Using these tools ensures that the internal audit activities are directed at addressing the highest risk areas first, and that the activities thus maximize the value of the internal audit function to the state agency. Creating annual audit plans based on a risk assessment also ensures that the internal audit function has not limited itself to addressing only fiscal or compliance issues, but has also considered a wide variety of factors to identify efficiency or economy gains for the state agency.

The planning methodology is based on Yellow Book requirements as well as best practices and recommendations compiled from a variety of sources, including the Institute of Internal Auditors' (IIA) *Professional Practices Framework* and other state and local governmental agencies.

Because of the nature of the work and the criticality of the audit planning function being performed by staff with the education and experience to do this work, draft legislation requires all audit plans to be created by an auditor at one of the highest classification levels—the Internal Audit Supervisor. It is strongly recommended that the audit plan and risk assessment be reviewed and approved by an internal auditor with oversight responsibility for the Internal Audit Supervisor.

In the table on the following page we present the audit planning methodology by answering frequently asked questions.

**Table B-1
Internal Audit Planning Overview**

Question	Response
Why develop an annual audit plan?	<p>The IIA states that, “internal auditing helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”</p> <p>Audit plans provide a roadmap for internal auditors to follow in conducting audit activities and ensure the internal audit function maximizes its value to the organization.</p>

¹ See **Appendix G – Draft Legislation** for this language.

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Question	Response
Why should internal audit plans be based on risk assessments?	The IIA, in its manual <i>Establishing an Internal Audit Activity</i> , states that, “A risk-based audit plan ensures that audit activities are effectively focused on those areas where the risks or materiality of exposure is greatest.” In other words, risk assessments ensure that the internal auditors are maximizing their value to the organization by concentrating their services on areas where the risk to the agency is highest. By doing so, the internal auditor is more likely to identify larger cost savings to the organization than if they focus on routine fiscal audits.
Does this mean that internal audit plans can not be changed once they have been created?	Audit plans are not “set in stone” and internal auditors need to be free to amend the plans in response to changes in the organization or when new information surfaces. However, because effective internal audit plans are based on an assessment of risks and exposures that may affect the organization, changes should be made only if the new information or change indicates a higher risk (through the use of the risk assessment tool provided in this methodology), than items already identified as being a priority for the organization during the fiscal year.
How do state agencies without in-house internal audit functions conduct annual audit planning activities?	As described in Appendix F, the proposed Office of Internal Audits has a pool of internal auditors available for use by smaller state agencies (those agencies that do not have a sufficient demand based on operating revenue to establish an in-house internal audit function). ² State agencies can contract with the Office of Internal Audits to have an experienced Internal Audit Manager conduct the risk assessment and develop the internal audit plan for the state agency. Management of the agency will be allowed to give feedback; however, the final assessment of risk and creation of the audit plan will be the responsibility of the contracted internal auditor just as if the internal auditor were on the agency’s staff.

Risk Assessment and Prioritizing Internal Audit Tasks

As the first and one of the most critical steps in the audit planning process, a risk assessment helps organizations identify the possible events that will occur that can be harmful to the organization and/or can be a hindrance to the organization in achieving its goals. Risk assessment allows internal auditors help focus their efforts on areas where the organization’s risk of exposure or risk is greatest and avoid scheduling audits according to a standard cycle of rotation.

The risk assessment framework requires internal auditors to consider the following facets and categories of agency operations:

- Financial
- Operational
- Criticality of the Auditable Unit to the Agency
- Legal and Compliance Requirements

² As discussed further in **Appendix F**, this shared pool of internal audit resources is being proposed in the proposed North Carolina Internal Audit Act (see **Appendix G**) to address providing resources for smaller state agencies that may not need a full-time internal auditor.

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- Technology
- Probability of Fraud
- Public or Political Sensitivity
- Strategic Activities

Table B-2 below identifies the steps an internal auditor must take to identify risk within the state agency.

**Table B-2
Steps in the Risk Assessment Methodology**

Step One: Define the Organization's "Auditable Units"
Step Two: Conduct Data-Gathering Interviews
Step Three: Document Key Information on the Auditable Unit
Step Four: Quantify Each Auditable Unit's Risk
Step Five: Calculate the Weighted Risk
Step Six: Prioritize Internal Audit Tasks By Weighted Risk and Create Audit Plan

Below, we describe how to complete each of these steps.

Step One: Define the Organization's "Auditable Units"

The first step in the risk assessment process is to define the organization's "auditable units." An auditable unit is the smallest level in the organization that should be considered for a risk assessment.

Auditable units can be individual applications or processes such as payroll or purchasing, but can also be offices or units within the state agency. Many organizations define auditable units as the smallest unit for which the organization tracks accounting information such as revenues and expenditures.

- In the North Carolina Accounting System (NCAS) hierarchy, for example, many state agencies may wish to define auditable units by their "center" portion of their accounting codes.
- Note that NCAS definitions, including descriptions of how accounting codes are assigned can be located at http://www.ncosc.net/sigdocs/sig_docs/sigNCAS_Data_Elements.html.

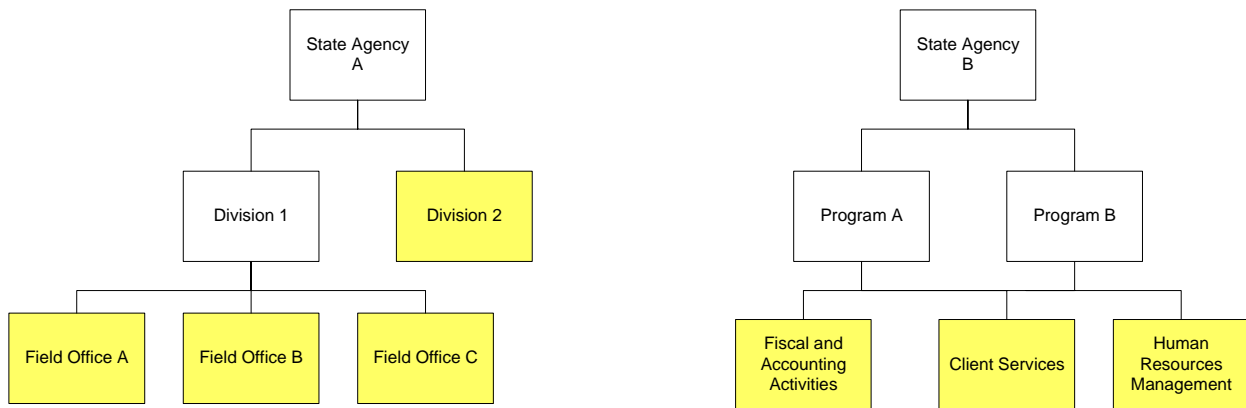
Defining an auditable unit in overly broad terms such as an entire department, results in an unmanageable and unrealistic audit scope, and dilutes issues identified in the risk assessment. On the other hand, if auditable units are defined in too narrow terms, financial or performance data may be unavailable or unable to be broken out to the

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overly narrow level. Auditors should use their professional judgment and input from agency management in defining auditable units.

Figure B-1 shows two examples of state agencies that have identified their auditable units.

**Figure B-1
Identification of Auditable Units in Two State Departments**



In **Figure B-1** above, the auditable units are the shaded boxes. Notice that in Agency A, the field offices of Division One are the auditable units, because they are the smallest level under that organization. Division Two, having no field offices, is itself an auditable unit.

In Agency B, the auditor has identified auditable units by processes or activities conducted by the agency. In this instance, the administrative and client services are the lowest level, and thus the auditable units.

Identifying the auditable units is a key first step and internal auditors should carefully take the time to consider management input, as well as organization charts, strategic plans, and department policies and procedures before making decisions on how to identify the auditable units.

Step Two: Conduct Data-Gathering Interviews

Data gathering for the purposes of assessing risk can take the form of reading through prior audit reports or reviews, obtaining documentation such as technical manuals, policies and procedures, bulletins, or other published guidance for the auditable unit, or reviewing the unit's Web site. However, a great deal of the information that auditors will need to consider will come from interviews with agency and auditable unit management, as well as key staff.

Preparing for interviews to assess risk requires the auditor to obtain some information ahead of time about the unit's operations. Examples of ways to collect information before the interview include but are not limited to:

- Reviewing the agency and/or unit Web site.
- Reviewing the strategic plan or mission statement.

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- Reviewing any risk assessment information completed in prior years.
- Reviewing any internal or external audit reports or reviews of the unit or agency from prior years.
- Obtaining the unit's budget from the department's fiscal staff.

Interviews are best conducted in-person, which helps to build the relationship between the agency staff and the auditor. The auditor may wish to follow-up through e-mails or phone calls for key points raised during the interview.

Interviewing agency staff and managers serves several purposes, including:

- Allowing the internal auditor to obtain and document information about the unit's operations, goals, mission, strengths, and weaknesses.
- Serving as an opportunity for the internal auditor to provide a brief background on what the role of internal auditing is and the types of services provided.
- Providing an opportunity for the internal auditor to obtain feedback on the performance of internal audit functions within the agency (for example, by asking if internal auditing is meeting the unit or agency expectations or if additional services are required).

Appendix B—Supplement 1 (Risk Assessment Interview Guide), at the end of this appendix is a sample interview guide for internal auditors to use in conducting their interviews. It should be noted that this supplement is intended to give auditors general guidance, but should not be taken as limiting them from creating their own lists of questions or information requests based on their understanding of the state agency.

Step Three: Document Key Information on the Auditable Unit

To gain a greater understanding of the unit, ensure that organizational knowledge is maintained in future years, and for tracking purposes, auditors should document key information on the auditable unit and maintain it in the internal audit permanent records.

Documentation can include reports and information collected from the unit or outside agencies. It can also include the auditor's notes from the results of their interview from the previous task. For key information obtained from interviews or information that appears to indicate higher risks, the auditor may wish to verify this information in writing with the unit manager, to better confirm their understanding.

Appendix B—Supplement 2 (Auditable Unit Tracking Form) presents a sample template for internal auditors to track key data from year-to-year on auditable units. Internal auditors can track this information electronically in databases, spreadsheets, or word documents, or they may wish to retain a permanent paper file of the state agency and its auditable units that is updated annually.

Step Four: Quantify Each Auditable Unit's Risk

Internal auditors should assess each auditable unit's risk related to risk factors. The risk assessment tool in this appendix considers all of these risk factors to ensure that the internal auditors go beyond looking only at financial, compliance, and internal controls and that they are also reviewing performance. By doing so, they are maximizing their

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value to the state agency by ensuring that they are considering program activities and ways to add value through improving the agency's efficiency and effectiveness of operations.

The internal auditor should use the information gathered in earlier steps to quantify each unit's risk for the two risk component types by using the risk assessment tool. The information shown in **Appendix B— Supplement 3, (Risk Assessment Components and Considerations)**, presents risk factor descriptions, considerations, and guidance for internal auditors to use in assessing risks. The guidance is based on best practices and industry recommendations. If an internal auditor has intimate knowledge of a state agency and experience evaluating risk in preparation for developing an audit plan, that auditor should feel free to add or modify these risk components based on that experience.

A compact disc (CD) with tools such as the risk assessment is included in this package. The CD has an excel spreadsheet that internal auditors can use to record risk assessments and which will calculate weighted risks for each auditable unit. To quantify each auditable unit's risk, the auditor can use the template to assign a numeric value to each risk assessment.

Higher numbers in the risk assessment indicate higher risk. For example, a determination that the financial risk was "high" by the auditor, would result in the auditor assigning a value of "3" to a particular auditable unit, whereas a determination that risk was medium would result in a value of "2," and a determination of low risk would result in an assigned value of "1." This exercise will allow the auditor to quantify the total risk associated with each auditable unit. Those units with the highest values at the end of the risk assessment will be the units on which the auditor should place the highest priority in auditing.

Step Five: Calculate the Weighted Risk

In assigning weights to risk, not all risk components may have equal importance or emphasis for agency management. Weighting the risks puts emphasis on those areas that management and internal auditors feel are more critical or areas where the agency is more vulnerable. This allows the auditor to identify audits that maximize the value of their services to the organization.

Assigning relative weights to the risk components should be done through consensus between agency management and the internal auditors. After assigning a weighted risk to each risk component, the auditor can calculate the quantified risk associated with each auditable unit by multiplying a point value assigned based on the risk level assessed (high, medium, or low) multiplied by the assigned weight given to that risk factor. The total weighting for all factors should always equal 100 percent.

The specific steps to calculating the weighted risk are as follows:

- Auditor with management input assigns a relative weight (percentage) to each risk component factor.
- Auditor multiplies the weight value (percentage) multiplied by the risk assessment for each auditable unit.

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Table B-3 below is an example showing how an agency calculates the weighted risk for two of its auditable units. In this example, both units are assigning weights to the risk components, but each has assigned a different weight based on their understanding of their operations. As can be seen, the total weighted risk is equal to 100 percent in both cases.

Table B-3
Example of Comparison of Weighted Risk Assignments

Risk Component	Weighted Value of the Risk Component	Auditable Unit 1		Auditable Unit 2	
		Risk Assessment	Calculated Risk	Risk Assessment	Calculated Risk
Criticality of the Unit	20%	Medium 2	0.4 (= 20% * 2)	High 3	0.6 (= 20% * 3)
Opportunities for Improvement and Cost Savings	30%	Medium 2	0.6 (= 30% * 2)	High 3	0.9 (= 30% * 3)
Internal Control	5%	High 3	0.15 (= 5% * 3)	Low 1	0.05 (= 5% * 1)
Public or Political Sensitivity	15%	Low 1	0.15 (= 15% * 1)	Medium 2	0.3 (= 15% * 2)
Legal and Governance	15%	Low 1	0.15 (= 15% * 1)	Medium 2	0.3 (= 15% * 2)
Change in Management or Organizational Structure	10%	High 3	0.3 (= 10% * 3)	Low 1	0.1 (= 10% * 1)
Financial Impact	5%	High 3	0.15 (= 5% * 3)	Low 1	0.05 (= 5% * 1)
TOTALS	100%	15	1.90	13	2.30

If the agency had not assigned weighted values to the risk components, the internal auditor would have determined that Auditable Unit 1 was the highest priority of the two units, just based on the assignment of high, medium, or low values to the risk components. However, because this agency has placed more of an emphasis on the first two risk areas, in actuality, the auditor should assign a higher priority to reviewing the operations of Auditable Unit 2.

Included in the CD as part of this package is an excel spreadsheet that internal auditors can use to record risk assessments and which will calculate weighted risks for each auditable unit.

Step Six: Prioritize Internal Audit Tasks By Calculated Weighted Risk and Create the Annual Audit Plan

After conducting the audit risk assessment and calculating weighted ranks, the auditor can prioritize audit tasks by assessed and weighted risk. This is done by selecting the auditable units with the highest weighted score (as calculated in step five above) for priority on the audit plan list. This prioritized list can be used to develop the annual audit plan. The audit planning process includes establishing goals, developing work schedules, establishing staffing plans and financial budgets, and distributing status reports on the progress of activities.

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The annual audit plan is the tool that ensures that the internal audit unit has adequate resources to conduct its activities throughout the year. That is, in addition to prioritizing the various audit tasks, audit plans also identify the types of audit and the resources needed in terms of auditor hours, staffing assignments, and the qualifications and experience needed for each audit.

Identifying the types of audits to be conducted (financial, internal control, performance, efficiency/economy, compliance, or investigative) is the decision of the auditor. The auditor typically makes this determination based on information gathered during the risk assessment process in conjunction with the assignment of risk levels to the risk components. For example, if the auditor identified concerns with the efficiency with which the highest priority auditable unit was operating, he or she may decide to conduct a performance or efficiency audit of that unit's operations.

The audit plan should allow for some flexibility in the allocation of audit resources so that the internal auditors can respond to agency questions and provide some consulting-type services (technical assistance, limited training, etc.) during the year. The amount of flexibility that should be built into the audit plan will vary depending upon the nature of the state agency. Internal audit directors should also consider the time needed for professional development and administrative activities in considering available time to perform the audits.

After the audit plan has been prepared, it should be shared with the head of the state agency and/or the agency's governing body (if any) for review, comment, and endorsement. It should be noted that the final approval of the audit plan rests with the director of internal audits for the organization (that is, the highest ranking internal auditor within the organization who reports directly to the head of the agency and/or to those charged with the agency's governance). In the case of agencies that have contracted with the shared internal audit pool for services, the Director of the Internal Audit pool, in conjunction with the contracted auditor, will be considered the agency's de facto "director of internal audits" and thus will have final approval of the plan. To ensure proper communication of audit planning activities, after initial distribution, senior management should be kept informed of any changes to the plan.

Appendix B—Supplement 4 (Sample Internal Audit Plan) at the end of this appendix is a sample annual internal audit plan that internal auditors can customize for their own use. This plan can and should be modified by state agencies to meet their individual needs, but should contain, at a minimum, those components identified in the supplement.

As discussed further in the report, to ensure that state agencies have the staff and resources they need, and that they are implementing internal audit activities in accordance with the proposed North Carolina Internal Audit Act of 2007, MGT has recommended that in fiscal years 2007-08 through 2011-2012, the Office of the State Auditor (OSA) conduct annual assessments of the implementation of the internal audit function throughout state agencies. Therefore, state agencies will need to submit their audit plans to OSA for evaluation against the Internal Audit Act requirements, professional standards, and best practices.

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Types of Audits

As part of the audit process, internal auditors also need to identify the types of internal audit reviews or audit procedures that they will be performing of the highest risk auditable units.

Based on the internal auditor's risk assessment, there may be a variety of types of procedures required for the auditable unit. For example, if the internal auditor's risk assessment indicates that the highest risk auditable unit was rated high due to weak internal controls, problems with financial reporting, and highly liquid assets (indicating a higher likelihood for fraud to occur), then the audit plan may call for three types of review of this auditable unit: one related to the compliance issues with the internal controls, one related to financial reporting processes, and one related to the unit's ability to safeguard its assets.

Determination of what types of procedures, and what type of audit to conduct, is at the discretion of the internal audit manager creating the internal audit plan. As a result, it is even more crucial that the person conducting this work have the necessary skills and expertise in performing a variety of types of audits and reviews, so as to use experience to best judge what audit work is required. A discussion of the types of work and services that auditors perform is also provided in **Appendix C** of this report.

Reporting and Follow-up on Annual Internal Plans

An important step in the audit methodology is reporting and follow-up on the annual audit plan and results of audit findings. This process has a dual purpose: first to evaluate the internal audit function as to how well it managed and completed the audit plan, and secondly to provide a mechanism to ensure that audit findings are adequately addressed by management.

As part of the annual audit report, auditors should compare actual activities to planned audit activities from the prior year and discuss all significant variances. Issues may arise during the year or come to the attention of the auditor that require changes to the internal audit plan. However, it is important for the auditor to track these variances and the reasons for changes so that management has a way of measuring the effectiveness of the internal audit function. Additionally, differences between planned and actual activities may indicate that additional resources are needed for an internal audit unit, requiring management to make allocation decisions when requesting approval for its budget.

Although implementing audit recommendations is the responsibility of agency management, it is the auditor's responsibility to track progress toward accomplishing improvements. The IIA's *Standards for the Professional Practice of Internal Auditing* states that internal auditors "...should establish a follow-up process to ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action." The follow-through ensures valuable recommendations to improve the efficiency and effectiveness of the agency are implemented. It is the auditor's responsibility to continuously seek implementation of the audit findings by discussing the progress with the agency head.

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Because the nature of audits can vary greatly, and each agency is unique, it is difficult to adopt precise rules for follow-up activities. Nevertheless, general guidelines can be established to provide a mechanism for ensuring that audit findings are tracked. Follow-up activities that should be conducted periodically, such as semi-annually, include:

- Obtaining management's written response to audit findings and recommendations. For purposes of these definitions, "management" refers to the person or persons charged with oversight and management of the auditable unit that was reviewed.
- Requiring management to provide a written action plan and timetable with accomplishment deadlines for implementing audit recommendations.
- Determining whether management takes appropriate and timely action on audit findings.
- Determining the extent to which management has addressed the audit findings. If not completely addressed, describe why not addressed.
- Conducting periodic desk review(s) of management progress toward implementing the recommendations.³
- Conducting follow-up audits if needed.
- Reporting on management's progress of implementing recommendations to the head of the agency.

Establishing an audit findings database or tracking form is a best practice used by many internal auditors in tracking the progress toward recommended implementation. The database or tracking form can track identifying information about each audit report along with a summary of each finding, the management position responsible for taking corrective action, and the estimated completion date for corrective action. It can also be used to track whether or not a finding has been corrected, what was done to correct the issue, whether corrective actions should be tested, and the date corrective action was completed. This information will also be needed when annually determining the level of performance against what was expected (targets). (See Appendix D on performance measures for further explanation.)

Key data elements that internal auditors should track for each audit are the following:

- Auditable unit name.
- Management name and contact information.
- Detailed list of all findings that includes the condition, criteria, cause, effect, and recommendation(s).
- Management's response to the findings and recommendations.
- Timetable for implementing the recommendations.
- Contact name and information for the staff or manager assigned responsibility for implementing a particular recommendation.
- Status and notes related to the recommendation's implementation status.

³ Desk reviews are typically quick reviews of documents provided to the internal auditor or follow-up conversations with management and staff. Desk reviews typically do not involve detailed transaction testing or performing comprehensive audit procedures.

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Appendix B Supplemental Figures

The following pages and sections represent samples of interview forms, data tracking worksheets, definitions of risks, and sample audit plans.

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The following supplement (**Supplement 1: Risk Assessment Interview Guide**) presents a sample interview guide and tracking form that internal auditors can use when conducting annual interviews of agency management and staff to collect information needed for the risk assessment and annual audit plan.

