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A REVIEW OF THE TEXAS STATE INTERNAL AUDITING STATUTE:  
A COMPARATIVE ANALYSIS WITH PROFESSIONAL STANDARDS  
AND OTHER STATE AUDITING STATUTES

BY

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## **Chapter I-Introduction and Statement of the Research Question**

### **A. General Introduction and Chapter Summaries**

The title of this Applied Research Project is: A Review of the Texas State Internal Auditing Statute: A Comparative Analysis with Professional Standards and Other State Internal Auditing Statutes.

Chapter 1 will provide an introduction to the applied research project and will summarize the coverage given in the six chapters that follow. The research question will be stated as follows: "What are the components of an ideal internal auditing statute for Texas state government?" The chapter will also describe the purpose and value of researching, investigating, and reporting on this topic.

Chapter 2 will provide the reader with background information on the professional setting. This chapter will focus primarily on defining the purpose and scope of the internal auditing profession. The dimensions of internal auditing practice include financial, compliance, performance, and program results audits. The profession has a common body of knowledge and auditing standards for financial, information systems, government, and general internal auditors.

This setting chapter will further explore and compare the ongoing development of auditing standards as promulgated by four authoritative professional auditing organizations: the Institute of Internal Auditors, the United States General Accounting Office, the American Institute of Certified Public Accountants, and the Electronic Data Processing Auditors Foundation.

Chapter 3 will provide the literature review for this research topic. The literature review will explore the world of internal auditing -- its foundation and history, the link with the accounting profession, the five major functions of management, the emphasis on the controlling and evaluating responsibilities of the management model, and recent national trends and developments in the profession.

The chapter will also explain the internal auditing paradigm and will identify and classify significant auditing practices such as independence, proficiency and competence, and field work and reporting practices. The latter elements are considered the practices of most importance to public sector internal auditors. The summaries by category of the primary auditing practices will represent the implied hypotheses for this applied research project.

Chapter 4 will present information pertaining to the research setting, and will include recent developments in the internal auditing profession particularly within the State of Texas. This includes the formation of the State Agency Internal Audit Forum, initiatives from the Texas Governor's Office, special reviews of internal auditing conducted in 1988 (by the State Auditor's Office, the Speaker of the House of Representatives, and a gubernatorial task force), and the passage and implementation of the Texas Internal Auditing Act of 1989. In addition, notice will be taken of the passage of internal auditing statutes in approximately 15 states. Of particular interest will be the statutory actions taken in certain states comparable to Texas in size, population, and budget.

Chapter 5 will explain the methodology to be used in conducting the research. This descriptive study will primarily use document analysis of social artifacts such as professional auditing standards, state laws, and

official government documents. This chapter will also discuss the strengths and weaknesses of the methodology selected and will describe data sources and variables measured.

Chapter 6 will analyze the results of the reviews of (1) the professional organizations and (2) the internal auditing statutes of other states. This will include a category-by-category analysis of specific auditing criteria and a determination of whether or not the criteria is essential or desirable for the ideal internal auditing statute for the State of Texas.

Chapter 7 will summarize the applied research project methodology and results and also offer conclusions and recommendations. The research question will be answered and the implications of the study will be drawn. A revision to the current Texas statute will be proposed and proffered. Discussion of study limitations and suggestions for future research will also be detailed.

The Appendix contains several useful and relevant references. Among the appendices are the following:

- Summary of the standards of the four primary professional auditing organizations,
- The Texas Internal Auditing Act of 1989,
- The model internal auditing statute developed by The Institute of Internal Auditors, Inc.
- The internal auditing statutes of five to seven states used in the comparison model,
- A glossary of key internal auditing terms.

## **B. Statement of the Research Question**

What are the components of an ideal internal auditing statute for Texas state government? This is an important question because the State of Texas faces a projected deficit of approximately \$4.5 billion for the 1992-1993 biennium. This descriptive study and comparative analysis will include the development of a model internal auditing statute.

Internal auditing is a management assistance tool that can identify more economical, efficient, and effective means of conducting state services. Public sector managers can enhance the level of agency accountability, integrity, and control by implementing audit advice and recommendations.

The Texas Internal Auditing Act was passed by the Legislature two years ago and became effective in September, 1989. Since that time, a number of reports issued by the State Auditor's Office have criticized state agencies for non-compliance with the statute. In addition, one Attorney General Opinion has already been issued interpreting the new law.

## **C. Statement of the Purpose**

The Texas internal auditing law should be consistent with auditing standards in order to assure taxpayers of comprehensive, accurate, and professional audit reports to guide public management actions. If the statute is not in compliance with professional auditing standards, audit work done by state agencies might overlook much financial and performance inefficiencies as well as fraud. In addition, such sub-standard work might result in federal audit exceptions requiring the refund of undocumented expenses.

Operational costs to state government would be significantly higher without regular, effective financial and performance audits. Development of

an ideal internal auditing statute could positively and significantly impact current and future state budgets.

The new governor, lieutenant governor and comptroller of public accounts have recently convinced the Texas Legislature that comprehensive performance audits of state agencies should be conducted as a means of finding additional budget savings. Senate Bill 111 of the 72nd Texas Legislature was the first bill signed by new Governor Ann Richards and requires the Legislative Budget Board to coordinate detailed performance audits of state agency expenditures and performance by July 1, 1991. This legislation requires the Legislative Budget Board to take a number of significant actions including the following:

(1) Challenge and question the basic assumptions underlying all state agencies and programs and services offered by the state to identify those that are vital to the best interests of the people of the State of Texas and those that no longer meet that goal; (2) conduct a complete review of all state agencies and all programs, services, and activities operated by those agencies; and (3) evaluate the efficiency with which state agencies operate the programs under their jurisdiction and fulfill duties assigned to them by law . . . .

The state leadership is hopeful that these performance audits will lead to the consolidation of like functions, a more efficient and effective operation, and significantly less new revenue needed for funding state government. The role of performance auditing in a time of fiscal crisis highlights the need and importance of professional and regular internal audit programs in state agencies. This research paper will provide recommendations to enhance or refine the 1989 Texas Internal Auditing Act.

## Chapter II-Professional Setting

### A. Definition and Purpose of Internal Auditing

#### 1. Development of the Internal Auditing Profession

Internal auditing has developed into a career area separate from the traditional direct association with the accounting profession. The Institute of Internal Auditors (IIA) is a worldwide organization with more than 40,000 members and has professional standards for practice, an ethics code, a certification program, and considerable emphasis on continuing professional development.

The IIA's founding president noted in 1941 that:

... in many corporations, internal auditing goes far beyond the mere verification of records and transactions. . . . the internal auditor performs three major functions: (1) he acts as an arm of management; (2) he rounds out and perfects the system of internal control; (3) he directly participates in the verification of financial statements.<sup>1</sup>

Internal auditing is an "independent appraisal function established to examine and evaluate activities as a service to the organization".<sup>2</sup> The introduction to the Institute of Internal Auditor's Standards further states that:

The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed.<sup>3</sup>

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<sup>1</sup> J. B. Thurston, "Modern Internal Auditing Has Just Been Born," Internal Auditor 23 (Summer 1966): 59.

<sup>2</sup> Institute of Internal Auditors, Standards for the Professional Practice of Internal Auditing (Altamonte Springs, Florida: Institute of Internal Auditors, 1978), 1.

<sup>3</sup> Ibid.



In the early 1970s, the "accountability movement" became popular as public pressure mounted on the legislative and executive branches to improve the management of government operations. Freeman correctly surmised that "Demand for improved internal auditing soars in this situation."<sup>4</sup>

In 1972, Knighton's nationwide survey noted that "Out of all the departments and agencies of state government, only 115 of them were reported to have internal auditors whose responsibilities could be defined as that of conducting an independent appraisal. . ."<sup>5</sup>

## 2. Roles and Responsibilities of Internal Auditors

There are many views on the proper role and responsibilities of the internal auditor. A publication written by members of a major CPA firm indicates that "The primary purpose of an internal audit department is to assist management in evaluating the function of systems and controls."<sup>6</sup> The same auditing textbook notes that auditing services rendered may vary due to "differences in operations, organizational structures, quality of personnel, management concepts, and availability of funding."<sup>7</sup>

Chelimsky explains the differences between auditing and evaluation:

Auditing uses the relationships of what is found with what is generally agreed to be a correct or proper situation to report on the degree of correspondence between the two. That is, auditing asks a normative question, the purpose of which is essentially one of accountability. Program evaluation,

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<sup>4</sup> Robert J. Freeman, "Internal Auditing in State and Local Governments: Poised for Take-Off," Internal Auditor 30 (March-April 1973): 74.

<sup>5</sup> Lennis M. Knighton, "Improving Internal Auditing in State Agencies," Internal Auditor 29 (November-December 1972): 72.

<sup>6</sup> Felix Pomeranz, Alfred J. Cancellieri, Joseph B. Stevens, and James L. Savage, Auditing in the Public Sector (Boston: Warren, Gorham, & Lamont, 1976): 87.

<sup>7</sup> Ibid, 87.

however, in seeking to relate program activities to program effects in a way that will be useful for a broad array of information needs, asks other questions as well.<sup>8</sup>

Dittenhofer distinguishes between performance auditing and performance evaluation in a slightly different way:

... performance auditing relates the operation to the elements of efficiency, economy, and effectiveness . . . performance evaluation is the determination of whether a program is accomplishing what the legislature had in mind when the program was designed and resources were made available."<sup>9</sup>

A recent auditing textbook listed and explained the following diverse services available in many modern internal audit departments:

- financial auditing
- fraud prevention and detection
- internal accounting control
- contract auditing
- EDP auditing
- compliance auditing
- operational auditing
- internal consulting
- productivity auditing
- managerial auditing
- personnel development
- outside contacts.<sup>10</sup>

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<sup>8</sup> Eleanor Chelimsky, "Comparing and Contrasting Auditing and Evaluation," Evaluation Review 9 (August 1985): 489.

<sup>9</sup> Mortimer Dittenhofer, "Audit Standards and Performance Auditing in State Government--A Reply," Association of Government Accountants Journal 37 (Fall 1988): 65.

<sup>10</sup> Gil Courtemanche, Audit Management and Supervision (New York: John Wiley & Sons, 1989): 14.

### 3. Public versus Private Sector Auditing

There are some similarities and differences between public and private sector auditing. Corporate internal auditing often focuses on the profit or "bottom line" of the entity being reviewed whereas governmental auditing is more often concerned with some workload or performance measurement.<sup>11</sup> While most public and private internal audit groups engage in considerable financial audit activity, governmental auditors are especially likely to conduct compliance audits that review the organization's conformity with laws, regulations, rules, policies, and procedures.<sup>12</sup>

Over the past ten years, many governmental audit functions have expanded their scope of coverage beyond financial and compliance audits into program effectiveness and performance auditing. Much of this expanded audit coverage has been fostered and promoted by the United States General Accounting Office (GAO), probably the leading audit organization in the public sector. The GAO publishes a monthly listing of current audit reports issued to the Congress-- each issue contains a wide range of coverage in topics such as the budget, defense, education, environment, health, income security, public service, social services, and taxation.<sup>13</sup>

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<sup>11</sup> State of Illinois Office of the Auditor General, Management Audit: Illinois' State Programs of Internal Auditing (Springfield, Illinois: Office of the Auditor General, 1988): 3.

<sup>12</sup> Richard L. Ratliff, Wanda A. Wallace, James K. Loebbecke, and William G. McFarland, Internal Auditing Principles and Techniques (Altamonte Springs, Florida: Institute of Internal Auditors, 1988): 688-689.

<sup>13</sup> Up to five free copies of GAO Reports are available by writing U. S. General Accounting Office, P. O. Box 6015, Gaithersburg, Maryland 20877.

## **B. Professional Auditing Standards and Certification**

### **1. Institute of Internal Auditors Standards**

In 1978, the Institute of Internal Auditors issued the landmark Standards for the Professional Practice of Internal Auditing. These standards are further supplemented by periodic Statements on Internal Auditing Standards (SIAS)<sup>14</sup> providing practitioner updates. The IIA Standards give special emphasis to promoting "an understanding of the role and responsibilities of internal auditing to all levels of management, boards of directors, public bodies, external auditors, and related professional organizations."<sup>15</sup> Note: The IIA and other professional standards are profiled in summary form in Table 1.

The Certified Internal Auditor (CIA) designation is achieved by successful completion of a four part examination administered by the IIA. While two parts of the examination are devoted to the theory and practice of internal auditing, the other two parts include testing knowledge of a broad range of disciplines. Questions are asked on the following areas: accounting, management, operations research, behavioral sciences, economics, commercial law, taxation, finance, quantitative methods, and computer information systems.<sup>16</sup>

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<sup>14</sup> Seven Statements on Internal Auditing Standards have been published by the IIA and cover such topics as control guidelines, quality assurance, fraud detection and investigation, and communication with Boards of Directors and independent outside auditors.

<sup>15</sup> Institute of Internal Auditors, Standards for the Professional Practice of Internal Auditing, 2.

<sup>16</sup> Dallas R. Blevins, "Another Look at the CIA Examination," Internal Auditor 47 (December 1990): 56, 58.

**TABLE 2.1**  
**PROFESSIONAL AUDITING STANDARDS**  
 Background Information

Organization	Standards Title	Organization Founded	Standards Published	Revised Standards Published
American Institute of Certified Public Accountants (AICPA)	Codification of Auditing Standards and Procedures	1887	1963	Sixty-three Statements on Auditing Standards (SAS) issued.
Electronic Data Processing Auditors Foundation (EDPAF)	General Standards for Information Systems Auditing	1969	1987	Two Statements on Information Systems Standards (SISAS) issued.
General Accounting Office (GAO)	Government Auditing Standards	1921	1972	Major revisions in 1981 and 1988.
Institute of Internal Auditors (IIA)	Standards for the Professional Practice of Internal Auditing	1941	1978	Seven Statements on Internal Auditing Standards (SIAS) issued.

## 2. American Institute of Certified Public Accountants Standards

The American Institute of Certified Public Accountants (AICPA) is an organization that provides professional accountants and auditors with a set of guidelines commonly known as "generally accepted accounting principles" (GAAP). AICPA also promulgates auditing standards and offers opportunities for certification and professional development. The AICPA's Statements on Auditing Standards<sup>17</sup> regularly supplement codified professional standards and help define accepted practice primarily in reviewing financial statements and internal controls. Most of the standards, philosophies, and pronouncements contained in AICPA material can be directly applied to public sector audit activities.

Recognition of professional accomplishment is achieved through passing the Certified Public Accountant (CPA) examination. Test material centers on essays and problems in accounting theory, practice, auditing, and law. Note: The Canadian equivalent of this certification is the Chartered Accountant (CA) designation.

## 3. General Accounting Office Standards

The United States General Accounting Office (GAO) is the Congressional "watchdog" and an integral element of government accountability in the balance of powers between the executive, legislative, and judicial branches of government. GAO publishes the Government Auditing Standards--Standards for Audit of Governmental Organizations, Programs, Activities, and Functions.<sup>18</sup> Also known as the "yellow book," these standards are regularly

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<sup>17</sup> American Institute of Certified Public Accountants, Statements on Auditing Standards (New York: American Institute of Certified Public Accountants, issued 1972-1990).

<sup>18</sup> United States General Accounting Office, Government Auditing Standards--Standards for Audit of Governmental Organizations, Programs, Activities, and Functions (Washington: General Accounting Office, 1988).

used by internal auditors at all levels of government to develop and implement audit plans, programs, and procedures. Originally published in 1972, the GAO audit standards were revised in 1981 and 1988.

#### 4. Electronic Data Processing Auditors Foundation Standards

The EDP Auditors Association (EDPAA) is a professional organization that serves as a useful resource for the information systems control community. EDPAA is similar to the above-listed professional counterparts in terms of instituting some of the benchmarks that move an occupational area towards recognition as a profession. The General Standards for Information Systems Auditing<sup>19</sup> became effective in January, 1988. Further specific standards will be published on an on-going basis by the EDP Auditors Foundation.<sup>20</sup>

EDPAA has also promulgated a Code of Professional Ethics, considerable professional development materials, and a certification program. The Certified Information Systems Auditor (CISA) recognition is awarded to persons passing a four and a half hour examination pertaining to eight major domain areas in information systems audit:<sup>21</sup>

1. Auditing standards, procedures, and techniques
2. Organization and management
3. Information processing facility operations
4. Logical access, physical access, and environmental controls
5. Continuity of operations

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<sup>19</sup> EDP Auditors Foundation, General Standards for Information Systems Auditing (Carol Stream, Illinois: EDP Auditors Foundation, 1987).

<sup>20</sup> The first two Statements on Information Systems Auditing Standards were issued by the EDP Auditors Foundation in 1989 and relate to auditor independence. Statement 1 discusses attitude and appearance and organizational relationship; Statement 2 focuses on auditor involvement in the systems development process.

<sup>21</sup> EDP Auditors Association, Certified Information Systems Auditor Bulletin of Information and Registration Form (Carol Stream, Illinois: EDP Auditors Association, 1990).

6. Operation systems software development, acquisition, and maintenance
7. Application development, acquisition and maintenance
8. Application systems.

## 5. Development of Common Bodies of Knowledge and Certification Programs

Barrett indicates that "professions develop when individuals recognize that others like themselves offer the same or a similar service to society." <sup>22</sup> He describes the exchange of information that leads to the gradual transformation of a profession. The body of professional knowledge becomes meaningful when "the collective experiences of these like-minded individuals are translated into generalizations, which are then set forth as a series of statements and exercises that are formally conveyed to novices in the form of books, articles, and so forth."<sup>23</sup>

Barrett further notes that the IIA, the EDPAA, and certain other professional organizations use a well-developed common body of knowledge "to guide the development of their certification programs."<sup>24</sup>

An increasing number of auditors both in the public and the private sector are seeking and obtaining professional certification (Certified Internal Auditor, Certified Information Systems Auditor, Certified Public Accountant). Still others are achieving lesser known credentials including Certified Fraud Examiner (CFE), Certified Management Accountant (CMA), and Certified Bank Examiner. Many other auditors are pursuing graduate degrees and other opportunities for professional development. In the information systems audit arena alone, internal auditors should have general familiarity with

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<sup>22</sup> Michael J. Barrett, Gerald W. Lee, S. Paul Roy, and Leticia Verastegui, A Common Body of Knowledge for Internal Auditors: A Research Study (Altamonte Springs, Florida: Institute of Internal Auditors Research Foundation, 1985): 5.

<sup>23</sup> Ibid.

<sup>24</sup> Ibid, 8-9.



mainframe and microcomputer operations, generalized audit software packages, automated budgets and plans, and such emerging trends as expert systems and artificial intelligence.

#### 6. Other Audit-Related Organizations

A number of other professional organizations have specific responsibilities and input roles and responsibilities in the development of generally accepted accounting and auditing principles. These groups will not be profiled in depth in this report and include the Financial Accounting Standards Board, the Government Accounting Standards Board, the Association of Government Accountants, the Government Finance Officers Association, the American Accounting Association, and the National Association of Accountants.<sup>25</sup>

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<sup>25</sup> Thomas R. Weirich and Alan Reinstein, Accounting & Auditing Research: A Practical Guide (Cincinnati: South-West Publishing Company, 1988): 36-37.

## Chapter III-Literature Review

### A. Introduction

The Professional Setting chapter explored the world of internal auditing--the definition and purpose, roles and responsibilities, and the evolution towards professional standards and certification. This chapter will explain the foundation and history of the internal auditing profession including the reliance on the basic management model, the roots in the accounting profession, and the expansion to performance auditing and other management services.

The literature review will also cover recent national developments in the profession and will discuss the paradigmatic elements of internal auditing practice. Further, the paper will specifically focus on significant practices and standards observed by internal auditors today particularly in the areas of independence, proficiency, field work, and reporting. This chapter will conclude with a summary of hypotheses pertaining to the structure and content of an ideal internal auditing statute.

The National Commission on the Public Service issued a bold, clear message in its final report in 1989:

We call for a renewed sense of commitment by all Americans to the highest traditions of public service--to a public service responsive to the political will of the people and also protective of our constitutional values; to a public service able to cope with complexity and conflict and also able to maintain the highest ethical standards; to a public service attractive to the young and talented from all parts of our society and also capable of earning the respect of all our citizens.<sup>1</sup>

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<sup>1</sup> National Commission on the Public Service, Leadership for America: Rebuilding the Public Trust (Washington: National Commission on the Public Service, 1989), 1.

The internal auditing profession can serve an increasingly important role in helping public sector agencies better achieve the components of the National Commission's idealized design. Accountability and integrity in government programs is regularly assessed via the oversight role of the internal auditor.

## **B. Foundation and History of the Internal Auditing Profession**

### **1. Major Functions of Management**

The major value of financial, compliance, performance, and computer system audits is in the independent review, assessment, and evaluation of an organization's systems and procedures. Many of the techniques, tests, and methods used in internal audit programs are rooted in the five functions of management: planning, organizing, directing, controlling, and evaluating.

Planning involves determining the desired objectives, goals, and strategies of the organization and developing a plan of action to bridge the gap between "where we are" and "where we want to be." Organizing is the process of assigning authority and responsibility for achievement of the organization's goals and objectives. Directing is the leadership element--motivating and guiding people towards accomplishment of the stated goals. Controlling involves making adjustments as needed to correct problem areas in order that planned objectives are met. Evaluating is the measurement and analysis of operational results with a view towards improving future performance, efficiency, and effectiveness. The evaluating element of the management function is a primary basis for internal auditing practices and procedures.

"Management" has been defined by many authors in various ways. Fundamentally, management involves achieving objectives specifically "getting things done" by, with, and through other persons. Sawyer says that

"Managers must be able to establish objectives, devise plans, develop organizations, allocate resources, direct the efforts of people, and control events so that goals will be met effectively, efficiently, and economically."<sup>2</sup> Easier said than done. It is clear that the tasks and responsibilities of government executives and information systems managers have grown increasingly complex in the past decade. Correspondingly, the need for conscientious, professional, well-founded appraisals of management actions is more critical than ever today.

## 2. Emphasis on Controlling and Evaluating Functions

Over the past several years, we have seen considerable emphasis on accountability and integrity initiatives in the public sector. This has manifest itself in the federal government's creation of the President's Council on Integrity and Efficiency (PCIE), the establishment and expansion of the Inspector General concept for major federal agencies, and in some recent recommendations of the National Commission on the Public Service (Volcker Commission). Texas has seen a State Government Effectiveness Program, operational audits conducted by business and industry "experts," and the 1989 passage of the State Internal Auditing Act. Despite these significant measures, we continue to read and hear about government officials involved in varying degrees of ethical, moral, and legal difficulties with some being indicted, convicted, and removed from office.

Some recent events from the information systems world underscore the need for public sector managers to further develop skills and abilities in the controlling and evaluating aspects of management. Computer-related

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<sup>2</sup> Lawrence B. Sawyer, The Practice of Modern Internal Auditing (Altamonte Springs, Florida: Institute of Internal Auditors, 1981), 677.

crime is unfortunately on the rise and in many cases occurs due to lack of basic internal controls in an organization.