**Appendix B – Supplement 1:
Risk Assessment Interview Guide**

Appendix B—Supplement 1: Risk Assessment Interview Guide	
Internal Auditor's Name	
Date of the Interview	
Name and Title of Interviewee	
Interviewee Phone Number	
Interviewee E-mail Address	
Interview Questions	
What are the main goals, objectives, and functions of the unit? Has your unit met its objectives in recent years? Does your auditable unit have performance measures that are reported to the Office of State Budget and Management annually, and if so, how has the unit performed over the past two fiscal years?	
What is the risk if your unit is unable to meet its goals and objectives or conduct its core functions? (In other words, what exposures do you have that could potentially pose a threat or disruption to your operations or to the operations of the state agency as a whole?)	
What obstacles do you face that could affect or keep your unit from achieving its goals and objectives (for example, lack of resources, lack of support from management, negative public exposure, etc.)? What measurable changes would occur if these obstacles were removed?	
How do you measure your performance? Are there any metrics or data you use on a regular basis?	
Have there been any recent events (positive or negative) that have affected the [unit/agency name]? If so:	
<ul style="list-style-type: none"> • What was the impact of these events on the [unit/agency name]? • Did the event(s) affect the organization's ability to deliver its services or carry out its core functions? • For negative events, were you able to mitigate the effects in any way? 	
Have there been any changes to the budget (increases or reductions)? If so, what were the specific impacts of these changes on the [unit/agency name] operations?	
What other groups (internal or external to the agency) do you interact with regularly or rely on in carrying out your functions and meeting your objectives? Have there been any problems in this area? Do you feel you receive the information and support you need from these units? If not, please explain why and the difficulties you encountered.	
What is the worst thing that has happened within the last five years in this [unit/agency name]? What was the ultimate impact? What is the likelihood it will reoccur?	
What are some of the areas of risk that your [unit/agency] is facing? In other words, what exposures	

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Appendix B—Supplement 1: Risk Assessment Interview Guide
do you have that could potentially pose a threat or disruption to your services or activities? What is the likelihood of these events occurring? ⁴ Consider areas such as:
<ul style="list-style-type: none"> • Financial risks • Operational risks • Criticality of the auditable unit to the agency • Legal or compliance risks • Technology risks • Fraud risks • Public or political sensitivity (reputation risks) • Strategic risks
What do you have in place to manage and deal with risks, including disaster recovery plans for technology used within the unit or agency?
What happens to the agency if the unit is unable to provide its services within required time frames or at normally expected levels?
What would be the impact to the agency if the unit ceased to exist or failed to provide any services at all for an extended period of time?
What issues have been identified with the unit’s internal controls in recent years?
Who oversees the unit’s internal controls, and how do they go about doing this?
What would be the impact to the agency if negative information about the unit was made public in some way?
How dependent is this unit on funding from the state? From federal agencies? (For example, 50 percent federally funded.)
Is the unit engaged in any current or potential litigation?
What outside agencies or policies govern the unit’s operations (such as federal grant requirements, Environmental Protection Agency, Occupational Safety and Health Administration [OSHA] requirements, etc)?
Have there been any major personnel or process changes, including reorganization of the personnel or processes in the unit or management and key personnel turnover?
If the unit misused funds, or something went wrong financially, what would be the impact to the agency from a financial perspective?
What reports or external reviews have you had in the past year that have addressed compliance or other operational issues? (If any, obtain a copy.)
What unique information technology applications or systems do you have and how critical are they to the functioning of your unit? Have you had any performance issues? Who supports your unit from a technology aspect? Who do you call if there is a problem?
Has your unit had a misuse of funds in the past five fiscal years? If so, are you aware of the process to report this misuse? (If not, discuss the process with the individuals.)
What benefits do you and/or your unit receive or would like to receive from the internal audit function?

⁴ See **Appendix B – Supplement 3: Definition of Audit Risks** for definitions of each of these risk types.

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**Appendix B—Supplement 1:
Risk Assessment Interview Guide**

Would you feel comfortable calling the internal audit unit with a problem or concern?

Note, that these are sample interview questions collected by MGT during its review of best practices employed by internal auditors. Each state agency's internal auditor should review these questions and modify or add to them as seen fit. It is important, however, that internal auditors gain a deep understanding of the unit/agency before conducting the risk assessment.

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The following supplement (**Supplement 2: Auditable Unit Tracking Form**) presents examples of information that internal auditors should track for each of the auditable units in the state agency. This form should be updated no less than annually by the internal audit team as part of the annual risk assessment process.

**Appendix B – Supplement 2:
Auditable Unit Tracking Form**

Appendix B—Supplement 2: Auditable Unit Tracking Form	
Data Field	Response
Internal Auditor's Name	<i>Name of the internal auditor filling out the tracking form.</i>
Date Updated	<i>Date that the internal auditor either obtained or updated the tracking form for this auditable unit.</i>
Name of Auditable Unit	<i>Either the department's official name for the unit (for example, the Office of Fiscal Support) or the name of the process identified as the auditable unit (for example, human resources management).</i>
Unit Manager	<i>The name and title of the person responsible for overseeing the activities or functions of the auditable unit.</i>
Contact Person	<i>The name and title of the main contact person within this unit (if different from the unit manager).</i>
Contact Phone Number	<i>The main contact's phone number.</i>
Contact E-mail Address	<i>The main contact's e-mail address.</i>
Current Fiscal Year	<i>The fiscal year for which information is being collected and reported in the tracking form.</i>
Budget for Current Fiscal Year	<i>The total budget for this auditable unit, obtained from either the department's fiscal and accounting staff or North Carolina Office of State Budget and Management Web site.</i>
Date of Last Audit	<i>Date that the last internal audit was completed for this unit.</i>
Main Goals and Objectives of the Unit	<i>The goals and objectives of the unit (the purpose it exists within the state agency).</i>
Obstacles or Challenges Within the Unit	<i>Based on the goals and objectives of the unit, and discussions with the unit manager or with other agency staff, the obstacles that the unit faces that could affect it or keep it from achieving the goals and objectives. Try to keep high-level and in short-bulleted items.</i>
Means of Measuring Performance (Outputs, Outcomes, and Efficiency)	<i>Identification of any means and the location of the data sources used by the unit to track its performance, including measures related to the output of the unit, the efficiency with which the unit utilizes its resources, and the outcomes (to the agency or to the general public) that are generated by the audit unit.</i>
Recent Events	<i>Description of any recent major events within the unit (that is, change in management, reorganization, loss of positions, negative public exposure due to investigative press articles, etc.).</i>

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Appendix B—Supplement 2: Auditable Unit Tracking Form	
Data Field	Response
Main Areas of Risk Within the Unit	<p><i>The exposures that could potentially pose a threat or disruption to the unit’s activities.⁵ These could include:</i></p> <ul style="list-style-type: none"> • <i>Financial risks</i> • <i>Operational risks</i> • <i>Criticality of the auditable unit to the agency</i> • <i>Legal or compliance risks</i> • <i>Technology risks</i> • <i>Fraud risks</i> • <i>Public or political sensitivity (reputation risks)</i> • <i>Strategic risks</i>
Prior Audit Findings	<p><i>Reference to whether prior audit findings exist, (internal audits and external audits or investigations and reviews) and location of a copy of the prior audit or review report (if any).</i></p>

Note, that these are sample items that internal auditors should consider tracking. Each state agency’s internal auditor should modify or add to this list as seen fit. It is important, however, that the internal auditor retain sufficiently deep information on the agency to enhance the understanding of the agency’s programs and issues.

⁵ See **Appendix B – Supplement 3: Definition of Audit Risks** for definitions of each of these risk types.

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**Appendix B – Supplement 3:
Risk Assessment Components and Considerations**

This section identifies the categories of operations that internal auditors should consider in developing their annual audit plans. This supplement addresses the following categories of an agency’s operations:

- Financial
- Operational
- Criticality of the auditable unit to the agency
- Legal and Compliance Requirements
- Technology
- Probability of Fraud
- Public or Political Sensitivity
- Strategic Activities

The compact disc that accompanies this appendix also contains a spreadsheet that internal auditors can use to capture information during risk assessments and calculate weighted risk assignments.

It should be noted that the titles shown for each of the categories described above use the word “risk” to indicate that the internal auditor is considering and evaluating the risks related to the agency’s operations for each category above.

Appendix B—Supplement 3: Risk Assessment Components and Considerations	
Financial Risks	
Description	The risk that financial reporting is inaccurate, incomplete or untimely due to a variety of factors, including errors, changes in accounting standards, or the pressure on management to meet financial expectations.
Considerations	<p><u>Use of Significant Estimates /Application of Judgment</u> – Risk is increased if a more reliance is placed on estimates, adjustments or reserves that are subjective and difficult to accurately quantify or when application of complex accounting rules or other judgments is required.</p> <p><u>Inadequate Cost Accounting and Control</u> – The risk of inadequate, imprecise, or poorly designed systems and metrics for tracking resources consumed by the work unit.</p> <p><u>Size and Volume of Transactions</u> – Risk is increased if processed transactions consist of unusually large individual transactions or an extremely high volume of transactions. Risk is generally decreased if the population is made up of relatively few transactions.</p> <p><u>Complexity of Transactions</u> – Complex transactions increase risk. Simple transactions decrease risk. Transactions that involve complicated calculations, compliance with laws,</p>

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Risk Assessment Components and Considerations**

Financial Risks

	<p>rules or regulations, or other factors may be considered complex.</p> <p><u>Centralization</u> – Risk increases as processes are centralized and highly controlled by upper management.</p> <p><u>Prior Errors</u> – A history of unintentional errors identified during prior internal or external audits may indicate a higher risk.</p> <p><u>Materiality to the Agency</u> – Risk increases if the amount of transactions processed by the business process or unit relative to the overall agency size or total budget is large or material.</p>
Rating	Rating Examples
High (3 points)	The business process or unit has major impact on the agency’s overall financial goals and objectives. There is a high volume of complex transactions. Financial reporting is judgmental, not easily monitored, and extremely complex. Estimates are relied upon to a material extent, and <i>incorrect decisions and entries would have a serious effect on the accuracy and reliability of the financial statements</i> . There is no cost accounting system to determine the direct and indirect cost of activities of the work entity and unit costs of products and services.
Medium (2 points)	The business process or unit has moderate impact on the agency’s overall financial goals and objectives and the volume of processing is moderate. The reporting processes are moderately complex, have some monitoring in place and place only moderate reliance on estimates. The cost accounting system measures direct costs for which reporting may be required by federal or private funding bodies, but does not capture all direct and indirect costs provided by the state or customers. Management monitors costs of only those items that are subject to audit or review by federal or private funding bodies.
Low (1 point)	The business process or unit has limited impact on the agency’s overall financial goals and objectives. The reporting processes are relatively simple, have built-in monitoring either in the division or by another division within the agency, and do not rely on material estimates. There is a cost accounting system for measuring direct and indirect costs of all activities. Unit costs are measured for all products and services, reported, and used routinely by management. The unit is able to construct a unit budget by multiplying unit costs by the number of outputs planned for the budget period.

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**Appendix B—Supplement 3:
Risk Assessment Components and Considerations**

Operational Risks

Description	The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events. This risk addresses barriers to the timeliness, accuracy, authorization, and completeness of these processing activities. Failures related to operational risks could result in the auditable unit failing to deliver required services and to carry out its primary mission and objectives.
Considerations	<p><u>Inefficient/Ineffective Process Design</u> – The risk of inadequate or poorly designed processes, including a lack of end-to-end process ownership and accountability.</p> <p><u>Compliance with Policies and Procedures and Employee Error</u> – The risk that staff responsible for executing business activities will fail to comply with the agency’s policies and procedures or commit unintentional errors, whether due to lack of training or competence, failures of communication, unfamiliarity with policies and procedures, or mindful disregard.</p> <p><u>Employment Practices and Workplace Safety</u> – An act inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity/discrimination events.</p> <p><u>Inappropriate Data Usage</u> – The risk of the misuse of sensitive or confidential information by employees or outside parties.</p> <p><u>Nonroutine/Complex Transactions</u> – The risk that incorrect or inconsistent handling of infrequent or complex activities could cause internal/external customer dissatisfaction.</p> <p><u>Customers, Products, and Business Practices</u> – An unintentional or negligent failure to meet a professional obligation to specific customers (including fiduciary and suitability requirements), or from the nature or design of a product.</p> <p><u>Execution, Delivery, and Process Management</u> – Failed transaction processing or process management, from relations with trade counterparties and vendors.</p> <p><u>Inadequate Delivery of Outsourced Activities</u> – The risk that outsourcing providers do not deliver services in line with expectations or commit actions that are inconsistent with the agency’s strategies, objectives, and values. Risk is increased for processes that are outsourced to third-party providers.</p> <p><u>Damage to Physical Assets</u> – The loss or damage to physical assets from natural disaster or other events.</p> <p><u>Business Disruption and System Failures</u> – The risk that disasters, system failures, or business interruptions could jeopardize customer service.</p>

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Operational Risks

Rating	Rating Examples
High (3 points)	Processing activities have major risks and high possibility of significant losses or embarrassment exists if the processes are not adequately controlled. The auditable unit has undergone or is anticipated to undergo in the near future a very high degree of change that is large-scale, complex, and/or that requires extensive support. The auditable unit's services and operations are critical to the agency and catastrophic loss to the agency could result from even a short interruption of these processing activities. Management has struggled with controlling operations of the auditable unit and issues have begun to arise. The unit's processes are not documented and/or staff are unfamiliar with requirements (state or federal laws and regulations or departmental policies and procedures) related to the program. Assets are highly liquid and can easily be converted to cash.
Medium (2 points)	Processing activities have moderate risk of loss or interruption. Proven procedures are used which are not particularly complex. The auditable unit has documented some, but not all, of its policies and procedures. Management and staff have some knowledge of the requirements related to the unit's operations, but some training or documentation of processes is still required. The auditable unit experiences a moderate level of change. Moderate risk to the agency would result in interruption of one to three days. Assets are generally not liquid and require authorization for conversion. Financial data developed from these activities is moderately sized and can be independently re-created.
Low (1 point)	Processing activities are relatively simple, and have minimal risk of loss or interruption. Processes are well documented and management and staff appear skilled and knowledgeable in the requirements related to the unit's operations. Interruption of processing of activities in excess of three days can be managed without significant loss to the agency. The auditable unit experiences limited levels of change; assets cannot be easily converted to cash and financial data is minimal and easily re-created.

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Appendix B—Supplement 3: Risk Assessment Components and Considerations	
Criticality to the Agency	
Description	The importance of the unit to the agency's ability to continue to function and carry out its primary mission.
Considerations	<p><u>Reliance on External Parties</u> – The risk that external parties, including vendors or subcontractors, cannot provide needed services or products and can cause disruptions in service delivery by the unit or the agency. Risk increases with more reliance on external vendors or parties.</p> <p><u>Lack of Planning</u> – The risk that if the unit is unable to function timely or at expected levels, the agency has not implemented backup mechanisms or cross-training to allow other units or functions to take on these roles until service can be restored.</p> <p><u>Execution, Delivery, and Process Management</u> – Failed transaction processing or process management that results in other units within the agency being unable to function.</p> <p><u>Inadequate Delivery of Activities</u> – The risk that slowdowns in services provided by this unit will result in the agency being unable to deliver services in line with expectations or will cause the agency to fail to meet its goals and objectives.</p> <p><u>Business Disruption and System Failures</u> – The risk that disasters, system failures or business interruptions could jeopardize customer service and result in heightened negative publicity for the unit and the agency.</p> <p><u>Reliance on the Unit</u> – The increase in risk that occurs as other units within the agency and members of the general public interact with and/or depend on this unit's function.</p>
Rating	Rating Examples
High (3 points)	The business process or unit has a major impact on the agency's ability to meet goals and objectives. The unit's infrastructure is outdated or inadequate to support its mission. The unit has experienced slowdowns or failures in providing services over the prior year that have impacted other units in the agency or members of the general public served by the agency. Management has not created policies or procedures to address issues.
Medium (2 points)	The business process or unit has a moderate impact on the agency's ability to meet goals and objectives. The unit has some processes in place to mitigate for risks of slowdown, but these may not be sufficient to prevent service problems or slowdowns from occurring and impacting other units in the agency or members of the general public. The unit has experienced some minor problems in delivering its services in the past year.
Low (1 point)	The business process or unit has a limited impact on the agency's ability to meet goals and objectives. The unit has in place, documented and functioning processes to address service failures or slowdowns. The unit has not experienced problems in delivering its services in the past year.

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Legal or Compliance Risks	
Description	The risk of direct or indirect loss resulting from failure to follow regulations and directives. This includes loss due to loss of funding or increased expenditures from fines and/or penalties by external oversight agencies.
Considerations	<p><u>Unresponsive to Legal/Regulatory/Compliance Changes</u> – The risk that occurs when the agency is unaware of or does not respond to changes in laws and regulations to ensure compliance.</p> <p><u>Litigation Issues</u> – Lawsuits can result in expensive settlements, litigation costs, and corrective action (for example, employee/customer litigation, contract/fiduciary liability, etc.). This risk increases if the agency or unit is currently in or anticipates being involved in litigation related to its activities.</p> <p><u>Major Consumer Compliance Regulations</u> – The risk that violations of consumer regulations can result in negative customer reaction/publicity, significant civil money penalties, expensive corrective action, and other regulatory sanctions.</p> <p><u>External Regulation</u> – The risk that an act inconsistent with employment, health, or safety laws or agreements can result in penalties or loss of federal funding due to noncompliance. This risk increases if the unit is answerable to multiple external parties.</p> <p><u>Hazardous Work Environments</u> – The risk that occurs in work environments involving frequent or prolonged employee exposure to hostile people, inmates, explosives, hazardous materials, animals, fire, high voltage, severe weather conditions, or disease vectors, or who are required to use law enforcement paraphernalia, construction equipment, chain saws, patrol cars, boats, aircraft, or motorcycles.</p> <p><u>Potential Threats to Public or Environment</u> – The risk that the work products or services may create unintentional harm to the public served by the unit or to people near the unit’s facilities. Examples include escapes of detainees or inmates; release of hazardous substances from stores or laboratories; deaths or injuries that may occur on site as a result of employee negligence, presence of high-voltage power lines, scenic overlooks, boats, swimming pools, playground equipment, exotic animals, etc.</p>
Rating	Rating Examples
High (3 points)	Activities are subject to a high level of regulatory compliance. Laws and regulations apply that are significant and complex. The consequences of noncompliance are likely to result in major fines and embarrassment, or could result in loss of life, bodily injury, or harm to the public. The agency is currently involved in litigation or anticipates being involved in litigation due to problems in delivering services or complying with laws, regulations, or policies. <u>Note that if the auditable unit’s operations result in a potentially or actually hazardous work environment or if the potential threat to the public or environment is high due to the nature of operations, this risk should always be rated as “High”.</u>

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Legal or Compliance Risks

Medium (2 points)	Activities are subject to regulatory compliance; however, regulations are not particularly complex. Some possibility of fines or restrictions exists, but they would have minimal impact on the business unit. The agency is not currently involved in litigation, nor does it anticipate that there is a high likelihood of litigation being resolved in its favor.
Low (1 point)	Limited or no regulations and laws apply and the possibility of losses from noncompliance is remote. The agency is not currently involved in litigation.

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Technology Risks	
Description	<p>This risk considers the level of use, sophistication, complexity, robustness, ease of use and speed and accuracy of recovery/replacement of systems. Addresses the overall importance of technology within the organization and the availability and quality of information the organization can access to support decision making, and the security around key information.</p>
Considerations	<p><u>Lack of Information Integrity</u> – The risks associated with the authorization, completeness, timeliness, and accuracy of transactions/data as they are entered into, processed, and reported by various systems.</p> <p><u>Inappropriate Infrastructure</u> – The risk that the agency does not have the necessary technology infrastructure to cost-effectively support current and future business activities.</p> <p><u>Lack of Fall-Back Plans</u> – The risk that the agency has not put measures in place to ensure continuing operations in the case of system problems or failure.</p> <p><u>Lack of Timely, Reliable, and Relevant Information for Decision Making</u> – The risk that relevant internal and external information necessary for decision making is not available on a timely basis and/or is unreliable.</p> <p><u>Inadequate Data Security and Access</u> – The risk of not adequately restricting access to and protecting information.</p> <p><u>Unavailability and Instability of Systems</u> – The risk that critical systems are unstable or unavailable, threatening the delivery of operations and processes. The risk of natural disasters, catastrophic events, or terrorist attacks that significantly impact the agency’s ability to sustain activities.</p> <p><u>Integration/Alignment of Information Technology (IT) Infrastructure</u> – The risk that key business activities are supported by IT infrastructure unsuited to their business purpose (for example, too fragile, slow, expensive, unsecured) or that staff who architect and maintain the infrastructure are not aware of and included in strategic plans impacting the business activities and supporting infrastructure.</p> <p><u>Sensitivity of Data</u> – The risk that the organization will divulge, inappropriately use, or fail to control customer data which is confidential or private.</p> <p><u>Level of System or Application Documentation</u> – The risk that the organization’s software applications or systems are inadequately documented. To the extent that the department’s software has been highly customized or is modified frequently this risk may increase.</p>

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Appendix B—Supplement 3: Risk Assessment Components and Considerations	
Technology Risks	
Rating	Rating Examples
High (3 points)	The infrastructure supporting key information systems is unstable, outdated, or undersized to support the size and nature of computing activity. The computing environment is large with numerous complex tools and facilities used in provision of service. A number of applications or subsystems are supported in the environment. Security and change controls systems are complex, nonstandard and administered in a decentralized manner. The types of production activities are complex and “mission critical”. Errors could have significant impact on customer service and quality of decision-making information. The nature of information managed is subject to significant privacy and security concerns—the violation of which could result in regulatory or legal consequences.
Medium (2 points)	The infrastructure supporting key information systems is reasonable to support the size and nature of computing activity. Multiple moderately complex tools and facilities are used in the provision of service and security and change control systems are somewhat standardized and administered by qualified staff with consistent procedures. The type of production activities may include routine as well as complex transactions, and errors would have moderate impact on customer service and quality for decision-making information. Systems breakdowns or processing delays would somewhat disrupt operations. Incorrect system information would cause inaccurate conclusions that would be relied upon for management purposes. The nature of the information managed is subject to moderate privacy and security concerns.
Low (1 point)	The infrastructure supporting key information systems is clearly adequate to support the size and nature of computing activity. Few and relatively simple tools and facilities are used in the provision of service and security, and change control systems are standardized and centrally administered. The type of production activities are generally routine, and errors would be quickly identified and have limited impact on the quality of decision-making information. Systems breakdowns would be an inconvenience for customers and business users. The nature of information managed is not subject to privacy or other security concerns.

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Fraud Risks	
Description	The risk of loss due to intentional misappropriation of assets or intentional misstatement of financial reporting.
Considerations	<p><u>Fraudulent Financial Reporting</u> – The risk that fraudulent financial reporting schemes involving earnings management arise from improper revenue recognition, overstatement of assets, or understatement of liabilities.</p> <p><u>Misappropriation of Assets</u> – The risk that an employee engages in external and/or internal schemes, such as embezzlement, payroll fraud, and theft. Characteristics of assets that are more susceptible to misappropriation include: large amounts of cash on hand or cash processed; inventory characteristics such as small size, high value or high demand; easily convertible assets; fixed asset characteristics such as small size, marketability, or lack of ownership identification.</p> <p><u>Expenditures and Liabilities for Improper Purposes</u> – The risk that an agency engages in commercial or public bribery, as well as other improper payment schemes.</p> <p><u>Fraudulently Obtained Revenue and Assets, and Costs and Expenses Avoided</u> – The risk that an agency commits a fraud against its employees or third parties, or when an agency improperly avoids an expense, such as tax fraud.</p> <p><u>Internal Fraud</u> – The risk that business activities process transactions or are responsible for assets with a high potential for employee fraud and theft (for example, teller transactions, deposit account suppression, information theft, etc.). The business activity could be directly or indirectly involved in monitoring and identifying fraud.</p> <p><u>Misconduct/Abuse</u> – The risk that transactions or activities could be susceptible to management and/or officer override (for example, intellectual capital, conflicts of interest, code of ethics violations, nepotism, accepting bribes or kickbacks etc.). Unit could be directly or indirectly involved in monitoring and identifying misconduct and/or abuse.</p> <p><u>External Crime</u> – The risk that areas and activities could be exposed to external theft and destruction (for example, employee safety, robbery, asset/information theft, etc.). Unit could be directly or indirectly involved in monitoring and identifying external crime.</p> <p><u>External Fraud</u> – The risk that transactions and activities could be exposed to external fraud (for example, check frauds and kiting, false credit/customer information, etc.). Unit could be directly or indirectly involved in monitoring and identifying external fraud.</p>
Rating	Rating Examples
High (3 points)	Assets, transactions, information, and/or overall unit process have significant value and are easily transported and disposed of; therefore, highly attractive targets of fraud. Risk increases substantially with highly liquid assets that are easily converted to cash or with poor controls related to assets or funds, including investment pools and pension funds. Overall processing is complex and highly judgmental, resulting in frequent or high-value overrides and exceptions. Incidents of loss could cause a serious financial or customer/vendor impact and significant embarrassment. Damage to the agency’s reputation would result.
Medium (2 points)	Assets, transactions, information, and/or overall unit process have moderate value and are somewhat transferable. Overall processing is moderately complex, resulting

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Fraud Risks

	in infrequent overrides and exceptions. Incidents of loss are unlikely to create serious financial impact, although reputation impact may be significant.
Low (1 point)	Assets, transactions, information, and/or overall unit process have limited value and are relatively simple. Assets are not easily transferred, and overrides of procedures are infrequent and small. Incidents of loss are minimal and unlikely to cause significant impact.

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Appendix B—Supplement 3: Risk Assessment Components and Considerations Public or Political Sensitivity (Reputation) Risks	
Description	The sensitivity of the unit to public exposure of any internal issues and the level of public embarrassment that could be caused to the agency as a whole.
Considerations	<p><u>Inherent Reputation Risks</u> – The primary mission of the unit or process requires it to interact with the general public and is heavily dependent on customer satisfaction from external units in the agency and from members of the general public.</p> <p><u>Environmental or Life Safety Risks</u> – The primary mission of the agency requires the agency as a whole to interact with the general public or to be heavily dependent on customer satisfaction. This risk increases if the unit and/or agency has high visibility with the general public (for example, impacts children, medical services, public health, safety, etc). Risk is compounded if the unit may be accused of <i>untimely or improper response that could result in death or severe injury to the public</i> (first responders, crisis hotline operators, lifeguards, emergency medical technicians, domestic violence or child abuse investigators) or of <i>neglect or abuse</i> (day care centers, boarding schools, clinics, mental hospitals, elder care facilities, mental institutions, jails, prisons, juvenile justice facilities, etc.) Risk increases if there is any probability of sexual exploitation, or abuse or neglect of children or elders or if such incidents have occurred in the program.</p> <p><u>Integrity</u> – The perception that the agency and/or unit has not operated with integrity in the past or lacks oversight and appropriate mechanisms to ensure that employees are acting in an ethical manner.</p> <p><u>Prior Incidents</u> – The agency or unit's prior experience in uncovering unethical or improper activities and its role in making these activities public and putting fixes into place.</p>
Rating	Rating Examples
High (3 points)	<p>The agency or unit has had press or prior public audits or reviews that resulted in a large amount of negative publicity for the agency. Failure to perform activities timely or correctly could result in life safety consequences. Current policies and procedures do not indicate that management is prepared to address negative publicity or to deal effectively with findings and issues if discovered internally. The agency does not have a good reputation in the state for acting ethically or for dealing effectively with problems as they arise.</p> <p><u>Note that if the auditable unit's operations result in a potentially or actually hazardous work environment or if the potential threat to the public or environment is high due to the nature of operations, this risk should always be rated as "High".</u></p>
Medium (2 points)	The agency or unit has had some press or prior public audits or reviews that resulted in a moderate amount of negative publicity for the agency. Current policies and procedures indicate that management has some plans to deal with findings and issues, but weaknesses exist in these procedures.
Low (1 point)	The agency or unit has not had any press or prior public audits or reviews that resulted in negative publicity for the agency. Current policies and procedures indicate that management has strong plans to deal with findings and issues if brought to light. The agency has a reputation for acting ethically and for dealing

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NORTH CAROLINA INTERNAL AUDIT PROGRAM

Appendix B—Supplement 3:
Risk Assessment Components and Considerations

Public or Political Sensitivity (Reputation) Risks

effectively with problems as they arise.

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Appendix B—Supplement 3: Risk Assessment Components and Considerations	
Strategic Risks	
Description	The risk that work performed is no longer justified. Or, if justified, the risk that business objectives will not be achieved because business strategies are poorly defined and communicated, or the organization is unable to execute these strategies due to inadequate organizational structure, infrastructure, or alignment. Strategic risk is managed by appropriate organizational governance. Failure to adequately plan and execute against organizational goals may result in significant damage to the organization’s reputation.
Considerations	<p><u>Failure to Stop Work that is No longer Justified</u> – The risk that activities will continue in spite of alternative approaches that will achieve the same result at no or lower cost to the state.</p> <p><u>Lack of Performance Measurement</u> – The risk of operating without metrics for gauging units of services or work (outputs) produced and for determining results or effectiveness (outcomes).</p> <p><u>Insufficient or Inadequate Strategic Planning</u> – The risk that an inefficient and ineffective strategic planning process, including poor assumptions, results in sub-optimal business strategies and direction.</p> <p><u>Ineffective Organizational Structure and Alignment</u> – The risk of not organizing and aligning the various business lines and top-level objectives in an organizational structure that avoids uncoordinated and/or counterproductive activities.</p> <p><u>People or Key Resources</u> – The risk that barriers (for example, high turnover, inexperienced staff/skill limitations, excessive reliance on a key staff member, insufficient staffing/resources, etc.) can increase business risk impact and likelihood of its occurrence.</p> <p><u>Organization Reputation</u> – The risk that the agency’s reputation could be exposed based on lack of customer satisfaction with products or services; negative public reaction due to identified regulatory or legal issues; inability to change as technology changes; and, inability to add value, whether financial or nonfinancial.</p>
Rating	Rating Examples
High (3 points)	The unit is continuing to operate without periodically determining whether the work is still justified or could be performed at lower or no costs. Management cannot prove a demonstrable link between what the unit is doing and results beneficial to the agency and ultimately the state. Alternatively, the business process/unit has major impact on the agency’s primary strategic objectives or initiatives. Business process and operating environment are experiencing significant changes, either in process or management. Because of change or growth, the unit’s infrastructure is outdated or inadequate to support its purposes. Inappropriate management decisions or poor communication of objectives may lead to significant damage of reputation. There is no system for gauging units of services or work (outputs) and for determining results or effectiveness (outcomes). Outputs are estimated and outcomes are defined anecdotally or are unknown. Managers and employees are not held accountable for achieving measurable performance objectives.
Medium	The business unit contributes to the performance of the agency; although there may

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NORTH CAROLINA INTERNAL AUDIT PROGRAM**

Appendix B—Supplement 3: Risk Assessment Components and Considerations	
Strategic Risks	
(2 points)	<p>be alternative lower cost approaches that have not been considered. The business process/unit has moderate impact on the agency’s primary strategic objectives or current management initiatives. Business process and operating environment may experience some changes, but infrastructure is adequate to support the unit’s purposes. The purposes of the unit are reasonably well understood. There is a limited system for gauging units of services or work (outputs) that covers some activities and some results or effectiveness (outcomes). The measures are not comprehensive, may not be measurable, and are used primarily for external reporting if required by state or federal law. Managers and employees use performance measures on a limited basis but do not use them for employee or manager accountability.</p>
Low (1 point)	<p>The business unit has periodically determined that what it does is still justified and is performed more economically compared to alternative approaches. Management has proved a demonstrable link between what the business unit is doing and results beneficial to the agency and ultimately the state. The business process/unit has limited impact on the agency’s primary strategic objectives or current key initiatives. Business process and operating environment are generally stable, and infrastructure is adequate to achieve the unit’s purposes. The objectives of the unit are clear and widely understood. Performance measurement is comprehensive, extensive, and exceeds federal and state legal requirements. The unit gauges units of services (outputs), and at regular intervals measures and reports results or effectiveness (outcomes), and uses performance measures when reviewing job performance of supervisors and managers.</p>

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This section shows an example of an internal audit annual plan. Internal auditors should consider adding to or modifying this as needed, but should ensure that their final plan contains the elements identified below.

**Appendix B – Supplement 4:
Sample Internal Audit Plan**

**DEPARTMENT NAME
FISCAL YEAR 200X-200Y**

Section One: Internal Audit Division Organization Chart and Resources

In this section, the internal audit should include an organizational chart that reflects the position of the internal audit department and the chief audit executive in the organizational structure. Also, indicate the head of the agency and whether the state agency has another governing body (such as in the case of the universities or community colleges).

Note that “Figure A” shows the organization chart for an in-house internal audit function, while “Figure B” shows the organization chart for a contracted internal audit position using the Office of Internal Audits staff.

Figure A

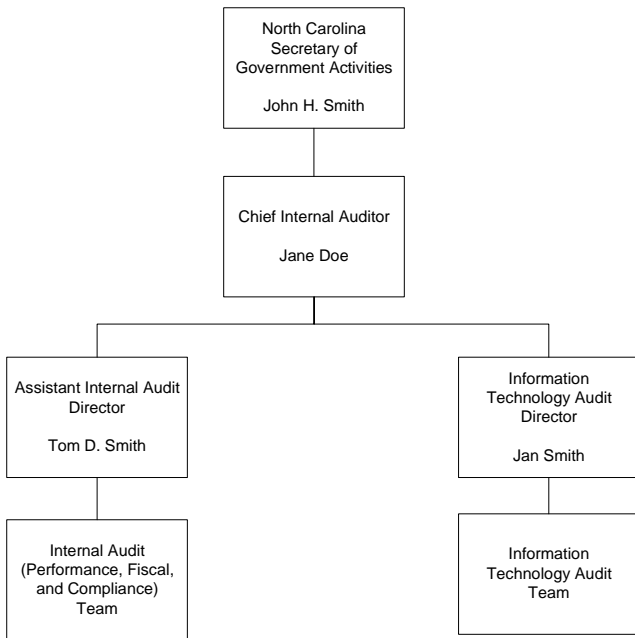
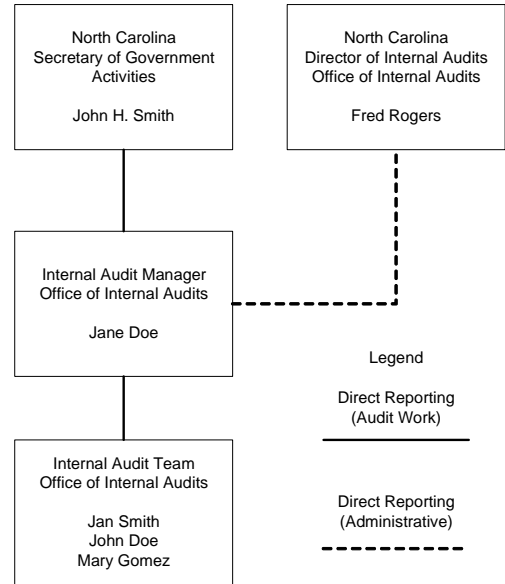


Figure B



Internal audit resources: *In this section, the plan should give a brief overview of the number and type of staff and any subdivisions or units within the internal audit section. This section should also describe the extent to which the department is using the Office of Internal Audits resources.*

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- The internal audit division, headed by Chief Internal Auditor Jane Doe has two divisions headed by Internal Audit Manager IIs (Tom D. Smith and Jan Smith).
- The general internal audit section has three Internal Auditor Is, four Internal Auditor IIs, and seven Internal Audit Trainees.

Section Two: Risk Assessment Component Definitions

In this section, describe the risk assessment components used. These should include the components described in Appendix B at a minimum, as well as any additional risk components deemed necessary for consideration by the state agency.

As part of audit planning, the Internal Audit division performs a risk assessment analysis of all units to identify the potential areas of high risk throughout the agency. The following figure identifies the types of risks assessed annually by the internal audit team.

Risk Components
Financial Risks: The risk that financial reporting is inaccurate, incomplete, or untimely due to a variety of factors, including errors, changes in accounting standards, or the pressure on management to meet financial expectations.
Operational Risks: The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events.
Criticality of the Auditable Unit to the Agency: The importance of the unit to the agency's ability to continue to function and carry out its primary mission.
Legal or Compliance Risks: The risk of direct or indirect funding loss from failure to follow regulations and directives.
Technology Risks: This risk considers the level of use, sophistication, complexity, robustness, ease of use, and speed or accuracy of recovery/replacement of systems or applications.
Fraud Risks: The risk of loss due to intentional misappropriation of assets or intentional misstatement of financial reports.
Public or Political Sensitivity: The sensitivity of the unit to public exposure of any internal issues and the level of public embarrassment that could be caused to the agency as a whole.
Strategic Risks: The risk that business objectives will not be achieved because business strategies are poorly defined and communicated or the organization is unable to execute these strategies due to inadequate organizational structure, infrastructure, or alignment.

Section Three: Internal Audit Plan for Fiscal Year 200X-200Y

In this section, provide a brief description of the audit area or auditable unit to be reviewed and a summary of the key objectives for each project.

The following represents the agency's internal audit plan for fiscal year 200X-200Y.

Title	Scope/Objectives
Financial Audit – Field Office 1	Review of Field Office 1's cash procedures (specifically, compliance with segregation of duties and depositing large sums of cash).
Internal Control Review – Agency Personnel	Review of the agency's internal controls over entering leave data into the payroll system.
Performance Audit – Meal Vouchers Program	Follow-up to state auditor's report on provision of meal vouchers to qualifying individuals.
Efficiency/Economy Review – Field Offices 3 and 5	Review to determine the need for having two field offices in the same town and whether the offices' operations can be combined to

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Title	Scope/Objectives
	realize savings.
Compliance Review – Title X Requirements	Review of agency’s data entry procedures to determine whether they comply with Federal Title X requirements (preparation in anticipation of federal review during 2007-08).
Investigative Audits – Ongoing	Ongoing review of matters reported through agency’s whistleblower Web site.

Section Four: Results of Prior Year Audit Activities

In this section, provide a description of the summary of issues from the prior year that were scheduled to be reviewed, the status of the activities, and any deviations or additions to the plan.

Title	Status	Scope	Status of Management Response
Financial Audit - Field Office 3	Complete	Reviewed the financial operations for field office 3.	Finding One: resolved. Finding Two: field office manager disagrees, went to agency head for review.
Internal Control Review – Agency Personnel	In Progress	Review process of ensuring that leave slips have been properly reviewed and approved before entry.	n/a
Performance Audit – Meal Ticket Program	Complete	Reviewed the department’s production for numbering meal tickets sequentially.	All findings implemented, resulted in net savings of \$11,245 for this year.
Efficiency/Economy Review – Field Offices 2, 4, and 6	Complete	Review of operations to determine whether efficiencies can be gained in combining operations.	Finding One: Moved staff from offices 4 and 6 to office 2, cut back on three vacant positions, estimated savings \$96,432. Finding Two: Management is implementing.
Compliance Review – Title XI Requirements	Pending	Review in anticipation of federal audit in fiscal year 2007-08 of agency’s compliance with Title XI requirements.	On hold pending clarification from the federal oversight agency.
Investigative Audits – Ongoing	Ongoing	Ongoing review of matters reported through agency’s whistleblower Web site.	Findings resulted in three employee actions and one termination. Legal department is seeking recovery of misused funds.
New (not part of last year’s plan): Efficiency/Economy Review – Phone Calls	Complete	Review of department’s control over the use of long-distance phone calls (came to attention as a result of investigative audit).	Identified issues that resulted in implementation of phone cards for long-distance calls. Estimated savings of \$1,345 for the administrative offices.

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Title	Status	Scope	Status of Management Response
New (not part of last year's plan): Efficiency/Economy Review – Parking	Complete	Review of parking issues (came to attention as a result of investigative audit).	Identified issues with controls over parking meters, resulted in new locks added to parking structure payment box and possible reduction in misused cards.

Section Five: Performance Metrics

In this section, provide data for specific metrics as shown in the examples below.

Measure	Results	Notes / Explanations										
Output Percent of audits identified as high risk in the audit plan that were completed.	50% (three high risk audits completed out of six planned)	Two areas not considered for audit during last year's plan came to attention of management and the internal auditor during the year. These were deemed to be of higher risk than three of the planned audits.										
Output Number of total available hours spent on unanticipated and/or unscheduled activities.	3,500	Hours were redirected to provide technical assistance to the fiscal review team in anticipation of federal oversight agency visit. Also, redirected staff due to two new high-risk audit areas.										
Outcomes Percent of recommendations implemented within one year.	60% (six out of ten recommendations from prior year's audits)	Management is contesting two of the recommendations; internal audit team is working to resolve this issue. Other two recommendations were dropped due to new legislation.										
Outcomes Usefulness of recommendations to Director.	92%	Internal audit survey revealed 92% satisfaction rating.										
Efficiency Number of audits conducted per staff member.	35.7% (five audits completed, 14 staff)	Anticipate this increasing next year due to high number of new hires this year.										
Efficiency Average number of hours consumed per audit type.	<table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left;">Audit Type</th> <th style="text-align: right;">Average Number of Hours</th> </tr> </thead> <tbody> <tr> <td>Financial</td> <td style="text-align: right;">168.2</td> </tr> <tr> <td>Internal Control</td> <td style="text-align: right;">75.3</td> </tr> <tr> <td>Performance</td> <td style="text-align: right;">253.4</td> </tr> <tr> <td>Efficiency/ Economy</td> <td style="text-align: right;">143.5</td> </tr> </tbody> </table>	Audit Type	Average Number of Hours	Financial	168.2	Internal Control	75.3	Performance	253.4	Efficiency/ Economy	143.5	
Audit Type	Average Number of Hours											
Financial	168.2											
Internal Control	75.3											
Performance	253.4											
Efficiency/ Economy	143.5											

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Measure	Results		Notes / Explanations
	Compliance	48.9	
	Investigative	29.5	

Section Six: External Quality Assurance Review (Peer Review)

In this section, provide a copy of the most recent external quality assurance review's executive summary or a summary of issues and the status for resolution. If no peer review has been conducted, provide a description of the agency's plan to obtain a peer review to ensure compliance with standards. If the peer review has resulted in a qualified opinion, the findings, recommendations, and the internal audit unit's status of addressing the recommendations should be presented below.

Date of last peer review: May 4, 200x

Type of opinion: Unqualified

Date next peer review is due: May 4, 201x

The peer review report is attached as an addendum to this report.

APPENDIX C

INTERNAL AUDITOR PROFESSIONAL QUALIFICATIONS



**APPENDIX C
INTERNAL AUDITOR
PROFESSIONAL QUALIFICATIONS**

Introduction

According to the Institute of Internal Auditing’s (IIA’s) manual, *Establishing an Internal Audit Activity*, one of the most significant challenges agencies face in establishing internal audit functions is to attract, develop, and retain highly specialized and qualified staff. This section of the report provides guidance for North Carolina to assist the state in staffing the internal audit function within state agencies, and provides guidance on the required qualifications that internal auditors should possess. This section also contains MGT’s recommendations related to creating job classifications within the state’s personnel system that meet best practice recommendations for minimum standards for internal auditors.

The chart below contains questions and answers regarding these requirements and standards.

Question	Response
Do professional standards specify any minimum education or experience levels for internal auditors?	No. Neither <i>Government Auditing Standards</i> nor IIA’s Professional Practices Framework specify minimum education or experience levels for internal auditors. However, both sets of standards require that audits be performed by staff possessing the knowledge, skills, and other competencies to perform their individual responsibilities. The IIA has published a manual entitled, <i>Establishing an Internal Audit Activity</i> , that contains model job descriptions for internal auditors.
Should internal auditors have mainly “accounting” or “finance” educational backgrounds?	No. The IIA recommends that in staffing internal audits, staffing strategies should result in internal audit teams that possess the skills necessary to meet agencies’ objectives. This means that internal auditors should not be drawn solely from candidate pools with accounting backgrounds. Auditors conducting performance audits do not need to have an accounting background to identify cost savings opportunities. Internal auditing can result in auditors performing a variety of services. Types of services that internal auditors may provide are: <ul style="list-style-type: none"> • Assurance Services: Objective examinations of evidence to provide an <i>independent assessment</i> on risk management, control, or governance processes for the agency. Assurance services can include: <ul style="list-style-type: none"> – Financial audits of the agency’s accounting statements or methodologies. – Internal control reviews of the department’s controls related to financial reporting. – Management or performance audits of the agency’s units, programs, activities, or functions. – Efficiency or economy reviews to evaluate areas in need of

**APPENDIX C: INTERNAL AUDITOR PROFESSIONAL QUALIFICATIONS
NORTH CAROLINA INTERNAL AUDIT PROGRAM**

Question	Response
	<p>improvement to help increase operating effectiveness, efficiency, or to realize economies.</p> <ul style="list-style-type: none"> - Compliance audits or reviews to assess compliance with one or more sets of laws and regulations. - Investigative or fraud audits to determine whether suspected illegal or inappropriate activities have occurred. <ul style="list-style-type: none"> • Consulting Services: Advisory services to add value and improve an agency's governance, risk management, and control processes without the internal auditor assuming management responsibility. (Note: Professional standards [Yellow Book and IIA] prohibit internal auditors from assuming management responsibilities or auditing their own work. Therefore, internal auditors should use caution in providing nonassurance services). <p>The nature of either the assurance or consulting service being performed by the internal auditor will dictate the skill levels, experience, and education needed.</p> <p>Note: The IIA does not require that internal auditors need to be qualified in all disciplines and appears to allow for a wide variety of degrees and backgrounds for internal auditors. Some of the disciplines that it includes in its practice advisories touch on such varied topics as economics, finance, statistics, information technology (IT), engineering, taxation, law, accounting, auditing, and environmental affairs.</p> <p>Ideally, the internal audit activity should comprise individuals with diverse backgrounds, skill sets, and experience to provide adequate skill sets to conduct a variety of types of audits.</p>

Below, we discuss the issues identified with the state's current internal auditor job classifications, and recommend changes to the structure to align with best practices.