Reports issued in the past year by the U. S. General Accounting Office (GAO), the investigative arm of Congress, reveal the diversity of the technical, administrative, and management problems experienced and unresolved in the federal sector. GAO findings reaffirmed the Volcker Commission's conclusions that "the state of public service is not what it needs to be and, as a result, programs and services have suffered."<sup>3</sup> Recent performance audits and audit management letters issued by the Texas State Auditor's Office also illustrate that accountability, integrity, and good management and control practices are lacking in some state agencies.<sup>4</sup>

### 3. Accounting Roots, the Attest Function, and Financial Auditing

Modern internal auditing has deep roots in the accounting profession to the extent that many people today still believe that internal auditing and accounting are virtually synonymous. In truth, many internal auditors rank financial accounting as one of their least preferred audit areas as well as least proficient skills area. But this was not always the case.

There is some evidence to suggest that persons performing the role and responsibilities of internal auditors can be found in the time of Persian King Darius the Great around the year 425 BC as well as in service to the King of Spain in the early 1500s.<sup>5</sup> One historian notes that internal auditors

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<sup>3</sup> United States General Accounting Office, "The Public Service: Issues Affecting Its Quality, Effectiveness, Integrity, and Stewardship," Report to the President of the United States, the President of the Senate, and the Speaker of the House of Representatives, June 6, 1989, 2.

<sup>4</sup> Copies of specific reports may be obtained by writing Office of the State Auditor, P. O. Box 12067, Austin, Texas 78711.

<sup>5</sup> Alasdair Murray, "History of Internal Audit," The Accountant (UK) 173 (November 20, 1975): 585.

were conducting financial audits at branches of worldwide businesses in the 1800s.<sup>6</sup>

The AICPA centennial issue of the Journal of Accountancy notes that with the rise of British investment in the New World in the late 1800s, accountants were sent to "vouch for the reported results of these undertakings."<sup>7</sup> The auditing profession experienced another landmark with the Federal Reserve Board's 1917 publication of the "Uniform Accounts."<sup>8</sup> This pronouncement provided detailed specifications on audit verification of balance sheet accounts and also recommended for the first time that the auditor express an opinion on the financial statements.<sup>9</sup>

The attest or authentication role of accountants and auditors relates to the verification of financial records and statements and is important to stockholders, taxpayers, management, and the general public. Over the years internal auditors have moved from primarily assisting accountants and independent auditors in financial verifications to conducting broad-based reviews of all of the activities of the business or government enterprise.

The importance of understanding the organization's system of internal control systems and procedures is essential to the internal auditor's role. The accounting and administrative control systems form the underlying basis for day-to-day business transactions and audit monitoring is essential. Thompson describes the role of auditing: "An audit tests the system; checks

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<sup>6</sup> Sidney Davidson and George D. Anderson, "The Development of Accounting and Auditing Standards," Journal of Accountancy 163 (May 1987): 112.

<sup>7</sup> Ibid.

<sup>8</sup> James J. Tucker, III, "Government Oversight in 1917: The Shape of Things to Come," Journal of Accountancy 163 (May 1987): 73.

<sup>9</sup> Ibid, 74.

it for operation in accordance with management's plan; and evaluates the system's effectiveness and efficiency." <sup>10</sup>

Internal auditing made great strides in forming a separate profession 50 years ago with the founding of The Institute of Internal Auditors (IIA) in New York City. John B. Thurston, the first president of IIA, was one of the first to clearly distinguish between internal auditors and accountants in a September 1941 speech:

... internal auditing goes far beyond the mere verification of records and transactions. ... the internal auditor ... handles special assignments, acts as a direct channel of information and as a conduit of ideas, provides a reservoir of trained executive material, verifies and maintains personnel, takes up the shock of special jobs and emergency personnel situations, perfects the budget technique, verifies compliance with the company policies and manuals, establishes observance of laws, regulations, and contract terms, acts as a coordinator, ascertains the adequacy of many types of physical property, and the propriety of their use, and, in addition, performs many other functions as a direct arm of management."<sup>11</sup>

Heeschen and Sawyer further differentiate between accounting and auditing by explaining the primary audit role: "Modern internal auditors are more concerned with people and systems throughout companies. Today's goal is to improve operations rather than point out errors."<sup>12</sup> He sees the auditor as a "problem-solving partner" rather than an adversary.<sup>13</sup> Often described as the grandfather of modern internal auditing, Sawyer further

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<sup>10</sup> William E. Thompson, A Focus on the Role of the Internal Auditor (Altamonte Springs, Florida: Institute of Internal Auditors, 1970): 7.

<sup>11</sup> Thurston, 59.

<sup>12</sup> Paul E. Heeschen and Lawrence B. Sawyer, Internal Auditor's Handbook (Altamonte Springs, Florida: Institute of Internal Auditors, 1984): 28.

<sup>13</sup> Ibid.

defines internal auditing as a "distinctive discipline" with different purposes, scope and outcome than accountants and external auditors.<sup>14</sup>

Atkisson and Brink describe the evolution of the internal auditor from the historical role as a "financially oriented checker and more of a policeman than a co-worker."<sup>15</sup> As organizations became more diverse both geographically and in product line, the audit role was enlarged as management needed more complex reviews and evaluations to be performed on all aspects of the enterprise. The internal auditor became the "eyes and ears of management" in practice as well as theory.

#### 4. Expansion to Performance Auditing and Evaluation

Performance or operational auditing was a logical next step to follow financial and compliance reviews. Brink describes and highlights the "linkage" between financial and non-financial audits and suggests that "Since the accounting record directly or indirectly reflects all operational activities, the financial review has served to open the door to the other activities."<sup>16</sup>

Alvarez describes a "conspicuous difference" between financial and operational auditing: "The financial auditor reviews consummated transactions and recommends remedial action based on actual findings. The operational auditor anticipates problems, visualizes improvements, and proposes preventive action."<sup>17</sup> He further makes the point that financial auditing describes effect and is remedial in nature while operational auditing helps ascertain the cause and is preventive.<sup>18</sup>

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<sup>14</sup> Sawyer, The Practice of Modern Internal Auditing, 7.

<sup>15</sup> Robert M. Atkisson, Victor Z. Brink, and Herbert Witt, Modern Internal Auditing (New York: John Wiley & Sons, 1986): 6.

<sup>16</sup> Ibid, 7.

<sup>17</sup> Abdon P. Alvarez, "The Role of the Internal Auditor in Policy and Decision Making," Internal Auditor 27 (November-December 1970): 17.

<sup>18</sup> Ibid, 17-18.



Of particular significance to many state governments is the increased movement away from strictly financial and compliance auditing and towards performance auditing. Performance auditing is also known as program results auditing and in Canada is known as "value for money" auditing. An excellent textbook on the subject defines performance auditing as follows:

Performance auditing is central to the effort to assess how well government is using the taxpayer's monies. It examines an organization's use of the resources made available to it, and its program accomplishments, and it does so in specific, objective terms.<sup>19</sup>

Greathouse adds the following history to the above definition:

Performance auditing was invented by accountants but is, today, practiced mostly by persons with training in the social sciences. Therefore, in performance auditing, the scientific method and the methods of rigorous social research have become fused with the discipline and traditions of auditing."<sup>20</sup>

There appears to be much overlap between and no standard definitions among the terms operational auditing, management auditing, and performance auditing. Performance auditing is defined by the United States General Accounting Office to include (1) economy and efficiency and (2) program audits.<sup>21</sup>

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<sup>19</sup> Richard E. Brown, Thomas P. Gallagher, and Meredith C. Williams, Auditing Performance in Government (New York: John Wiley & Sons, 1982): 283.

<sup>20</sup> Frank L. Greathouse and Mark Funkhouser, "Audit Standards and Performance Auditing in State Government," Association of Government Accountants Journal (Winter 1987-1988): 58.

<sup>21</sup> United States General Accounting Office, Government Auditing Standards, 2-3.

Economy and efficiency audits examine the use of resources, the causes of inefficiencies, and compliance with laws and regulations. Program audits (formerly known as program results audits) look at the overall organizational objectives, the results accomplished or achieved, legal and regulatory compliance, and the overall "effectiveness of organizations, programs, activities, or functions."<sup>22</sup>

Operational auditing has become synonymous for the overall work of the internal auditor today. Areas audited in many organizations include such diverse functions as personnel and payroll, purchasing and supply, distribution, production operations, data processing and computer operations, facilities management, sales and marketing, advertising, engineering and construction, fraud, and other administrative functions.

Program performance audits focus on effectiveness concerns such as the establishment, implementation, and achievement of goals and objectives for the organization or program. Efficiency concerns include the use of facilities, staff, and equipment in performing the program goals and objectives.<sup>23</sup> Though still relatively sparse in number, program evaluation activities have been found more frequently in the public sector during the past ten years.

The IIA Standards specifically direct internal auditors to report on "underutilized facilities, nonproductive work, procedures which are not cost justified, and overstaffing or understaffing."<sup>24</sup> The Standards further require auditors to assist management in the assessment of "objectives, goals, and systems by determining whether the underlying assumptions are

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<sup>22</sup> Ibid.

<sup>23</sup> Ratliff, et al, 683-695.

<sup>24</sup> Institute of Internal Auditors, Standards for the Professional Practice of Internal Auditing, standard 340.02.

appropriate, whether accurate, current, and relevant information is being used; and whether suitable controls have been incorporated into the operations or programs."<sup>25</sup>

### **C. Recent Developments in the Internal Auditing Profession**

The purpose of this section is to highlight some recent developments in public sector auditing. An understanding of these issues, factors, and constraints helps to understand the forces influencing the daily work of state agency internal auditors. Public sector auditing has experienced a large number of changes over the past decade resulting in more complex and more professional audit processes and products for legislators, agency managers, agency clients, and the general public.

#### **1. Complexities of Public Sector Auditing**

Governmental auditing continues to be very different from private sector auditing. Tierney suggests that public sector auditing has changed considerably to the extent that "government executives and legislators expect a rather comprehensive audit report that includes not only an opinion on the fairness of the government's financial statements, but also a report on the adequacy of control and the extent of compliance with laws and regulations."<sup>26</sup>

Former U. S. Comptroller General Elmer Staats says that "Audit complexity has also grown with changes in organizational structure such as mergers, internationalization, changes in technology, financing arrangements,

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<sup>25</sup> Ibid, standard 350.02.

<sup>26</sup> Cornelius E. Tierney, Governmental Auditing (Chicago: Commerce Clearing House, 1989): 9.

and complexities growing out of changes in laws and regulations by federal, state, and local government."<sup>27</sup>

Among the significant trends in state government auditing are the increased use of the microcomputer in audit work, the rise in electronic data processing audits, the resurgence of performance audits, an emphasis on "professionalism" and compliance with various audit standards, and the growing number of audits of federal programs.<sup>28</sup> Elliott speaks of the "tremendous expansion in the extent, scope, and types of information being audited" and the use of expert systems in auditing applications.<sup>29</sup>

Albrecht notes there has been an "explosion in the volume of professional literature (110 accounting and auditing pronouncements were issued before 1970; more than 300 have been issued since 1970)."<sup>30</sup>

## 2. Federal Government Initiatives

Some significant developments at the federal level have had significant impact on State Auditor organizations and ultimately, the internal audit functions of individual state agencies. These include the following:

- the Foreign Corrupt Practices Act of 1977,
- the Inspector General Act of 1978,
- the Single Audit Act of 1984,
- the 1987 hearings conducted by the National Commission on Fraudulent Financial Reporting (Treadway Commission),

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<sup>27</sup> Elmer B. Staats, "Why Today's Audit is More Difficult," Internal Auditor 44 (April 1987): 31.

<sup>28</sup> Stanley B. Botner, "Trends and Developments in State Post-Auditing," State and Local Government Review 18 (Winter 1986): 16-18.

<sup>29</sup> Robert K. Elliott, "Auditing in the 1990s: Implication for Education and Research," California Management Review 28 (Summer 1986): 89, 95.

<sup>30</sup> W. Steve Albrecht, "Researching Accounting and Auditing Issues," The CPA Journal (September 1987): 12.

- the hearings conducted by the House Subcommittee on Oversight and Investigations in 1986-1987,

The significance of the above and related government actions is that each considers an increased role for internal audit functions as part of the solution set for the significant problems to be addressed. The influence of the Foreign Corrupt Practices Act is still being felt some 13 years after passage. A major public accounting firm notes that "Systems of management control, particularly accounting controls monitored by an effective internal audit function, provide the basic foundation on which the accountability structure must be built."<sup>31</sup>

The Federal Inspector General Act has resulted in more focused auditing in those 24 federal agencies and departments with statutory inspectors general. One writer complains that scandals such as the recent Department of Housing and Urban Development problems could have been addressed sooner had the President, the Congress, and the press paid attention to timely and available inspector general reports.<sup>32</sup>

Major problems are being experienced by internal audit groups who work closely with CPA firms in assuring that certain entities are reviewed in line with the requirements of the Single Audit Act. A publication of the American Institute of Certified Public Accountants (AICPA) notes that there are "about 19,000 audits are anticipated under the Single Audit Act."<sup>33</sup> The article also warns of past problems in complying with this law: "After

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<sup>31</sup> Price Waterhouse & Company, Does Your Internal Audit Department Measure Up? (New York: Price Waterhouse & Company, 1979): 1.

<sup>32</sup> Scott Shuger, "When the Inspector General Speaks, Nobody Listens," Washington Monthly 21 (January 1990): 24-26.

<sup>33</sup> Joan Meinhardt, Joseph F. Moraglio, and Harold I. Steinberg, "Governmental Audits: An Action Plan for Excellence," Journal of Accountancy 164 (July 1987): 87.

scrutinizing 120 statistically selected audits by independent CPAs of government units receiving federal financial assistance, the GAO concluded that 34 percent of those audits didn't satisfactorily comply with applicable auditing standards."<sup>34</sup>

One member of the House Subcommittee on Oversight and Investigations spoke clearly of the audit role by calling internal auditors "the first line of defense when it comes to detecting and deterring fraud."<sup>35</sup> On a sour note, one of the leading experts on fraud notes that "Auditors now turn up only about 20% of the frauds detected. Most fraud cases are discovered by accident or are revealed through complaints by co-workers."<sup>36</sup>

Efforts at greater federal-state audit cooperation have improved the quality of joint efforts, but there remains much room for improvement in this relationship. Two state audit practitioners spoke in the early 1980s of four barriers to effective cooperation that continue to exist to some extent today: the absence of a formal mechanism for suggesting changes, federal rules impeding program improvements, inefficient duplication of effort, and one-way communication from the federal sector.<sup>37</sup>

### 3. Increased Scrutiny and Litigation

Another relatively new area of concern to auditors and accountants in the government arena is the potential for personal liability. Many government officials, media representatives, and taxpayers believe that the auditor should uncover all problems. Representative of that sort of belief is

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<sup>34</sup> Ibid, 86.

<sup>35</sup> Anonymous, "U. S. Congress Looks at Internal Auditors," Internal Auditor 44 (October 1987): 6.

<sup>36</sup> Joseph T. Wells, "Six Common Myths About Fraud," Journal of Accountancy 169 (February 1990): 82.

<sup>37</sup> Jeffrey H. Brewer and Glenn E. Deck, "A Different Perspective: Intergovernmental Auditing and Evaluation," GAO Review 16 (Fall 1981): 38-39.

the following statement: "The detection of any and all fraud and waste, as well as policy and procedural shortcomings effecting the overall health of the audited entity, have impliedly fallen within the bailiwick of the auditor . . ."38

The scrutiny given audits of governmental entities by outside parties appears to have increased in the past several years and deservedly so. Hepp and Holder sum up the interest well:

"The news media, public interest organizations and agencies involved in regulating or granting funds to state and local governments often believe -- because taxpayer dollars are at stake -- that more stringent standards apply to the activities of auditors when they serve the government sector."39

Self-scrutiny is also on the rise with the trend towards quality assurance or peer reviews of audit functions. Urton Anderson of the University of Texas places quality review as a sure sign of the development of a profession:

When an occupation becomes a true profession, it means that society has granted it freedom to define its work and its duty to its public . . . But with this freedom also comes the responsibility for the profession to control itself and to provide its services at a level commensurate with its current level of skills and knowledge and to increase that knowledge. It is up to the profession to take the leadership role in developing mechanisms to insure the quality of service it provides."40

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38 James Durnil and Peter Millsbaugh "Government Auditing and Legal Liability," Association of Government Accountants Journal 37 (Fall 1988): 28.

39 Gerald W. Hepp and William W. Holder, "A New Look in Governmental Audits," Journal of Accountancy 161 (April 1986): 83.

40 Urton Anderson, Quality Assurance in Internal Auditing (Altamonte Springs, Florida: Institute of Internal Auditors, 1983): 17.

#### 4. Conflict Between Auditor and Legislator Roles

A major problem in the minds of one former legislative auditor is the inherent conflict in auditor and legislator interests. Brown states that "Although many state legislators respect the audit function, even if they do not fully understand it, this respect dissipates rather quickly, or is at least rendered impotent, in the face of more important political ends."<sup>41</sup> A subsequent article by Walton and Brown indicated there are two primary areas of conflict between legislative and audit functions: "(1) inaction by the legislature on audit findings and recommendations, and (2) attempts at inappropriate legislative control over the audit function."<sup>42</sup>

One state inspector general bluntly stated the realities of some audit work: "... the hardest part of the job is facing the reality that people will betray the public trust in the job they've been given."<sup>43</sup>

#### 5. Canadian Comprehensive Audits

For many years the Canadian government has conducted "comprehensive audits" that involve some of the same elements as GAO's performance audits, i.e. economy, efficiency, effectiveness, and program results. Since 1980, the Canadian Comprehensive Auditing Foundation (CCAF) has served to coordinate policy development and training related to comprehensive audits."<sup>44</sup> Increasingly, internal audit functions are performing audits that look specifically at "systems and practices that

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<sup>41</sup> Richard E. Brown, "On the State of State Auditing: Analysis; Reflections," Public Budgeting & Finance 5 (Summer 1985): 85.

<sup>42</sup> Karen Schuele Walton and Richard E. Brown, "State Legislators and State Auditors: Is There An Inherent Role Conflict?," Public Budgeting & Finance 10 (Spring 1990): 11.

<sup>43</sup> Cheri Collis, "State Inspectors General: The Watchdog Over State Agencies," State Government News 33 (April 1990): 14.

<sup>44</sup> William F. Radburn, "Legislated Internal Audit: Canada's New Provisions," Internal Auditor 43 (June 1986): 24.



provide both for the economical and efficient use of resources and the effectiveness of operations.<sup>45</sup> Information systems and reporting practices are examined along with the use of financial, physical, and human resources and an assessment is made of program accountability.<sup>46</sup>

#### 6. Importance of Human Relations Skills

A Canadian writer speaks to one of the greatest challenges facing auditors at all levels of government today--human relations and interpersonal skills. Salmon foresees an evolving internal audit role that "must consider the influence of the growing corporate culture in government . . . a growth in "partnership" relationships will require that the audit community . . . ensures its products are relevant to all potential users-clients, agencies, other auditors, and other government officials."<sup>47</sup>

Kirkendall makes a similar point by suggesting that "more effective audit results can be obtained if the audit process is characterized by openness and cooperation between the auditor and his or her client."<sup>48</sup> He cited survey results wherein "70% of managers believed their associates would label the auditors with an image of a policeman or prosecutor."<sup>49</sup> Larry Sawyer, acknowledged by many practitioners as the "grandfather of modern internal auditing," has said it many times and said it again recently:

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<sup>45</sup> Ibid.

<sup>46</sup> Dan Garnet Brathwaite, "Aiming at a Moving Target: The Government Auditor's Dilemma," Internal Auditor 46 (October 1989): 61.

<sup>47</sup> E. R. Salmon, "Internal Audit in Government: Responding to Changing Demands," Optimum: A Forum for Management 19 (1988-1989): 14.

<sup>48</sup> Donald Kirkendall, "Can Auditors Polish Their Tarnished Image?," Association of Government Accountants Journal 39 (Summer 1990): 3.

<sup>49</sup> Ibid.

"Nothing ever happens until somebody sells something. That something could be your product, yourself, or your attitude."<sup>50</sup>

#### **D. Internal Auditing as a Paradigm**

##### **1. Conceptual Foundation of Internal Auditing**

The conceptual foundation of the internal auditing profession is built on the management model with deep roots in the accounting profession. The internal auditor's role in assisting management and the organization has evolved and now encompasses a broad range of audit activities which includes financial, compliance, operational, and performance audits of administrative and programmatic operations. Ultimately, internal auditing as an independent appraisal activity is charged with broad and complex responsibilities in assuring accountability and integrity of the public agency.

Internal control techniques and risk assessment help determine the scope and types of audit reviews to be performed. Audit plans, programs, and procedures guide the day-to-day performance of the internal auditor's job performance.

Relatively standard practices and procedures exist for planning the audit, examining and evaluating information, and reporting the results. These practices and procedures are well accepted in the internal auditing profession and are codified as standards issued by several professional associations. These standards and practices represent the consolidated "conceptual lens" through which professionals conduct their work and assess the work of others.

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<sup>50</sup> Lawrence B. Sawyer, "The Human Side of Auditing," Internal Auditor 45 (August 1988): 40.

## 2. Internal Auditing Paradigm

The coverage given in this literature review deviates substantially from the typical conceptual foundation model. This is due in large part to the paradigm that guides internal auditing principles and practice.

Babbie defines a paradigm as "a fundamental model or system for understanding things."<sup>51</sup> Social systems or structural/functional paradigms "treat society and social groups as integrated wholes composed of parts, with each part performing functions within the whole."<sup>52</sup>

Kuhn describes paradigms as "accepted examples of actual scientific practice" that "provide models from which spring particular coherent traditions."<sup>53</sup> The practice of internal auditing in the 1990s appears to be a structural paradigm. Study of the internal auditing profession's accepted standards, work practices, ethical requirements, and policies and procedures support the notion of an emerging paradigm.

Kuhn suggests that "members of a community learn their trade" by studying such artifacts as "textbooks, lectures, and laboratory notes."<sup>54</sup> So it has been and is with the internal auditing profession. The historical development of internal auditing as a separate profession is quite recent, although the heritage in management and accounting is more established. The early works of Cadmus, Thurston, Sawyer, and Brink have been bolstered by the more recent writings of Barrett, Ratliff, Wallace, Fonorow, Courtemanche, and others.

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<sup>51</sup> Earl Babbie, Observing Ourselves: Essays in Social Research (Belmont, California: Wadsworth Publishing Company, 1986): 29.

<sup>52</sup> Ibid, 30.

<sup>53</sup> Thomas S. Kuhn, The Structure of Scientific Revolutions, (Chicago: The University of Chicago Press, 1962): 10.

<sup>54</sup> Ibid, 43.

Much of the literature which deals with the practice of internal auditing can be found in numerous accounting and auditing textbooks and is long established. The basic paradigm of internal auditing is well articulated and consistently described in textbook references. Therefore, it is felt that the foundation for this research can be substantially drawn from texts rather than current journal articles.

## **E. Significant Practices in Internal Auditing**

### **1. Auditor Independence**

The Statement of Responsibilities of Internal Auditing<sup>55</sup> was first developed in 1947 and has been revised several times. The current edition of this IIA document explicitly details the need for auditor independence in the work place:

Internal auditors should be independent of the activities they audit. Internal auditors are independent when they carry out their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of audits. It is achieved through organizational status and objectivity.

Why is independence important? One author suggests that intimidation by management could seriously compromise the auditor's objective judgment, effectiveness, and the resultant audit product.<sup>56</sup> Atkisson and Brink assert that "there are always conditions that to some extent limit independence."<sup>57</sup> Despite the limitations, the authors suggest

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<sup>55</sup> Institute of Internal Auditors, Statement of Responsibilities of Internal Auditors (Altamonte Springs, Florida: Institute of Internal Auditors, revised 1981).