Current Internal Auditor Job Classifications

North Carolina's current job classification scheme for internal auditors consists of two journey-level, and three management-level audit classifications, as shown in Figure C-1 on the following page.

The review of the current job classification structure found several issues that the state should address to ensure that the internal auditor job classifications align with best practices. These issues are as follows:

- **No entry level classification:** The current classification allows internal auditors to enter into the career path only after having a minimum number of years experience in conducting financial accounting or auditing. This does not allow for the development of internal auditors throughout the spectrum of their full career path and does not acknowledge that auditing is not solely financially-based work.
- **Heavily weighted for finance or accounting candidates:** North Carolina's job classifications for internal auditors, which are weighted heavily towards

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accounting candidates, may preclude qualified individuals from entering the internal auditing field. Best practices research indicates that qualified internal audit candidates may have education and experience in fields other than accounting or finance, such as tax, law, environmental affairs, or economics.

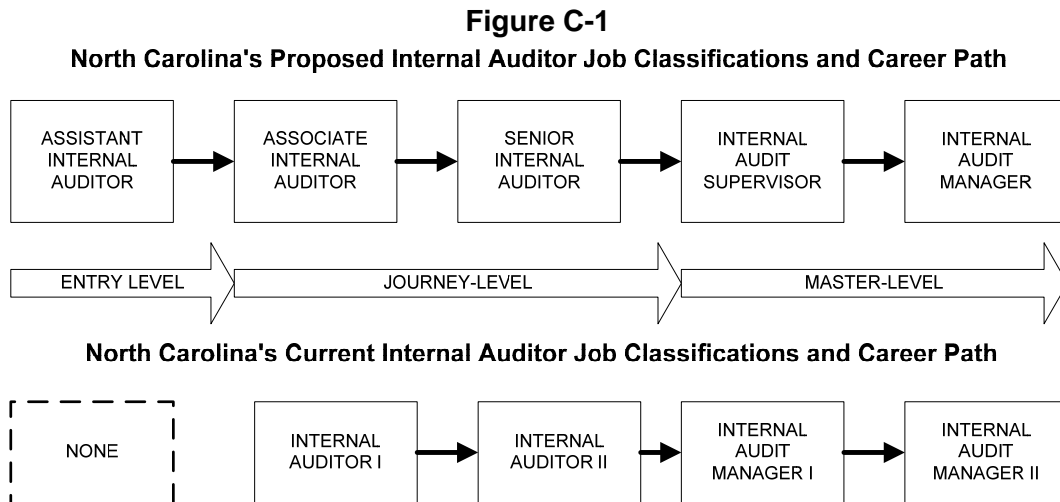
- **Education levels are insufficient:** The current structure allows entry into the internal audit field for candidates with two-year (associate's) degrees in accounting. This does not comply with best practice recommendations, which indicate that, at a minimum, internal audit candidates should possess at least a four-year degree from an accredited college or university. The two-year degree is too focused on accounting and bookkeeping and does not expose the candidate to a wide variety of topics and classes to result in a sufficiently well-rounded candidate possessing the requisite knowledge and education needed to perform the internal audit function.

Proposed Internal Auditor Job Classifications

Based on best practice research, the recommended internal auditor career path will do the following:

- Align North Carolina's scope of internal audit activities *and* staff skills with that envisioned in industry standards.
- Facilitate entry to the career path of internal auditing by creating an entry-level apprentice position available to candidates graduating from college.
- Enhance, encourage, and promote the flow of valuable experience from outside the state system into the IIA career path by removing barriers to entry for outside candidates at all levels of the career path.

Figure C-1 below illustrates the proposed internal auditor career path compared to the current internal auditor classifications.



The proposed job classification encompasses the full spectrum of the internal auditor career path. Additionally, the new classification scheme takes into account factors beyond experience that play a part in differentiating the various levels. Movement from

**APPENDIX C: INTERNAL AUDITOR PROFESSIONAL QUALIFICATIONS
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the entry-level to journey-level stage of the career path is dependent on experience, technical skills, and knowledge. Movement from the journey-level to master-level, however, is more dependent on knowledge, management abilities, and strategic planning skills.

Figure C-2 below illustrates the main ways that each career step is distinguished from the preceding step.

**Figure C-2
Movement Within the Internal Auditor Career Path**

Internal Auditor Career Step	Chiefly Distinguished from Prior Step By:
Assistant Internal Auditor	n/a
Associate Internal Auditor	<ul style="list-style-type: none"> • Level of education. • Types of audit experience (financial, compliance, investigative, etc.). • Number of years of experience. • Certifications, such as the Certified Public Accountant (CPA), Certified Internal Auditor (CIA), etc.
Senior Internal Auditor	<ul style="list-style-type: none"> • Ability to work on more complex audits. • Number of years of experience. • Ability to work independently. • Ability to supervise small internal audit teams.
Internal Audit Supervisor	<ul style="list-style-type: none"> • Number of years of experience. • Ability to supervise wide variety of internal audit engagement types, of varying complexity levels (simple to highly complex) and audit team sizes (small to large).
Internal Audit Manager	<ul style="list-style-type: none"> • Breadth of audit experience. • Number of years of experience. • Strategic planning abilities.

The job classification descriptions are provided at the end of this appendix. However, discussed below are some specific areas within the classification, and how they differ from level to level. Further, contained within the job classification descriptions at the end of this appendix are requirements that will allow for the migration from staff in existing internal auditor classifications to the new structure if the staff possess the requisite skills, knowledge, education, and experience.

Education and Experience

Best practices research of IIA publications, other state entities, and data collected by IIA’s Global Audit Information Network (GAIN) indicate that the preferred (and often required) minimum education level for internal auditors is a bachelor’s (four-year) degree from an accredited college or university.

**APPENDIX C: INTERNAL AUDITOR PROFESSIONAL QUALIFICATIONS
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Many internal audit job descriptions specify that the candidate possess a major in accounting or finance, even though survey data collected by GAIN indicates that this often may not be the preferred candidate for an internal audit function. That is, highly qualified internal auditors can have degrees in other fields, such as business administration, public administration, public policy, tax, law, or economics.

The experience levels of the proposed internal auditor job classifications vary depending on the job classification. However, it is not only *years* of experience that are important, but the *types* of experience that are key. As auditors progress, they should become familiar with, and gain experience conducting, a variety of types of audits (financial, compliance, investigative, performance, efficiency, and economy, etc.). Supervisors and managers will need to ensure that in making staff assignments they are providing training and development opportunities for staff to gain this exposure. Further, auditors progressing in the career path should gain experience in performing more challenging, technically complex internal audit work. Auditors at the “Senior Internal Auditor” level should also be given opportunities to manage small teams of junior level staff as preparation for transitioning to a supervisory or management role.

Figure C-3 below identifies the experience requirements for each of the proposed classifications, as well as qualifications that can substitute for experience.

**Figure C-3
Experience Requirements for Proposed Internal Auditor Classifications**

Job Title	Experience
Assistant Internal Auditor	None required.
Associate Internal Auditor	At least two years.
Senior Internal Auditor	At least four years.
Internal Audit Supervisor	At least six years experience. At least two years of audit supervisory experience.
Internal Audit Manager	At least eight years experience. At least four years of audit supervisory experience.
Qualifications That Can Substitute for Experience:	
A certification as a Certified Internal Auditor (CIA), Certified Information Systems Auditor (CISA), Certified Fraud Examiner (CFE), or Certified Public Accountant (CPA) may substitute for one year of required experience.	
A graduate degree in accounting, auditing, business administration, public administration, public policy, or a related field may substitute for one year of required experience.	
No more than two years of experience can be substituted at any level for a certificate or degree.	

The job classification descriptions at the end of this appendix contain recommended experience and skill sets that will allow for entry into the North Carolina internal audit career path for candidates coming from outside the state government structure.

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The IIA and best practices also have established recommendations regarding preferred qualifications. These include certifications such as CPA, CIA, CISA, Certified Government Financial Manager (CGFM), or CFE certifications, or graduate-level degrees. Agencies may also need to establish preferred qualifications on a position-by-position basis depending on the type of work and the agency's operating environment. For example, agencies with a heavy focus on financial accounting and reporting, especially from grantees or subcontractors, may wish to have a candidate with a CPA certification and/or a four-year degree in accounting. Other agencies may need other skills, such as sociology backgrounds, research, data analysis, or IT experience and education.

Required Knowledge, Skills, and Abilities

Auditors need to be able to perform a wide variety of work that may involve moderate to high levels of complexity depending on the project. Generally, internal auditors at all levels need to be able to demonstrate certain knowledge, skills, or abilities. For example, as part of IIA's *Professional Practices Framework*, IIA recommends that internal auditors be skilled in dealing with people and communicating effectively—both in oral and written communications—so that they can clearly and effectively convey audit matters and maintain satisfactory relationships with agency staff.

Additionally, as part of the *Professional Practices Framework*, IIA recommends that internal auditors have the proficiency to carry out their audit work. The IIA defines “proficiency” for internal auditors, as requiring them to possess certain knowledge skills and other competencies. These include:

- Proficiency in applying internal auditing standards, procedures, and techniques. Proficiency means the ability to apply knowledge to situations likely to be encountered and to deal with them without extensive recourse to technical research and assistance.
- An understanding of management principles. An understanding means the ability to apply broad knowledge to situations likely to be encountered, to recognize significant deviations, and to be able to carry out the research necessary to arrive at reasonable solutions.
- An appreciation of the fundamentals of such subjects as accounting, economics, law, taxation, finance, quantitative methods, and IT. An appreciation means the ability to recognize the existence of problems or potential problems and to determine that further research be undertaken or that assistance be obtained.
- Proficiency in accounting principles and techniques (for internal auditors working extensively with financial records and reports).

Transition for Internal Auditors in Existing Classifications

The table shown at the end of this appendix details qualifications required for internal auditors at each stage of their career path. Included in the “experience” row is information on how existing internal auditors can transition to the new classifications.

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Director of the Proposed Office of Internal Audits

Appendix F of this report recommends creation of a proposed shared internal audit pool located within the Office of Statewide Budget and Management. This proposed Office of Internal Audits will be headed by a Director who will oversee the administrative operations of this office as well as supervise and guide the staff within the office.

The director will need to oversee staff that could include Internal Audit Manager classifications. This is because the proposed office will need staff at these higher classification levels to conduct internal audit risk assessments and audit planning for the state agencies using the office's services.

The Director of the Office of Internal Audits has the same qualifications as those identified for the Internal Audit Manager classification in the following pages, with the exception of those qualifications listed under "Experience". Because the director will have added administrative responsibilities, and will be supervising and evaluating employees in the Internal Audit Manager classification, we have proposed the following experience levels for the director:

Two years experience working as an Internal Audit Manager.

OR

For candidates transitioning from the state's current internal auditor classification:

At least one year of experience working in the Internal Audit Manager II or Internal Audit Manager III job classification.

OR

For candidates coming from outside the North Carolina state personnel system:

Eight years of increasingly responsible professional auditing or management consulting experience which must have involved the preparation of reports and presentations of recommendations to management. For at least one of these years, the responsibilities must have included duties at a level equivalent to that of an Internal Audit Manager. At least four of these years must have included management or supervision of auditing or consulting activities. At least two of these years must have included overseeing and administering the activities of a medium to large-sized internal audit function.

With the added administrative responsibilities and experience, the salary range for the Director of the Office of Internal Audits is proposed to fall into the North Carolina Office of State Personnel's salary grade of 82, slightly higher than grade 80 as recommended for Internal Audit Managers.

Figure C-4 on the following page identifies the proposed internal auditor classifications and associated salary levels, including estimated benefits.

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**Figure C-4
Proposed North Carolina Internal Auditor Classifications and Salary Ranges**

Internal Auditor Staff Level (Job Classification)	Salary Grade	Minimum Salary	Maximum Salary	Maximum Salary with Benefits^a
Assistant Internal Auditor	69	\$34,216	\$55,116	\$68,840
Associate Internal Auditor	72	\$38,530	\$63,044	\$78,742
Senior Internal Auditor	75	\$43,641	\$72,316	\$90,323
Internal Audit Supervisor	78	\$49,830	\$83,020	\$103,692
Internal Audit Manager	80	\$54,539	\$91,034	\$113,701
Director of the Office of Internal Audits	82	\$59,606	\$99,932	\$124,815

Source: MGT of America, Inc. proposed classifications, Appendix C: Internal Auditor Qualifications.

- a Benefits estimated at approximately 24.9 percent of total salary, and includes retirement, taxes, unemployment, and insurance costs paid by the state.

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Assistant Internal Auditor	Associate Internal Auditor	Senior Internal Auditor	Internal Audit Supervisor	Internal Audit Manager
Proposed North Carolina Office of State Personnel Salary Grade				
69 (\$34,216 - \$55,116)	72 (\$38,530 - \$63,044)	75 (\$43,641 - \$72,316)	78 (\$49,830 - \$83,020)	80 (\$54,539 - \$91,034)
Reports To				
Senior Internal Auditor or above.	Senior Internal Auditor or above.	Internal Audit Supervisor or above.	Internal Audit Manager or head of the agency and/or those charged with governance.	Head of the agency and/or those charged with governance.
Supervises				
None	None	Assistant Internal Auditor Associate Internal Auditor	Assistant Internal Auditor Associate Internal Auditor Senior Internal Auditor	All internal audit staff.
Basic Job Description				
This is the recruiting, training, and development class for persons qualified to learn, under close supervision, internal auditing methods. This person will perform entry-level internal auditing work (simple performance, financial, management and/or compliance audits), working under extensive supervision, and with limited latitude for initiative and independent judgment.	This is the first journeyman level requiring independence and proficiency in handling moderately complex and difficult internal audit assignments. This person will perform professional internal auditing work (low to moderately complex performance, financial, management and/or compliance audits), working under limited to moderate supervision, with moderate latitude for initiative and independent judgment.	This is the final journeyman level in the internal auditor career path requiring independence and proficiency in handling complex, advanced, and difficult internal auditing assignments. This person will perform highly complex professional internal auditing work independently or under general supervision with considerable latitude for initiative and independent judgment. This person may also supervise and direct the work of a group of audit teams performing the less complex internal audits.	This is the first master-level (management) classification in the internal auditor career path. This person is responsible for planning, organizing, and directing the work of groups of audit teams performing a variety of internal audits of the state agency. This person may perform advanced level professional internal auditing work, but on a limited basis only. The majority of work requires managing the day-to-day operations of the internal audit office. This person works independently with extensive latitude for initiative and independent judgment.	This person serves as the state agency's most senior internal auditor, functioning as a member of the agency's executive management team. This person reports to the head of the agency. This person is responsible for the long-range planning, directing, and coordinating of internal audit efforts within the agency. This person may perform advanced-level professional internal auditing work or supervise teams of internal auditors, but on a limited basis only. This person works independently with extensive latitude for initiative and independent judgment.
Education				
Same for all job classifications:				
Bachelor's (four-year) degree from an accredited college or university, with a major in accounting, auditing, business administration, public administration, public policy, or a related field. For internal auditors who will work extensively with financial accounts and records, at least 12 semester hours in accounting or auditing is required.				

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Assistant Internal Auditor	Associate Internal Auditor	Senior Internal Auditor	Internal Audit Supervisor	Internal Audit Manager
Experience				
<p>None</p>	<p>Two years experience working as an Assistant Internal Auditor.</p> <p>OR</p> <p><i>For candidates transitioning from the state’s current internal auditor classification:</i></p> <p>At least one year experience working in the Internal Auditor I job classification.</p> <p>OR</p> <p><i>For candidates coming from outside the North Carolina state personnel system:</i></p> <p>Two years of increasingly responsible professional auditing or management consulting experience which must have involved the preparation of reports and presentations of recommendations to management.</p>	<p>Two years experience working as an Associate Internal Auditor.</p> <p>OR</p> <p><i>For candidates transitioning from the state’s current internal auditor classification:</i></p> <p>At least one year of experience working in the Internal Auditor II job classification.</p> <p>OR</p> <p><i>For candidates coming from outside the North Carolina state personnel system:</i></p> <p>Four years of increasingly responsible professional auditing or management consulting experience which must have involved the preparation of reports and presentations of recommendations to management. For at least one of these years, the responsibilities must have included duties at a level equivalent to that of an Associate Internal Auditor.</p>	<p>Two years experience working as a Senior Internal Auditor.</p> <p>OR</p> <p><i>For candidates transitioning from the state’s current internal auditor classification:</i></p> <p>At least one year of experience working in the Internal Audit Manager I job classification.</p> <p>OR</p> <p><i>For candidates coming from outside the North Carolina state personnel system:</i></p> <p>Six years of increasingly responsible professional auditing or management consulting experience which must have involved the preparation of reports and presentations of recommendations to management. For at least one of these years, the responsibilities must have included duties at a level equivalent to that of a Senior Internal Auditor. At least two of these years must have included management or supervision of auditing or consulting activities.</p>	<p>Two years experience working as an Internal Audit Supervisor.</p> <p>OR</p> <p><i>For candidates transitioning from the state’s current internal auditor classification:</i></p> <p>At least one year of experience working in the Internal Audit Manager II job classification.</p> <p>OR</p> <p><i>For candidates coming from outside the North Carolina state personnel system:</i></p> <p>Eight years of increasingly responsible professional auditing or management consulting experience which must have involved the preparation of reports and presentations of recommendations to management. For at least one of these years, the responsibilities must have included duties at a level equivalent to that of an Internal Audit Supervisor. At least four of these years must have included management or supervision of auditing or consulting activities.</p>
Qualifications That Can Substitute for Experience				
<ul style="list-style-type: none"> • A certification as a Certified Internal Auditor (CIA), Certified Information Systems Auditor (CISA), Certified Public Accountant (CPA), Certified Government Financial Manager (CGFM), Certified Government Auditing Professional (CGAP), Certified Fraud Examiner (CFE) or an equivalent related certification may substitute for one year of required experience. • A graduate degree in accounting, auditing, business administration, public administration, public policy, or a related field may substitute for one year of required experience. • No more than two years of experience can be substituted at any level for these qualifications. 				

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Assistant Internal Auditor	Associate Internal Auditor	Senior Internal Auditor	Internal Audit Supervisor	Internal Audit Manager
Types of Work Performed				
<ul style="list-style-type: none"> • Under the extensive supervision of a Senior Internal Auditor or above, typically does the following: • Conducts interviews. • Collects and reviews documents. • Administers surveys. • Identifies or develops criteria. • Reviews and analyzes evidence. • Documents agency processes and procedures. • Prepares working papers. 	<p>Under the general supervision of a Senior Internal Auditor or above, typically does the following:</p> <ul style="list-style-type: none"> • Conducts interviews. • Collects and reviews documents. • Develops and administers surveys. • Composes summary memos. • Identifies, develops, and documents audit issues and recommendations using independent judgment concerning areas reviewed. • Identifies or develops criteria. • Reviews and analyzes evidence. • Documents agency processes and procedures. • Creates written reports of audit findings and recommendations. • Prepares working papers. <p>On a limited or occasional basis:</p> <ul style="list-style-type: none"> • Communicates the results of audit work via oral presentations to agency management. • Assists in identifying and evaluating the organization's risk areas and provides input to the development of the annual audit plan. 	<p>Under the general supervision of an Internal Audit Supervisor, or independently, typically does the following:</p> <ul style="list-style-type: none"> • Same tasks as those listed for the Associate Internal Auditor, plus the tasks listed below. • Identifies and defines criteria for agency-wide or global issues. • Supervises small teams of auditors conducting low to moderately complex audit work. • Conducts quality control reviews of workpapers and audit work products (memos, reports, findings, or recommendations) of subordinate internal audit staff. • Communicates the results of audit work via oral presentations to agency management. • Identifies and evaluates the organization's risk areas and provides key input to the development of the annual audit plan. • Provides consulting-type services (technical assistance, training, etc.) to the state agency's management and staff. • Provides some training and coaching to internal audit staff and may be asked to provide input into annual job assessments. 	<p>Under the general supervision of an Internal Audit Manager, manages internal audit staff in carrying out the day-to-day activities required of the internal audit function. Typically does the following:</p> <ul style="list-style-type: none"> • Provides guidance to audit staff in the identification, development, and documentation of audit issues and recommendations. • Staffs the internal audit work using the annual audit plan, taking into account the need to provide on-the-job training and development for junior-level internal auditors. • Supervises a wide variety of audit team sizes (small to large) and staff conducting low to highly complex audit work. • Conducts quality control reviews of workpapers and audit work products (memos, reports, findings, or recommendations). • Communicates the results of audit and consulting projects via written reports and oral presentations to agency management. • Manages the identification and evaluation of the organization's risk areas and provides major input into the development of the audit plan. • Provides consulting-type services (technical assistance, training, etc.) required by the agency's management and staff. 	<p>Responsible for overseeing the internal audit function within the state agency and directing a comprehensive audit program that includes at least performance, financial, management, and compliance audit projects. Typically does the following:</p> <ul style="list-style-type: none"> • Provides direction and leadership to Internal Audit Supervisors and/or Senior Internal Auditors. • Monitors Internal Audit Supervisors to ensure they are providing sufficient on-the-job training and development to lower-level staff. • Provides general direction in the conduct of internal audit work, and monitors the overall progress of completing planned activities. • Manages the internal audit resources, including ensuring that adequate staff are available to carry out planned activities. • Provides high-level guidance to audit staff in the identification, development, and documentation of audit issues and recommendations. • Approves the final audit reports. • Communicates the results of audit and consulting projects via written reports and oral presentations to agency management.

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Assistant Internal Auditor	Associate Internal Auditor	Senior Internal Auditor	Internal Audit Supervisor	Internal Audit Manager
			<ul style="list-style-type: none"> • Provides training and coaching to internal audit staff and conducts annual job assessments. • Hires, trains, and evaluates staff and takes corrective actions when needed to address performance problems. • Represents internal audit team on agency project teams, at management meetings, or with external organizations. 	<ul style="list-style-type: none"> • Directs the identification and evaluation of the organization's risk areas and is the person responsible for developing, finalizing, approving, and implementing the annual audit plan. • Presents audit plan to agency head for feedback. Responsible for submitting annual audit plan to the Office of State Budget and Management. • Represents internal audit team on agency project teams, at management meetings, or with external organizations. • Conducts annual job assessments of Internal Audit Supervisors. <p>On a limited basis only:</p> <ul style="list-style-type: none"> • Supervises a wide variety of audit team sizes (small to large) and staff conducting low to highly complex audit work. • Conducts quality control reviews of workpapers and audit work products (memos, reports, findings, or recommendations). • Provides consulting-type services (technical assistance, training, etc.) required by the agency's management and staff.

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Assistant Internal Auditor	Associate Internal Auditor	Senior Internal Auditor	Internal Audit Supervisor	Internal Audit Manager
Knowledge, Skills, and Abilities				
<ul style="list-style-type: none"> • Familiarity with basic management information systems terminology, concepts, and practices. • Proficiency in applying internal auditing standards, procedures, and techniques. Proficiency means the ability to apply knowledge to situations likely to be encountered and to deal with them without extensive recourse to technical research and assistance. • Proficiency in accounting principles and techniques (for internal auditors working extensively with financial records and reports). • An understanding of management principles and preferred business practices. An understanding means the ability to apply broad knowledge to situations likely to be encountered, to recognize significant deviations, and to be able to carry out the research necessary to arrive at reasonable solutions. • An appreciation of the fundamentals of such subjects as accounting, economics, law, taxation, finance, quantitative methods, and information technology. An appreciation means the ability to recognize the existence of problems, or potential problems, and to determine that further research be undertaken or that assistance be obtained. 	<ul style="list-style-type: none"> • Same as Assistant Internal Auditor, plus those shown below. • Familiarity with professional standards, including <i>Government Auditing Standards</i> and the Institute of Internal Auditors' <i>Professional Practices Framework</i>. • Familiarity with basic statistics and sampling procedures. • Familiarity with organization and management practices specific to state governmental agencies. • Knowledge of current trends and/or problems in governmental management. • Familiarity with the financial organization and procedures of the state's accounting system (for internal auditors working extensively with financial records and reports). • Familiarity with policies, rules, and regulations of the General Assembly, State Controller, State Treasurer, or other central control agencies as they relate to state agency activities. 	<ul style="list-style-type: none"> • Same as the Associate Internal Auditor, plus those shown below. • Extensive knowledge of and familiarity with professional standards, including <i>Government Auditing Standards</i> and the Institute of Internal Auditors' <i>Professional Practices Framework</i>. • Knowledge of statistics and sampling procedures, including the applications of probability sampling to auditing. • Extensive knowledge of and familiarity with organization and management practices, including program budgeting, specific to state governmental agencies. • Extensive knowledge of and familiarity with principles of electronic data processing, the state's accounting system, and the financial organization and procedures of the state (for internal auditors working extensively with financial records and reports). • Knowledge of the principles and techniques in personnel management and supervision. • Familiarity with methods of auditing through electronic data processing systems (for auditors working extensively with electronic data systems). 	<ul style="list-style-type: none"> • Same as the Senior Internal Auditor, plus those shown below. • Extensive knowledge of and skills in applying management principles and techniques in personnel management and supervision. • Knowledge of auditing techniques and best practices required to complete highly complex or technically challenging management audit assignments. • Knowledge of the organizational operating environment and activities of a range of state personnel policies, including those published by the Office of State Personnel. • Knowledge of and skills in applying group leadership techniques. • Knowledge of and skills in internal audit planning and staff evaluation. 	<ul style="list-style-type: none"> • Same as the Internal Audit Supervisor, plus those shown below. • Knowledge of and skills in planning, organizing, and directing the work of an internal audit office. • Skills in presenting and defending audit recommendations to the highest levels of management within the state agency. • Skills in negotiating and resolving issues that management may have with internal audit findings and/or recommendations.



APPENDIX D

INTERNAL AUDIT PERFORMANCE MEASURES



APPENDIX D INTERNAL AUDIT PERFORMANCE MEASURES

Introduction

Performance-based management—the use of performance measures in the decision-making process—enables leaders to use performance data to focus the organization on continuous improvement. It is not a one-time activity, but a leadership approach to managing an organization. There are approximately six types of performance measures (input, output, outcome, efficiency, quality, and process) that enable managers to evaluate performance in a variety of areas. Per the Request for Proposal (RFP), recommendations for three specific types of performance measures (output, outcome, and efficiency) for state agencies must be identified.

Performance measures enable managers in state agencies to evaluate how well an activity is being performed in (1) quantity of output, (2) effect the activity had on the agency, and (3) efficiency with which the activity was conducted. When performance is measured, attention is drawn to that performance. The purpose of drawing attention to the performance is—as a manager and decision maker—to determine whether the performance is meeting expectations and, if not, identify ways to increase the performance.

Managers use these measures to evaluate the performance of a unit—the internal auditing function in this case. Knowing how well the unit performed against expectations enables managers to make decisions about allocation of resources and direction of the activity.

No single measure should be viewed as a conclusive measure of the value added by the presence and activities of the internal audit function. Performance across an array of factors should be considered when assessing the outcomes—or value added—by the internal audit unit.

When developing performance measures it is essential to keep in mind the incentives created by the measures themselves as well as the weight given to each measure. For example, placing a priority on the number of projects completed by the internal audit unit without also valuing quality may result in a high number of reports being produced, but of low quality. Likewise, placing an emphasis on the number of audit findings and recommendations without also assessing feasibility of implementing the recommendations will not benefit the state agency or the public it serves.

Collecting and analyzing the performance measures and then taking appropriate action to improve performance is a management responsibility. Holding agencies accountable for their performance is a responsibility held by both the executive and legislative branches.

Three Types of Performance Measures

We recommend that all state agencies collect data for three types of performance measures. Output measures quantify the amount of work completed; for example, the number of audit findings developed. Outcome measures identify the effect internal auditing has had on the agency. For example, an outcome measure might describe how cash management has changed as a result of a finding of lack of segregation of duties.

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Lastly, efficiency measures quantify the number of resources consumed per unit produced. This could take the form of number of hours per audit.

The collected data shall be reported to the head of the agency, the General Assembly, and the State Auditor annually by August 1. The purpose of the agency head receiving the performance measures is to make strategic decisions based on the metrics. The General Assembly and State Auditor will use the metrics to evaluate the degree to which the internal audit function is being implemented throughout state agencies and the value internal auditing provides the state.

Understanding Performance Measures

Table D-1 below answers common questions encountered when developing performance measures, provides examples of performance measures, and includes recommendations as to which specific performance measure data should be collected.

Table D-1
Answers Regarding Performance Measures

Question	Response
What are performance measures?	Performance measures are metrics that state entities can use to quantify internal audit activities and effort.
Why should state agencies measure the performance of their internal audit functions?	<p>Performance measures serve a valuable purpose, including:</p> <ul style="list-style-type: none"> • Enabling the state agency to determine how the internal audit function serves the agency. • Helping decision makers to evaluate whether there are sufficient resources to perform the internal audit function. • Focusing internal audit efforts on achieving priorities identified in the audit plan. • Helping make the internal audit function more accountable to the Director. <p>The two standards promoted in these recommendations recognize the value of collecting data for performance measures. Performance measures are an integral part of the internal audit unit’s self-monitoring and quality assessment as required in <i>Government Auditing Standards</i> and the Institute of Internal Auditors’ <i>Professional Practices Framework</i>.</p>
How can every department have the same measures if we perform different services?	Given the large number of areas that internal auditors can affect, agencies may question how the state can track and compare performance metrics across a wide variety of state agencies, programs, and services. The performance measures below quantify the <i>performance of the internal audit function</i> , not the department’s program or services. The performance measures identified below are those that are useful regardless of program delivered as they target the activities performed by internal auditors.
Will audit staff change their behavior once required to collect data	Whenever an organization focuses on a particular objective, there is a potential that staff will change their behavior to achieve the objective. It is important to have counterbalancing

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Question	Response
for these performance measures?	<p>performance measures. For example, if there is a performance measure that quantifies output (how much was accomplished), there should be counterbalancing performance measure that quantifies quality (how well the work was performed). Having counterbalancing performance measures reduces the chances that behavior is modified to meet just one aspect of the internal audit function's performance.</p> <p>Over reliance on a particular measure may create undesirable incentives. It is important to take into account all the performance measures concurrently to define the year's accomplishment, make managerial decisions, and establish a strategic direction for the coming year.</p>
Can my agency select one or two of the measures and use those instead of the recommended measures?	The recommended performance measures are the <i>minimum</i> measures for which data should be collected to evaluate performance of the internal audit function. Each agency is encouraged to collect additional measures to the degree it facilitates evaluation and management of the internal audit function. As the internal audit function is further developed within state government, internal auditors from different agencies should share best practices, definitions and additional measures.
My agency does not want to report our measures because we will just be "punished" for not performing.	<p>The purpose of establishing performance metrics for the internal audit function is not to punish state agencies when the data indicates the agency did not perform as well as it had projected—unless that is a pattern over several years. Performance measures help the managers understand what is working well and where there might be issues to address. Performance measures are one tool for managers to evaluate performance and make adjustments as deemed necessary.</p> <p>Since the performance measures provide an indication of performance in the state agency, the information will be valuable to the General Assembly.</p>
Will internal auditors spend all their time collecting data and not performing internal audits as a result of these performance measures?	<p>Data for performance measures will not be overly burdensome to collect. The purpose of collecting the performance measure data is to provide sufficient information for management to evaluate performance and change direction as needed. The recommended performance measures below require minimal data to collect and analyze.</p> <p>Additionally, this guide was established to facilitate the process as it defines terms and specific data elements needed to collect the correct information.</p>
Can agencies' internal audit units be compared to each other using performance	It is difficult to compare performance between agencies because the degree of difficulty of auditing one type of program is likely to be different than another department's program. Varying levels of funding, program complexity, staffing, authorizing statute, departmental mission, and type of audit

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Question	Response
measures?	<p>activity performed in a given year do not easily allow for a comparison of one department's performance against another's performance.</p> <p>Having said that, each agency should establish targets for each performance measure. A target is a numerical indicator of the expected performance for the coming year. Each year, agencies should report on their actual performance against expected performance and explain any discrepancies. There may be discrepancies in performance because a greater risk was identified after the audit plan was created. By performing the audit that was not identified in the audit plan, resources were diminished to perform the other audits in the audit plan. There are many reasons for a discrepancy in expected versus actual performance. The internal auditor should maintain a log of the reasons why the performance varied from the expectation to be able to explain the discrepancy to the agency and legislature.</p>
What are the types of performance measures?	<p>The six types of performance measures are identified and described below.</p> <ul style="list-style-type: none"> • Input measures quantify the amount of resources consumed. For example, number of hours consumed on an audit. • Output measures quantify how much work was produced. For example, six performance audits, one financial compliance audit. • Outcome measures quantify the affect the internal audit unit had. For example, savings identified for each recommendation that was implemented. • Efficiency measures quantify how many units of product were developed per resource. For example, percent of audits completed on or ahead of schedule. • Quality measures help determine the quality of the output. For example, the percentage of recommendations implemented within six months; the percentage of Directors and auditees surveyed that rate themselves as "satisfied or very satisfied" with the internal audit services. • Process measures quantify the amount of time to complete a process. For example, number of hours to develop an audit plan.

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Question	Response
<p>It seems that outcome measures are more difficult to quantify than output or efficiency measures. Is that typically the case?</p>	<p>Yes. Outcome measures are typically the most difficult to quantify but also provide the most important insight into the value of the internal audit function to the agency. They are difficult because measuring effect necessitates taking into account external factors. For example, measuring whether the recommendation was implemented can be challenging because the auditor may not know whether the recommendation was not implemented because it was not viable or something unexpected distracted staff from implementing the recommendation. There are many external factors that must be considered when quantifying outcome measures.</p> <p>Internal auditors should not avoid measuring outcomes because of external factors—auditors should account for them and accept responsibility for the auditors’ contribution.</p>
<p>To whom and how do we report the data on each performance measure?</p>	<p>The head internal auditor for each agency should establish a method for collecting data for each performance measure. The method might include a database and processes.</p> <p>The internal auditor should establish baselines for existing performance. A baseline is the current level of performance from the internal audit unit. If there is no internal audit unit, there is not current baseline. In those cases, data from the first year that the internal audit function is adequately staffed should be the baseline. Baseline data is used in subsequent years to enable the organization to know whether the change in performance is positive or not.</p> <p>Outcome measures gauge the extent to which negative conditions are near zero or go down and positive conditions go up and are sustained over time. If internal audits are effective, rates of negative performance as measured against baselines should be as near zero as possible. Similarly, positive performance as measured against baselines should improve. Each year, provides the new baseline for the next year.</p> <p>Each internal audit unit should collect data on each of the performance measures identified below. The head of the internal audit unit should report annually on the performance data to the head of the agency for his/her use to manage the agency’s internal audit function. The data will provide important information on the value of the internal audit function to the agency.</p> <p>Each state agency should also report data on each of the recommended performance measures (and any others for which they collect data) to the General Assembly fiscal committees by August 1 each year. The General Assembly will evaluate the degree to which the internal audit function is being implemented in each agency by reviewing this data.</p> <p>Additionally, this information shall be provided to the State Auditor annually by August 1 each year for the State Auditor to</p>

**APPENDIX D: PERFORMANCE MEASURES
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Question	Response
	<p>use to evaluate the implementation of the internal audit function throughout state government.</p> <p>For state agencies using the shared internal audit resources available through the Office of Internal Audits, the data should be collected by the Office of Internal Audits and reported to the head of the state agency. This information will be used by the Director of the Office of Internal Audits in assessing the performance of his or her staff. For state agencies using the pool, the agency, not the Office of Internal Audits, is responsible for reporting the performance data to the General Assembly fiscal committees and the State Auditor annually by August 1.</p> <p>All performance data should be accompanied with an explanation of the performance. For example, if 100 percent of high-risk audits were completed, but only 70 percent of all audits identified in the audit plan were completed, the state agency should explain why only 70 percent of all audits were completed. It may be due to the fact that unanticipated audits were performed that redirected the auditors to conduct a higher risk audit than was projected.</p>

Examples of Measures

Below are descriptions and examples of each of the three types of performance measures. These are merely a few examples. There are as many examples as there are configurations of information regarding internal auditing.

Output Performance Measures

Output measures enable the state agency to quantify the amount of internal audit activities or work performed. Table D-2 provides examples of output performance measures that can be used for both strategic decision-making and managerial decisions.

**Table D-2
Output Measures**

Output Performance Measure
Percent of planned audit reports (those identified in the audit plan) that were issued.
Percent of audits completed that were identified as high risk.
Number of recommendations implemented at end of the year.
Percent of scheduled audits completed.
Percent of core audits (those that must be conducted periodically) performed.
Number of recommendations issued.
Number of audits identified in the audit plan at the end of the year that were issued.
Percent of federally required audits identified in audit plan that were issued.
Number of advisory (consulting) hours consumed.
Number of audits issued, by audit type.

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Outcome Performance Measures

Outcome measures identify the effect on the state agency the internal audit unit has had. Outcome measures determine what has changed as a result of the internal audit activities. An outcome measure quantifies the value added to an agency as a result of the presence of and services provided by internal auditors.

Table D-3 provides examples of outcome performance measures. Like output measures, there are many types of outcome measures. These are just a few examples below.

Table D-3
Outcome Performance Measures

Outcome Performance Measure
Estimated cost savings of recommendations.
Usefulness of recommendations to Director and auditee.
Percent of recommendations implemented within one year.
Percent of recommendations that can be reasonably implemented within one year.

Efficiency Performance Measures

Efficiency measures enable the state agency to determine the number of resources used per unit of output. As resources per unit of output diminish, efficiency increases.

Table D-4 provides examples of efficiency performance measures. As with the others, there are many types of efficiency performance measures. There are just a few examples.

Table D-4
Efficiency Performance Measures

Percent of audits identified in audit plan that were conducted with the identified number of staff.
Estimated dollar value of recommendations per dollar spent on internal auditing.
Number of audits issued per auditor (by type of audit).
Number of hours per audit issued (by type of audit).

Recommended Performance Measures

The following are performance measures for which we recommend each state agency collect and report data. These performance measures will provide a better understanding of the internal audit unit's performance for agency heads and the North Carolina General Assembly. Note that the recommended performance measures are strategic in nature. Each state agency can determine whether it wants to identify, collect, and analyze data for additional performance measures. Doing so provides a rich array of data to have when making decisions about the value of the internal audit unit.

Table D-5 below identifies the performance measures for which we recommend data be collected, a description of the performance measure, and an identification of the data that needs to be collected to measure performance.

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Table D-5
Recommended Performance Measures

Recommended Performance Measures	Description	Data to Collect
Output		
Percent of audits identified as high risk in the audit plan that were issued.	Defines the degree to which there is focus on the highest risk issues in the state agency. Since it is most important that high-risk audits be completed, capturing this information will determine whether there were sufficient resources for these audits and there was sufficient focus on the most important audits to complete.	<ul style="list-style-type: none"> • Number of audits issued that were defined as high risk in the audit plan. • Number of audits that were identified as high risk in the audit plan.
Percent of total available hours spent on unanticipated and/or unscheduled activities.	Quantifies the amount of time auditors were called upon to perform unanticipated services. If the internal auditors were unable to complete the scheduled audits, working on unscheduled activities may contribute to the reason. This also demonstrates the value agencies put on auditing when asking for additional assistance.	<ul style="list-style-type: none"> • List of unanticipated and/or unscheduled activities. • Hours consumed by staff member for unanticipated and/or unscheduled activities.
Outcome		
Percent of recommendations implemented within one year.	Evaluates the reasonability of the recommendations identified by staff. If the department finds value in the recommendation, they are more likely to implement the recommendation. If few recommendations are implemented, the agency head should evaluate the quality and focus of the audits.	<ul style="list-style-type: none"> • Number of recommendations issued. • Number of recommendations implemented within one year of issue date.
Usefulness of recommendations to Director and auditee.	Defines the value of the internal audit function to the agency Director and program or unit owner that is the subject of the audit. If the agency head indicates that the audit recommendations are not useful, the agency head	<ul style="list-style-type: none"> • Survey responses from Director and auditee. (To gather this information, the Director and auditee must be surveyed. The results of the responses from the surveys define the usefulness of the

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Recommended Performance Measures	Description	Data to Collect
	and head auditor should identify ways in which the internal audit function can be of more value.	recommendations. Multiple questions can be posed including logic of findings, quality of presentations and briefings, adequacy of recommendations in correcting problem, etc.)
Efficiency		
Percent of audits completed on schedule.	Quantifies the number of audits which were completed before the projected deadline.	<ul style="list-style-type: none"> • Identification of audits issued. • Date projected for completion of each audit. • Actual completion date.
Percent of internal audits completed at or below budget.	Quantifies the number of times that staff completed work with fewer resources than originally projected.	<ul style="list-style-type: none"> • Identification of audits issued. • Projected cost to complete audit. • Actual cost to complete audit.

Optional Performance Measures

The performance measures above should be considered the minimum number and type of performance measures for which data is collected to evaluate the internal audit function in the state. Collecting data for these additional performance measures provides internal audit managers and agency heads a greater understanding of the value of internal auditing to the agency.

Below are additional performance measures for which agencies may want to consider collecting data. The measures below provide a more complete understanding of the affect of the internal audit unit on the agency. Agencies are cautioned, though, that collecting data for too many performance measures can distract the agency from the focus of its efforts as performance measures establish the priorities of the agency. Too many priorities typically results in no priority since the organization cannot focus its resources.

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Table D-6
Optional Performance Measures

Measure	Description	Data to Collect
Output		
Percent of federally required audits identified in audit plan that were issued.	Measures the degree to which compliance with federal requirements was met.	<ul style="list-style-type: none"> • Number of audits in audit plan required by federal government. • Number of audits in audit plan required by federal government that were issued.
Number of recommendations issued.	Quantifies the number of recommendations as a production number.	<ul style="list-style-type: none"> • Number of recommendations in audit plans.
Outcome		
Cost savings achieved as a result of implementing recommendations.	Quantifies the fiscal value of the audit to the agency.	<ul style="list-style-type: none"> • Dollar value of each recommendation that was implemented.
Percent of recommendations implemented within one year.	Provides perspective on reasonability of recommendations and agency's ability to implement recommendations.	<ul style="list-style-type: none"> • Number of recommendations issued. • Number of issued recommendations that were implemented.
Efficiency		
Percent of audits identified in audit plan that were conducted with the identified number of staff.	Quantifies the degree to which staff are performing at expected levels.	<ul style="list-style-type: none"> • Audit in audit plan quantified by number of projected auditor hours. • Time sheets for auditors, aggregated by audit.
Estimated dollar value of recommendations per dollar spent on internal auditing.	Quantifies the value of the auditors' time vis-à-vis each recommendation. This allows management to determine whether auditors the type of audit and the amount of time spent on a particular type of audit is worth the time spent on it.	<ul style="list-style-type: none"> • Estimated dollar value of recommendations, per audit. • Actual hours spent on each audit by auditor. • Wages of each auditor, or average wage, by audit.



APPENDIX E

INTERNAL AUDIT STAFFING METHODOLOGY



APPENDIX E
STAFFING METHODOLOGY
and
CASE STUDY OF TEN AGENCIES

Introduction

This appendix presents a methodology for determining the number of internal auditors needed by state agencies. We demonstrate how this methodology is implemented by applying it to ten state agencies. The results are in this appendix.

The internal audit function can be an incredible tool for the state agency to make improvements to agency operations. However, it is key for the internal audit function to be staffed at a sufficient level and with the correct mix of skills to carry out the work. Too often, internal audit functions are understaffed, as reported by the North Carolina State Auditor in his September 2006 report, *Internal Auditing in North Carolina Agencies and Institutions*.

Currently, there is little information in the way of best practices or standards available on how to calculate internal audit staffing levels. Neither the American Institute of Certified Public Accountants (AICPA), the Internal Auditors Association (IIA), nor the Government Accountability Office (GAO) have published metrics on how to calculate the optimal number of internal auditors needed by an agency. Studies performed by other states, such as New York for its Internal Control Task Force and North Carolina in the September 2006 State Auditor's Report, have also experienced similar difficulties in identifying staffing metrics.

The IIAs' Global Audit Information Network (GAIN) collects and publishes benchmark data on a wide variety of internal audit activities and demographics, including ratios of average numbers of internal audit staff to total agency size, revenues, or assets. However, this information is based on survey data identifying existing staffing levels, and does not identify or separately report on those agencies at "ideal" staffing levels versus those that are under-staffed. Moreover, the level of participation by government agencies in the survey is so low that the data is not statistically valid for use as a comparison against government entities as a whole. Therefore, any conclusions drawn from the GAIN data will be drawn using the universe of all respondents, most of whom are not from the public sector.