<sup>56</sup> Ratliff, et al, 19.

<sup>57</sup> Atkisson, et al, 35.

that a continuing effort is needed to strengthen auditor independence as an "essential basis for effective modern internal auditing."<sup>58</sup>

The job duties of the internal auditor require the impartial review and assessment of activities audited. Objectivity and organizational status allow the internal auditor to conduct audits without fear of being censored or being directed to withhold material findings and deficiencies. Sawyer says that "Objectivity implies a mental attitude that views events on a purely factual basis without influence by one's personal feelings, prejudices, opinions, or interests."<sup>59</sup>

## 2. Auditor Proficiency and Competence

Proficiency in performing audit work is essential to success of the audit product. Internal auditors should possess certain basic knowledge, skills, abilities, and interests to be successful in their profession. Internal auditors today are schooled in many disciplines ranging from the traditional accounting and business administration to public administration, finance, marketing, law, psychology, economics, mathematics, liberal arts, engineering, and other areas.

An article in a 1975 British periodical gave one of the better descriptions of the type of person who would be an excellent internal auditor:

As long as the person has the requisite qualities of adaptability, inquisitiveness, imagination, objectivity, responsibility and analytical ability, and the capacity for understanding and dealing with people, he can become a modern internal auditor and should have no trouble learning the methodology.<sup>60</sup>

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<sup>58</sup> Ibid.

<sup>59</sup> Sawyer, The Practice of Modern Internal Auditing, 778.

<sup>60</sup> Murray, 585.

The Conference Board business consortium published a 1977 research report on internal auditing that noted the qualifications for internal auditing positions have been raised commensurate with the increased scope of auditor responsibilities.<sup>61</sup> Among the trends noted were the increasing requirements for certification (particularly for senior auditor or audit management positions) and the need for audit specialists in areas such as data processing and statistics.<sup>62</sup>

Another author notes that certification programs and the Certified Internal Auditor designation in particular "promote(s) a standard of excellence for the profession among those who call themselves professional internal auditors."<sup>63</sup> Atkisson and Brink suggest that such personal qualifications as a natural curiosity, persistence, courage, and self-confidence are helpful traits that correspond with effective internal auditing.<sup>64</sup> Further, these traits describe competence and professional proficiency in an internal auditor.

### 3. Audit Field Work Practices

Audit field work incorporates both the planning and examination stages of the audit process. Planning the audit involves a myriad of often critical decisions on scope of work and time, manpower, and budget allocations. These decisions in turn are linked with larger concerns such as the development and implementation of annual and long-term audit plans and the conduct of risk assessments done on the organization's activities and functions.

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<sup>61</sup> Paul Macchiaverna, Internal Auditing (New York: The Conference Board, 1979): 4.

<sup>62</sup> Ibid.

<sup>63</sup> Ratliff, et al, 75.

<sup>64</sup> Atkisson, et al, 154-155.

There are many aspects to conducting the details of an internal audit engagement. Among these are developing audit programs and procedures, determining audit objectives, conducting a preliminary survey of the areas to be audited, researching changes that have occurred since the last review, and notifying appropriate managers of the upcoming audit. The actual examination of facilities, books, records, and computer files is usually supplemented by personal interviews of management, staff, customers, and other interested parties.

Sawyer describes the audit field work process as encompassing "all the efforts of the auditor to accumulate, classify, and appraise information so as to support an opinion and to make any needed recommendations for improvement . . . .Field work, when reduced to its barest essentials, is simply measurement and evaluation."<sup>65</sup>

After completion of the preliminary survey, the scope of the audit work should be more definitive. Fonorow notes that after such a preliminary analysis, the auditor "should be able to determine the activity's size, volume of business, number of employees, types of operating problems, and the relative success of the managers."<sup>66</sup> Further, a comparative study of financial and program operating statistics and trends will likely lead to areas needing further investigation.

Much audit field work is devoted to analyzing the organization structure and the assignment of duties, reviewing internal control systems, determining whether or not policies and procedures are being followed, and inspecting records, reports, and facilities. The verification process keeps in

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<sup>65</sup> Sawyer, The Practice of Modern Internal Auditing, 169-170.

<sup>66</sup> Milton Stevens Fonorow, Internal Auditor's Manual and Guide: The Practitioner's Guide to Internal Auditing (Englewood Cliffs, New Jersey: Prentice Hall, 1989): 171.

mind an objective "to ascertain the degree to which actual operations and controls conform to the written and oral descriptions and understandings that departmental management has given to the auditor."<sup>67</sup>

Among the techniques used in assessing an auditee's operations are internal control questionnaires, flowcharts, narrative descriptions, analytical reviews such as trend analysis and other comparisons, walk through tours, limited systems tests, document analysis, and procedure and policy reviews.<sup>68</sup>

Atkisson and Brink suggest that "familiarization, verification, and analysis have now set the stage for evaluation."<sup>69</sup> To best serve management, he asks three critical questions during the evaluation phase:

- "How good is the present result being achieved?
- Why is the result what it is?
- What could be done better?"<sup>70</sup>

Sawyer delineates the six forms of field work as "observing, questioning, analyzing, verifying, investigating, and evaluating"<sup>71</sup> He agrees that evaluating is the culmination of the examination process and states that "Proper evaluations lift the audit from what may be a detailed check to a management appraisal."<sup>72</sup>

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<sup>67</sup> David S. Kowalczyk, Cadmus' Operational Auditing (New York: John Wiley & Sons, 1987): 20.

<sup>68</sup> Ratliff, et al, 288-317.

<sup>69</sup> Atkisson, et al, 147.

<sup>70</sup> Ibid.

<sup>71</sup> Sawyer, The Practice of Modern Internal Auditing, 176.

<sup>72</sup> Ibid, 182.



Standard 300 of the IIA Standards<sup>73</sup> summarizes the broad scope of internal audit work activity:

- the reliability and integrity of information,
- compliance with policies, plans, procedures, laws, and regulations,
- safeguarding of assets,
- economical and efficient use of resources, and
- accomplishment of established objectives and goals for operations and programs.

#### 4. Audit Reporting Practices

Communication of the results of audit work is a major step in the audit process. Audit reports that clearly, concisely, and correctly convey audit findings and recommendations are the key to deficiency resolution and progress towards a better, more effective organization. Much literature can be found on audit report writing techniques, styles, and approaches. Typical advice centers on the need for a clear statement regarding the objectives, scope, and result of the audit activity, and recommendations for operational improvement.

Bromage offers that "The end product of functional writing, a formal report, is expected to be direct, concise, objective, verifiable, convincing, and (what is more) interesting."<sup>74</sup> She also illustrates the importance of the written word in persuading the reader to take action:

"... it may not be enough to determine that moneys have been lost, that staff hours have been wasted, or that benefits have been lacking. Only when

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<sup>73</sup> Institute of Internal Auditors, Standards for the Professional Practice of Internal Auditing, standard 300.

<sup>74</sup> Mary C. Bromage, Writing Audit Reports (New York: McGraw-Hill Book Company, 1979): 1.

the author convinces the reader that such problems can be solved can the report be said to have succeeded."<sup>75</sup>

Sawyer says that audit reports have two primary functions: information and persuasion.<sup>76</sup> He suggests communication difficulties occur when the writer fails "to comprehend that communication is not in the writer, the utterer; it is in the recipient. Until the recipient perceives, there is no communication -- only words on paper."<sup>77</sup>

Among Sawyer's tips for good writing are the characteristics of "accuracy, conciseness, clarity, timeliness, and tone."<sup>78</sup>

Some practitioners have concluded that the audit report is the "product" produced by the audit department. This is significant because "the internal auditor's reputation largely is based upon the audit report because it represents the only formal presentation of his or her expertise and performance."<sup>79</sup> It is important to note that audit reports serve several different audiences including executive and line management, the Board, external auditors, government and professional regulatory bodies, as well as the auditors themselves.<sup>80</sup>

Communicating the results of audit field work has been a regular area of concern and interest for many years. To illustrate the need for more professional reporting, in 1983 the Institute of Internal Auditors published Statement on Internal Auditing Standards Number 2 entitled

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<sup>75</sup> Ibid, 7.

<sup>76</sup> Sawyer, The Practice of Modern Internal Auditing, 432.

<sup>77</sup> Ibid, 433.

<sup>78</sup> Ibid, 434.

<sup>79</sup> Ratliff, et al, 189.

<sup>80</sup> Ibid, 367-369.

"Communicating Results."<sup>81</sup> According to Atkisson and Brink, this Statement was based on the "attributes model" for systems analysis.<sup>82</sup> This approach recognizes the following five attributes to audit findings:

- Statement of Condition--What is?
- Criteria--What should be?
- Effect--So what?
- Cause--Why?
- Recommendation--What should be done?

By answering these questions, the auditor provides considerable information and a frame of reference for management decision making and action. It is clear that communicating audit results is an audit practice area warranting considerable attention.

## 5. Quality Practices

Quality control practices in any administrative or programmatic operation is an indication that management is committed to producing a better product or service. Quality control in an internal audit operation often takes the form of internal checks and edits on the development and ultimate release of a written or verbal report.

Quality can also take the form of an external or peer review by other audit professionals. This subject was highly theoretical in most internal auditing discussions as recently as ten years ago. With the development of statutory requirements and the rise of professional standards, external review is becoming more commonplace.

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<sup>81</sup> Institute of Internal Auditors, Statement on Internal Auditing Standards Number 2-Communicating Results (Altamonte Springs, Florida: Institute of Internal Auditors, 1983).

<sup>82</sup> Atkisson, et al, 224.

Heeschen and Sawyer speak of the intrinsic value of soliciting user departments and managers on the value of audit services.<sup>83</sup> These authors recommend an "audit effectiveness questionnaire" that asks auditees to rate such factors as the usefulness of the audit, the appropriateness of audit objectives, the communication and demeanor of assigned auditors, and the fairness and completeness of findings and recommendations.<sup>84</sup>

Fonrow believes that external peer reviews are "an excellent tool for keeping the internal audit staff up-to-date on new auditing approaches and new areas for audit examinations."<sup>85</sup> He suggests that this can be particularly useful as an evaluation benchmark to assess future needs for new audit directors and for board audit committees.

Ratliff and Wallace believe many audit departments are not evaluated externally due to a frequent feeling by executive management and board members that they rather than outsiders are in the best position to assess internal audit performance.<sup>86</sup>

Sawyer disagrees strongly as he believes the most independent evaluation comes from professional peer review:

The reviews . . . seek to determine whether the quality control policies and procedures are adequately documented, communicated to the staff auditors, and effectively complied with so as to provide reasonable assurance that the internal auditing department is meeting the standards of the profession . . .<sup>87</sup>

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<sup>83</sup> Heeschen and Sawyer, Internal Auditor's Handbook, 113.

<sup>84</sup> Ibid, 163-164.

<sup>85</sup> Fonrow, 8.

<sup>86</sup> Ratliff, et al, 480.

<sup>87</sup> Sawyer, The Practice of Modern Internal Auditing, 669.

Among the areas to be evaluated in a quality review are organizational status and working relationships with management, audit policies and procedures, scope of audit work, compliance with professional standards, and quality of working papers and reports.

The Institute of Internal Auditors recognized the need for additional guidance on this topic in 1984 with the publication of Statement on Internal Auditing Standards Number 4 on quality assurance. This pronouncement provided practitioners with guidance on a three prong approach: supervisory reviews, internal reviews, and external reviews.<sup>88</sup> The statement further noted an important value of external reviews was "to provide independent assurance of quality to senior management, the audit committee, and others such as the independent outside auditors who rely on the work of the internal auditing department."<sup>89</sup>

Anderson published one of the earliest guides to conducting a quality review program in 1983 and suggested there are four stages in the process: preliminary preparation for a review, preparation for field work, performance of field work, and reporting.<sup>90</sup>

Preliminary preparation involves an audit organization's self analysis study as well as handling the administrative arrangements for a competent team to conduct the study. The components of field work preparation include distributing survey forms to auditee management, completing self study forms, and scheduling interviews. Actions required in the field work performance and reporting stages typically parallel routine audit activity.

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<sup>88</sup> Institute of Internal Auditors, Statement on Internal Auditing Standards Number 4- Quality Assurance (Altamonte Springs, Florida: Institute of Internal Auditors, 1986).

<sup>89</sup> Ibid.

<sup>90</sup> Anderson, 35-37.

Willborn indicates "the area of quality control of audits remains largely unresearched."<sup>91</sup> He believes that quality review of audit methodologies and techniques can better assure that "defects in the form of false findings and conclusions, reporting, interpretations, etc., can be minimized."<sup>92</sup>

A recent report of the Texas State Auditor's Office suggests that audit management can do more to provide a measure of quality in internal audit performance. The State Auditors noted that twenty-five percent of audit directors surveyed "have not established performance measures to assess the effectiveness of their internal auditing departments."<sup>93</sup>

## **F. Summary of Hypotheses**

### **1. Overview**

This is an excellent juncture to repeat the research question for this project: "What are the components of an ideal internal audit statute for Texas state government?"

There appears to be much common ground on the typical policies, practices, and procedures to conducting effective audits in the public sector. Much of the literature on internal audit practice and performance leads one back to the primary standards for practicing the internal auditing profession--the IIA Standards. It is apparent that the pervasive impact of the 1978 IIA Standards has been felt both in the literature and in audit practice.

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<sup>91</sup> Walter Willborn, Compendium of Audit Standards (New York: American Society for Quality Control, 1980): 5.

<sup>92</sup> Ibid.

<sup>93</sup> Texas State Auditor's Office, Statewide Review of Internal Auditing (Austin, Texas: State Auditor's Office, 1991): 2.

Table 3.1 illustrates key criteria that are essential for performing effective audit work. The implied hypothesis is that these identified practices are highly desirable for effective audit operations and therefore should be found in an effective internal auditing statute for the State of Texas.

## 2. General Standards Category

There are two general standards that are important for effective audit performance: independence and proficiency/competence. Independence assures that the audit work is performed objectively in the best interests of all stakeholders--taxpayers, the Legislature as the elected representatives of the people, clients, vendors, management, employees, the Board, and other customers.

An effective internal auditing statute should demonstrate independence through specific statements that allow auditor interaction with a wide variety of parties including management at all levels, board audit committees, external auditors, and professional associations.

Proficiency/competence is an important general standard because the skills and abilities of internal auditors are the basis for quality audit products. The ideal internal auditing statute should include requirements for college education and diverse experiences for the chief auditor. Priority should also be given for continuing professional development with encouragement for certification.

## 3. Field Work Standards Category

The literature consistently argues that there are at least two areas for consistent practices or standards in the performance of audit field work: (1) scope of work and (2) planning and examination. The ideal auditing statute should include definition of a wide range of types of audits including

**TABLE 3.1**  
**SIGNIFICANT INTERNAL AUDIT PRACTICES/CRITERIA**

CATEGORIES	PRACTICE	DESCRIPTION
General Standard	Independence	Assures that audit work is performed objectively with access to various stakeholders.
General Standard	Proficiency/Competence	Auditor knowledge, skills, and abilities are the basis for quality audit reports.
Field Work Standard	Scope of Work	Authority needed to pursue wide range of financial, compliance, and performance audits throughout the organization's financial and administrative operations.
Field Work Standard	Planning and Evaluation	Annual and long-range audit plans are needed; need standards for audit examination and evaluation.
Reporting Standard	Format and Distribution	Reports should be professional in form and content; management should not limit distribution
Quality Standard	External Review	Internal audit function should be reviewed periodically by peers or other external parties; quality assurance reviews should assess compliance with professional standards.



financial, compliance, performance. The latter includes the conduct of program results audits whereby the organization's established goals and objectives are assessed in detail.

Auditors should have the authority to perform diverse administrative, financial, data systems, and other audits as well as perform investigative projects. The internal auditing law should clearly delineate these authorities and responsibilities.

Accepted planning and examination practices should also be spelled out in the statute. This better assures the development of annual and long-range audit plans, the assessment of risk among competing audit project needs, and the analysis of complex administrative and accounting control systems that underlie daily business transactions. Professional practices in reviewing and evaluating evidence and documenting audit work papers should also be referenced in order to assure proper conduct of the audit and sufficient, relevant documentation to support audit findings and recommendations.

#### 4. Reporting Standard Category

The statute should also provide authorization for publication and distribution of audit reports. The content and format of reports should conform to established professional practice and the distribution should not be limited to management's jurisdiction. The internal auditing law should give the auditor authority to send report copies to appropriate managers, board members, and external auditors such as the State Auditor's Office.

#### 5. Quality Standard Category

Quality control is an important variable in any administrative or programmatic operation. It is part of the evaluating function of management and can lead to better planning and better systems and procedures for

providing goods or services to customers. Quality assessment and monitoring in an internal audit operation helps answer the inevitable question "Who audits the auditors?"

Both internal and external reviews of the audit process and results can lead to better audit reports and overall a more effective audit department. External peer reviews of internal audit operations are a fairly recent development in the profession and can be of significant value to the organization.

## 6. Summary

In summary, an internal auditing statute that includes the attributes described above will better serve the needs of all interested parties and will better insure objective, unbiased assessments of public agency performance. The research method used to accomplish the above analysis is a descriptive study primarily using document analysis. Social artifacts to be reviewed include the standards of four leading professional associations and the internal auditing statutes of six or more states including the current Texas law.

Little previous research on this specific and emerging topic was uncovered in the literature review. The research setting for the applied project is detailed in Chapter IV.

## Chapter IV-Research Setting

### A. Internal Auditing in Texas State Agencies

Internal auditing in the Texas agencies has been an especially popular subject for review, appraisal, analysis, and reporting in the past several years. Table 4.1 is a "Chronology of Statements, Reports, and Other Documentation on Internal Auditing in Texas State Agencies."<sup>1</sup> The following discussion will highlight documents most relevant to the literature review.

#### 1. State Agency Internal Audit Forum

In July 1984, the Texas State Agency Internal Audit Forum (SAIAF) issued a 13-point Position Statement of Internal Auditing in State Agencies.<sup>2</sup> This SAIAF action was one of the earliest documented efforts to establish and nourish a vital communication network of state agency internal auditors and has resulted in enhanced professional development and job classification opportunities for state agency auditors. The SAIAF organization has continued to operate as a subcommittee of the State Agency Coordinating Committee, composed of the fourteen largest Texas state agencies. SAIAF has sponsored projects involving audit management concerns such as career ladders, training seminars, and input on pending legislation. Currently, there are preliminary plans to develop an external peer review capability among member agencies in order to independently assess internal audit operations and comply with the IIA Standards.

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<sup>1</sup> The assistance of Robert H. Strickland, Assistant Commissioner for Management Audit, Texas Rehabilitation Commission, is gratefully acknowledged in obtaining copies of several of the documents in this compilation.

<sup>2</sup> David J. MacCabe and Robert J. Stanislawski, "Solutions-Texas Style," Internal Auditor 42 (June 1985): 59-60.

**TABLE 4.1**  
**CHRONOLOGY OF STATEMENTS AND REPORTS ON INTERNAL**  
**AUDITING IN TEXAS STATE AGENCIES**

May 12, 1983	Governor's State Agency Coordinating Committee, Internal Audit and Review Subcommittee. <u>Position Statement on Internal Auditing in State Agencies.</u>
July 5, 1984	Texas State Agency Internal Audit Forum. <u>Position Statement on Internal Auditing in State Agencies.</u>
Nov. 1984	LBJ School of Public Affairs, University of Texas at Austin, <u>Management Study of the Texas State Auditor's Office.</u>
Nov. 12, 1987	Governor's Executive Order WPC 87-18 regarding Internal Auditing
May 26, 1988	Office of the State Auditor. <u>Statewide Report on Internal Auditing: A Report to the Legislative Audit Committee.</u>
Aug. 30, 1988	Speaker's Advisory Task Force on Internal Auditing. <u>Recommendations for Improvement of Internal Audit in State Government: A Report to the Speaker of the House of Representatives.</u>
Dec. 1988	Governor's Office. <u>Findings and Recommendations of the Accounting, Auditing and Financial Reporting Task Force.</u>
May 27, 1989	71st Texas Legislature, Regular Session. House Bill 2728, <u>Texas Internal Auditing Act</u> (later codified as V.A.C.S. article 6252-5d.).
1989	C. Aubrey Smith Center for Audit Education and Research initiated at the University of Texas at Austin (State of Texas was a charter sponsor).
Feb. 1991	Office of the State Auditor. <u>Statewide Review of Internal Auditing.</u>

## 2. Management Review of the State Auditor's Office

A November 1984 study of the State Auditor's Office noted that:

The internal audit function should be given appropriate independence in every agency where it exists by having the head of that unit report to the chief executive officer . . . with the clear understanding that he (she) also has direct and immediate access to the governing body of the agency."<sup>3</sup>

The report recommended the State Auditor's Office get more directly involved and "give strong leadership to the internal audit movement."<sup>4</sup> A proposed policy directive from the Legislative Audit Committee to the State Auditor was developed as part of the report recommendations. This directive was later issued and required the State Auditor's Office to use the IIA Standards in evaluating agency internal audit practice.<sup>5</sup>

Another major recommendation of the study was that "The State Auditor should take immediate steps to establish an EDP audit capability and discontinue placing undue reliance on the computer without testing."<sup>6</sup> The EDP Audit Division was founded in 1985 and considerable audit activity has been conducted using both vendor and in-house software and reviewing general and application controls. According to audit executive Ronnie Jung, "99% of the time, using automation will lead to more effective audits."<sup>7</sup> He also believes that using the computer allows better audit coverage, helps understanding of the total population reviewed, and reduces inherent risks.

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<sup>3</sup> Terrell Blodgett, Management Study of the Texas State Auditor's Office (Austin: LBJ School of Public Affairs, 1984): 114-115.

<sup>4</sup> Ibid., 115.

<sup>5</sup> Ibid.

<sup>6</sup> Ibid., 11.

<sup>7</sup> Ronnie Jung, Director of Planning and Support Services, State Auditor's Office, interview by the author, Austin, Texas, April 25, 1990.

### 3. Governor's Office Initiatives

During this same year Governor Mark White communicated with state agency board chairpersons on the need for board audit committees and the creation of inspector general or internal audit functions. A handbook issued to newly-appointed board and commission members stressed the importance of the internal audit function, the board's review of audit findings and recommendations, and support for the internal audit role of assisting management "in ascertaining that agency operations--fiscal and otherwise--are conducted with legality, fidelity, efficiency, and in accord with board-adopted policies and procedures."<sup>8</sup>

Another significant event in Texas was the November 1987 executive order on internal auditing issued by Governor Bill Clements. The order recognized that internal auditing was "a highly regarded professional management support and control procedure" and stated that agencies meeting certain budget, personnel, revenue, and other criteria should particularly consider establishing an internal audit function.<sup>9</sup> It is interesting to note that much of the language and details of this executive order served as the framework for the Texas Internal Audit Act some two and a half years later.

### 4. Legislative and Other Reviews Conducted in 1988

Three major reports issued in 1988 further analyzed the world of Texas state government internal auditing. The Statewide Report on Internal

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<sup>8</sup> Texas Governor's Office, Handbook for Members of Texas State Boards and Commissions (Austin: Texas Advisory Commission on Intergovernmental Relations, 1984): VII-10.

<sup>9</sup> Texas Governor's Office, Executive Order WPC 87-18 pertaining to internal auditing, November 12, 1987.

Auditing<sup>10</sup> developed by the State Auditor's Office reviewed auditing functions in 48 of the largest state agencies and universities. The report noted strengths, areas of improvement, and separate recommendations for consideration by the State Legislature and by state agencies and universities.