In trying to identify recommended staffing levels, we also looked at comparisons to occupations that were similar to state governmental internal auditors, including external and internal auditors in the private sector and state and federal Offices of the Inspector General. Ultimately, our research found that there is no "ideal" or "optimal" way to calculate internal audit staffing levels, primarily because no research or data exists documenting the staffing levels or percentages required to be considered "fully" or "adequately" staffed.

That being said, we have developed a way to quantify estimated internal audit resource needs. This estimate, while not ideal, is at least a starting point for the discussion on

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what the state needs for internal audit resources and should only be used as a starting point. In developing this methodology, we drew conclusions from research and reviews of other internal audit organizations, professional organization’s publications, and discussions with internal auditors working in North Carolina as well as in other states.

Methodology

Based on the research and discussions, we developed a list of rules for staffing internal audit functions in state agencies as shown in **Table E-1** below.

Table E-1
Internal Audit Staffing Rules

Rule	Rationale
Agencies maintaining an in-house internal audit function should have more than one internal auditor.	<ul style="list-style-type: none"> • Having more than one internal auditor allows for the collaboration and sharing of best practices among the audit staff. • Many of North Carolina’s state agencies that currently have a single auditor have lower-level internal audit staff (Internal Auditor I or Internal Auditor II classifications). As reported by the State Auditor, the temptation for state agencies is to assign these staff nonaudit-related duties (that is, to use them for accounting or program monitoring work, rather than internal auditing). The staff may not feel that they have sufficient authority to decline these tasks. • Typically, no single auditor can perform all the types of audits an agency may need because audits require different skills. For example, fiscal compliance audits require different education, skills, and experience than information technology audits.
Agencies that believe they need less than two full-time internal auditors (for example, one full-time and one part-time position) are encouraged to staff their internal audit function from a shared pool of internal auditors.	<ul style="list-style-type: none"> • Multiple state agencies are sharing the costs to hire the more experienced (and thus, more costly) internal auditors. • The shared pool of internal auditors allows for collaboration and sharing of best practices among the audit staff. • Using the Office of Internal Audits provides access to a variety of audit skills.¹
Every internal audit function in every state agency must be overseen by an internal auditor at the “Internal Audit Manager” job classification level. Agencies contracting with the	<ul style="list-style-type: none"> • Audit planning and risk assessment are such key components in maximizing the internal audit function’s value to the agency that the tasks should be led by someone with sufficient knowledge, proficiency, and competency to carry out this work.

¹ The proposed Office of Internal Audits is described in **Appendix F**. The General Assembly will need to consider whether to enact legislation creating this office.

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Rule	Rationale
Office of Internal Audits must contract for a staff person at the Internal Audit Manager job classification level to develop the agency's audit plan.	
Supervisor to staff ratios should be maintained at approximately one to four or one to six. (The variance is dependent upon the classification level of the supervisor.)	<ul style="list-style-type: none"> • The ratio agrees with best practice recommendations. • For North Carolina state employees, this will equate generally to: <ul style="list-style-type: none"> – One Internal Audit Supervisor to every six junior level staff (Assistant Internal Auditors, Associate Internal Auditors, or Senior Internal Auditors). – One Senior Internal Auditor to every four junior level staff (Assistant Internal Auditors or Associate Internal Auditors).
This staffing methodology provides a basis for identifying the number of staff needed. Staffing levels need to be adjusted and validated based on the risk assessment and audit plans of the state agency.	<ul style="list-style-type: none"> • Quantifying, weighting, and rating risks by auditable unit (as discussed in Appendix B) help define the audit population, and the approximate scope and objectives of the audit work. This in turn helps to identify the types and number of internal auditors required to carry out the work.
Estimated <i>minimum</i> internal audit costs calculated for each agency represent the <i>least</i> amount that state agencies should expect to spend for internal audit activities.	<ul style="list-style-type: none"> • The estimates of internal audit costs were created using benchmark figures from a GAIN report. However, there is insufficient information to determine that the benchmark data represents the "ideal" staffing model. Therefore, this information should be taken as an estimate of needs only. • The estimates only consider one operational factor (state agency's operational expenditures) that is not indicative of all the considerations that play a part in determining staffing levels.
State agencies need to estimate staffing needs based on their unique operating environments.	<ul style="list-style-type: none"> • Because the estimates of internal audit staffing costs are a minimum only, state agencies may need additional positions or more funding to cover the costs of travel, staffing multiple field offices, auditing highly complex or diverse programs, etc.
Staffing percentages calculated using GAIN benchmark data apply percentages calculated using revenue data but that are applied against state agency operating expenditure data.	<ul style="list-style-type: none"> • The GAIN survey collects benchmark information about internal audit costs and requests that survey respondents report their total revenues, but not total expenditures. • Private firms use revenue to meet their obligations and to continue operations, while state governmental entities use budgeted operating expenditures to meet

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Rule	Rationale
	their obligations and continue operations. Therefore, we have elected to apply the revenue data to state agency operating expenditure data.

Consideration for the Office of State Budget and Management and the General Assembly

Identification of which agencies to provide funding to first needs to be based on a risk assessment that quantifies, weights, and prioritizes funding needs based on risk factors associated with the agency. The assignment of high, medium, or low risk to each agency for each risk factor should be based on the same general factors identified and discussed in **Appendix B—Audit Planning Methodology** of this report. These risk factors² are:

- Financial risks.
- Operational risks.
- Criticality of the agency to state operations (impact on other agencies) and Criticality of the agency to citizens (impact on the public served).
- Legal or compliance risks.
- Technology risks.
- Fraud risks.
- Public or political sensitivity (reputation risks).
- Strategic risks.

Based on an initial evaluation conducted with state General Assembly staff, the top ten highest-priority agencies for internal audit needs (using the risk factors above) were determined to be (in order from highest priority to lowest):

- Health and Human Services
- Transportation
- Office of Information Technology Services
- Public Instruction
- Corrections
- Revenue
- State Treasurer
- Justice
- Juvenile Justice and Delinquency
- Judicial Branch (including the Administrative Office of the Courts)

² See **Appendix B, Supplement 3** for the definitions of each of these risks.

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Methodology for Determining Minimum Internal Audit Staffing Needs

A methodology that can be used to estimate the minimum number of internal audit staff that any particular state agency needs is as follows:

- Document operating expenditures: Using the Office of State Budget and Management (OSBM) budget documents, or documents provided by the agency’s fiscal staff, document the total operating expenditures for each agency using actual data for the most recently completed fiscal year (FY).
- Calculate the Internal Audit Cost Percentage: Obtain the most recent GAIN study data and calculate internal audit costs as a percentage of total **revenues** for selected revenue ranges. (We used the percentage even though we applied it to expenditure data for the reasons stated above.)
- Calculate minimum Internal Audit Costs: Multiply total operating expenditures for each state agency by the Internal Audit Cost Percentage to calculate the expected internal audit costs.
- Determine whether other conditions exist that could affect the number of internal auditors required, and determine approximate levels of staff, including Internal Audit Manager.

Application of the Methodology

Using the top ten state agencies (those identified as the highest priority agencies within the state using the risk assessment), the following represents an illustration of how the methodology works.

1. Document the total operating expenditures.

We obtained the operating expenditure data from the most recently completed fiscal year—FY 2005-06, for the ten agencies identified as being the highest risk agencies (using the internal audit risk factors and assessment by General Assembly staff). Note that in the risk assessment, some of the agencies tied when the risk assessment scores were calculated. Therefore, ten agencies representing the top *seven* highest scores are shown below in **Table E-2**.

Table E-2
Ten Highest-Risk State Agencies

	Risk Assessment Ranking	Agency Name	Total Operating Expenditures (FY 2005-06 Actual)
1	1	Health and Human Services	\$ 4,228,220,359
2	1	Transportation, Division of Motor Vehicles, Trust Fund, and Turnpike Authority	2,896,027,650
3	2	Office of Information Technology Services	13,500,000
4	3	Public Instruction	7,406,146,454
5	4	Corrections	1,161,021,560
6	5	Revenue	87,338,290
7	5	State Treasurer and Retirement Benefits	18,339,193
8	6	Justice	90,797,289
9	6	Juvenile Justice and Delinquency Prevention	150,003,907

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	Risk Assessment Ranking	Agency Name	Total Operating Expenditures (FY 2005-06 Actual)
10	7	Judicial Branch, Administrative Office of the Courts, and Indigent Defense Fund	497,593,688

Source: Office of State Budget and Management—State of North Carolina Certified Budget and State Agency Risk Assessment Exercise, April 2007.

2. Calculate GAIN percentages.

We obtained the most recent GAIN data (based on 2004 survey results). Data in the report represents data for both the public and private sectors. However, the number of government respondents was so low (fewer than 50) that it is more appropriate to use the universe of all respondents (public and private sector) because the types of internal audits and other activities reported as being performed by the universe of respondents and the “government industry” classification were similar.

Further, as described in Figure E-1 above, we determined to use the percentages calculated using reported *revenues* but applied against state agency’s *operating expenditures*.

The data for internal audit costs, revenue, and revenue ranges was as shown below in **Table E-3**.

Table E-3
Estimated Internal Audit Costs as Percentage of
Total Revenues (Operating Expenditures)

Revenue (Operating Expenditures) Range	Average Internal Audit Costs (Column A)	Average Revenue (Column B)	Internal Audit Costs as a Percentage of Revenue (Operating Expenditures) = Column A ÷ Column B
Under \$300 million	\$450,790	\$150,055,812	0.3004%
\$300 million to less than \$700 million	625,622	482,576,763	0.1296%
\$700 million to less than \$1 billion	1,080,471	829,512,918	0.1303%
\$1 billion to less than \$2 billion	1,196,670	1,394,806,937	0.0858%
\$2 billion to less than \$3 billion	1,732,819	2,516,622,583	0.0689%
\$3 billion to less than \$4 billion	1,399,226	3,357,540,014	0.0417%
\$4 billion to less than \$5 billion	1,825,374	4,616,230,100	0.0395%
\$5 billion to less than \$10 billion	2,725,215	7,060,377,723	0.0386%
\$10 billion to less than \$30 billion	5,808,299	15,450,634,028	0.0376%

Source: The Institute of Internal Auditors’ GAIN Benchmarking Report, April 2007.

3. Calculate internal audit costs.

Taking the GAIN percentages as representing the *minimum* expected internal audit costs, and using each agency’s FY 2005-06 operating expenditures, we calculated the estimated internal audit costs for the top ten highest risk agencies as shown in **Table E-4** on the following page.

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Table E-4
Estimated Internal Audit Costs as
Percentage of Operating Expenditures for Ten State Agencies

	Risk Assessment Ranking	Agency Name	Total Operating Expenditures (FY 2005-06 Actual)	Estimated Internal Audit Staff Costs
1	1	Health and Human Services	\$ 4,228,220,359	\$1,670,147 = (0.0395% * 4,228,220,359)
2	1	Transportation, Division of Motor Vehicles, Trust Fund, and Turnpike Authority	2,896,027,650	1,995,363 =(0.0689% * 2,896,027,650)
3	2	Office of Information Technology Services	13,500,000	40,554 =(0.3004% * 13,500,000)
4	3	Public Instruction	7,406,146,454	2,858,773 =(0.0386% * 7,406,146,454)
5	4	Corrections	1,161,021,560	996,156 =(0.0858% * 1,161,021,560)
6	5	Revenue	87,338,290	262,364 =(0.3004% * 87,338,290)
7	5	State Treasurer and Retirement Benefits	18,339,193	55,091 = (0.3004% * 18,339,193)
8	6	Justice	90,797,289	272,755 =(0.3004% * 90,797,289)
9	6	Juvenile Justice and Delinquency Prevention	150,003,907	450,612 =(0.3004% * 150,003,907)
10	7	Judicial Branch, Administrative Office of the Courts, and Indigent Defense Fund	497,593,688	644,881 =(0.1296% * 497,593,688)

Source: MGT of America, Inc. created estimates using data provided by the North Carolina Office of State Budget and Management and using estimates created from data in The Institute of Internal Auditors' GAIN Benchmarking Report, April 2007.

4. Determine whether other conditions exist that could affect the number of internal auditors required.

Each agency will need to identify considerations such as travel, number of field offices they wish to review, and total auditable or potentially auditable units based on their risk assessment (see **Appendix B—Audit Planning Methodology** of this report for the methodology). The identification of all considerations for each agency will need to be determined by the agency's Internal Audit Manager using feedback from the agency's management and staff.

This final determination of staff levels and amount of internal audit expenditures is key because the methodology presented above represents the estimated level of effort only. That is, the GAIN percentages used to estimate internal audit costs by agency are based on self-reported survey data, but there is no guarantee that these represent optimum staffing levels. Further, the GAIN percentages drop off sharply as operating expenditures increase. As shown in the table above, this can result in a situation where a state agency with lower operating expenditures than another state agency has a higher estimated internal audit cost. For example, as shown above, the Department of Transportation's estimated internal audit costs are larger than the estimated internal audit costs for the Department of Health and Human Services,

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even though the Department of Health and Human Services' operating expenditures are almost 150 percent of those of the Department of Transportation. In practice, the Department of Health and Human Services may actually need more internal auditors than are identified here. The Department must identify its need through its internal audit risk assessment and planning processes.

Further, as reported in **Appendix C—Internal Auditor Qualifications**, we proposed a series of Internal Auditor job classifications for the state. Using these classifications and proposed salaries, plus estimated benefits, the approximate number of internal auditor staff can be calculated. There are many various ways of combining higher level and junior level staff, and the illustration shown below is only one of these. In the illustration below, to keep the exercise clear and concise, we did not use any classification lower than a “Senior Internal Auditor,” although in practice, it would be expected that each state agency would select from all of the internal audit classifications based on its needs.

First, using the salary grade and ranges for the proposed Internal Auditor classifications (see **Appendix C—Internal Auditor Qualifications**), we identified the minimum and maximum salaries by job classification. The maximum salary and benefits for each job classification was also calculated by multiplying the top of the salary range by 24.9 percent to account for benefits such as retirement, insurance, taxes, and unemployment. **Table E-5** shown below identifies the recommended job classifications and salaries.

Table E-5
Recommended Internal Audit Job Classifications and Salaries

Internal Auditor Staff Level (Job Classification)	Salary Grade	Minimum Salary	Maximum Salary	Maximum Salary with Benefits ^a
Assistant Internal Auditor	69	\$34,216	\$55,116	\$68,840
Associate Internal Auditor	72	\$38,530	\$63,044	\$78,742
Senior Internal Auditor	75	\$43,641	\$72,316	\$90,323
Internal Audit Supervisor	78	\$49,830	\$83,020	\$103,692
Internal Audit Manager	80	\$54,539	\$91,034	\$113,701
Director of the Office of Internal Audits	82	\$59,606	\$99,932	\$124,815

Source: MGT of America, Inc. proposed classifications, Appendix C—Internal Auditor Qualifications.

a Benefits estimated at approximately 24.9 percent of total salary, and includes retirement, taxes, unemployment, and insurance costs paid by the state.

Next, using the estimated internal audit costs calculated in step three above and the maximum salary with benefits, we calculated the numbers of positions by job classification level that could be staffed with these amounts. In doing so, we used the assumption that every agency needed an Internal Audit Manager and that supervisors to staff were at a ratio of one to six. **Table E-6** on the next page identifies one possible way that the ten state agencies using our staffing model could staff their internal audit units. It is important to note that the calculations in this illustration have not been adjusted for risk. For example, it may be that since the health and human services programs have such a significant impact on the public, that agency should have more funding (auditors) than identified below. The calculation below is based on the GAIN data noted above. The staffing methodology should serve as a starting point in a conversation within the agency

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and between the agency and legislature about funding levels. Funding levels should be adjusted based on a risk assessment completed by the agency. Nevertheless, the staffing methodology provides a sound approach as a foundation for that discussion.

Table E-6
Illustration of Staffing Models Using Estimated Internal Audit Costs
For the Top Ten Highest Risk State Agencies

Job Classification	Number of Positions	Maximum Salary and Benefits For the Position(s)
Health and Human Services		
Internal Audit Manager	1.0	\$113,701
Internal Audit Supervisors	3.0	\$311,076
Senior Internal Auditors	13.8	\$1,246,457
Total, Health and Human Services	17.8	\$1,671,234
Transportation, Division of Motor Vehicles, Trust Fund, and Turnpike Authority		
Internal Audit Manager	1.0	\$113,701
Internal Audit Supervisors	3.0	\$311,076
Senior Internal Auditors	17.4	\$1,571,620
Total, Transportation, Division of Motor Vehicles, Trust Fund, and Turnpike Authority	21.4	\$1,996,397
Office of Information Technology Services		
Recommend that this agency contract with the Office of Internal Audits for \$40,556 worth of internal audit services.		
Public Instruction		
Internal Audit Manager	1.0	\$113,701
Internal Audit Supervisors	4.0	\$414,768
Senior Internal Auditors	25.8	\$2,330,333
Total, Public Instruction	30.8	\$2,858,802
Corrections		
Internal Audit Manager	1.0	\$113,701
Internal Audit Supervisors	2.0	\$207,384
Senior Internal Auditors	7.3	\$659,358
Total, Corrections	10.3	\$980,443
Revenue		
Internal Audit Manager	1.0	\$113,701
Internal Audit Supervisors	1.0	\$103,692
Senior Internal Auditors	0.5	\$45,162
Total, Revenue	2.5	\$262,555
State Treasurer and Retirement Benefits		
Recommend that this agency contract with the Office of Internal Audits for \$55,094 worth of internal audit services.		
Justice		
Internal Audit Manager	1.0	\$113,701
Internal Audit Supervisors	1.0	\$103,692
Senior Internal Auditors	0.6	\$54,194
Total, Justice	2.6	\$271,587
Juvenile Justice and Delinquency Prevention		
Internal Audit Manager	1.0	\$113,701
Internal Audit Supervisors	1.0	\$103,692
Senior Internal Auditors	2.6	\$234,840
Total, Juvenile Justice and Delinquency Prevention	4.6	\$452,233

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Judicial Branch, including Administrative Office of the Courts and Indigent Defense Fund		
Internal Audit Manager	1.0	\$113,701
Internal Audit Supervisors	1.0	\$103,692
Senior Internal Auditors	4.7	\$424,518
Total, Judicial Branch, including Administrative Office of the Courts and Indigent Defense Fund	6.7	\$641,911
Grand Total for Top Ten Highest Risk Agencies	96.7	\$ 9,230,812

Existing Internal Auditor Positions

As shown in **Figure E-7**, many of the agencies identified as being of the highest risk do have at least one internal auditor position currently. However, it should be noted that many of these internal auditors appear to be in lower job classifications than they should be. Additionally, many of the agencies have an insufficient number of staff to perform the internal audit function. **Table E-7** identifies only those employees currently in the “Internal Auditor” or “Internal Audit Manager” classifications. The ten high-risk agencies have resources identified individually. Based on discussions with state agencies and the Office of State Personnel, some agencies may be using staff in other classifications to perform internal audit activities.

Table E-7
Current Internal Auditor Positions in North Carolina for Specified Agencies

State Agency	Internal Auditor I	Internal Auditor II	Internal Audit Manager I	Internal Audit Manager II	Total Number of Auditors
Health and Human Services	0	3	0	0	3
Transportation, Division of Motor Vehicles, Trust Fund, and Turnpike Authority	0	14	4	1	19
Office of Information Technology Services	0	0	0	0	0
Public Instruction	0	1	0	0	1
Correction	7	5	0	1	13
Revenue	0	1	0	0	1
State Treasurer and Retirement Benefits	0	1	0	0	1
Justice	0	0	0	0	0
Juvenile Justice and Delinquency Prevention	2	1	0	0	3
Judicial Branch, Administrative Office of the Courts, and Indigent Defense Fund	0	0	0	0	0
All other state agencies	15	21	1	0	37
All State Agencies	24	47	5	2	78

Source: North Carolina Office of State Personnel, approved position counts as of April 2007.

In many instances, there are alternative means available for funding internal audit positions rather than directly requesting allocation of funds from the state. For example,

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many state agencies have current, noncritical appropriated positions that have been vacant for more than six months. These positions should be considered as a resource to better serve the agency by being converted to internal auditing positions. As shown in the **Table E-8** below, each of the top ten highest-risk agencies have current noncritical, appropriated positions that have been vacant for more than six months. The positions and funding is identified by fund source for each of these agencies. In total, there are 1,555.74 positions of this nature vacant representing \$58,040,033. However, there are likely to be restrictions on some of these positions and funds. For example, funds from the federal government are often prescribed for a particular use and cannot be used for other purposes.

Table E-8
Noncritical Appropriated Positions Vacant More Than Six Months
Selected Agencies

Risk Assessment Ranking	Agency Name	Noncritical Appropriated Positions Vacant More Than Six Months	
		Total Vacant Positions	Total Vacant Salary
1	Health and Human Services	130.5 (General)	\$5,307,273 (General)
		63.12 (Federal)	\$3,155,031 (Federal)
		1.61 (Receipt)	\$67,808 (Receipt)
		195.23 (TOTAL)	\$8,530,112 (TOTAL)
1	Transportation, Division of Motor Vehicles, Trust Fund, and Turnpike Authority	0.5 (Receipt)	\$28,837 (Receipt)
		1,111.5 (Highway)	\$38,956,271 (Highway)
		1,112.0 (TOTAL)	\$38,985,108 (TOTAL)
2	Office of Information Technology Services	0.5 (General)	\$26,240 (General)
		0.5 (Receipt)	\$26,240 (Receipt)
		1.0 (TOTAL)	\$52,480 (TOTAL)
3	Public Instruction	14.99 (General)	\$933,810 (General)
		2.01 (Federal)	\$104,465 (Federal)
		17.0 (TOTAL)	\$1,038,275 (TOTAL)
4	Corrections	119.5 (General and TOTAL)	\$4,683,949 (General and TOTAL)
5	Revenue	13.0 (General)	\$731,580 (General)
		2.0 (Highway)	\$90,822 (Highway)
		15.0 (TOTAL)	\$822,402 (TOTAL)
5	State Treasurer and Retirement Benefits	1.0 (General and TOTAL)	\$50,880 (General and TOTAL)
6	Justice	11.75 (General)	\$466,706 (General)
		2.25 (Federal)	\$115,050 (Federal)
		14.0 (TOTAL)	\$581,756 (TOTAL)
6	Juvenile Justice and Delinquency Prevention	43.0 (General and TOTAL)	\$1,457,352 (General and TOTAL)
7	Judicial Branch, Administrative Office of the Courts, and Indigent Defense Fund	38.01 (General and TOTAL)	\$1,837,719 (General and TOTAL)
	Total	372.25 (General) 67.38 (Federal) 2.61 (Receipt) 1113.5 (Highway) 1,555.74 (GRAND TOTAL)	\$15,495,509 (General) 3,374,546 (Federal) 122,885 (Receipt) 39,047,093 (Highway) \$58,040,033 (GRAND TOTAL)

Source: Office of State Budget and Management Prepared-Report of Non-Critical Vacant Permanent Positions (Appropriated Funds Only) Vacant More Than Six Months as of April 16, 2007.