The recommendations for the Legislature dealt with (1) the need for a state law requiring audits to be conducted following IIA Standards and (2) the value of establishing a Department of the State Internal Auditor (similar to the Virginia statute). The report provided 11 recommendations to agency managers in areas such as standards, scope of audits, planning and risk assessment, training, summary reporting to the board, board audit committees, and certification.

A task force established by the Speaker of the House of Representatives reported on Recommendations for Improvement of Internal Audit in State Government in August 1988.<sup>11</sup> Among the major recommendations were the establishment of an independent office for a State Coordinator of Internal Audit and the enactment of a state law requiring audits to be conducted in line with the IIA Standards. The task force further addressed audit training, job classification, and quality assurance needs.

The December 1988 report of the Governor's Task Force on Accounting, Auditing and Financial Reporting contained detailed recommendations on a number of areas including internal financial and

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<sup>10</sup> Texas State Auditor's Office, Statewide Report on Internal Auditing: A Report to the Legislative Audit Committee (Austin: State Auditor's Office, 1988).

<sup>11</sup> Texas Speaker's Advisory Task Force on Internal Auditing, Recommendations for Improvement of Internal Audit in State Government: Report to the Speaker of the House of Representatives, August 30, 1988.

performance auditing.<sup>12</sup> The task force focused on the need for an internal auditing statute, board audit committees, and statewide oversight and coordination of state agency internal audit operations.

#### 5. Auditing Research and Education

In 1989, the University of Texas at Austin established the C. Aubrey Smith Center for Audit Education and Research. Its principal objective is to provide professional development opportunities for both public and private sector auditors. In the past year, the C. Aubrey Smith Center has offered seminars on such topics as audit planning, peer review and quality assurance, risk analysis, and an auditing standards update.<sup>13</sup> The Center will co-sponsor a conference on "Measuring Audit Productivity" with the Institute of Internal Auditors Research Foundation in May 1991. In addition, during the past year the University of Texas offered its first internal auditing class (including an EDP audit component) in the master of business administration curriculum.<sup>14</sup>

Despite some encouraging actions, there are indications that internal auditing still has much development work ahead among state agencies. A review of the current membership list for the EDP Auditors Association Austin Chapter indicates that only 12 state agencies have one or more

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<sup>12</sup> Texas Governor's Task Force on Accounting, Auditing and Financial Reporting, Findings and Recommendations of the Accounting, Auditing and Financial Reporting Task Force, December 21, 1988.

<sup>13</sup> Urton Anderson, Associate Director, C. Aubrey Smith Center for Auditing Education and Research, University of Texas at Austin, interview by the author, January 22, 1991.

<sup>14</sup> The development of this program answers the concerns and cries of many including a University of Texas thesis writer who stated the College of Business Administration curriculum "does not adequately prepare the normal accounting major for an internal auditing job." See Michaela Lara' Elam, The Professional at Work: The Internal Auditor, Professional Report, May 1978, 89.



members. This contrasts sharply with the 29 agencies with members in the local Institute of Internal Auditors chapter.

Conversations with some audit managers and directors lead this author to believe that few comprehensive surveys have been conducted among Texas state agencies analyzing the scope and extent of internal audit activities since passage of the 1989 law. Much can be learned from the successes and the failures of sister agencies in initiating and expanding internal audit programs.

#### 6. Texas Internal Auditing Act

The Texas Internal Auditing Act,<sup>15</sup> passed by the Texas Legislature in 1989, mandates state agencies to include accounting, administrative, EDP and other major systems and controls as part of an on-going internal audit program. The Legislature did not establish the recommended internal audit oversight office as recommended by all three 1988 studies, ostensibly due to budget constraints.<sup>16</sup> This Texas law was effective on September 1, 1989 and will be profiled more extensively in the "Internal Auditing Legislation" section of this chapter.

The State Auditor's Office distributed an Internal Audit Policy Statement to state agency executive directors and internal audit directors in January 1989 and issued a supplemental version in September 1990.<sup>17</sup> The statement provides guidance on how the Auditor's Office will assess state agency compliance with the Texas Internal Auditing Act. The revised

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<sup>15</sup> Texas Legislature, H. B. 2728, 71st Legislature, Regular Session, 1989 (later codified as V.A.C.S. article 6252-5d). A copy of the Texas Internal Act is included as Appendix E to this report.

<sup>16</sup> G. Alex McAlmon, "Strengthening Internal Audit in Texas Government," Today's CPA 15 (May/June 1990): 34.

<sup>17</sup> Texas State Auditor's Office, Internal Audit Policy Statement. Operation Memo #30 issued on January 30, 1989 to Executive Directors and Internal Audit Directors of Texas state agencies. Supplemental version issued September 24, 1990.

version takes into account the first opinion issued by the Texas Attorney General's Office on this new law.<sup>18</sup>

## 7. Statewide Review of Internal Auditing

The Texas State Auditor's Office is required to conduct reviews of agency internal audit functions every biennium<sup>19</sup> and recently issued a report on the statewide review of internal auditing. State Auditor Lawrence Alwin's cover letter to the Members of the Legislative Audit Committee notes that as a result of the 1989 law, "the State of Texas took a major step in enhancing statewide accountability over public funds."<sup>20</sup>

Among the four major issues profiled in the State Auditor's report are two that are germane to this research effort. The State Auditors suggested that "Internal Auditing departments can improve audit effectiveness by following professional standards."<sup>21</sup> Specifically cited were a greater need for organizational independence, audit follow-up work, expanded scope of work, coverage of automated data systems, and external quality assurance reviews.

A second issue of interest is that "Professional certification is required for internal auditing directors."<sup>22</sup> The State Auditor's report found that 24 of 91 agencies subject to the law did not have Certified Internal Auditors or Certified Public Accountants in the audit department. Several other agencies

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<sup>18</sup> Texas Attorney General's Office, Opinion JM-1183 re: Applicability of the Texas Internal Auditing Act, article 6252-5d., V.A.C.S., Letter to the Commissioner, Texas Rehabilitation Commission, July 5, 1990.

<sup>19</sup> Ronnie Jung, Director of Planning and Support Services, Texas State Auditor's Office, interview by the author, November 28, 1990.

<sup>20</sup> Texas State Auditor's Office, Statewide Review of Internal Auditing (Austin: State Auditor's Office, 1991).

<sup>21</sup> Ibid, 10.

<sup>22</sup> Ibid, 16.

had CIAs/CPAs but the internal audit director was lacking this credential required by law.<sup>23</sup>

## **B. Internal Auditing Legislation**

### **1. Inventory of State Internal Auditing Statutes**

Texas joined approximately 15 other states with the passage of the 1989 legislation. California, Illinois, and Tennessee were among the first states to pass legislation addressing state government internal audit functions.

It is important to note that there are wide differences among the 16 states in the scope and depth of internal auditing laws. Some state legislation is limited to the mandated use of the IIA Standards; this in itself is significant. Other state laws provide only brief mention of the need for internal auditing as a paragraph or two in more comprehensive legislation on a related topic. Yet another group of states (including Texas) have full-fledged internal auditing statutes with significant coverage and requirements.

Table 4.2 is a summary analysis listing states with internal auditing statutes and details the date of passage of the law, professional audit standards cited, and whether or not the CIA or CPA qualifications are required by the law. A more comprehensive analysis will be developed when conducting the applied research project.

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<sup>23</sup> Ibid, Appendix A-Agencies Under the Texas Internal Auditing Act, 17-19.

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**TABLE 4.2**  
**ANALYSIS OF STATES WITH INTERNAL AUDITING STATUTES**

<u>State</u>	<u>Date of Statute</u>	<u>Standards Cited</u>	<u>CIA/CPA Qualification</u>
California	1982	IIA	no
Florida	1990*	IIA and (GAO)	CIA/CPA
Illinois	1989*	IIA and GAO	CIA/CPA
Louisiana	unknown	IIA	no
Maine	1988	unknown	CIA/CPA
Michigan	1986	none	no
Nebraska	1984	AICPA, GAO, GASB	CPA
New York	1987	(IIA)	no
Tennessee	1984	IIA	no
<b>TEXAS</b>	<b>1989</b>	<b>IIA</b>	<b>CIA/CPA</b>
Virginia	1985	IIA	no
Washington	unknown	IIA	CIA

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\* Indicates statute was revised this date.

Note: The states of New Jersey, Ohio, Pennsylvania, and South Carolina also have internal auditing statutes but are not included in this table due to lack of information.

Sources: (1) Documents obtained from the Texas State Auditor's Office and other states and (2) Kevin M. Carhill and James K. Kincaid, "Applying the Standards in Governmental Internal Auditing," Internal Auditor 46 (October 1989): 50-55.

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## 2. Legislation Content

The Florida,<sup>24</sup> Illinois,<sup>25</sup> and Texas internal auditing laws are among the most comprehensive in the nation. The following is a list of subject areas covered in one or more of these laws:

- purpose of the law
- definitions (e. g. agency, administrator, audit)
- appointment method
- qualifications, e. g. CIA or CPA
- reporting relationships
- independence
- annual audit plans using risk assessment techniques
- scope of audits, i. e. accounting, administrative, EDP, and other major systems and controls
- duties, e. g. conduct audits, prepare audit reports, conduct quality assurance reviews
- external consultations with State Auditor's Office and others
- professional standards compliance, e. g. IIA and GAO
- professional development and training
- effective date of statute.

The Commonwealth of Virginia is unique in the establishment of a separate agency -- the Department of the State Internal Auditor -- set up by legislation to provide "policy and technical leadership, staffing, monitoring

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<sup>24</sup> The Florida law is cited as Florida Statutes, Chapter 20.055, 1990 Supplement to Florida Statutes, 1989. A copy of the Florida Internal Audit Act is located at Appendix I to this report.

<sup>25</sup> The Illinois statute is cited as Illinois Statutes, Civil Administrative Code, Public Act 86-936, Fiscal Control and Internal Auditing Act, 1989. A copy of the Illinois law may be referenced at Appendix J.

effectiveness, and professional development."<sup>26</sup> DSIA was established by the Code of Virginia as a separate state agency in July 1985. DSIA staff members currently teach some 25 different courses in topics such as basic internal auditing and information systems and conduct regular evaluations of agency compliance with IIA's professional standards.<sup>27</sup>

The 1982 California statute uses the \$50 million aggregate spending threshold for state and local agencies to "consider establishing an ongoing internal audit function."<sup>28</sup> Those California agencies with ongoing audit functions are required to comply with the IIA Standards.

In the State of Maine, a 1988 law gave supervisory auditors in state agencies a three year grace period in which to obtain the Certified Internal Auditor designation.<sup>29</sup> The New York State Governmental Accountability, Audit and Internal Control Act of 1987 specifies that audit functions will be established "upon an evaluation of exposure to risk; costs and benefits of implementation, and any other factors determined to be relevant."<sup>30</sup>

In Florida, a citizens advocacy group reported that "expanding the internal audit function would help build citizen confidence, increase assurance that government agencies and programs perform properly and productively, and save taxpayers more than \$70 million."<sup>31</sup> The Florida

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<sup>26</sup> John H. Huston and Richard A. Kovatch, "Weighing the *Standards*: Where is the Emphasis in Quality Assurance?," Internal Auditor 43 (December 1986): 31.

<sup>27</sup> Letter from Phyllis C. Petree, Internal Audit Technical Manager, DSIA to the author, January 22, 1991.

<sup>28</sup> State of California, California Government Code, Sections 1237, Financial Accountability and State Managers Accountability Act, 1982.

<sup>29</sup> Anonymous, "Certification in the Maine Stream," IIA Today 8 (November-December 1988): 12.

<sup>30</sup> New York Statutes, S. 6442, A. 8534, Chapter 814, section 952, 1987.

<sup>31</sup> Sam McCall, "Internal Auditing in Florida State Government," IIA Today 10 (March-April 1990): 12.

Auditor General has conducted over 20 quality assurance reviews of agency internal audit operations.<sup>32</sup>

Texas State Auditor Larry Alwin says that "the passage of the Texas Internal Auditing Act demonstrates the commitment on the part of our Governor and legislature to improving accountability for public funds."<sup>33</sup>

### 3. Institute of Internal Auditors Model Statute

The Institute of Internal Auditors has developed a model state internal auditing statute and actively promotes passage of such legislation. IIA also has a Government Relations Committee that is currently chaired by Texas State Auditor Larry Alwin.

An executive of the Institute of Internal Auditor recently indicated that implementation of the Standards for the Professional Practice of Internal Auditing has continued to spread and have recently been implemented by legislation in a number of countries including Canada, Israel, the United Arab Emirates, and in December 1990 by the United Nations.<sup>34</sup> The IIA representative further stated that the Code of Ethics for internal auditors is now printed in English, Spanish, and French and the CIA examination will soon be administered in Danish, Hebrew, and Indonesian in addition to the more traditional languages.<sup>35</sup>

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<sup>32</sup> Letter from Sam M. McCall, Deputy Auditor General to the author, January 25, 1991.

<sup>33</sup> Anonymous, "Texas Passes Internal Audit Act," IIA Today 9 (November-December 1989): 12.

<sup>34</sup> Thomas E. Powell, Director of Professional Practices, Institute of Internal Auditors, telephone interview, December 3, 1990.

<sup>35</sup> Ibid.

### **C. Summary**

As developed in the literature review, sound internal audit practice is grounded in understanding and practicing the basic management functions of planning, organizing, directing, controlling, and evaluating. The profession has been significantly enhanced over the 1970s and 1980s with the development and implementation of the IIA, AICPA, GAO, and EDPA audit standards.

The internal auditor today deals with a changing environment with increasingly complex, diverse, and sometimes conflicting demands. This requires significant human relations, technological, and other skills. Quality assurance has become increasingly important for the profession and its stakeholders.

The State of Texas conducted several self-examinations of internal audit activity in the 1980s. The end results appear to be a stronger, more professional audit community and more diverse and comprehensive internal audits. A review of available records indicates that Texas is one of approximately 16 states with internal auditing legislation; Texas, Florida, and Illinois appear to be among the more comprehensive auditing statutes.

The author believes much more can be learned by conducting further investigation into internal auditing statutes and has therefore selected this applied research topic. The methodology to be used in conducting this project is described in Chapter V.



## Chapter V-Methodology

### A. Descriptive Study Characteristics

This project is a descriptive study of internal auditing statutes in effect across the United States including a comparative analysis with the Texas statute. Specific techniques used to address the research purpose were document analysis of public records, written correspondence, and personal interviews.

Babbie notes that the description of observed situations and events is the purpose of many social science studies conducted.<sup>1</sup> According to Adams and Schvaneveldt, the main goal or strength of descriptive research is "to portray an accurate profile of persons, events, or objects."<sup>2</sup> The authors further state that such studies "are concerned with taxonomy building, providing profiles, showing the emergence of phenomena, and the general relationship between events, persons, or objects."<sup>3</sup>

Adams and Schvaneveldt caution that considerable care should be taken in deriving descriptive research samples.<sup>4</sup> Weaknesses of descriptive research include (1) the need for careful selection of the subject analyzed and presented and (2) the need to focus on specific events or items while excluding others.

A descriptive study will not provide detailed information on the implementation success or failure of specific internal auditing statutes.

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<sup>1</sup> Earl Babbie, The Practice of Social Research (Belmont, California: Wadsworth Publishing Company, 1989): 81.

<sup>2</sup> Gerald R. Adams and Jay D. Schvaneveldt, Understanding Research Methods (New York: Longman, Inc., 1985): 106

<sup>3</sup> Ibid, 111.

<sup>4</sup> Ibid, 113.

Descriptive analysis provides base line information and is an essential point of departure for future research.

## **B. Research Subjects and Materials**

Social artifacts were used as the data source or unit of analysis. They include (1) the laws of selected state governments pertaining to the practice of internal auditing and (2) the standards of leading auditing professional organizations. Statistics used were raw frequencies and percentages (relative frequencies). Variables were measured using a nominal scale. Descriptive variables reviewed included the purpose of the law, definitions, applicability, audit program coverage, appointment method, qualifications, duties, consultative relationships, professional standards used, and professional development requirements.

Some background information and perspective was obtained via personal interviews and/or correspondence with State Auditor/Auditor General offices in seven large states. The sample of seven large states is representative of governmental units similar in budget, size, geographic diversity, and population to Texas. Sample states were California, Florida, Illinois, Michigan, New York, Virginia, as well as Texas.

Copies of the seven state internal auditing statutes were obtained from the Texas State Auditor's Office. In addition, copies of the statutes were obtained directly from the Auditor General's Office in each state (State Internal Auditor in Virginia). This latter action was useful since statutes in Florida, Illinois, and Virginia had been revised since the Texas State Auditor's Office developed their compilation in 1988.

Approximately 30 letters were written to obtain supplementary information and documentation. Several contacts were also made with members of the Texas state government internal audit community. Table 5.1 gives the title and date of each state statute and indicates whether the state law emphasizes internal audit or internal control.

**TABLE 5.1**  
**STATE LAWS ON INTERNAL AUDITING AND INTERNAL CONTROLS**  
**Review of State Statutes**

State	Title	Date	Emphasis
California	Financial Integrity and State Managers Accountability Act	1983	Internal controls
Florida	Internal Audit Act	Revised 1990	Internal audit
Illinois	Fiscal Control and Internal Auditing Act	Revised 1989	Internal audit/ internal controls
Michigan	Internal Control Act	1986	Internal controls
New York	State Governmental Accountability, Audit, and Internal Control Act	1987	Internal controls
Texas	Internal Auditing Act	1989	Internal audit
Virginia	Not specified	Revised 1990	Internal audit

Table 5.2 illustrates that audit statutes and Auditor General reports were the primary documents used in conducting this comparative study.

Additional materials reviewed included audit policies and procedures, and directives and reports from legislative groups. The standards of four

**TABLE 5.2**  
**PRIMARY DOCUMENTS REVIEWED**  
**Review of State Statutes**

State	Audit Statute	Auditor General Reports	Other Documents
California	yes	no	State Administrative Manual
Florida	yes	yes	Auditor General Report to Joint Legislative Auditing Committee
Illinois	yes	yes	Department of Central Management Services correspondence
Michigan	yes	yes	Guide entitled General Framework for Evaluating Internal Accounting and Administrative Control Systems
New York	yes	no	Guide entitled Standards for Internal Controls in New York State Government
Texas	yes	yes	Attorney General's Opinion; State Auditor's Office Operations Memo; legislative correspondence
Virginia	yes	no	Office of the State Internal Auditor correspondence; Commonwealth's Audit Manual

leading audit organizations (the American Institute of Certified Public Accountants, the Electronic Data Processing Auditors Foundation, the United States General Accounting Office, and the Institute of Internal Auditors) were also examined and evaluated.

### **C. Research Procedures**

Professional auditing standards and state internal auditing laws were reviewed and evaluated. Elements of the laws and standards were classified according to the six significant audit practices/criteria identified in the literature review:

- independence
- proficiency/competence
- scope of audit work
- audit planning and examination
- reporting
- quality review.

A model was developed of the key features contained in generally accepted internal auditing standards and state internal auditing laws. These two references essentially validated the criteria hypothesized for the ideal or model statute.

Table 5.3 illustrates the review of data sources to determine whether the hypothesis could be operationalized. Each of these six variables was located within the language of professional auditing standards and state internal auditing statutes. Thus, the hypothesis appears to be valid.

**TABLE 5.3**  
**SUMMARY OF METHODOLOGY**

Variable	Data Sources	Operationalization*
General Standard- Independence	Professional Standards State Statutes	Present
General Standard- Proficiency/Competence	Professional Standards State Statutes	Present
Field Work Standard- Scope of Work	Professional Standards State Statutes	Present
Field Work Standard- Planning	Professional Standards State Statutes	Present
Reporting Standard- Format, Content, and Distribution	Professional Standards State Statutes	Present
Quality Standard- External Review	Professional Standards State Statutes	Present

Explanatory notes:

(1) Professional standards reviewed include auditing standards promulgated by the Institute of Internal Auditors, the United States General Accounting Office, the American Institute of Certified Public Accountants, and the Electronic Data Processing Auditors Association.

(2) State statutes reviewed were California, Florida, Illinois, Michigan, New York, Texas, and Virginia.

\* If the variable is present, it is operationalized by the actual wording in the statute or standard.

The current Texas internal auditing statute was compared to the ideal model and recommendations were made for the refinement of the Texas law. The above methodology was implemented in conducting the applied research project. Chapter VI describes in detail the comparative analysis conducted and the results obtained from the research experiment.

## **Chapter VI—Analysis and Results**

### **A. Overview**

The introduction, professional setting, and literature review chapters have laid an extensive foundation for the research. The setting chapter described the environment of Texas state government internal auditing and summarized several recent management reviews and special studies. Further, the Texas Internal Auditing Act of 1989 was profiled as were similar laws from other states.

The methodology chapter delineated the techniques used to conduct the study. The results of this analysis will ultimately answer the research question: "What are the components of an ideal internal auditing statute for Texas state government?"

In this chapter the six significant audit practices identified in the literature review will be compared with the practices of two important groups: (1) the four leading audit professional organizations and (2) the internal auditing statutes of seven large states. This assessment will be accomplished in order to verify whether these six practices are appropriate components for the ideal model of a state internal auditing law. The current Texas statute (in effect since 1989) will then be compared to the model and recommendations may be made for enhancement of the law.

### **B. Results of the Review of the Standards of Professional Audit Organizations**

#### **1. General Discussion**

This section summarizes the results of the review of the standards of the four leading audit professional organizations. Each of the six significant



practices/criteria discussed in the literature review was compared to the audit standards of the American Institute of Certified Public Accountants (AICPA), the Electronic Data Processing Auditors Foundation (EDPAF), the United States General Accounting Office (GAO), and the Institute of Internal Auditors (IIA). These four organizations have a high degree of recognition and status among professional internal auditors.

Table 6.1 profiles the significant practices/criteria by standard-making body. The table provides specific reference for each practice within each of the standards as applicable. All six practices are discussed in the AICPA, GAO, and IIA standards. Four of the six practices are discussed in the EDPAF standards.

A major initial finding of this review is that with few exceptions, the significant practices are covered in depth in the professional standards of the authoritative audit bodies. Appendixes A, B, C, and D summarize the standards of each audit organization. The reader is cautioned that much more information and guidance may be obtained by reviewing the source material in detail.

## 2. General Standards Discussion

-- The first practices to be compared to professional standards are the two general standards: independence and proficiency/competence. It is logical to assume that the internal auditor should have considerable degree of independence and a high level of proficiency in conducting professional audit work.

The GAO standards appear to be among the most comprehensive in summarizing auditor independence:

**TABLE 6.1**  
**REVIEW OF PROFESSIONAL ORGANIZATIONS**  
Composition of Ideal Standards

Category	AICPA	EDPAF	GAO	IIA	Ideal
General Standards A1-Independence	Gen Std No. 2 AU 220	Gen Stds. Nos. 1-2	Second general standard	Stds 100, 110, and 120	Yes
A2-Proficiency/ Competence	Gen Std No. 1 AU 210	Gen Stds Nos. 4-5	First general standard	Stds 200 through 280	Yes
Field Work Standards B1-Scope of Work	AU 801	<b>Not specified</b>	Ch. 4 & 6	Stds 300 through 350	Yes
B2-Audit Planning/ Examination	AU 311, 319, and 326	Gen Stds Nos. 6, 7, and 8	Third general standard	Stds 400 through 420	Yes
Reporting Standard- C-Format/Distribution	AU 410, 420, and 431	Gen Stds Nos. 9 & 10	Ch. 5 & 7	Std 430	Yes
Quality Standard- D-External Review	AU 161	<b>Not specified</b>	Fourth general standard	Std 560	Yes

In all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, should be free from personal and external impairments, should be organizationally independent, and should maintain an independent attitude and appearance.<sup>1</sup>

The AICPA standard on independence stresses five key concepts:

- an independence in mental attitude
- the obligation for fairness and impartiality
- ability to be intellectually honest
- without bias or obligation to or interest in client, management, or owners
- public confidence in the level of independence.<sup>2</sup>

EDPAF states that "The information systems auditor is to be independent of the auditee in attitude and appearance."<sup>3</sup> EDPAF also stresses the objective completion of the audit and the need for integrity and objectivity. In 1989, EDPAF published two supplemental statements on independence: the first statement covered attitude and appearance and organizational relationships and the second provided guidance on auditor involvement in the systems development process.

IIA's general standard on independence requires that "Internal auditors should be independent of the activities they audit."<sup>4</sup> According to

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<sup>1</sup> United States General Accounting Office, Government Auditing Standards (Washington: General Accounting Office, revised 1988): 3-4 and 3-5.

<sup>2</sup> American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards (New York: American Institute of Certified Public Accountants, 1990): 17.

<sup>3</sup> Electronic Data Processing Auditors Foundation, General Standards for Information Systems Auditing (Carol Stream, Illinois: Electronic Data Processing Auditors Foundation, 1987): 5.

<sup>4</sup> Institute of Internal Auditors, Standards for the Professional Practice of Internal Auditing (Altamonte Springs, Florida: Institute of Internal Auditors, 1978): 9.

IIA, achievement of independence is better assured when auditors have sufficient organizational status and objectivity. Organizational status is achieved by reporting to a level of executive management that assures actions will be taken on audit issues and recommendations.

Thus, all four audit professional organizations place a high level of importance on the independence of the auditor. It is important that an auditor independence practice should be included in the ideal model.

The second general practice to be reviewed is auditor proficiency or competence. IIA standard 200 states that "Internal audits should be performed with proficiency and due professional care."<sup>5</sup> The Institute further delineates what is meant by proficiency by explaining the types of knowledge, skills, and disciplines needed in today's internal audit practice. Other sections within this standard highlight staffing and supervision criteria, professional standards of conduct, human relations and communication skills, continuing education, and due professional care.<sup>6</sup>

AICPA general standard number number one requires that "The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor."<sup>7</sup> The standard also says that "The attainment of that proficiency begins with the auditor's formal education and extends into his subsequent experience."<sup>8</sup>

GAO's first general standard for government audits is that "The staff assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required."<sup>9</sup> The GAO standards

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<sup>5</sup> Ibid, 12.

<sup>6</sup> Ibid, 12-16.

<sup>7</sup> AICPA Standards, 15.

<sup>8</sup> Ibid.

<sup>9</sup> GAO Standards, 3-1.

specifically discuss knowledge and skills needed and the importance of continuing education and training required to maintain competence. Similarly, EDPAF general standards four and five discuss skills and knowledge and continuing professional education.<sup>10</sup>

Based on the above, professional proficiency and competence is a significant requirement in the internal auditing community. A review of the professional standards thus supports the use of professional proficiency and competence as a component of an ideal statute.

### 3. Field Work Standards Discussion

Two significant audit field work practices were profiled in the literature review: scope of work and audit planning and examination. Both of these categories represent major aspects of the internal auditor's daily business and professional standards provide considerable guidance.

IIA standard 300 provides a comprehensive statement of audit scope:

The scope of the internal audit should encompass the examination and evaluation of the adequacy and effectiveness of the organization's system of internal control and the quality of performance in carrying out assigned responsibilities.<sup>11</sup>

Internal control is important because it represents the foundation of laws, regulations, policies, procedures, and practices upon which the organization is built and the means by which accountability and integrity is better assured. The Institute further explains five primary objectives of internal control. (This is in one of the more comprehensive definitions available in the professional literature):

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<sup>10</sup> EDPAF Standards, 6.

<sup>11</sup> IIA Standards, 17.

- The primary objectives of internal control are to ensure:
- (1) The reliability and integrity of information,
  - (2) Compliance with policies, plans, procedures, laws, and regulations,
  - (3) the safeguarding of assets,
  - (4) the economical and efficient use of resources, and
  - (5) the accomplishment of established objectives and goals for operations or programs.<sup>12</sup>

The GAO standards emphasize the comprehensive nature of public sector auditing and differentiate clearly between financial statement, financial related, economy and efficiency, and program audits.<sup>13</sup> GAO provides separate field work standards for both financial and performance audits. Both sets of standards make reference to the scope of audit work including the need for tests of compliance with laws and regulations. Also addressed is the importance of understanding the organization's internal control system as a basis for determining the "nature, timing, and extent of the tests to be performed."<sup>14</sup>

AICPA cross references GAO's Government Auditing Standards in providing certified public accountants and auditors with advice on how to conduct compliance audits of government programs. Again, legal and regulatory compliance and internal control systems are heavily emphasized. The EDPAF standards do not provide significant coverage in the scope of audit work perhaps because the concentration of that professional group is

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<sup>12</sup> Ibid.

<sup>13</sup> GAO Standards, 2-1 through 2-6.

<sup>14</sup> Ibid, 4-7.

on information systems or EDP audits rather than the organization as a whole.

In summary, it appears that the scope of work should include financial, compliance, and performance audits with an emphasis on the credibility of internal control processes in place within the organization.

A second field work practice of interest relates to audit planning and evaluation. AICPA defines audit planning for certified public accountants as the development of "an overall strategy for the expected scope and conduct of the audit."<sup>15</sup> Numerous considerations must be taken into account in planning the audit including the organization's policies and procedures, the methods used to process information, and judgments about the materiality or significance of different accounting transactions.<sup>16</sup>

GAO's field work standards advise government auditors that "Work is to be adequately planned"<sup>17</sup> and that "Planning should include consideration of the audit requirements of all levels of government."<sup>18</sup> Planning and supervision is the subject of EDPAF general standard number six which states that "Information system audits are to be planned and supervised to provide assurance that audit objectives are achieved and compliance with these standards is met."<sup>19</sup>

IIA defines a multi-step approach to planning the audit revolving around establishing the audit objectives, determining the needed resources, performing a familiarization survey, and writing the audit program.<sup>20</sup>

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<sup>15</sup> AICPA Standards, 31.

<sup>16</sup> Ibid., 31-32.

<sup>17</sup> GAO Standards, 6-1.

<sup>18</sup> Ibid., 4-1.

<sup>19</sup> EDPAF Standards, 6.

<sup>20</sup> IIA Standards, 20.

All four audit organizations include planning and evaluation in their professional standards. Hence, planning and evaluation is a substantive audit activity worthy of placement in the ideal model.

#### 4. Reporting Standard Discussion

The product of the internal auditor's work is the formal audit report that provides management and the organization with recommendations, advice, and counsel. All four audit professional bodies give specific guidance on audit reporting. IIA's basic standard on "Communicating Results" was enhanced in 1983 with a supplemental statement.<sup>21</sup> Together these standards call for reports to be "objective, clear, concise, constructive, and timely."<sup>22</sup> Audit findings should be framed with consideration to the attributes of criteria, condition, cause, and effect. Reports should present the auditor's opinion and recommendation and may also include the auditee's views on the issues and concerns.<sup>23</sup>

EDPAF standards concur that the auditor should state the audit work objectives, "the nature and extent of the audit work performed," and findings and conclusions along with appropriate qualifying remarks.<sup>24</sup> GAO provides detailed reporting standards for both financial and performance audits conducted on governmental entities. Likewise, AICPA provides specific direction in the form of three general standards for reporting. These three standards pertain to adherence to generally accepted accounting

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<sup>21</sup> Institute of Internal Auditors, Statement on Internal Auditing Standards Number 2-Communicating Results (Altamonte Springs, Florida: Institute of Internal Auditors, 1983).

<sup>22</sup> IIA Standards, 21.

<sup>23</sup> *Ibid.*

<sup>24</sup> EDPAF Standards, 6.



principles, the consistency in application of said principles, and the adequacy of information presented and disclosed within financial statements.<sup>25</sup>

Again, all four professional organizations are unanimous in suggesting that audit reporting is a significant step in the audit cycle. It follows that such criteria should be an integral part of the ideal audit statute.

#### 5. Quality Standard Discussion

Quality in the audit process encompasses both internal and external assessments of the performance of audit work. GAO's fourth general standard states that:

Audit organizations conducting government audits should have an appropriate internal quality control system in place and participate in an external quality control review program.<sup>26</sup>

GAO suggests that two main concerns of a quality review program should be insuring that (1) audit policies and procedures have been established and are used and that (2) appropriate audit standards have been adopted and are being followed.<sup>27</sup>

IIA standard 560 mandates that "The director of internal auditing should establish and maintain a quality assurance program to evaluate the operations of the internal auditing department."<sup>28</sup> The quality review should focus on conformity with the audit department's charter, IIA's Standards for the Professional Practice of Internal Auditing, and with other appropriate standards. According to IIA, the quality program should be achieved via supervisory, internal, and external reviews. The latter review

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<sup>25</sup> AICPA Standards, 233-244.

<sup>26</sup> GAO Standards, 3-17.

<sup>27</sup> Ibid

<sup>28</sup> IIA Standards, 25

"should be performed by qualified persons who are independent of the organization and who do not have either a real or apparent conflict of interest."<sup>29</sup>

The EDPAF appears to have no specific quality assurance standard. AICPA urges member firms to establish internal quality control mechanisms in order to provide "reasonable assurance of conforming with generally accepted accounting standards in its audit engagements."<sup>30</sup>

In summary, quality review of the internal audit organization is deemed to be a significant practice with credibility in the standards of most audit professional organizations. It should be incorporated in the ideal model for an internal auditing statute.

Table 6.1 summarizes the presence of the six significant practices discussed in the literature review: independence, proficiency/competence, scope of work, audit planning and examination, reporting, and quality review.

The above discussion indicates there is overwhelming evidence that these six audit practices are important as illustrated in the authoritative pronouncements of four leading professional organizations. Based on this, it appears that each of these factors is appropriate for inclusion in the ideal model for a state government internal auditing statute. A second test of verification will be made in the next section with a focus on state internal auditing laws.

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<sup>29</sup> Ibid, 26

<sup>30</sup> AICPA Standards, 9.

## **C. Results of the Review of Other State Internal Auditing Statutes**

### **1. General Discussion**

This section summarizes the comparative review of the six significant practices/criteria with the internal auditing statutes of seven large states. The states selected for analysis were California, Florida, Illinois, Michigan, New York, Texas, and Virginia.

It is important to note that the absence of a specific practice in the state internal auditing law does not mean the category or criteria is non-existent. Like other laws on other subjects, many state internal auditing statutes are general in nature and may be supplemented by state administrative policies and procedures.

### **2. General Standards Discussion**

The first general standard reviewed was auditor independence. Table 6.2 illustrates that five of the seven statutes require that the chief auditor reports directly to either the agency head/chief executive officer or the governing board. Neither California nor Virginia statutes address this topic.

The Illinois<sup>31</sup> and Texas<sup>32</sup> laws provide auditor consultation access to a broad range of parties outside the state agency including offices of the legislature, governor, and state auditor. These two laws also provide that the internal auditor will be free of operational duties and responsibilities that interfere with audit work. Thus, there is verification given to the importance of the independence criteria in the ideal model of an internal auditing statute.

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<sup>31</sup> Illinois Statutes, Civil Administrative Code, Public Act 86-936, Fiscal Control and Internal Auditing Act, 1989, section 2004.

<sup>32</sup> Texas Statute, Vernon's Annotated Civil Statutes, article 6252-5d, Internal Auditing Act, 1989, section 7.

**TABLE 6.2**  
**GENERAL STANDARD--INDEPENDENCE**  
**Review of State Statutes**

State	Reports To	Consults With	Free of Operational Duties
California	Not specified	Not specified	Not specified
Florida	Agency Head	Not specified	Not specified
Illinois	Chief Executive Officer	Governing Board, Auditor, Legislative, Budget Bureau, Internal Audit Advisory Board	Yes
Michigan	Department Head (Agency Head)	Not specified	Not specified
New York	Agency Head	Not specified	Not specified
Texas	Governing Board	Governing Board, Agency Administrator, Governor's Office, State Auditor's Office, Legislative Agencies	Yes
Virginia	Not specified	Not specified	Not specified

The second general practice proposed for the ideal model is auditor proficiency or competence. A review of the qualifications for chief internal auditors was thought to be a significant test for this criteria. Table 6.3 summarizes the results of this comparison.

Only three of the seven statutes specifically identify the combination of education, experience, and other appropriate credentials needed. The Florida<sup>33</sup> and Illinois<sup>34</sup> laws are fairly consistent with the requirement for a bachelor's degree and five years experience. Both laws specify that one less year of experience is needed if the chief auditor is a certified internal

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**TABLE 6.3**  
**GENERAL STANDARD-PROFICIENCY/COMPETENCE**  
**Review of State Statutes**

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State	Qualifications for Chief Internal Auditor
California	Not specified in statute or Administrative Manual; Bachelor's degree per Illinois Auditor General study
Florida	Bachelor's degree and five years experience; four years experience with MBA, MPA, master's in accounting, CIA, or CPA
Illinois	Bachelor's degree and five years experience; four years experience with CPA/CIA
Michigan	Not specified in statute or guide for Evaluating Internal Accounting and Administrative Control Systems; Bachelor's degree per Illinois Auditor General study
New York	Not specified in statute
Texas	Bachelor's degree, CIA or CPA, and three years experience
Virginia	Not specified in statute; Bachelor's degree, CIA or CPA, and seven years experience per Illinois Auditor General

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<sup>33</sup> Florida Statutes, Chapter 20.055, 1990 Supplement, Internal Audit Act, section (3).

<sup>34</sup> Illinois Statutes, section 2002 (a).

auditor (CIA) or a certified public accountant (CPA). The Florida law would also permit persons with an appropriate master's degrees the opportunity to serve as chief auditor with only four years experience.

The Texas statute<sup>35</sup> is more demanding in mandating that the auditor possess either the CIA or CPA credential. However, the chief auditor needs only three years experience with a bachelor's degree. The Texas law calls for three years "auditing experience" but does not require either public sector or internal auditing experience.

The Illinois law says that the auditor will have "progressively responsible auditing experience."<sup>36</sup> In contrast, the Florida law clarifies that the experience should be "as an internal auditor or independent post auditor, electronic data processing auditor, accountant, or any combination thereof. The experience shall at a minimum consist of audits of units of government or private business enterprises, operating for profit or not for profit. . ."<sup>37</sup>

The state laws of California, Michigan, Illinois, and Virginia do not contain specific qualifications needed for agency chief internal auditors. (Note: The Virginia statute does require that the State Internal Auditor be certified as a CPA or CIA<sup>38</sup>).

.. It is probable that some requirements exist in the personnel job classification policies of each of these states. A 1988 study conducted by the Illinois Auditor General<sup>39</sup> indicated that California and Michigan require only a bachelor's degree whereas Virginia requires a bachelor's degree with seven

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<sup>35</sup> Texas Statutes, section 5.

<sup>36</sup> Illinois Statutes, section 2002 (a) (2).

<sup>37</sup> Florida Statutes, section (3) (a).

<sup>38</sup> Virginia Statutes, Code of Virginia, Chapter 14.1. 1985 as amended 1990, section 2.1-234.30.

<sup>39</sup> Illinois Auditor General. Management Audit: Illinois' State Programs of Internal Auditing (Springfield, Illinois: Office of the Auditor General, May 1988): 51.

years experience and certification. The chief auditor qualifications for the state of New York are not specified in the statute and not detailed in the Illinois study.

Another point of interest is that continuing professional development and/or training needs of internal auditors are included in the laws of Illinois, Texas, and Virginia. This indicates these three states mandate continuing education for auditors as a necessity.

Despite the mixed returns delineated above, there is significant value to formally codifying the qualification requirements of the chief internal auditor. This is a valid measure for inclusion in the model state internal auditing law.

### 3. Field Work Standards Discussion

There is considerable consistency among the states regarding the internal auditor's scope of work. Table 6.4 provides an overview of the results of this analysis. Internal administrative and accounting controls are referenced in six of the seven state laws with some references to the three major types of audits: financial, compliance, and performance.

Data processing or information systems audits are included in the Illinois and Texas laws and the Commonwealth of Virginia is the only state without reference to the types of audits to be conducted. The Commonwealth has an extensive Internal Audit Manual<sup>40</sup> that may provide guidance on this practice.

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<sup>40</sup> Office of the State Internal Auditor. Internal Audit Manual-Commonwealth of Virginia (Richmond, Virginia: Office of the State Internal Auditor, 1983).

**TABLE 6.4**  
**FIELD WORK STANDARD--SCOPE OF WORK**  
**Review of State Statutes**

State	Types of Audits Conducted	Audit Standards
California	Internal accounting and administrative controls	IIA, GAO, and AICPA
Florida	Internal controls, financial, compliance, and performance audits, special audits	IIA and GAO
Illinois	Internal controls, fiscal, grants, electronic data processing, and special audits	IIA and GAO
Michigan	Internal accounting and administrative controls, financial, efficiency, fraud and abuse	Appropriate professional and auditing standards
New York	Internal controls and operations of state agencies	Generally accepted standards
Texas	Accounting, administrative, electronic data processing, and other major systems and controls	IIA
Virginia	Not specified in statute	IIA



The IIA Standards are referenced in five of the seven state laws with GAO's Government Auditing Standards listed in three states. Michigan and New York<sup>41</sup> do not specifically name IIA and GAO but rather incorporate the use of "appropriate professional and auditing standards"<sup>41</sup> and "generally accepted standards"<sup>42</sup> respectively.

In summary, this compilation verifies the desirability of including a scope of work provision in the ideal internal auditing statute.

Table 6.5 illustrates that the need for audit planning is referenced only in the Illinois and Texas internal auditing laws.

The Illinois law specifies that the audit program will include "A two year plan, identifying audits scheduled for the pending fiscal year, approved by the chief executive officer before the beginning of the fiscal year."<sup>43</sup> Also required is an annual report from the chief auditor to the chief executive officer providing details on actual accomplishment versus planned activities.

The Texas statute requires "an annual audit plan, prepared using risk assessment techniques, which identifies the individual audits to be conducted during each year."<sup>44</sup> The law further requires plan approval by the governing board or designee as well as documentation of deviations from the annual plan.

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<sup>41</sup> Michigan Public Acts of 1986, Act No. 272, section 486 (5).

<sup>42</sup> New York Statutes, S. 6442, A. 8534, chapter 814, section 952, 1987.

<sup>43</sup> Illinois Statutes, section 2003 (a) (1).

<sup>44</sup> Texas Statutes, section 4 (1) and 6 (2).

**TABLE 6.5**  
**FIELD WORK STANDARD--AUDIT PLANNING & EXAMINATION**  
**Review of State Statutes**

State	Statutory or Administrative Requirement
California	Not specified
Florida	Not specified
Illinois	Two year audit plan
Michigan	Not specified
New York	Not specified
Texas	Annual audit plan
Virginia	Not specified

The internal auditing laws of the other five states did not include reference to audit planning and examination requirements. Since audit planning is a necessary part of the audit cycle as defined in professional standards, it is probable that this is being carried out in the other five states.

Adoption of the IIA Standards by several states indicates a commitment to practice audit planning activities. Evidence of additional requirements for this practice could possibly be found in the audit policy and procedure manuals and the audit charters within these states.

Despite the limited degree to which audit planning is specified in statute, the author believes this is a credible component for the model internal auditing law.

#### 4. Reporting Standard Discussion

Four of the seven statutes contain requirements on communicating audit results. Table 6.6 summarizes the results of this comparative analysis. California<sup>45</sup> and Michigan<sup>46</sup> specify biennial reports on the Auditor General's evaluation review of internal control reports provided by state agencies. The Florida and Texas laws are again more explicit than the other states.

The Texas statute requires the internal auditor to "prepare audit reports, which shall be reviewed by the agency administrator and the agency's board or commission."<sup>47</sup>

The Florida law states that the chief auditor will submit reports to the agency head and the Auditor General.<sup>48</sup> The latter statute also specifies that preliminary reports will be shared with auditee management who in turn has 20 days to respond to adverse findings. The law also directs the Auditor General to "give appropriate consideration to internal audit reports and the resolution of findings therein."<sup>49</sup>

Audit reporting is another key event in the audit cycle and based on the above findings should be included in the ideal model.

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<sup>45</sup> California Government Code, section 13405, Financial Integrity and State Managers Accountability Act, 1982.

<sup>46</sup> Michigan Statute, section 485.

<sup>47</sup> Texas Statutes, section 6 (4).

<sup>48</sup> Florida Statutes, section 20.055 (7).

<sup>49</sup> Ibid.

**TABLE 6.6**  
**REPORTING STANDARD--FORMAT AND DISTRIBUTION**  
**Review of State Statutes**

State	Statutory or Administrative Requirement
California	Biennial reports on internal control reviews; Not specified for other internal audit reports
Florida	Prepare audit reports of findings; contain statement that audit conducted in line with appropriate standards; coordinate draft report with auditee; distribute final reports to Agency Head and Auditor General
Illinois	Not specified in statute
Michigan	Biennial reports on internal control reviews; Not specified on other internal audit reports
New York	Not specified in statute
Texas	Distribution to Agency Head and Governing Board
Virginia	Not specified in statute

##### 5. Quality Standard Discussion

Quality in the audit process is highlighted in three of the seven statutes (Florida, Texas, and Virginia) as summarized on Table 6.7. At least two other states (Illinois and Michigan) have conducted external quality reviews of internal audit functions despite the absence of such a requirement in the statute.

**TABLE 6.7**  
**QUALITY STANDARD--EXTERNAL REVIEW**  
**Review of State Statutes**

State	Statutory or Administrative Requirement
California	Not specified in statute or Administrative Manual
Florida	Auditor General required to review sample of each agency's reports at least once every three years
Illinois	Not addressed in statute; Legislative Audit Commission resolution required Auditor General to conduct management audit of state internal audit programs
Michigan	Not addressed in statute; Auditor General required to evaluate and report on comprehensive internal accounting and administrative controls by principal state departments (includes internal audit component)
New York	Not specified in statute
Texas	Agencies required to conduct quality assurance reviews in line with IIA Standards including periodic external peer reviews
Virginia	Department of the State Internal Auditor conducts quality assurance review of agency internal audit functions every three years

The Florida law requires the legislative auditor to review a sample of each agency internal audit operation's work every three years.<sup>50</sup> Virginia requires the Office of the State Internal Auditor to perform similar tests.<sup>51</sup>

<sup>50</sup> Ibid.

<sup>51</sup> Virginia Statutes, section 2.1-234.32.

Texas requires compliance with the IJA Standards requirement for external reviews every three years but does not specify who will conduct the test or how it will be accomplished.<sup>52</sup>

The Illinois Legislative Audit Commission required the Auditor General's Office to conduct a management audit (including a quality assurance component) of the state's internal audit programs. The Auditor General's May 1988 report<sup>53</sup> resulted in statutory changes to enhance the practice of internal auditing in Illinois state government. The report criticized internal audit operations in areas such as compliance with the statute and professional standards, continuing professional education, and chief auditor qualifications.