APPENDIX E: STAFFING METHODOLOGY
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Ultimately, the legislature and each state agency will need to determine whether it is feasible and practical to convert vacant positions or current internal audit positions to the recommended classifications and functions discussed in this report. It is a manner, though, to fund this critical function without increasing the state budget.

Appendix E—Supplement One
Estimated Statewide Internal Audit Needs

Based on the factors and using the methodology discussed above, as part of this study, we created estimated costs for the internal audit function for the State of North Carolina. In total, it appears that the minimum need for internal auditing based on the methodology shown above is \$16.143 million for all state agencies collectively.³ This represents costs for every state agency including the university and community college systems, Council of State member agencies, the courts, and the Department of Public Instruction. That figure includes expenditures already devoted to the internal audit resources. In other words, much of the \$16.143 million is already being allocated to agencies if the legislature converts noncritical, vacant positions to the recommended internal auditor classifications.

This supplement presents a breakdown of the statewide estimated costs for internal audit activities based on the methodology illustrated in this appendix. The table also includes recommendations on whether the function should reside within the agency or whether the agency should consider contracting with the proposed Office of Internal Audits for internal audit services.⁴ A threshold of \$217,393 was used to determine whether the internal audit services should reside “in-house” or should be “contracted with the Office of Internal Audits”. The \$217,393 figure is the maximum cost, with benefits, of an Internal Audit Manager and an Internal Audit Supervisor using the proposed classifications and salaries presented in **Appendix C**.

Table E-9 below provides an estimate of the statewide internal audit expenses and identifies which of the 10 agencies should establish an internal audit function and which should contract with the Office of Internal Audits.

Table E-9
Estimated Statewide Internal Audit Expenditures

Agency Name	Total Operating Expenditures (FY 2005-06 Actual)	Estimated Internal Audit Staff Costs	Recommendation for Internal Audit Location
Public Instruction	\$ 7,406,146,454	\$2,858,773 =(0.0386% * 7,406,146,454)	In-house
Health and Human Services	4,228,220,359	1,670,147 = (0.0395% * 4,228,220,359)	In-house
Transportation, Division of Motor Vehicles, Trust Fund, and Turnpike Authority	2,896,027,650	1,995,363 =(0.0689% * 2,896,027,650)	In-house
North Carolina Universities	1,881,507,715	1,614,334 = (0.0858% * 1,881,507,715)	In-house
Corrections	1,161,021,560	996,156	In-house

³ **Appendix E – Supplement 1** provides a detailed breakdown of this total.

⁴ See **Appendix F** for a description of the proposed office for sharing internal audit resources.

APPENDIX E: STAFFING METHODOLOGY
NORTH CAROLINA INTERNAL AUDIT PROGRAM

Agency Name	Total Operating Expenditures (FY 2005-06 Actual)	Estimated Internal Audit Staff Costs	Recommendation for Internal Audit Location
		= $(0.0858\% * 1,161,021,560)$	
North Carolina Community Colleges	921,350,647	1,200,520 = $(0.1303\% * 921,350,647)$	In-house
Judicial Branch, Administrative Office of the Courts, and Indigent Defense Fund	497,593,688	644,881 = $(0.1296\% * 497,593,688)$	In-house
Environment and Natural Resources	249,443,568	749,328 = $(0.3004\% * 249,443,568)$	In-house
Highway Patrol	208,477,901	626,268 = $(0.3004\% * 208,477,901)$	In-house
Employment Security Commission	202,566,350	608,509 = $(0.3004\% * 202,566,350)$	In-house
Juvenile Justice and Delinquency Prevention	150,003,907	450,612 = $(0.3004\% * 150,003,907)$	In-house
Commerce	131,716,372	395,676 = $(0.3004\% * 131,716,372)$	In-house
North Carolina State Health Plan	129,288,534	388,383 = $(0.3004\% * 129,288,534)$	In-house
Justice	90,797,289	272,755 = $(0.3004\% * 90,797,289)$	In-house
Revenue	87,338,290	262,364 = $(0.3004\% * 87,338,290)$	In-house
Cultural Resources	73,182,663	219,841 = $(0.3004\% * 73,182,663)$	In-house
Agriculture	58,619,723	176,094 = $(0.3004\% * 58,619,723)$	Contract with Office of Internal Audits
Administration	57,837,903	173,745 = $(0.3004\% * 57,837,903)$	Contract with Office of Internal Audits
General Assembly	50,093,343	150,480 = $(0.3004\% * 50,093,343)$	Contract with Office of Internal Audits
Crime Control and Public Safety	42,815,948	128,619 = $(0.3004\% * 42,815,948)$	Contract with Office of Internal Audits
Insurance and Workers Compensation Fund	35,151,786	105,596 = $(0.3004\% * 35,151,786)$	Contract with Office of Internal Audits
Housing Finance Agency	22,188,445	66,654 = $(0.3004\% * 22,188,445)$	Contract with Office of Internal Audits
State Controller	20,588,429	61,848 = $(0.3004\% * 20,588,429)$	Contract with Office of Internal Audits
State Treasurer and Retirement Benefits	18,339,193	55,091 = $(0.3004\% * 18,339,193)$	Contract with Office of Internal Audits
Labor	16,377,367	49,198 = $(0.3004\% * 16,377,367)$	Contract with Office of Internal Audits
Office of Information Technology Services	13,500,000	40,554 = $(0.3004\% * 13,500,000)$	Contract with Office of Internal Audits
State Auditor	12,539,138	37,668 = $(0.3004\% * 12,539,138)$	Contract with Office of Internal Audits
Office of State Budget and Management	12,414,342	37,293 = $(0.3004\% * 12,414,342)$	Contract with Office of Internal Audits
Secretary of State	10,698,491	32,138 = $(0.3004\% * 10,698,491)$	Contract with Office of Internal Audits
Office of State Personnel	8,259,839	24,813 = $(0.3004\% * 8,259,839)$	Contract with Office

APPENDIX E: STAFFING METHODOLOGY
NORTH CAROLINA INTERNAL AUDIT PROGRAM

Agency Name	Total Operating Expenditures (FY 2005-06 Actual)	Estimated Internal Audit Staff Costs	Recommendation for Internal Audit Location
		=(0.3004% * 8,259,839)	of Internal Audits
Governor's Office	6,105,966	18,342 =(0.3004% * 6,105,966)	Contract with Office of Internal Audits
Board of Elections	6,045,480	18,161 =(0.3004% * 6,045,480)	Contract with Office of Internal Audits
Administrative Hearings	3,476,565	10,444 =(0.3004% * 3,476,565)	Contract with Office of Internal Audits
Lieutenant Governor's Office	905,034	2,719 =(0.3004% * 905,034)	Contract with Office of Internal Audits
TOTAL – All State Agencies	\$20,710,639,939	\$16,143,367	

Source: MGT of America, Inc. created estimates using data provided by the North Carolina Office of State Budget and Management and using estimates created from data in The Institute of Internal Auditors' GAIN Benchmarking Report, April 2007.

Note that per the above estimates, the agencies for which a recommendation of "Contract with the Office of Internal Audits" was made, have estimated internal audit needs totaling \$1,189,455, while the totals for agencies that we recommend house internal auditing within their agencies comes to \$14,953,910. Using the recommendation made in **Appendix F – Office of Internal Audits** to add 20 percent to this estimated need to cover the additional services that the Office of Internal Auditors staff will be performing, results in a total estimated expenditure for the Office of Internal Audits' annual costs of \$1,427,346. It will be up to the individual agencies that are using the Office of Internal Audits services on how they will fund these activities. Possible funding sources could include transferring their current internal audit positions (if any) to the Office of Internal Audits as a shared resource, or converting noncritical appropriated positions that have been vacant for more than six months.

Table E-10 below shows a possible staffing makeup for the Office of Internal Audits using the estimated costs of \$1,427,346. Note that in this possible staffing composition, the staff are heavily weighted toward the upper classifications within the proposed internal audit career path described in **Appendix C**.

Table E-10
Illustration of Staffing Models for Proposed Office of Internal Audits

Job Classification	Number of Positions	Maximum Salary and Benefits For the Position(s)
Office of Internal Audits		
Director of the Office of Internal Audits	1.0	\$124,815
Internal Audit Managers	3.0	\$341,103
Internal Audit Supervisors	3.0	\$311,076
Senior Internal Auditors	7.0	\$632,261
Total, Office of Internal Audits	14.0	\$1,409,255

Source: MGT of America, Inc. created estimates using proposed classifications from Appendix C.

In evaluating the estimates of costs for the state, MGT considers that the projected expenditures required for the Office of Internal Audits represent "new" costs that the

APPENDIX E: STAFFING METHODOLOGY
NORTH CAROLINA INTERNAL AUDIT PROGRAM

General Assembly will need to fund. That is, the General Assembly will need to either provide funding directly to this Office, or will need to require the agencies utilizing the Office's services to convert existing funded non-critical vacant positions or existing appropriated internal audit positions to positions for the Office.

To the extent that state agencies have existing internal auditor positions for which funding has already been appropriated, or have non-critical appropriated positions vacant longer than six months that they can convert to internal audit classifications, the state will not need to identify new funding sources for these agencies. MGT analyzed current internal audit resources, and vacant positions for the agencies for which we have recommended in-house internal audit functions. Of the \$14,953,910 in estimated internal audit costs for these agencies, only \$3.8 million is not currently being funded. Table E-11 below demonstrates how this figure is derived.

Table E-11
Unfunded Internal Audit Costs

Agency Name	Estimated Internal Audit Staff Costs	Estimated Unfunded Portion	Rationale
Public Instruction	\$2,858,773	\$1,758,773	Conversion of currently appropriated positions will fund approximately \$1.1 million of the cost.
Health and Human Services	\$1,670,147	\$0	Conversion of currently appropriated positions will fund 100% of the cost.
Transportation, Division of Motor Vehicles, Trust Fund, and Turnpike Authority	1,995,363	0	Conversion of currently appropriated positions will fund 100% of the cost.
North Carolina Universities	1,614,334	0	Conversion of currently appropriated positions will fund 100% of the cost.
Corrections	996,156	0	Conversion of currently appropriated positions will fund 100% of the cost.
North Carolina Community Colleges	1,200,520	775,520	Conversion of currently appropriated positions will fund approximately \$425,000 of the cost.
Judicial Branch, Administrative Office of the Courts, and Indigent Defense Fund	644,881	0	Conversion of currently appropriated positions will fund 100% of the cost.
Environment and Natural Resources	749,328	0	Conversion of currently appropriated positions will fund 100% of the cost.
Highway Patrol	626,268	270,268	Conversion of currently appropriated positions will fund approximately \$356,000 of the cost.
Employment Security Commission	608,509	608,509	Did not identify currently appropriated positions
Juvenile Justice and Delinquency Prevention	450,612	0	Conversion of currently appropriated positions will fund 100% of the cost.
Commerce	395,676	0	Conversion of currently appropriated positions will fund 100% of the cost.
North Carolina State Health Plan	388,383	388,383	Did not identify currently appropriated positions
Justice	272,755	0	Conversion of currently appropriated positions will fund 100% of the cost.
Revenue	262,364	0	Conversion of currently appropriated positions will fund 100% of the cost.

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Agency Name	Estimated Internal Audit Staff Costs	Estimated Unfunded Portion	Rationale
Cultural Resources	219,841	0	Conversion of currently appropriated positions will fund 100% of the cost.
TOTAL – All State Agencies Having Own Internal Audit Function	\$14,953,910	3,801,453	

APPENDIX F

ESTABLISHING AN
INTERNAL AUDIT POOL
- OFFICE OF INTERNAL AUDITS

APPENDIX F GUIDANCE ON ESTABLISHING SHARED INTERNAL AUDIT RESOURCES

Introduction

We recommend that the North Carolina General Assembly pass legislation that establishes a pool of internal auditors for use by state agencies per the guidelines below. These shared resources shall be called the Office of Internal Audits (Office). The head of this office shall be called the Director of the Office of Internal Audits.

The pool of internal auditors is intended to be a cost-effective method by which small state agencies acquire internal audit services. The mission of the Office is to serve state agencies by providing quality internal audit services in a timely manner by qualified staff.

Establishing the Office of Internal Audits

The pool of internal auditors shall reside within the Office of State Budget and Management (OSBM). The sole responsibility of OSBM to the Office is to provide administrative support (for example, payroll). The OSBM has no authority to direct the operations of the Office.

State agencies that do not meet a certain minimal need of internal auditors as determined by a staffing methodology will be required to use internal auditors from the Office, except that Council of State members shall be exempt from being required to use internal auditors from the pool. Council of State member agencies have the option of using the internal audit pool and are strongly encouraged to do so as a cost containment measure. To the extent that smaller agencies have existing internal auditor positions, the North Carolina Legislature should consider shifting these positions and funding to the Office to pay for the services its auditors will be providing. Doing so minimizes the amount of new funds needed for the internal audit function in the state.

There shall be a mix of skills and experience among the internal auditors including experience with performance audits, efficiency and effectiveness studies, fraud investigations, financial and information technology audits, and internal control reviews. **Appendix C** of this report describes the recommended internal auditor qualifications for each classification in the entire career path. Although in time the Office may wish to begin hiring staff in the lower levels (Assistant or Associate Internal Auditors), it is MGT's recommendation that in the first five years of the Office's operations, it does not use any auditor with a qualification lower than Senior Internal Auditor. State agencies will be relying on the Office to provide guidance and planning for their agencies' internal audit functions. These are not services that should be provided by junior, less-experienced internal audit staff.

The internal auditors in the pool should be assigned to specific agencies to enable them to build knowledge of the agency's programs over time. The auditors will report findings and recommendations directly to the head of the agency for which they are providing audit services. These internal auditors have all the rights and responsibilities that internal auditors housed within a specific agency have.

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The Office and individual auditors will be held to the standards in law as well as those adopted by the Director of the Office.

The Office shall be considered a resource for all state agencies with regard to internal audit resources. As such, the Office shall:

- Adopt standards for the uniformity and quality of state agency internal audit activities.
- Refine the staffing methodology based on industry best practices.
- Refine and update audit guides, suggested best practices, and policies.
- Identify independent external peer review resources.
- Define the best practices for the use of external peer reviews.
- Identify resources that provide training and professional development opportunities for internal auditors.
- Solicit and publish audit plans that are best in class as a model for other state agencies.
- Develop a method for agencies to use to follow-up on previously identified issues so that they can determine whether the recommendation was implemented. For example, develop a database and processes that enables internal auditors to input recommendations for internal tracking purposes. This tool should be made available to all state agencies for their own internal tracking of the status of implementing recommendations.
- Develop a method for agencies to use to track data on their performance measures.
- Describe lessons learned by staff while conducting internal audits.
- Determine whether agencies should be required to collect data for more performance measures. If so, identify the performance measures.
- Develop additional optional performance measures.

The Office shall make all of this information available to all state agencies on its Web site.

Staffing the Office of Internal Audits

Based on the recommendations in **Appendix E—Staffing Model**, MGT identified initial and on-going costs for the Office of approximately \$1.4 million (see below for detailed explanation and calculations). The General Assembly will need to consider how to fund these services, whether through directly appropriating the funds, or by requiring the individual agencies using their existing appropriations for these activities. Possible funding sources could include turning over their current internal audit positions (if any) to the Office as a shared resource, or converting non-critical appropriated positions that have been vacant for more than six months.

The table below shows a possible staffing makeup for the Office using the estimated costs of \$1,409,255. Note that in this possible staffing composition, the staff is heavily weighted toward the upper classifications within the proposed internal audit career path described in **Appendix C**.

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Table F-1
Illustration of Staffing Models for Proposed Office

Job Classification	Number of Positions	Maximum Salary and Benefits For the Position(s)
Office		
Director of the Office	1.0	\$124,815
Internal Audit Managers	3.0	\$341,103
Internal Audit Supervisors	3.0	\$311,076
Senior Internal Auditors	7.0	\$632,261
<i>Total, Office</i>	<i>14.0</i>	<i>\$1,409,255</i>

Source: MGT of America, Inc. created estimates using proposed classifications from **Appendix C**.

Organization of Office of Internal Audits

The question and answers below detail how the Office will be organized, where it will be housed, and how the resources will be allocated and funded.

Question	Response
Why create a pool of internal auditors?	<p>State agencies have a need for internal auditors to comply with the new laws and professional standards for the internal audit function. There are typically a variety of different types of audits that are conducted ranging from technology audits to internal control reviews. Each of these audits require different skill sets. Additionally, best practices research indicates that for optimum performance and to facilitate sharing of knowledge and lessons learned, internal audit functions should not be staffed with fewer than two auditors.</p> <p>The analysis of estimated numbers of internal auditors needed, based on the methodology described in Appendix E—Staffing, indicates that some of the state agencies need fewer than two positions to perform the internal audit function. The size and complexity of their operations, and the relative level of assessed risk related to their agency, may not warrant allocating funding for two or more internal auditor positions.</p> <p>Because it is highly unusual to have a single auditor who has the skills and experience to perform every type of audit, and best practices dictates collaboration among auditors, we recommend that the pool of auditors with varied experiences in types of audits provide the service to these agencies. Rather than each state agency hiring an internal auditor with each of the varied skills and experience required—which may exceed the number of auditors indicated for that agency—a pool of internal auditors is being created so that internal auditors with a variety of skills can serve an agency in a cost-effective manner. State agencies will have a pool of staff to call upon depending on the type of audit that needs to be performed.</p>
Governance	
Where will the pool of internal auditors be housed?	For cost efficiency purposes, the Office should be housed within an existing department. We recommend that it be housed within the OSBM. This department will provide administrative support to the Office. The Office, however, shall be considered an agency unto itself.
Who will oversee the pool of internal	There will be a Director of the Office who will oversee the pool of auditors.

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NORTH CAROLINA INTERNAL AUDIT PROGRAM

Question	Response
auditors?	
Who selects the Director of the Office for the pool?	Except the State Auditor, the Council of State members who are heads of North Carolina state agencies will be responsible for selecting and/or terminating the Director of the Office.
Will the Director of the Office serve a fixed term?	The Director of the Office will serve a five-year term at the end of which time the Council of State members will evaluate his/ her performance. The Council of State members can evaluate the Director's performance upon the request of any member at any time that any member believes there may be a performance issue. The Council of State may choose to re-appoint the Director to his/her position or may elect to choose from other qualified candidates at that time.
What are the qualifications required of the Director of the Office?	The Director of the Office must meet, at a minimum, all qualifications described for the "Internal Audit Manager" job classification and must have had at least two years experience in managing and administering a medium- or large-sized internal audit shop. The proposed qualifications for each classification can be found in Appendix C—Internal Auditor Professional Qualifications .
To whom do the audit findings and recommendations developed by these auditors get reported?	Internal auditors in the pool should perform their work as though they work directly for the state agency for which they are conducting the audit. Following IIA and Yellow Book guidelines, that means that these internal auditors have direct access to the head of the agency, including for reporting purposes. The Director of the Office may review the findings and recommendations only for the purpose of quality control and evaluation of staff performance. The Director of the Office does not take action on the findings and recommendations; management of the agency for which the audit was conducted has that responsibility.
What state agencies will use the pool of internal auditors?	Any state agency whose operating expenditures are below \$60 million are required to use the pool of internal auditors. The Council of State members are not required to use the pool of internal auditors but are encouraged to avail themselves of these services as a means of obtaining the full breadth of these services in a cost-effective manner.
Organizational and Professional Standards	
What are the education and experience requirements for the internal auditors in the pool?	The internal auditors in the pool have all the same requirements as internal auditors housed within a state agency. For our recommendations on staff qualifications, please see Appendix C—Professional Qualifications .
How many internal auditors will staff the pool?	We used the staffing methodology to calculate the number of internal auditors in the pool for those state agencies with a need of fewer than two positions. We added 20 percent more auditor positions to accommodate overlapping assignments. Based on projections that agencies with a need of fewer than two internal auditors will be staffed by the pool and that all Council of Member agencies use the pool auditors, we estimate that the pool will require about 16 internal auditors (See Table F-1). The Office will also need administrative support staff. This estimate should be revised as the Director of the

APPENDIX F: INTERNAL AUDIT POOL
NORTH CAROLINA INTERNAL AUDIT PROGRAM

Question	Response
	Office determines what the workload necessitates.
Will these internal auditors perform the same type of audits that internal auditors housed in state agencies perform?	These internal auditors will perform the same types of audits as those auditors housed within agencies including performance, compliance, technology, and fiscal audits, and internal control reviews per the Institute of Internal Auditor's (IIA) guidelines.
Besides performing internal audits, what other services will the pool of internal auditors provide?	<p>The internal auditors shall only provide internal auditing services per the IIA's guidelines. Doing otherwise is a misuse of these funds that have been allocated for internal auditing purposes. Additionally, redirecting internal auditors to other work violates the principal of being independent and therefore not being able to perform other work as it could potentially result in the auditor auditing his/her own work in the future.</p> <p>The services include conducting annual risk assessments; creating the annual audit plan; auditing, providing technical assistance and limited training; and reporting on performance metrics.</p>
Standards	
Do these auditors follow the same guidelines as internal auditors housed within a state agency?	Yes. The internal auditors in the pool are bound by the same statutes, standards, and guidelines as auditors housed within a state agency.
Funding The Pool	
How is the pool of internal auditors funded?	The legislature must determine how best to fund the pool. In addition to using General Fund monies, the legislature may want to consider redirecting agencies non-critical positions that have been vacant for more than six months.
Do agencies that use the pool pay for the services they use?	We recommend that the Office not seek reimbursement for services provided that cost up to the allocation each agency has based on the staffing methodology in Appendix E . All state agencies, including the Council of State members that choose to use the pool of internal auditors for a total number of hours that exceeds the estimate of hours needed for that agency shall reimburse the General Fund for those services at a rate based on the salary of the internal auditor(s) whose services were used. For example, if the staffing formula indicates the agency needs \$72,000 of internal audit work and the agency requests \$100,000 from the pool, the agency will be required to reimburse the General Fund for the \$28,000 of service utilized in excess of allowable (budgeted) amounts.
How can the Office assist state agencies that decide to have internal auditors within the agency?	<p>The Office shall have responsibility for being a central provider of internal audit services to all state agencies. These services should extend beyond simply providing staff to agencies. The Office shall become a premier auditing organization that is a central repository of audit knowledge and services. The Director of the Office should be required to undertake the following, and make it available to all state agencies via the Internet:</p> <ul style="list-style-type: none"> • Adopt standards for the uniformity and quality of state agency

APPENDIX F: INTERNAL AUDIT POOL
NORTH CAROLINA INTERNAL AUDIT PROGRAM

Question	Response
	<p>internal audit activities.</p> <ul style="list-style-type: none"> • Refine the staffing methodology based on industry best practices. • Refine and update audit guides, suggested best practices, and policies. • Identify independent external peer review resources. • Define the best practices for the use of external peer reviews. • Identify resources that provide training and professional development opportunities for internal auditors. • Solicit and publish audit plans that are best in class as a model for other state agencies. • Develop a method for agencies to use to follow-up on previously identified issues so that they can determine whether the recommendation was implemented. For example, develop a database and processes that enables internal auditors to input recommendations for internal tracking purposes. This tool should be made available to all state agencies for their own internal tracking of the status of implementing recommendations. • Develop a method for agencies to use to track data on their performance measures. • Describe lessons learned by staff while conducting internal audits. <p>The Director shall identify internal audit resources that can be made available to state agencies on a temporary basis to supplement existing staff.</p>
Does housing the pool in OSBM mean that they are funded within that department?	The Office will have a separate budget that is built upon workload projections. This budget is subject to change just as every executive branch agency's budget is by both OSBM and the General Assembly. However, the budget cannot be changed by OSBM as OSBM considers its own budget. In other words, the budget for the Office should be considered a separate agency, not under the purview of OSBM when determining the Office's budget.
Priorities for the Office of Internal Audits	
How do I request that an audit plan for my agency be created?	<p>The Director of the Office will develop a methodology for prioritizing workload. However, the expectation is that agencies receive timely access to quality services.</p> <p>Heads of state agencies should notify the Director of the Office by March 31st of each year of their intent to use the services of the Office within the upcoming fiscal year.</p>
What is the timeline for the establishment of the Office?	If the proposed legislation is passed, the Office will be established July 1, 2007.