A similar report was completed in Texas<sup>54</sup> at the request of the Legislative Audit Committee in 1988 and was followed a year later by that state's first internal auditing statute. The same year a task force commissioned by the Texas Speaker of the House of Representatives recommended following the Virginia model for coordinating internal audit activities including quality assurance reviews.<sup>55</sup> A follow-up report on internal auditing by the Texas State Auditor's Office<sup>56</sup> indicated that problems existed in auditor independence, audit follow-up, scope of work,

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<sup>52</sup> Texas Statutes, section 6 (5).

<sup>53</sup> Illinois Auditor General, Management Audit: Illinois' State Programs of Internal Auditing. This report resulted passage of the Fiscal Control and Internal Auditing Act of 1989.

<sup>54</sup> Texas State Auditor's Office, Statewide Report on Internal Auditing: A Report to the Legislative Audit Committee (Austin, Texas: State Auditor's Office, May 1988).

<sup>55</sup> Texas Speaker's Advisory Task Force on Internal Auditing, Recommendations for Improvement of Internal Audit in State Government: A Report to the Speaker of the House of Representatives, letter report, August 30, 1988.

<sup>56</sup> Texas State Auditor's Office, Statewide Review of Internal Auditing (Austin, Texas: State Auditor's Office, February 1991).

standards compliance, automated systems audit coverage, and external peer reviews.

In Michigan, the Auditor General reported in 1988 on agency compliance with the state's Internal Control Act.<sup>57</sup> Among the audit areas criticized were standards compliance, organizational status and independence, scope of audit coverage, education and experience qualifications, EDP audit capabilities, and the size of audit staffs.

From the above discussion it is evident that external reviews of internal audit work are necessary. Compliance with relatively new or revised state laws is a problem in itself. A further issue is adherence to the professional standards of IIA and other authoritative bodies. Hence a quality review criteria should be included as an essential element in the model internal auditing statute.

#### **D. Development of the Ideal Model for an Internal Auditing Statute**

This section will combine the results of the comparative analyses conducted in sections B. and C. above. The ideal model for an internal auditing statute is based on what has been learned by looking in depth at the professional standards of the AICPA, the EDPAF, the GAO, and the IIA. Additionally, the internal auditing laws currently in effect in the states of California, Florida, Illinois, Michigan, New York, Texas, and Virginia were relevant and useful in developing this model.

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<sup>57</sup> Michigan Auditor General, Audit Report--Departments' Reports on Internal Accounting and Administrative Control Systems: Evaluation of Compliance. (Lansing, Michigan: Office of the Auditor General, March 1988).

Table 6.8 lists the six practices/criteria of independence, professional proficiency/competence, scope of work, audit planning and examination, audit reporting, and quality review. Significant evidence was found to support each of these practices being included in the ideal model for an internal auditing statute.

**TABLE 6.8**  
**IDEAL MODEL PRACTICES/CRITERIA**

Practice/Criteria	Ideal Professional Organizations	Ideal State Statutes	Ideal Model
General Standard-- Independence	Yes	Yes	Yes
General Standard-- Proficiency/Competence	Yes	Yes	Yes
Field Work Standard-- Scope of Work	Yes	Yes	Yes
Field Work Standard-- Planning	Yes	Yes	Yes
Reporting Standard-- Format and Distribution	Yes	Yes	Yes
Quality Standard-- External Review	Yes	Yes	Yes

### **E. Comparative Analysis of the Texas Statute with the Model Statute**

The final test involves a comparative analysis of the current Texas internal auditing law with the model statute. The review detailed in Table



6.9 indicates that all six factors in the ideal model are also present in the Texas law. However, there are elements of three factors deemed significant that are not included in the Texas statute.

The table provides the above comparison and indicates that in the areas of proficiency/competence, scope of work, and external review additional modifications could strengthen the Texas law. The specific recommendations will be included in Chapter VII of this report.

**TABLE 6.9**  
**FINAL ANALYSIS**

Practice/Criteria	Ideal Model	Current Texas Statute
General Standard-- Independence	Yes	Yes--No modification necessary.
General Standard-- Proficiency/Competence	Yes	*Yes--Recommend modifications.
Field Work Standard-- Scope of Work	Yes	*Yes--Recommend modifications.
Field Work Standard-- Planning & Examination	Yes	Yes--No modification necessary.
Reporting Standard-- Format and Distribution	Yes	Yes--No modification necessary.
Quality Standard-- External Review	Yes	*Yes--Recommend modifications.

\* Indicates the 1989 Texas internal auditing statute includes the basic practice/criteria but some changes are needed to improve the law.

## **F. Summary**

Chapter VI has provided a comparative analysis of the standards of four professional organizations and seven state internal auditing laws in developing the ideal model for a state internal auditing statute. The Texas law has been compared to the model statute and all six practices/criteria have been met.

The concluding chapter of the report will summarize research project activities and provide specific recommendations for the refinement of the Texas internal auditing statute.

## **Chapter VII-Summary and Conclusions**

### **A. Restatement of the Research Question**

The research question for this applied research project is once again brought into focus: What are the components of an ideal internal auditing statute for Texas state government? The implied hypothesis developed in the literature review suggested that six significant audit practices should be covered in the statute. These practices or criteria are independence, professional proficiency/competence, scope of work, audit planning and examination, reporting, and quality review.

### **B. Summary of Methodology and Findings**

This descriptive research project used document analysis, correspondence, and personal and telephone interviews to address the research question. The variables developed in the hypothesis were reviewed relative to the standards of four professional audit organizations and seven state internal auditing laws.

Through this comparative analysis, the six audit practices were verified as being essential elements for the ideal model for an internal auditing statute. The current Texas law was then evaluated using this model.

### **C. Answer to the Research Question**

Based on the review of professional standards and state laws, there are six components in an ideal internal auditing statute for Texas state government. These are the hypothesized variables discussed in detail in Chapters III and VI.

Independence is important to insure objectivity and high level management support for overall audit activities. Professional proficiency and competence are needed to provide credibility for audit findings and recommendations. A broad range of financial, compliance, and performance audits should be articulated in the scope of work provision of the law.

Audit planning and examination requirements should be established including the use of risk assessment techniques. Specifications are also needed on audit reporting methods, format, and distribution. Finally, the law should discuss external quality reviews of the internal audit function.

#### **D. Study Implications for Texas State Government**

The primary implications of this study are to add to the base of knowledge in the emerging area of state government internal auditing laws and more specifically to suggest some areas for statutory revision.

The results of this project verify that the Texas law is one of the best of the few internal auditing statutes that do exist. The Texas, Florida, Illinois, and Virginia laws each provide significant coverage and attention to an area that has often been neglected or underestimated in the public sector arena.

The study also shows that with some modifications, the Texas statute can be improved. The author believes the needed revisions would further strengthen accountability and professional audit practice in Texas state government.

## **E. Proposed Revision to the Texas Internal Auditing Statute**

Based on the research conducted, statutory modifications are recommended in three of the six audit practice areas analyzed: professional proficiency/competence, scope of work, and external quality review.

### **1. Professional Proficiency/Competence Recommendation**

The professional proficiency requirements are overly restrictive in mandating credentials as a certified internal auditor or certified public accountant without alternative means of qualification. At the same time, the three years auditing required is too little experience for a chief internal auditor in a Texas state agency today. This study recommends that consideration be given to changing the Texas law on auditor qualifications as follows:

- Amend section 5 to require a bachelor's degree and four years public sector internal auditing experience for the chief internal auditor. The law should also specify that chief auditors with credentials as a certified internal auditor, certified public accountant, master of business administration, or master of public administration need only four years experience.
- Further, revise section 5 of the law to encourage (but not require) all state agency internal auditors to seek professional certification. In addition to the certifications above, the law should recognize the value and importance of the certified information systems auditor and certified fraud examiner credentials.

## 2. Scope of Work Recommendation

The scope of work section of the current law requires the internal audit program to include a wide range of accounting, administrative, data processing, and other major systems audits. There is no discussion in the statute regarding the types of audits to be conducted.

A second issues needs to be considered relative to the scope of work provision. Although the statute properly makes reference to the standards of The Institute of Internal Auditors, it does not require auditor compliance with generally accepted government auditing standards, i. e. the standards promulgated by the United States General Accounting Office. This study recommends the law be altered as follows:

- Amend section 4 to require that each agency shall consider conducting the full range of financial, compliance, and performance audits as part of the annual audit plan development.
- Amend section 8 to require the conformance of internal audit departments to the Government Auditing Standards published by the United States General Accounting Office.

## 3. Quality Review Recommendation

Section 6 (5) of the law requires agency audit functions to conduct internal quality assurance reviews and submit to external peer reviews in line with professional standards. However, the statute does not define how the latter will be accomplished. Several states have utilized the services of the legislative auditor to accomplish the comprehensive external review.

The Commonwealth of Virginia has a unique approach whereby peer reviews are conducted by the Office of the State Internal Auditor. A similar approach was recommended for Texas in separate reports by the State

Auditor's Office and a task force recommended appointed by the Speaker of the House of Representatives.

This study recommends that the law be changed as follows:

- Create an Office of the State Internal Auditor modeled after the excellent Commonwealth of Virginia model. The function could be created either as a division of the State Auditor's Office or as a separate state entity. The Office of the State Internal Auditor would be charged with a broad range of coordination duties among the state internal auditing community. Among the major responsibilities would be periodic external quality assurance reviews as required by professional auditing standards.
- As an alternate to the above, revise section 6 of the current law to specify responsibilities for the State Auditor's Office to conduct external peer reviews of internal audit functions. (The Governor's Office and the State Agency Internal Audit Forum are two other alternative sources for providing the external review capability.)

## **F. Discussion of Study Limitations**

There were several limitations experienced in conducting this applied research project. The nature of descriptive research and the document analysis methodology has some inherent difficulties.

A review and analysis of current statutory requirements in no way assures the researcher of the actual conditions that might be found in the seven states. In fact, studies conducted by both the Illinois and Michigan Auditor General's Offices reveal numerous cases of statutory non-compliance

by internal audit groups. A February 1991 report by the Texas State Auditor's Office also expresses misgivings about state agency conformity with the law.

Another major constraint is that most precious commodity of time. It is logical that as the project progresses, the researcher becomes more knowledgeable, comfortable, and competent with the subject matter. There is never enough time to follow all promising leads, explore alternative approaches and methodologies, write a few more letters, and make some additional telephone calls. To a certain extent, there is a feeling that just as the grasp of the research topic becomes stronger and more secure, time constraints draw the project to a close.

## **G. Suggestions for Further Research**

After completing a project of this nature, it is inevitable that the researcher has some thoughts on other useful approaches to studying the subject. The value and significance of this descriptive study could probably be enhanced in several respects. Two major refinements that would be helpful are the use of a questionnaire survey and the expanded use of personal interview techniques.

A questionnaire survey of practitioners in Texas and the other six states would further clarify the degree to which current audit practices comply with state statutes. Additionally, the researcher could learn more about the existence and use of supplementary policies and instructions (other than the statute) that govern internal audit operations. This information would probably result in a more comprehensive review of the variables covered in the analysis and results chapter. For example, much of the significant audit practices and criteria in the Commonwealth of Virginia



can be found in agency audit charters and manuals rather than in state statutes.

Expanded use of the personal interview technique could have garnered more in-depth background on the background developments and history leading to the statutory initiation and revision in Texas and other states. In-depth interviews of the State Auditor, a representative of the Governor's Office, and selected state agency audit directors could unearth significant opinions and recommendations regarding the current law.

The Texas audit practitioner's view of the adequacy of the current statute would be both interesting and informative. There are indications there are diverse opinions among the 14 internal audit directors who comprise the Texas State Agency Internal Audit Forum. In addition, the views of a sample of state agency executive directors and board members would lend yet another interesting perspective and dimension to the study.

In an effort to stimulate further interest on this topic, copies of the completed applied research project will be provided to major parties of assistance during the project. Consideration may also be given to the preparation of an article based on the research for publication in a practitioner journal.

## **H. Project Postscript**

In selecting my applied research topic, one objective was to potentially impact public policy in an area of interest. The findings and recommendations of this study have been shared with the offices of two State Senators who have offered bills in the 72nd Texas Legislature which would amend the Internal Auditing Act of 1989 (see Appendices N through R). An amendment to one of these bills was developed by Sunset

Advisory Commission staff in consultation with the author of this research project.

The Senate Committees on Economic Development held a hearing in early April to debate the issue and a committee of the Texas House of Representatives is expected to do the same. The final chapter is not yet written but the product of this applied research project has already been used as input to an important and ongoing public policy debate.

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# APPENDICES

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**APPENDIX A**  
**INSTITUTE OF INTERNAL AUDITORS**  
**Summary of the General and Specific Standards**  
**for the Professional Practice of Internal Auditing**

100-INDEPENDENCE--Internal auditors should be independent of the activities they audit.

110-Organizational Status--The organizational status of the internal auditing department should be sufficient to permit the accomplishment of its audit responsibilities.

120-Objectivity--Internal auditors should be objective in performing audits.

200-PROFESSIONAL PROFICIENCY--Internal audits should be performed with proficiency and due professional care.

**The Internal Auditing Department**

210-Staffing--The internal auditing department should provide assurance that the technical proficiency and educational background of internal auditors are appropriate for the audits to be performed.

220-Knowledge, Skills, and Disciplines--The internal auditing department should possess or should obtain the knowledge, skills, and disciplines needed to carry out its audit responsibilities.

230-Supervision--The internal auditing department should provide assurance that internal audits are properly supervised.

**The Internal Auditor**

240-Compliance with Standards of Conduct--Internal auditors should comply with professional standards of conduct.

250-Knowledge, Skills, and Disciplines--Internal auditors should possess the knowledge, skills, and disciplines essential to the performance of internal audits.

260-Human Relations and Communications--Internal auditors should be skilled in dealing with people and in communicating effectively.

270-Continuing Education--Internal auditors should maintain their technical competence through continuing education.

280-Due Professional Care--Internal auditors should exercise due professional care in performing internal audits.

300-SCOPE OF WORK--The scope of the internal audit should encompass the examination and evaluation of the adequacy and effectiveness of the organization's system of internal control and the quality of performance in carrying out assigned responsibilities.

310-Reliability and Integrity of Information--Internal auditors should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.

320-Compliance with Policies, Plans, Procedures, Laws, and Regulations--Internal auditors should review the systems established to ensure compliance with those policies, plans, procedures, laws, and regulations which could have a significant impact on operations and reports and should determine whether the organization is in compliance.

330-Safeguarding of Assets--Internal auditors should review the means of safeguarding assets and, as appropriate, verify the existence of such assets.

340-Economical and Efficient Use of Resources--Internal auditors should appraise the economy and efficiency with which resources are employed.

350-Accomplishment of Established Objectives and Goals for Operations or Programs--Internal auditors should review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

400-PERFORMANCE OF AUDIT WORK--Audit work should include planning the audit, examining and evaluating information, communicating results, and following up.

410-Planning the Audit--Internal auditors should plan each audit.

420-Examining and Evaluating Information--Internal auditors should collect, analyze, interpret, and document information to support audit results.

430-Communicating Results--Internal auditors should report the results of their audit work.

440-Following Up--Internal auditors should follow up to ascertain that appropriate action is taken on reported audit findings.

500-MANAGEMENT OF THE INTERNAL AUDITING DEPARTMENT--The director of internal auditing should properly manage the internal auditing department.

510-Purpose, Authority, and Responsibility--The director of internal auditing should have a statement of purpose, authority, and responsibility for the internal auditing department.

520-Planning--The director of internal auditing should establish plans to carry out the responsibilities of the internal auditing department.

530-Policies and Procedures--The director of internal auditing should provide written policies and procedures to guide the audit staff.

540-Personnel Management and Development--The director of internal auditing should establish a program for selecting and developing the human resources of the internal auditing department.

550-External Auditors--The director of internal auditing should coordinate internal and external audit efforts.

560-Quality Assurance--The director of internal auditing should establish and maintain a quality assurance program to evaluate the operations of the internal auditing department.

**APPENDIX B**  
**GENERAL ACCOUNTING OFFICE**  
**Generally Accepted Government Auditing Standards**

**General Standards**

1. Qualifications--The staff assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required.
2. Independence--In all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, should be free from personal and external impairments to independence, should be organizationally independent, and should maintain an independent attitude and appearance.
3. Due Professional Care--Due professional care should be used in conducting the audit and in preparing related reports.
4. Quality Control--Audit organizations conducting government audits should have an appropriate internal quality control system in place and participate in an external quality control review program.

**Field Work Standards--Financial Audits**

1. Planning--Planning should include consideration of the audit requirements of all levels of government.
2. Legal and Regulatory Requirements--A test should be made of compliance with applicable laws and regulations.
3. Evidence--A record of the auditors' work should be retained in the form of working papers.
4. Internal Control--A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

## Reporting Standards--Financial Audits

1. **Statement on Auditing Standards**--A statement should be included in the auditor's report that the audit was made in accordance with generally accepted government auditing standards.
2. **Report on Compliance**--The auditors should prepare a written report on their tests on compliance with applicable laws and regulations.
3. **Report on Internal Controls**--The auditors should prepare a written report on their understanding of the entity's internal control structure and the assessment of control risk made as a part of a financial statement audit, or a financial related audit.
4. **Reporting on Financial Related Audits**--Written audit reports are to be prepared giving the results of each financial related audit.
5. **Privileged and Confidential Information**--If certain information is prohibited from general disclosure, the report should state the nature of the information omitted and the requirement that makes the omission necessary.
6. **Report Distribution**--Written audit reports are to be submitted by the audit organization to the appropriate officials of the organization audited and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, unless legal restrictions, ethical considerations, or other arrangements prevent it.

## Field Work Standards--Performance Audits

1. **Planning**--Work is to be adequately planned.
2. **Supervision**--Staff are to be properly supervised.
3. **Legal and Regulatory Requirements**--An assessment is to be made of compliance with applicable requirements of laws and regulations when necessary to satisfy the audit objectives.
4. **Internal Control**--An assessment should be made of applicable internal controls when necessary to satisfy the audit objectives.



5. Evidence--Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditors' judgments and conclusions regarding the organization, program, activity, or function under audit.

#### Reporting Standards--Performance Audits

1. Form--Written audit reports are to be prepared communicating the results of each governmental audit.

2. Timeliness--Reports are to be issued promptly so as to make the information available for timely use by management and legislative officials, and by other interested parties.

3. Report Contents--The report should include a statement of the audit objectives and a description of the audit scope and methodology.

4. Report Presentation--The report should be complete, accurate, objective, and convincing, and be as clear and concise as the subject matter permits.

5. Report Distribution--Written audit reports are to be submitted by the audit organization to the appropriate officials of the organization audited, and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, unless legal restrictions, ethical considerations, or other arrangements prevent it.

**APPENDIX C**  
**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**  
**Generally Accepted Auditing Standards**

**GENERAL STANDARDS**

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

**STANDARDS OF FIELD WORK**

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient, competent, evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

**STANDARDS OF REPORTING**

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed.

**APPENDIX D**  
**ELECTRONIC DATA PROCESSING AUDITORS FOUNDATION**  
**General Standards for Information Systems Auditing**

**Independence**

General Standard No. 1: Attitude and Appearance - In all matters related to auditing, the information systems auditor is to be independent of the auditee in attitude and appearance.

General Standard No. 2: Organizational Relationship - The information systems audit function is to be sufficiently independent of the area being audited to permit objective completion of the audit.

General Standard No. 3- Code of Professional Ethics - The information systems auditor is to adhere to the Code of Professional Ethics of the EDP Auditors Foundation.

**Technical Competence**

General Standard No. 4: Skills and Knowledge - The information systems auditor is to be technically competent, possessing the skills and knowledge necessary in the performance of the auditor's work.

General Standard No. 5: Continuing Professional Education - The information systems auditor is to maintain technical competence through appropriate continuing education.

**Performance of Work**

General Standard No. 6: Planning and Supervision - Information systems audits are to be planned and supervised to provide assurance that audit objectives are achieved and compliance with these standards is met.

General Standard No. 7: Evidence Requirement - During the course of the audit, the information systems auditor is to obtain evidence of a nature and sufficiency to support findings and conclusions reported.

General Standard No. 8: Due Professional Care - Due professional care is to be exercised in all aspects of the information system auditor's work, including observance of applicable auditing standards.

## Reporting

General Standard No. 9: Reporting of Audit Coverage - In preparing reports, the information systems auditor is to state the objectives of the audit, the period of coverage, and the nature and extent of the audit work performed.

General Standard No. 10: Reporting and Findings and Conclusions - In preparing reports, the information systems auditor is to state findings and conclusions concerning the work performed, and any reservations or qualifications that the auditor has with respect to the audit.

## APPENDIX E

### TEXAS INTERNAL AUDITING ACT (1989)

PUBLIC OFFICES, ETC.  
Title 110A

Art. 6252-5d

#### Art. 6252-5d. Internal Auditing Act

##### Short title

Sec. 1. This Act may be cited as the Texas Internal Auditing Act.

##### Purpose

Sec. 2. The purpose of this Act is to establish guidelines for a program of internal auditing to assist agency administrators by furnishing independent analyses, appraisals, and recommendations concerning the adequacy and effectiveness of an agency's systems of internal control policies and procedures, and the quality of performance in carrying out assigned responsibilities.

##### Definitions

Sec. 3. In this Act:

(1) "Agency" includes every state agency, department, board, bureau, institution, or commission that meets one or more of the following criteria:

(A) has an operating budget exceeding \$10 million annually;

(B) has a staff of more than 300 employees;

(C) receives and processes cash items in excess of \$10 million annually.

(2) "Agency administrator" means the executive head of an agency.

(3) "Audit" means a financial audit, a compliance audit, an economy efficiency audit, an effectiveness audit, or an investigation as defined by Sections 321.0131-321.0136, Government Code.

##### Program of internal auditing

Sec. 4. Each agency shall establish a full-time program of internal auditing which shall include:

(1) an annual audit plan, prepared using risk assessment techniques, which identifies the individual audits to be conducted during each year;

(2) audits of the department's accounting systems and controls, administrative systems and controls, electronic data processing systems and controls, and other major systems and controls, so as to ensure that all the major systems and controls are reviewed on a periodic basis.

##### Appointment of internal audit staff

Sec. 5. The governing board of an agency or its designee, or the administrator of an agency without a governing board, shall appoint an internal auditor, who shall be either a certified public accountant or a certified internal auditor and who shall have at least three years of auditing experience. The agency shall employ such additional professional and support staff as the agency administrator determines are necessary to implement an effective program of internal auditing.

**Duties of internal auditor**

Sec. 6. The internal auditor shall:

- (1) report directly to the agency's governing board or commission with access to the agency administrator;
- (2) develop an annual audit plan, which shall be approved by the governing board of the agency or its designee, or by the administrator of an agency without a governing board;
- (3) conduct audits as specified in the audit plan with documented deviations;
- (4) prepare audit reports, which shall be reviewed by the agency administrator and the agency's governing board or commission;
- (5) conduct quality assurance reviews in accordance with professional standards and periodically take part in a comprehensive external peer review; and
- (6) be free of all operational and management responsibilities that would impair the ability to make independent reviews of all aspects of the agency's operations.

**Consultations by internal auditor**

Sec. 7. An internal auditor may consult with the agency's governing board or commission, the governor's office, the state auditor, and other legislative agencies or committees concerning matters affecting duties or responsibilities under this Act.

**Internal audit standards**

Sec. 8. The internal audit program shall conform to the Standards for the Professional Practice of Internal Auditing, the Certified Internal Auditor Code of Professional Ethics, and the Statement of Responsibilities of Internal Auditing, as promulgated and periodically revised by the Institute of Internal Auditors.

**Professional development**

Sec. 9. The state auditor shall make available and coordinate a program of training and technical assistance to ensure that agency internal auditors have access to current information concerning internal audit techniques, policies, and procedures and to provide general technical and audit assistance to agency internal auditors upon request. The state auditor shall be entitled to receive reimbursement for costs associated with providing such services under the terms of interagency cooperation contracts negotiated between the state auditor and each agency. Such costs shall not exceed those allowed by the General Appropriations Act.

**Severability clause**

Sec. 10. If any provision of this Act or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this Act that can be given effect without the invalid provision or application, and to this end the provisions of this Act are declared to be severable.

Acts 1989, 71st Leg., ch. 787, eff. Sept. 1, 1989.

**Historical and Statutory Notes**

**Title of Act:**

An Act relating to the establishment of a program of internal auditing by certain state

agencies and institutions. Acts 1989, 71st Leg., ch. 787.

**APPENDIX F**  
**SENATE BILL 75, 72ND TEXAS LEGISLATURE**  
**Proposing to Amend the Texas Internal Auditing Act**



01/22/91

By Barrientos

Filed

SENATE BILL 75

A BILL TO BE ENTITLED

AN ACT

relating to the continuation, composition, and functions of the Texas State Board of Public Accountancy; creating a scholarship program for certain accounting students to be administered by the Texas Higher Education Coordinating Board; relating to the requirements for a certified public accountant or certified internal auditor to serve as an internal auditor for a state agency; providing a penalty.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 20. Section 5, Chapter 787, Acts of the 71st Legislature, Regular Session, 1989 (Article 6252-5d, Vernon's Texas Civil Statutes), is amended to read as follows:

Sec. 5. APPOINTMENT OF INTERNAL AUDIT STAFF. (a) Except as provided by Subsection (b) of this section, the [The] governing board of an agency or its designee, or the administrator of an agency without a governing board, shall appoint an internal auditor, who shall be either a certified public accountant or a certified internal auditor and who shall have at least three years of auditing experience. The agency shall employ such additional professional and support staff as the agency administrator determines are necessary to implement an effective program of internal auditing.

(b) An individual employed by an agency as an internal auditor on September 1, 1991, shall be exempt from the requirements of Subsection (a) of this section.

Amend S.B. 75, on the Texas State Board of Public Accountancy, as follows:

1. On Page 34, line 23 through Page 35, Line 8, delete Section 5 and substitute the following:

Sec. 5 APPOINTMENT OF INTERNAL AUDIT STAFF. The governing board of an agency or its designee, or the administrator of an agency without a governing board, shall appoint an internal auditor, ~~who shall be either a certified public accountant or a certified internal auditor~~ and who shall have at least five ~~three~~ years of internal auditing experience. Certification as a public accountant, internal auditor or other relevant certification or possession of a relevant advanced degree can substitute for two years of the required internal auditing experience. The agency shall employ such additional professional and support staff as the agency administrator determines are necessary to implement an effective program of internal auditing.

2. On Page 35, between lines 8 and 9, insert the following and renumber the following SECTIONS of the bill:

SECTION 21. Section 8, Chapter 787, Acts of the 71st Legislature, Regular Session, 1989 (Article 6252-5d, Vernon's Texas Civil Statutes), is amended to read as follows:

Sec. 8. INTERNAL AUDIT STANDARDS. The internal audit program shall conform to the Standards for the Professional Practice of Internal Auditing, generally accepted governmental auditing standards, the Certified Internal Auditor Code of Professional Ethics, and the Statement of Responsibilities of Internal Auditing, as promulgated and periodically revised by the Institute of Internal Auditors.



**APPENDIX G**  
**MODEL INTERNAL AUDITING STATUTE**  
**The Institute of Internal Auditors, Inc. (1985)**

DIGEST

1. Existing Law:

Except where audits are performed upon Federal Grant programs under the Single Audit Act of 1984, existing law does not specify the standards that the state and local governments must follow during the conduct of an audit.

2. Adoption of Standards:

This bill would require all public agency auditors to utilize as standards of internal auditing the "Standards for the Professional Practice of Internal Auditing", as published by The Institute of Internal Auditors, Inc., in its seventh printing, dated February 1984, and subsequent authoritative pronouncements on Internal Auditing Standards and Statements on Internal Auditing published by The Institute of Internal Auditors, Inc. ("Standards").\*

3. Audit Reports:

All audit reports would be required to include a statement as to whether the audit was conducted pursuant to the "Standards".\*

4. Recommendation to Establish an Internal Audit Function:

This bill would recommend that all state and local governments with \$ \_\_\_\_\_ or more annual spending to consider establishing an ongoing internal audit function.

5. Enforcement/Oversight:

This bill would require the [Director of Finance] [Controller] [Auditor General] to conduct an annual review in conjunction with the annual audit of state or local government financial statements, or when otherwise directed by the [legislative audit committee], of all state or local government auditing functions, for variance from the general practice.

Further, it would require the [Director of Finance] [Controller] [Auditor General] to submit reports to the Legislature and appropriate entities regarding significant variances from the general practice.

DIGEST (continued)

6. Waiver from Compliance:

This bill would also give local governments the option to comply with the standards, as indicated, and would authorize the [legislative audit committee] to grant waivers to any local government from compliance with the standards.

[SECTION 1.] The [Director of Finance] [Controller] [Auditor General], and respective staffs thereof, all state and local governments that have their own internal auditors, or that have internal audits conducted under contract, or that conduct internal audit activities, shall utilize as standards of internal auditing the publication entitled "Standards for the Professional Practice of Internal Auditing", as published by The Institute of Internal Auditors, Inc. in its seventh printing, dated February 1984, and subsequent authoritative pronouncements on Internal Auditing Standards and Statements on Internal Auditing Standards published by The Institute of Internal Auditors, Inc. ("Standards").\*

[SECTION 2.] All audit reports issued by internal auditors enumerated in SECTION 1. must include a statement as to whether the audit was conducted pursuant to the "Standards".\*

[SECTION 3.] All state and local entities with an aggregate spending of \_\_\_\_\_ million dollars (\$\_\_\_\_\_) or more annually shall consider establishing an ongoing internal audit function.

[SECTION 4.] The [Director of Finance] [Controller] [Auditor General] shall, in coordinating the internal auditors of state entities, insure that these auditors utilize the "Standards".

The [Director of Finance] [Controller] [Auditor General] shall, in conjunction with his annual audit of state financial statements, or when otherwise directed by the [legislative audit committee], test compliance with this section and report to the Legislature and the respective governmental entities on any significant variances from the general and specific standards for the professional practice of internal auditing.

[SECTION 5.] Notwithstanding the provisions of SECTION 1., the [legislative audit committee] may, by a majority vote, grant a waiver to any entity that petitions the committee from compliance with any standard prescribed in SECTION 1.

[SECTION 6.] Notwithstanding the provisions of SECTION 1., if an entity determines that the implementation of any specific standard enumerated in SECTION 1. would result in net additional costs which exceed any potential savings, the governing body of that entity shall have the option to determine the degree of implementation of the specified standard.

## DEFINITIONS AND NOTES RELATED TO THE MODEL LEGISLATION

### DEFINITIONS:

As a convenience, the words "state", "entity" and "local entities" are used in the model legislation.

The word "state" may be interchanged with "province" or any appropriate entity.

The words "entity" and "local entities" apply to any and all such state, county and municipal governments, agencies, authorities, districts, and related bodies. Each state would choose the appropriate wording, such as:

"Local governments, counties, tax districts, utility districts, political subdivisions, state departments, boards, commissions, institutions, agencies, authorities, or other entities of the state", or,

"Controller, Department of Finance, state agencies, cities, counties, and districts."

### NOTES:

- \* The wording "...and/or to other such standards as directed or appropriate" may be added to allow for the adoption of such standards as the "Standards for Audit of Governmental Organizations, Programs, Activities and Functions", published by the United States General Accounting Office.

The titles in brackets, [Director of Finance], [Controller], [Auditor General], and [legislative audit committee] vary from state to state. Each state would choose the appropriate offices for the various sections of the legislation.

**APPENDIX H**  
**STATE OF CALIFORNIA**  
**Financial Integrity and State Managers Accountability Act (1983)**

**GOVERNMENT CODE**

**§ 1236. Standards of internal auditing**

The Controller, the Director of the Department of Finance, and the respective staffs thereof, all state agencies that have their own internal auditors or that conduct internal audits or that conduct internal audit activities, and all city, county, city and county, and district employees that conduct internal audits or that conduct internal audit activities of those respective agencies, shall utilize the general and specified standards of internal auditing specified on the effective date of this section in the publication entitled "Standards for the Professional Practice of Internal Auditing," as published by the Institute of Internal Auditors, Inc. in its fourth printing, dated April 1980. The standards contained therein provide that: auditors should be independent of the activities they audit; internal audits should be performed with proficiency and due professional care; the scope of the internal audit should encompass the examination and evaluation of the adequacy and effectiveness of the organization's system of internal control and the quality of performance in carrying out assigned responsibilities; audit work should include planning the audit, examining and evaluating information, communicating results and following up; and the director of internal auditing should properly manage the internal auditing department.

Added Stats 1982 ch 101 § 1.

Optional implementation of standards: § 1238.

Waivers: § 1239.

Compliance with standards by state agencies: § 10529.

\*

**§ 1237. Establishment of internal audit functions**

All state and local agencies with an aggregate spending of fifty million dollars (\$50,000,000) or more annually shall consider establishing an ongoing internal audit function.

Added Stats 1982 ch 101 § 2.

**§ 1238. Optional implementation of specific standard**

Notwithstanding the provisions of Section 1236, if a city, county, city and county, or district determines that the implementation of any specific standard enumerated in Section 1236 would result in net additional costs which exceed any potential savings, the governing body of that city, county, city and county, or district shall have the option to determine whether or not to implement the specified standard.

Added Stats 1982 ch 101 § 3.

**§ 1239. Waivers**

Notwithstanding the provisions of Section 1236, the Joint Legislative Audit Committee, may, by majority vote, grant a waiver to any agency that petitions the committee from compliance with any standard prescribed in Section 1236.

Added Stats 1982 ch 101 § 4.

**§ 10529. Utilization of internal auditing standards by state agencies**

The Director of Finance shall, in coordinating the internal auditors of state agencies, insure that these auditors utilize the "Standards for the Professional Practices of Internal Auditing." The Auditor General shall, in conjunction with their annual audit of state financial statements, or when otherwise directed by the Joint Legislative Audit Committee, test compliance with this section and report to the Legislature and the respective governmental entities on the significant variances from the general and specific standards for the professional practice of internal auditing.

Added Stats 1982 ch 101 § 3.

Related provisions: §§ 1236 et seq.

**CHAPTER 5**

***The Financial Integrity and State Manager's Accountability Act of 1983***

[Added by Stats 1982 ch 630 § 1.]

- § 13400. Citation of act
- § 13401. Legislative findings
- § 13402. Responsibilities of agency heads for establishment of internal accounting systems
- § 13403. Elements of internal accounting and administrative control systems
- § 13404. Definitions
- § 13405. Reports and evaluations
- § 13406. Provision of false or misleading information in connection with evaluations and reports; Investigations
- § 13407. Use of existing resources

**§ 13400. Citation of act**

This act shall be known and may be cited as the Financial Integrity and State Manager's Accountability Act of 1983.

Added Stats 1982 ch 630 § 1.

**§ 13401. Legislative findings**

(a) The Legislature hereby finds that:

- (1) Fraud and errors in state programs are more likely to occur from a lack of effective systems of internal accounting and administrative control in the state agencies.
- (2) Effective systems of internal accounting and administrative control provide the basic foundation upon which a structure of public accountability must be built.
- (3) Effective systems of internal accounting and administrative control are necessary to assure that state assets and funds are adequately safeguarded, as well as to produce reliable financial information for the agency.

{1 Gov Code}

135

(4) Systems of internal accounting and administrative control are necessarily dynamic and must be continuously evaluated and, where necessary, improved.

(5) Reports regarding the adequacy of the systems of internal accounting and administrative control of each state agency are necessary to enable the executive branch, the Legislature, and the public to evaluate the agency's performance of its public responsibilities and accountability.

(b) The Legislature declares it to be the policy of the State of California that:

(1) Each state agency must maintain effective systems of internal accounting and administrative control as an integral part of its management practices.

(2) The systems of internal accounting and administrative control of each state agency shall be evaluated on an ongoing basis and, when detected, weaknesses must be promptly corrected.

(3) All levels of management of the state agencies must be involved in assessing and strengthening the systems of internal accounting and administrative control to minimize fraud, errors, abuse, and waste of government funds.

Added Stats 1982 ch 630 § 1.

#### **§ 13402. Responsibilities of agency heads for establishment of internal accounting systems**

State agency heads are responsible for the establishment and maintenance of a system or systems of internal accounting and administrative control within their agencies. This responsibility includes documenting the system, communicating system requirements to employees, and assuring that the system is functioning as prescribed and is modified, as appropriate, for changes in conditions.

Added Stats 1982 ch 630 § 1.

#### **§ 13403. Elements of internal accounting and administrative control systems**

(a) Internal accounting and administrative controls are the methods through which reasonable assurances can be given that measures adopted by state agency heads to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies are being followed. The elements of a satisfactory system of internal accounting and administrative control, shall include, but are not limited to, the following:

(1) A plan of organization that provides segregation of duties appropriate for proper safeguarding of state agency assets.

(2) A plan that limits access to state agency assets to authorized personnel who require these assets in the performance of their assigned duties.

(3) A system of authorization and recordkeeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures.

(4) An established system of practices to be followed in performance of duties and functions in each of the state agencies.

(5) Personnel of a quality commensurate with their responsibilities.

(6) An effective system of internal review.

(b) State agency heads shall follow these standards of internal accounting and administrative control in carrying out the requirements of Section 13402.

Added Stats 1982 ch 630 § 1.

#### § 13404. Definitions

As used in this chapter:

- (a) "Governor" means the Governor of California.
- (b) "Controller" means the Controller of California.
- (c) "Director" means the Director of Finance.

Added Stats 1982 ch 630 § 1.

#### § 13405. Reports and evaluations

(a) To ensure that the requirements of this section are fully complied with, the head of each agency which the director determines is covered by this section shall prepare and submit a report on the adequacy of the agency's systems of internal accounting and administrative control by December 31, 1983, and by December 31 following the end of each odd-numbered fiscal year thereafter.

(b) The report, including the state agency's response to report recommendations, shall be signed by the head of the agency and addressed to the agency secretary or the director of finance for agencies without an agency secretary. Copies of the reports shall be forwarded to the Legislature, the Auditor General, the Governor, and the Director of Finance. Copies of these reports shall also be forwarded to the State Library where they shall be available for public inspection.

(c) By January 1, 1983, the director, in consultation with the Auditor General and the Controller, shall establish a system of reporting and a general framework to guide the agencies in performing evaluations on their systems of internal accounting and administrative control. The director, in consultation with the Auditor General and the Controller, may modify the format for the report or the framework for conducting the evaluations from time to time as deemed necessary.

(d) Any material inadequacy or material weakness in an agency's systems of internal accounting and administrative control which prevents the head of the agency from stating that the agency's systems of internal accounting and administrative control provided reasonable assurances that each of the objectives specified above was achieved, shall be identified and the plans and schedule for correcting any such inadequacy described in detail.

Added Stats 1982 ch 630 § 1.

#### § 13406. Provision of false or misleading information in connection with evaluations and reports; Investigations

(a) The head of the internal audit staff of a state agency or a division, as specified by the director, or, in the event there is no internal audit function, a professional accountant, if available on the staff, designated as the internal control person by the head of the state agency or a division, shall receive and investigate any allegation that an employee of the agency provided false or misleading information in connection with the evaluation of the agency's systems of internal accounting and administrative control or in connection

with the preparation of the annual report on the systems of internal accounting and administrative control.

(b) If, in connection with any investigation under subdivision (a), the head of the internal audit staff or the designated internal control person determines that there is reasonable cause to believe that false or misleading information was provided, he or she shall report in writing that determination to the head of the agency or the division.

(c) The head of the agency or division shall review any matter referred to him under subdivision (b), shall take such disciplinary or corrective action as he deems necessary, and shall forward a copy of the report, indicating therein the action taken, to the director within 90 days of the date of the report.

Added Stat 1982 ch 630 § 1.

**§ 13407. Use of existing resources**

Because sound internal controls and the monitoring of those internal controls significantly inhibits waste of resources and thereby creates savings, the director and agencies and divisions shall carry out the provisions of this chapter by using existing resources.

Added Stat 1982 ch 630 § 1.



CALIFORNIA  
STATE ADMINISTRATIVE MANUAL  
AUDITING OF STATE AGENCIES

INTRODUCTION (Revised 9/86)

20000

The Director of Finance has general responsibilities for supervision over matters concerning the financial and business policies of the State as provided in Section 13070 of the Government Code. To assist the Director in fulfilling these responsibilities, the Financial and Performance Accountability Unit (FPA) of the Department of Finance has been delegated authority over three functional areas:

- . Performance Accountability Analysis
- . Audit Advisory Services
- . Coordination of Executive Branch Internal Auditing

Performance Accountability Analysis provides a systematic means for verifying budgetary, financial, and operating systems of control. It encompasses examinations, on a selective basis, of all operations funded by Federal and State resources including: all funds for which the State is accountable in the administration of programs; and funds passed through to local governments, school districts, community colleges, special districts, and private or nonprofit entities either by subventions, contracts, or grants.

Audit Advisory Services consist of audit consultation and technical assistance to State agencies, boards, and commissions that do not have audit expertise or resources. These services are provided as requested on a short-term, limited basis when it may not be economically feasible to hire staff or contract for services.

In the interest of economy and efficiency, the Legislature, in Sections 10534(c) and 12430 of the Government Code, has expressed its desire that internal auditing be coordinated within the Executive Branch and has assigned this responsibility to the Department of Finance. This coordination of Executive Branch Auditing affects all internal audit units, grant and contract auditors, and analysts who are performing internal auditing activities. It will include recommendations pertaining to procedures which will lead to uniform approaches to internal auditing and training where it is deemed desirable and beneficial. This coordination activity will not affect audit activities which are an integral part of a department's functions such as regulatory and tax auditors or other auditors who work directly with selected industries or taxpayers.

Coordination of audits of State agencies is further defined by Chapter 1167, Statutes of 1981 (AB 861), effective January 1, 1982, which directs that audits of State agencies be coordinated to ensure that there is a comprehensive review and examination of the financial condition of the State; to promote the efficiency and effectiveness of audits; and to satisfy the requirements established by the Federal Government and national bond rating companies.

# STATE ADMINISTRATIVE MANUAL

## AUDITING OF STATE AGENCIES

INTERNAL AUDITING STANDARDS (Renumbered from 20020, Revised 9/86)

20002

Section 1236 of the Government Code, added by Chapter 101, Statutes of 1982 (AB 1229), requires that all State agencies, including the State Controller's Office and the Department of Finance, that conduct internal auditing activities shall utilize the general and specific standards of internal auditing contained in the publication entitled Standards for the Professional Practice of Internal Auditing (SPPIA) adopted by the Institute of Internal Auditors, Inc.

An overview of SPPIA was made available to all state organizations performing internal auditing activities by the Department of Finance in their November 1981 publication entitled Auditing Standards for State Organizations Performing Internal Auditing Activities.

These standards relate to:

- . Independence
- . Professional Proficiency
- . Scope of Work
- . Performance of Audit Work
- . Management of the Internal Auditing Organization

While SPPIA establishes the basis for improvement and evaluation of state organizations performing internal auditing activities, it is management's responsibility to ensure that they are independent of the activities they audit (SPPIA's first general standard). Independence is achieved through organizational status. Therefore, the state organizations performing internal auditing activities should have organizational status sufficient to permit the accomplishment of their audit responsibilities. This will permit these audit organizations to accomplish their audit responsibilities and maintain their independence.

State agencies conducting internal control reviews will receive a quality control review of their activity by the Department of Finance. This review will comment upon the agency's compliance with SAM requirements and applicable SPPIA Standards.

INTERNAL CONTROL (Renumbered from 20021, Revised 9/86)

20003

State government, in a broad sense, is an economic entity created and operated principally to provide needed or desired services. Management of the entity involves assessing the risks involved in ongoing operations and deciding which ones shall be assumed, which reduced, which eliminated, and how this will be accomplished. The plan of organization and the system of policies, methods, and procedures adopted by management to ensure that resources are used in compliance with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data may be obtained, maintained, and accurately disclosed in reports collectively are called internal controls.

Internal Control is an internal check, to facilitate the achievement of management objectives, by serving as checks and balances against unauthorized and undesired actions. The ultimate responsibility for good internal control rests with management and should be recognized as an integral part of each system that management uses to regulate and guide its operations. Therefore, management should document internal control by using flowcharts, narratives, desk procedures, and organizational charts.

### Responsibility

Section 13402 of the Government Code defines internal accounting and administrative controls and sets forth the elements of a satisfactory system of internal control. Internal accounting and administrative controls are the methods through which reasonable assurances can be given that measures adopted by State agency heads to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribe managerial policies are being followed.

(Continued)

**APPENDIX I**  
**STATE OF FLORIDA**  
**Internal Audit Act (revised 1990)**

1990 SUPPLEMENT TO FLORIDA STATUTES 1989

s. 20.055

**CHAPTER 20**

**ORGANIZATIONAL STRUCTURE**

20.055	Agency chief internal auditors.
20.13	Department of Insurance.
20.17	Department of Commerce.
20.171	Department of Labor and Employment Security.
20.19	Department of Health and Rehabilitative Services.
20.21	Department of Revenue.
20.23	Department of Transportation.
20.30	Department of Professional Regulation.
20.315	Department of Corrections.
20.32	Parole Commission.

**20.055 Agency chief internal auditors.—**

(1) For the purposes of this section:

(a) "State agency" means each department created pursuant to chapter 20, and also includes the Executive Office of the Governor, the Department of Military Affairs, the Parole Commission, the Board of Regents, the Game and Fresh Water Fish Commission, the Public Service Commission, and the state courts system.

(b) "Agency head" means the Governor, a Cabinet officer, a secretary as defined in s. 20.03(5), or an executive director as defined in s. 20.03(6). It also includes the chairman of the Public Service Commission and the Chief Justice of the State Supreme Court.

(c) "Chief internal auditor" means the person appointed by the agency head to direct the internal audit function for the state agency.

(2) Each state agency shall employ a chief internal auditor who shall be appointed by and directly responsible to the agency head.

(3) The chief internal auditor shall possess the following qualifications:

(a) A bachelor's degree from an accredited college or university with a major in accounting, or with a major in business which includes five courses in accounting, and 5 years of experience as an internal auditor or independent postauditor, electronic data processing auditor, accountant, or any combination thereof. The experience shall at a minimum consist of audits of units of government or private business enterprises, operating for profit or not for profit; or

(b) A master's degree in accounting, business administration, or public administration from an accredited college or university and 4 years of experience as required in paragraph (a); or

(c) A certified public accountant license issued pursuant to chapter 473 or a certified internal audit certificate issued by the Institute of Internal Auditors or earned by examination, and 4 years of experience as required in paragraph (a).