APPENDIX G

PROPOSED LEGISLATION



**APPENDIX G
PROPOSED LEGISLATION TO ESTABLISH THE
INTERNAL AUDIT PROGRAM IN NORTH CAROLINA**

Introduction

This proposed legislation reflects recommendations to implement the new internal audit program, and is based on the Institute of Internal Auditor's model legislation. We recommend implementation of this legislation if the General Assembly supports the recommendations contained in the report and previous appendices. Because this will be an effort embraced throughout the state—for the first time in many agencies—we believe it important to clearly identify roles and responsibilities in statute so that all agencies will implement the internal audit program based on established, uniform protocols.

The General Assembly may wish to consider the level of prescription that is in statute once it is comfortable that the internal audit function outlined below has been implemented and functioning well in the majority of state agencies.

**A BILL TO BE ENTITLED
THE INTERNAL AUDIT ACT OF 2007**

The North Carolina General Assembly enacts:

Legislative Intent

Internal auditing is an independent, objective assurance and consulting activity designed to add value by identifying efficiencies and economies to improve an agency's operations. The audit function assists in accomplishing agency objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

The purpose of the Act is to establish an internal auditing program to assist in improving state agency operations.

SECTION 1. Chapter 143 of the General Statutes is amended by adding a new Article to read:

Article 79.
Internal Auditing

§ 143-738. Title.

This Article shall be known and may be cited as the "Internal Audit Act of 2007."

§ 143-739. Definitions; intent; applicability.

(a) For the purposes of this article:

- (1) "State agency" means each department created pursuant to Chapter 143A or 143B of the General Statutes, the Judicial Branch, University of North Carolina, North Carolina community colleges, the Department

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NORTH CAROLINA INTERNAL AUDIT PROGRAM

of Public Instruction, and any other state agency receiving state funds for any purpose.

- (2) "Agency head" means the Governor, a Council of State member, a cabinet secretary, the head of a department, the Chief Justice of the Supreme Court, the President of the University of North Carolina, President of the community colleges, and the Superintendent of Public Instruction.
- (3) "Office of Internal Audits" is an independent agency with responsibility for providing internal audit services to those agencies that need internal audit services.
- (4) "Director of the Office of Internal Audits" is the person appointed by the Council of State members to direct the internal audit function for the Office.

(b) This Article applies to all state agencies.

§ 143-740. Internal auditing required.

- (a) Each state agency shall establish a program of internal auditing that includes:
 - (1) Development of an annual audit plan based on a risk assessment for conducting internal audits.
 - (2) Reviews of the justification or effectiveness of agency programs and activities notwithstanding the statutory basis of any program or activity.
 - (3) Reviews to determine efficiency and economy and cost savings opportunities.
 - (4) Periodic audits of the agency's major systems and controls, including:
 - a. Accounting systems and controls.
 - b. Administrative systems and controls.
 - c. Information technology systems and controls.
- (b) Internal Audit Standards. Internal audits shall comply with *Government Auditing Standards* issued by the Comptroller General of the United States and, when not in conflict, with *Standards for the Professional Practice of Internal Auditing* issued by the Institute for Internal Auditors.
- (c) Qualifications of Internal Auditors. Any state employee who performs the internal audit function shall meet the minimum qualifications for internal auditors established by the Office of State Personnel.
- (d) Internal Audit Manager. Any state agency that employs state staff to perform the internal audit function must have at least one staff member classified as an Internal Audit Manager. Any state agency that uses the Office to staff the internal audit function must use an Internal Audit Manager to develop its audit plan.

APPENDIX G: PROPOSED LEGISLATION
NORTH CAROLINA INTERNAL AUDIT PROGRAM

§ 143-741. Auditor's Authority.

Internal auditors shall have unrestricted access to people including employees and contractors, information and records whether on paper or available electronically, and property for the purpose of performing their duties.

§ 143-742. Establishing the Office.

An Office is hereby created.

- (a) The mission of the Office is to provide quality auditing services in a timely manner to state agencies.
- (b) The Office shall be sited within the OSMB for the purposes of receiving administrative support.
- (c) The Office shall have a budget separate from the OSMB sufficient to carry out its responsibilities.
- (d) The Office shall be led by the Director of the Office who is selected by a majority of the Council of State Members, excepting the State Auditor, for a five-year term. There is no limit on the number of terms the Director of the Office may serve. A majority of the Council of State members may also remove the Director of the Office for cause before the five-year term has expired.
- (e) The Director of the Office shall hire a sufficient number of qualified internal auditors to perform auditing services for state agencies.
- (f) The Director of the Office shall make the following resources available via the Internet:
 - Standards for the uniformity and quality of state agency internal audit activities.
 - Staffing methodology based on industry best practices.
 - Audit guides, suggested best practices, and policies.
 - Independent external peer review resources.
 - Best practices for the use of external peer reviews.
 - Resources that provide training and professional development opportunities for internal auditors.
 - Audit plans that are best in class as a model for other state agencies.
 - Method for agencies to use to follow-up on previously identified issues so that they can determine whether the recommendation was implemented.
 - Method for agencies to use to track data on their performance measures.
 - Lessons learned by staff while conducting internal audits.
- (g) The Director of the Office shall assemble a team of auditors that are available on a temporary basis to all state agencies to perform audits beyond the capacity of the agency's existing resources.

APPENDIX G: PROPOSED LEGISLATION
NORTH CAROLINA INTERNAL AUDIT PROGRAM

§ 143-743. Appointment of the Internal Audit Manager, Staffing, Organizational Placement, and Funding of Audit Responsibility.

Any state agency that performs the internal audit function with its own staff must have an Internal Audit Manager.

- (a) The agency head shall ensure that the Internal Audit Manager is allowed to employ a sufficient number of professional and support staff to implement an effective program of internal auditing.
- (b) The internal audit unit within an agency shall have organizational status outside the agency's staff or line management functions or units subject to audit, and shall be free of operational and management responsibilities that would impair the ability to make independent audits of any aspects of the agency's operations.
- (c) The internal audit organization shall be provided a separate budget sufficient to carry out the responsibilities and functions established in this Act.

§ 143-744. Duties of the Internal Audit Manager.

The Internal Audit Manager shall report directly to the agency head with unrestricted access to the legislative body or governing board. The Internal Audit Manager in each state agency shall have the following responsibilities:

- (a) Provide independent, objective audit services to add value and improve operations.
- (b) Conduct financial, compliance, information technology, and performance audits of agency programs, activities, and functions and communicate audit findings. Performance audits are defined as evaluating the justification of the program, the program's efficiency and effectiveness, and governance of the program.
- (c) Review and evaluate internal controls over organization programs, accounting systems, administrative systems, information technology systems, and all other major systems necessary to ensure accountability of the state agency.
- (d) Develop annual audit plans based on a documented risk assessment. At the beginning of each fiscal year, the Internal Audit Manager shall submit a one- to five-year audit plan to the agency head for review and comment. The audit plan shall include the proposed plan for auditing any aspect of the agency for the period. This plan may be amended during the period after review with the agency head. Additionally, the Internal Audit Manager may spontaneously initiate and conduct any other audit deemed necessary. A copy of the approved annual audit plan shall be available upon request to the state and/or legislative auditor or any other appropriate external auditor.
- (e) Determine the scope and assignment of audits shall be determined by the Internal Audit Manager; however, the head of the agency may at any time request the Internal Audit Manager to perform an audit of a special program, activity, function, or organizational unit subject to the availability of internal audit staff.
- (f) Develop a method to track findings and the status of implementing recommendations. Ensure the data that is retained is the most recent available.

APPENDIX G: PROPOSED LEGISLATION
NORTH CAROLINA INTERNAL AUDIT PROGRAM

§ 143-745. Applicable Professional Standards.

All internal auditors of state agencies shall conduct audits or conduct audit activities in accordance with the general and specified standards prescribed by the *Government Auditing Standards* issued by the Comptroller General of the United States and, as appropriate, the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*.

§ 143-746. Professional Qualifications.

All internal auditors performing audit services shall possess qualifications within the internal audit classification scheme as defined by the Office of State Personnel.

§ 143-747. Confidentiality.

The Internal Audit Manager and all internal auditors shall maintain the confidentiality of any public records that are made confidential by law, and shall be subject to the same penalties as the custodian of those public records for violating confidentiality statutes.

§ 143-748. Report of Irregularities.

If during an internal audit the auditor becomes aware of fraud, abuse, or illegal acts or indications of such acts that could affect the governmental agency, the auditor shall report the irregularities to the agency head, as appropriate. In the case where the agency head is believed to be a party to fraud, abuse, or illegal acts, the Internal Audit Manager shall report the acts directly to the State Auditor. If it appears that the irregularity is criminal in nature, the auditor shall immediately notify the appropriate chief prosecuting authority in addition to the State Auditor.

§ 143-749. Quality Assurance Reviews.

Each internal audit organization shall have an external quality control review conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States.

The review shall be performed by qualified persons who are independent of the agency and have no real or apparent conflict of interest. The report issued on the external quality control review shall be a public record to the extent authorized by law.

SECTION 2. S.L. 1997-443 (Section 143B-216.50) is hereby repealed.

SECTION 3. S.L. 1997-443 (Section 143B-216.51) is hereby repealed.

SECTION 4. This act becomes effective July 1, 2007.

Establishing an Internal Audit Program in North Carolina's State Agencies

**Presentation of
Final Report
May 15, 2007**

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- **We would like to acknowledge the invaluable input of North Carolina General Assembly staff:**
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 - Department of Correction’s Director of Internal Audit, Vickie Haddock
 - The North Carolina General Assembly’s Internal Audit Manager, Tiesha Pope, all of whom shared policies and other guidance that were used in creating our recommendations.

Executive Summary

■ What is internal auditing?

- Internal auditing helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control, and governance processes. Internal auditing is a management tool; the state agency chooses which audits to perform.

■ How is this distinguished from the audits the State Auditor performs?

- The types of audits are similar. The State Auditor chooses which audits The Office of State Audits will conduct. However, unlike internal auditing, the audit can encompass multiple state agencies or programs such as the State Auditor's September 2006 report that evaluated the internal audit function in North Carolina state agencies. The purpose of these audits is to shed light on the program from an external perspective.

Executive Summary

Audit Responsibilities in the State of North Carolina

Who	Types of Audits or Reviews	Who Can They Audit or Review?	Who Can Request the Audit or Review?
State Agencies' Internal Auditors	<ul style="list-style-type: none"> ◆ Financial and compliance audits ◆ Economy and efficiency audits ◆ Program results audits 	<ul style="list-style-type: none"> ◆ Its own agency ◆ Subcontractors and sub-recipients 	<ul style="list-style-type: none"> ◆ Head of the state agency ◆ State agency Internal Audit Manager ◆ Program Manager within that state agency
Office of the State Auditor	<ul style="list-style-type: none"> ◆ Financial and compliance audits ◆ Economy and efficiency audits ◆ Program results audits 	<ul style="list-style-type: none"> ◆ All state agencies ◆ Any entity supported fully or partially by state funds 	<ul style="list-style-type: none"> ◆ Legislative committees ◆ Governor ◆ State agency ◆ (State Auditor has the final authority for prioritizing these requests)
Office of the State Controller	<ul style="list-style-type: none"> ◆ Internal control compliance reviews 	<ul style="list-style-type: none"> ◆ State agencies 	<ul style="list-style-type: none"> ◆ State agency ◆ Office of the State Controller
Office of State Budget and Management (OSBM)	<ul style="list-style-type: none"> ◆ Management analyses of organization, staffing, systems, processes, and delivery and quality of services 	<ul style="list-style-type: none"> ◆ State agencies 	<ul style="list-style-type: none"> ◆ Legislature ◆ State agency ◆ OSBM

Executive Summary

- Require all agencies to perform internal auditing.
- Establish pool of shared internal auditors for smaller agencies.
- Allow larger agencies to hire internal auditors.
- Require audits to be conducted in conformance with professional standards (*Government Auditing Standards*).
- Enhance minimum professional qualifications for internal auditor classifications.
- Require development of audit plans from risk-based assessments.
- Collect data on internal audit performance.

Methodology

- Reviewed State Auditor's report.
- Interviewed management from 12 state agencies including Council of State members and three General Assembly members.
- Conducted best practice industry research.
- Reviewed budget and staff classification documents.
- Drafted recommendations.
- Vetted ideas with state department staff, General Assembly staff, State Auditor, and six Council of State members.
- Developed Implementation Plan.
- Drafted legislation.

Recommendations

Questions Posed By GPAC

■ Planning

- How do you assure that internal auditors conduct efficiency, effectiveness, and program reviews in addition to accounting and internal control reviews?

Questions Posed By GPAC

■ Performance Measurement and Standards

- What are the professional standards for internal audit organizations?
- What professional qualifications should internal auditors possess?
- What output, outcome, and efficiency performance measures should be established?
- What should the internal auditor staffing levels be?

Questions Posed By GPAC

■ Governance

- Where should the internal audit function be placed within state agencies?
- What level of authority should be conferred upon internal auditors?
- Should services be provided by a central service provider for smaller agencies?
- What legislative and executive oversight bodies should review state agencies' implementation of professional standards and development of internal audit plans?

Planning

How do you assure internal auditors conduct efficiency, effectiveness, and program reviews in addition to accounting and internal control reviews?

- Every state agency should create an audit plan based on a documented agency-wide risk assessment. Risks are identified as those activities that endanger the agency's ability to act in the most cost-effective and efficient manner possible.
- Using a risk-based approach ensures that auditors go beyond looking only at financial or compliance issues when identifying which audits to perform.
- Audit plans, which are developed annually, identify the number and types of audits the internal audit unit intends to perform.

Planning

The methodology to create an audit plan shall include the following steps, at a minimum:

1. Define “auditable units.” An auditable unit is the smallest unit or program within the agency that merits auditing.
2. Conduct interviews to gather information about the unit.
3. Document key information on the auditable unit.
4. Answer questions that enable you to quantify each unit’s or program’s risk. The questions focus on those activities that can make an agency vulnerable. Risk categories include:

- Financial
- Operational
- Criticality to the Agency
- Legal or Compliance
- Technology
- Fraud
- Public or Political Sensitivity
- Strategic

Planning

Developing An Audit Plan, continued

5. Calculate the weighted risk to identify units or programs that are highest risk.
6. Prioritize internal audit tasks by calculated weighted risk. Create audit plan.

Appendix B contains a recommended audit planning methodology, detailed instructions on how to assess risk, and risk assessment tools.

Performance Management and Standards

What are the professional standards for internal audit organizations?

- Every state agency should use the following standards:
 - **Primary Standard:** *Government Auditing Standards* (Yellow Book), issued by the Comptroller General of the United States, provides requirements and guidance for financial, compliance, and performance audits of government entities.
 - **Secondary Standard:** *Professional Standards for the Practice of Internal Auditing* issued by the Institute of Internal Auditors (IIA)—provides requirements and guidance for internal auditors to consider.

Appendix A contains the standards. When in conflict, *Government Auditing Standards* prevail.

Performance Management and Standards

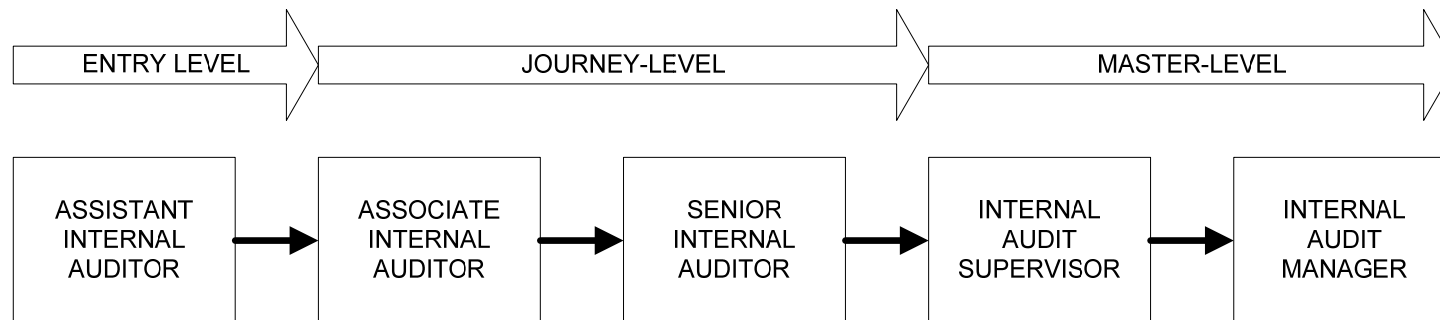
What professional qualifications should Internal Auditors possess?

- Education: Four-year (bachelor's) degree in one of many areas from an accredited college or university for all but entry-level position.
- Experience: Increases as auditor progresses through classification scheme.
- Graduate Degree: Not required but can be substituted for one year of experience.
- Certifications: Not required but can be substituted for one year of experience.

Performance Management and Standards

The chart below represents the proposed internal auditor classifications based on the enhanced education and experience requirements.

Proposed North Carolina's Internal Auditor Job Classifications and Career Path



Appendix C contains recommended qualifications for each stage of the internal auditor career path as well as recommended job classifications that meet industry best practices.

Performance Management and Standards

What output, outcome, and efficiency performance measures should be established?

- Performance measures enable decision makers to know the value that the internal auditing function is bringing to the state agency.
- The following performance measure types and what they measure are recommended:
 - Output: Answers the question “What is the level of internal audit activity?”
 - Outcome: Answers the question: “What changed as a result of the internal audit function?”
 - Efficiency: Answers the question “How many resources did it consume per unit of product?”

Performance Management and Standards

Below are the recommended performance measures decision-makers can use to gauge the value of the internal audit function.

- **Output Performance Measures**
 - Percent of audits identified as high risk in the audit plan that were issued.
 - Percent of total available hours spent on unanticipated and/or unscheduled activities.
- **Outcome Performance Measures**
 - Percent of recommendations implemented within one year.
 - Usefulness of recommendations to Director/auditee.
- **Efficiency Performance Measures**
 - Percent of audits completed on schedule.
 - Percent of audits completed at or below budget.

Governance

Should services be provided by a central service provider for smaller agencies?

- Pool of shared internal auditors – Office of Internal Audits.
- Office of Internal Audits must be used by smaller agencies.
- Council of State members have choice on whether to use Office of Internal Audits (not required).
- Office of Internal Audits housed at Office of State Budget and Management (OSBM).
- The OSBM responsible for all support functions (for example, payroll).

Governance

Shared audit services, continued

- Director of the Office of Internal Audits leads the pool.
- Director of the Office of Internal Audits is selected by majority vote of the Council of State members (excluding State Auditor).
- Only purpose of the Office of Internal Audits to receive audit report is to assess performance of the internal auditors working for the Office.

Appendix F describes the structure and mission of the Office of Internal Audits in greater detail.

Governance

Where should the internal audit function be placed (appropriate reporting level) within state agencies?

- Professional standards require that to maintain independence, the head of the internal audit function within a state agency should report directly to the agency head.
 - The Internal Audit Manager must not have managerial or operational responsibilities for any aspect of the agency other than internal auditing.
- For those agencies using the Office of Internal Audits, the auditor from the Office reports directly to the agency head.

Governance

What authority should be conferred upon internal auditors?

- To ensure internal auditors have the authority they need to perform their functions, internal auditors should have unrestricted and unannounced access to people, records, and property. These categories are described below:
 - State employees, contractors, any entity receiving state funds for a service or product.
 - All information whether on paper or electronic.
 - All property, including physical inspection.

Governance

What legislative and executive oversight bodies should review state agencies' implementation of professional standards and development of internal audit plans?

■ Executive Branch Oversight

- The OSBM should evaluate, through the budget process, the degree to which the internal audit program has been implemented throughout state agencies. The evaluation should include a determination of whether efficiency and economy audits are being conducted.

■ Legislative Branch Oversight

- Existing committees during the budget process should request reporting of performance measures by state agencies.
- Knowing how many audits and what the effect of internal auditing has been, the legislature can determine whether there has been sufficient progress.

Legislation

Which recommendations require new statutes?

- Requiring internal auditing of all state agencies.
- Establishment of Office of Internal Audits, housed within OSBM, provides auditing services to small agencies.
- Council of State members hiring and terminating Director of the Office of Internal Audits.
- Auditors follow industry standards for performing audits.
- Establishing minimum professional qualifications for internal auditors.
- Auditors have unrestricted access to people, records, and property.
- State agencies that are performing internal audits with own staff must have an Internal Audit Manager on staff.
- Internal Audit Manager has direct access to agency head.
- Every agency must create annual audit plan based on risk assessment.
- Agencies must seek external peer reviews per industry best practices.
- Irregularities (for example fraud) are reported to agency head.

Questions?

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