(4) The chief internal auditor shall review and evaluate internal controls necessary to ensure the fiscal accountability of the state agency. The chief internal auditor shall conduct financial, compliance, and performance audits of the agency and prepare audit reports of his findings. The scope and assignment of the audits shall be determined by the chief internal auditor; however, the head of the agency may at any time direct the chief internal auditor to perform an audit of a special program, function, or organizational unit. The performance of the audit shall be under the direction of the chief internal auditor.

(a) Such audits shall be conducted in accordance with the current Standards for the Professional Practice of Internal Auditing and subsequent Internal Auditing Standards or Statements on Internal Auditing Standards published by the Institute of Internal Auditors, Inc., or, where appropriate, in accordance with generally accepted governmental auditing standards. All audit reports issued by internal audit staff shall include a statement that the audit was conducted pursuant to the appropriate standards.

(b) Audit workpapers and reports shall be public records to the extent that they do not include information which has been made confidential and exempt from the provisions of s. 119.07(1) pursuant to law. However, when the chief internal auditor or a member of his staff receives from an individual a complaint or information that falls within the definition provided in s. 112.3187(5), the name or identity of the individual shall not be disclosed to anyone other than the chief internal auditor without the written consent of the individual, unless the chief internal auditor determines that such disclosure is unavoidable during the course of the audit or investigation. This exemption is subject to the Open Government Sunset Review Act in accordance with s. 119.14.

(c) The chief internal auditor and his staff shall have access to any records, data, and other information of the state agency he deems necessary to carry out his duties.

(5) At the conclusion of each audit, the chief internal auditor shall submit his preliminary findings and recommendations to the person responsible for supervision of the program function or operational unit who shall respond to any adverse findings of the chief internal auditor within 20 working days after receipt of the tentative findings. Such response and the chief internal auditor's rebuttal to the response shall be included in the final audit report.

(6) The chief internal auditor shall submit the final report to the head of the agency and to the Auditor General.

(7) The Auditor General, in connection with his independent postaudit of the same agency pursuant to s. 11.45, shall give appropriate consideration to internal audit reports and the resolution of findings therein. The Legislative Auditing Committee may inquire into the reasons or justifications for failure of the agency head to correct the deficiencies reported in internal audits that are also reported by the Auditor General and shall take appropriate action. The Auditor General shall also review a sample of each agency's internal audit reports at least once every 3 years to determine compliance with current Standards for the Professional Practice of Internal Auditing or, if appropriate, generally accepted governmental auditing standards. If the Auditor General finds that these standards have not been complied with, he shall include a statement of this fact in his audit report of the agency.

*History.*—ss. 1, 2, ch. 86-131; s. 1, ch. 87-30, ss. 1, 4, ch. 90-247.

*Note.*—As amended by s. 1, ch. 90-247, Section 5, ch. 90-247, provides that "[t]he Department of Administration shall revise the classification and pay grades for staff of chief internal auditors in order to ensure that chief internal auditors may recruit and retain appropriate internal auditing staff."

**APPENDIX J**  
**STATE OF ILLINOIS**  
**Fiscal Control and Internal Auditing Act (revised 1989)**

**FISCAL CONTROL AND INTERNAL AUDITING ACT**

AN ACT in relation to the fiscal control and internal auditing of State agencies, repealing the Internal Auditing Act. P.A. 86-936, amendatory veto overridden Oct. 31, 1989, eff. Jan. 1, 1990.

**ARTICLE 1. GENERAL PROVISIONS**

**1001. Short title**

§ 1001. Short title. This Act may be cited as the Fiscal Control and Internal Auditing Act.

**1002. Public policy**

§ 1002. Public policy. It is the policy of this State that the chief executive officer of every State agency is responsible for effectively and efficiently managing the agency and establishing and maintaining an effective system of internal control.

**1003. Definitions**

§ 1003. Definitions.

(a) "Designated State agencies" include the offices of the Secretary of State, the State Comptroller, the State Treasurer, and the Attorney General, the State Board of Education, the State colleges and universities, the Illinois Toll Highway Authority, the Illinois Housing Development Authority, and other State agencies designated by the Governor under Section 2001.<sup>1</sup>

(b) "State agency" means that term as defined in the Illinois State Auditing Act, as now or hereafter amended,<sup>2</sup> except the judicial branch which shall be covered by subsection (c) of Section 2001 and Section 3004 of this Act.<sup>3</sup>

(c) "Chief executive officer" includes, respectively, the Secretary of State, the State Comptroller, the State Treasurer, the Attorney General, the State Superintendent of Education, such chief executive officers as are designated by the governing board of each State college and university, the executive director of the Illinois Toll Highway Authority, and the executive director of the Illinois Housing Development Authority, as well as the chief executive officer of each other State agency.

<sup>1</sup> Paragraph 2001 of this chapter.

<sup>2</sup> Paragraph 301-1 et seq. of this chapter.

<sup>3</sup> Paragraph 3004 of this chapter.

**ARTICLE 2. INTERNAL AUDITING**

**2001. Program of internal auditing**

§ 2001. Program of internal auditing.

(a) Each designated State agency shall establish a full-time program of internal auditing. The Governor shall designate State agencies under this Act not later than April 1 of each odd numbered year. The designations shall be filed with the Index Division of the Office of the Secretary of State as a public record. The Legislative Audit Commission may make formal recommendations to the Governor that the Governor designate other State agencies under this Act.

(b) The chief executive officer of a State agency is not relieved from the responsibility for maintaining an effective internal control system merely because that State agency is not designated and required to have a full-time program of internal auditing under this Act. Agencies which do not have full-time internal audit programs may have internal audits performed by the Department of Central Management Services.

(c) The Supreme Court will establish by its rulemaking authority or by administrative order a full-time program of internal auditing of State-funded activities of the judicial branch, which is consistent with the intent of this Article.

**2002. Qualifications of chief internal auditor**

§ 2002. Qualifications of chief internal auditor.

(a) The chief executive officer of each designated State agency shall appoint a chief internal auditor with a bachelor's degree, who is either:

(1) a certified internal auditor by examination or a certified public accountant and who has at least 4 years of progressively responsible professional auditing experience; or

(2) an auditor with at least 5 years of progressively responsible professional auditing experience.

(b) The chief internal auditor shall report directly to the chief executive officer and shall have direct communications with the chief executive officer and the governing board, if applicable, in the exercise of auditing activities. All chief internal auditors and all full-time members of an internal audit staff shall be free of all operational duties.

**2003. Internal auditing program requirements**

§ 2003. Internal auditing program requirements.

(a) The chief executive officer of each designated State agency shall ensure that the internal auditing program includes:

(1) A two-year plan, identifying audits scheduled for the pending fiscal year, approved by the chief executive officer before the beginning of the fiscal year. By September 30 of each year the chief internal auditor shall submit to the chief executive officer a written report detailing how the audit plan for that year was carried out, the significant findings, and the extent to which recommended changes were implemented.

(2) Audits of major systems of internal accounting and administrative control conducted on a periodic basis so that all major systems are reviewed at least once every 2 years. The audits must include testing of:

(A) the obligation, expenditure, receipt, and use of public funds of the State and of funds held in trust to determine whether those activities are in accordance with applicable laws and regulations; and

(B) grants received or made by the designated State agency to determine that the grants are monitored, administered, and accounted for in accordance with applicable laws and regulations.

(3) Reviews of the design of major new electronic data processing systems and major modifications of those systems before their installation to ensure the systems provide for adequate audit trails and accountability.

(4) Special audits of operations, procedures, programs, electronic data processing systems, and activities as directed by the chief executive officer or by the governing board, if applicable.

(b) Each chief internal auditor shall have, in addition to all other powers or duties authorized by law, required by professional ethics or standards, or assigned consistent with this Act, the powers necessary to carry out the duties required by this Act.

#### 2004. Consultations by internal auditor

§ 2004. Consultations by internal auditor. Each chief internal auditor may consult with the Auditor General, the Department of Central Management Services, the Economic and Fiscal Commission, the appropriations committees of the General Assembly, the Bureau of the Budget, or the Internal Audit Advisory Board on matters affecting the duties or responsibilities of the chief internal auditor under this Act.

#### 2005. Internal Audit Advisory Board

§ 2005. Internal Audit Advisory Board. (a) An 11 member Internal Audit Advisory Board is created.

(b) The composition of the Board shall be as follows:

(1) the chief internal auditor of the Department of Central Management Services;

(2) the chief internal auditor of the Office of the State Comptroller;

(3) the chief internal auditor of the Office of the Secretary of State;

(4) the chief internal auditor of the Office of the State Treasurer;

(5) the chief internal auditor of the Office of the Attorney General; and

(6) 6 chief internal auditors appointed by the Governor.

At least one of the members appointed by the Governor must be an employee of a State college or university or university governing board.

(c) The initial appointments by the Governor of the 6 chief internal auditors who shall be members of the Board shall be made before the next February 1 after the date this Act takes effect and shall be as follows: 2 appointments for three-year terms, 2 appointments for two-year terms, and 2 appointments for one-year terms. After the initial terms each member appointed by the Governor shall serve a three-year term.

(d) A vacancy shall exist whenever a member ceases to be employed in the position which qualified the member for appointment. Vacancies shall be filled in the same manner as the original appointment. Persons appointed to fill a vacancy shall serve the balance of the unexpired term.

(e) The Board shall select a chairman from its members, who shall serve for a one-year term as chairman. Board members shall receive no additional compensation for their services, but shall be reimbursed by their employing agency for expenses necessarily incurred in the performance of their duties as Board members.

(f) The Board shall be responsible for:

(1) promulgating a uniform set of professional standards and a code of ethics (based on the standards and ethics of the Institute of Internal Auditors, the General Accounting Office, and other professional standards as applicable) to which all State internal auditors must adhere;

(2) serving as a clearinghouse for the correlation of internal audit training needs and training designed to meet those needs; and

(3) coordinating peer review activities among the State's internal audit units.

### ARTICLE 3. FISCAL CONTROLS

#### 3001. Internal controls required

§ 3001. Internal controls required. All State agencies shall establish and maintain a system, or systems, of internal fiscal and administrative controls, which shall provide assurance that:

(1) resources are utilized efficiently, effectively, and in compliance with applicable law;

(2) obligations and costs are in compliance with applicable law;

(3) funds, property, and other assets and resources are safeguarded against waste, loss, unauthorized use, and misappropriation;

(4) revenues, expenditures, and transfers of assets, resources, or funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the State's resources; and

(5) funds held outside the State Treasury are managed, used, and obtained in strict accordance with the terms of their enabling authorities and that no unauthorized funds exist.

#### 3002. Certification guidelines for chief executive officers

§ 3002. Certification guidelines for chief executive officers.

(a) By the next March 1 after the date this Act takes effect, the Comptroller, in consultation with the Director of Central Management Services, shall establish guidelines for:

(1) the evaluation by State agencies of their systems of internal fiscal and administrative controls to determine whether the systems comply with the requirements of Section 3001;<sup>1</sup> and

(2) the certification by chief executive officers required by Section 3003.<sup>2</sup>

(b) The guidelines must be approved by the Legislative Audit Commission and may be modified, as needed, with the Commission's approval.

<sup>1</sup> Paragraph 3001 of this chapter.

<sup>2</sup> Paragraph 3003 of this chapter.

#### 3003. Certification by chief executive officers

§ 3003. Certification by chief executive officers.

(a) By May 1 of each year, each chief executive officer of all State agencies shall, on the basis of an evaluation conducted in accordance with guidelines established under Section 3002,<sup>1</sup> prepare and transmit to the Auditor General a certification that:

(1) the systems of internal fiscal and administrative controls of the State agency fully comply with the requirements of this Act; or

(2) the systems of internal fiscal and administrative controls of the State agency do not fully comply with the requirements of this Act.

(b) If the systems do not fully comply with the requirements of this Act, the certification shall include a report describing any material weaknesses in the systems of internal fiscal and administrative controls and the plans and schedule for correcting the weaknesses, or a statement of the reasons why the weaknesses cannot be corrected.

<sup>1</sup> Paragraph 3002 of this chapter.

**APPENDIX K  
STATE OF MICHIGAN  
Internal Control Act (1986)**

Act No. 272  
Public Acts of 1986  
Approved by the Governor  
December 18, 1986  
Filed with the Secretary of State  
December 19, 1986

**STATE OF MICHIGAN  
83RD LEGISLATURE  
REGULAR SESSION OF 1986**

Introduced by Reps. Hickner, Richard A. Young, Van Regenmorter, Hertel, Stabenow, Stallworth, Berman, Bennane, Hillegonds, Strand, Van Singel, Joe Young, Jr., Trim, Gubow and Allen

**ENROLLED HOUSE BILL No. 4223**

AN ACT to amend the title of Act No. 431 of the Public Acts of 1984, entitled "An act to prescribe the powers and duties of the department of management and budget; to define the authority and functions of its director and its organizational entities; to authorize the department to issue directives; to provide for the capital outlay program; to provide for the leasing, planning, constructing, maintaining, altering, renovating, demolishing, conveying of lands and facilities; to provide for centralized administrative services such as purchasing, payroll, record retention, data processing, and publishing; to codify, revise, consolidate, classify, and add to the laws relative to budgeting, accounting, and the regulating of appropriations; to create funds and accounts; to make appropriations; to prescribe penalties; to rescind certain executive reorganization orders; and to repeal certain acts and parts of acts," as amended, being sections 18.1101 to 18.1594 of the Michigan Compiled Laws; and to add sections 483, 484, 485, 486, 487, 488, and 489.

*The People of the State of Michigan enact:*

Section 1. The title of Act No. 431 of the Public Acts of 1984, as amended, being sections 18.1101 to 18.1594 of the Michigan Compiled Laws, is amended and sections 483, 484, 485, 486, 487, 488, and 489 are added to read as follows:

**TITLE**

An act to prescribe the powers and duties of the department of management and budget; to define the authority and functions of its director and its organizational entities; to authorize the department to issue directives; to provide for the capital outlay program; to provide for the leasing, planning, constructing, maintaining; altering, renovating, demolishing, conveying of lands and facilities; to provide for centralized

administrative services such as purchasing, payroll, record retention, data processing, and publishing; to provide for a system of internal accounting and administrative control for certain principal departments; to provide for an internal auditor in certain principal departments; to provide for certain powers and duties of certain state officers and agencies; to codify, revise, consolidate, classify, and add to the powers, duties, and laws relative to budgeting, accounting, and the regulating of appropriations; to create funds and accounts; to make appropriations; to prescribe penalties; to rescind certain executive reorganization orders; and to repeal certain acts and parts of acts.

Sec. 483. As used in this section and sections 484 to 489:

(a) "Department head" means the head of a principal department.

(b) "Internal accounting and administrative control system" means the methods through which reasonable assurances can be given that measures are being used by a principal department and its state agencies to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

Sec. 484. (1) Not later than April 1, 1987, the director, in consultation with the auditor general, shall develop a system of reporting and a general framework which shall be used by the principal departments in performing evaluations on their respective internal accounting and administrative control systems.

(2) The director, in consultation with the auditor general, may modify the format for the report or the framework for conducting the evaluations after giving 30 days' notice to each principal department head and the senate and house appropriations committees.

Sec. 485. (1) Not later than October 1, 1987, the department head of each principal department shall establish and maintain an internal accounting and administrative control system within that principal department using the generally accepted accounting principles as developed by the accounting profession and in conformance with directives issued pursuant to section 141(d).

(2) Each internal accounting and administrative control system shall include, but not be limited to, all of the following elements:

(a) A plan of organization that provides separation of duties and responsibilities among employees.

(b) A plan that limits access to that principal department's resources to authorized personnel whose use is required within the scope of their assigned duties.

(c) A system of authorization and record-keeping procedures to control assets, liabilities, revenues, and expenditures.

(d) A system of practices to be followed in the performance of duties and functions in each principal department.

(e) Qualified personnel that maintain a level of competence.

(f) Internal control techniques that are effective and efficient.

(3) Each head of a principal department shall document the system, communicate system requirements to employees of that principal department, assure that the system is functioning as prescribed, and modify as appropriate for changes in condition of the system.

(4) Not later than October 1, 1987, the head of each principal department shall issue a report to the governor, the auditor general, the senate and house appropriations committees, and the director describing the current internal accounting and administrative control systems of the principal department, the organization and size of the internal audit staffs, and the manner in which the internal auditor will be utilized by the department head. Not later than March 1, 1988, the auditor general shall evaluate and report to the legislature on each principal department's report prepared pursuant to this subsection.

(5) Beginning March 1, 1989, and biennially thereafter, the head of each principal department shall provide a report prepared by the principal department's internal auditor on the evaluation of the principal department's internal accounting and administrative control system to the governor, the auditor general, the senate and house appropriations committees, and the director. For the period reviewed, the report shall include, but not be limited to, both of the following:

(a) A description of any material inadequacy or weakness discovered in connection with the evaluation of the department's internal accounting and administrative control system as of October 1 of the preceding year and the plans and a time schedule for correcting the internal accounting and administrative control system, described in detail.



(b) A listing of each audit or investigation performed by the internal auditor pursuant to sections 483(1) and 487.

Sec. 486. (1) Not later than October 1, 1987, each principal department shall appoint an internal auditor. Each internal auditor shall be a member of the state classified executive service.

(2) Except as otherwise provided by law, each internal auditor shall report to and be under the general supervision of the department head.

(3) A person may not prevent or prohibit the internal auditor from initiating, carrying out, or completing any audit or investigation. The internal auditor shall be protected pursuant to the whistleblowers' protection act, Act No. 469 of the Public Acts of 1980, being sections 15.361 to 15.369 of the Michigan Compiled Laws.

(4) The internal auditor of each principal department shall:

(a) Receive and investigate any allegations that false or misleading information was received in evaluating the principal department's internal accounting and administrative control system or in connection with the preparation of the biennial report on the system.

(b) Conduct and supervise audits relating to financial activities of the principal department's operations.

(c) Review existing activities and recommend policies designed to promote efficiency in the administration of that principal department's programs and operations as assigned by the department head.

(d) Recommend policies for activities to protect the state's assets under the control of that principal department, and to prevent and detect fraud and abuse in the principal department's programs and operations.

(e) Review and recommend activities designed to ensure that principal department's internal financial control and accounting policies are in conformance with the department of management and budget accounting division directives issued pursuant to sections 421 and 444.

(f) Provide a means to keep the department head fully and currently informed about problems and deficiencies relating to the administration of that principal department's programs and operations and the necessity for and progress of corrective action.

(g) Conduct other audit and investigative activities as assigned by the department head.

(5) Each internal auditor shall adhere to appropriate professional and auditing standards in carrying out any financial or program audits or investigations.

Sec. 487. (1) Each internal auditor shall report immediately to the department head if the internal auditor becomes aware of particularly serious or flagrant problems, abuses, or deficiencies relating to the administration of programs or operations of that principal department or its state agencies. If criminal activity is suspected, the department head shall immediately submit a report to the governor, attorney general, and the auditor general in accordance with reporting requirements established pursuant to section 484.

(2) Within 60 days after the receipt of a report filed pursuant to subsection (1), the department head shall submit a plan to correct the problems, abuses, or deficiencies to the director. Within 30 days after the receipt of the plan to correct, the director shall submit copies of the plan to correct to the auditor general and the senate and house appropriations committees.

(3) This section shall not be construed to authorize the public disclosure of information which is part of an ongoing criminal investigation or which is specifically prohibited from public disclosure by any other provision of law.

Sec. 488. (1) The governor's budget recommendations for the fiscal year beginning October 1, 1987 shall include a plan for each principal department to fully implement sections 483 to 487 and this section, including an identification of staff resources, an organizational plan, and any transfers of existing staff or resources.

(2) Except as otherwise provided by law, the state budget director may issue directives to a principal department to support the principal department's internal auditors through the use of that principal department's state grants funded from state resources. A directive issued under this subsection shall not authorize a principal department to allocate more than 10% of the principal department's state grants funded from state resources nor more than 10% of the principal department's state agencies state grants funded from state resources and shall provide for a uniform reduction in each of the state grants funded from state resources.

Sec. 489. Not later than September 30, 1989 and biennially thereafter, the auditor general shall evaluate and report to the legislature on the implementation of the requirements of sections 483 to 488.

**APPENDIX L**  
**STATE OF NEW YORK**  
**State Government Accountability, Audit**  
**and Internal Control Act (1987)**

S. 6442

CHAPTER 814, LAWS OF 1987

A. 8534

1987-1988 Regular Sessions

**SENATE—ASSEMBLY**

July 2, 1987

AN ACT to amend the state finance law, the executive law, the legislative law, the judiciary law, the public authorities law and the public officers law, in relation to systems of internal control for state agencies, covered authorities, the legislature and the judiciary and providing for the repeal of such provisions upon expiration thereof

The People of the State of New York, represented in Senate and Assembly, do enact as follows:

Section 1. Short title. This act shall be known and may be cited as the "New York state governmental accountability, audit and internal control act of 1987".

§ 2. Legislative findings. The legislature hereby finds that the scope, size and complexity of state government make it necessary to assure that the state's systems of internal control provide reasonable control over all state operations, and provide the public, the governor, the state legislature, the judiciary and the heads of state agencies and authorities with assurance that state assets and resources, including but not limited to, cash, investments, facilities inventories, supplies,

EXPLANATION--Matter in italics (underscored) is new; matter in brackets [ ] is old law to be omitted.

LBD11508-04-7

equipment, personal and contractual services are being utilized consistent with the requirements of law and duly established managerial policies and in an effective, economical and efficient manner.

The legislature further finds that the public has a right to know the extent to which state agencies and authorities, the legislature and the judiciary are achieving the objectives of internal control described herein and consequently to be fully informed of weaknesses identified through the conduct of external audits of internal controls.

The legislature further finds that prudent management of state government requires controls in all aspects of state government designed to assure that assets are properly safeguarded, that accounting entries and data are accurate and reliable, and that prescribed managerial policies are adhered to, including assurances that such assets and resources are used only for proper purposes. Therefore, this act requires systems of internal control throughout state government as well as the external audit thereof.

The legislature finds that the adequacy and effectiveness of existing state government internal controls and internal audit functions can be improved by the implementation of a more comprehensive system of internal control and internal audit that encompasses all of state government and will foster the effective and efficient use of government resources and ensure the integrity of accounting systems.

The legislature further finds that it is responsible for the generation of revenue and the appropriation of funds; and, in keeping with the constitutional principle of the separation of powers and the fact that it is directly chosen by the people, the legislature is itself directly responsible to the public for the proper use and application of the resources necessary for its operation; and the operational requirements of the legislature, which is a lateral, collegial institution rather than a hierarchical organization and is constitutionally charged with determining the rules of its own proceedings, differ in many respects from those agencies charged with the delivery of goods and services to the people of the state.

The legislature, therefore, finds that existing systems of internal control can be improved and made more comprehensive, and that it is desirable to build on and coordinate existing internal control efforts and provide a firm statutory foundation for an effective and continuing comprehensive system that will foster the effective and efficient use of government resources and ensure the integrity of accounting systems.

§ 3. The state finance law is amended by adding a new section two-a to read as follows:

§ 2-a. Additional definitions. As used in subdivisions two-b and two-c of section eight of this chapter, the following terms shall have the following meanings:

1. "Internal controls". Internal controls encompass the plan of organization and all of the coordinate methods and measures adopted within an organization to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. Internal controls encompass both internal administrative controls and internal accounting controls.

2. "Internal administrative controls". The plan of organization and procedures and records that are concerned with the decision processes leading to management's authorization of transactions.

3. "Internal accounting controls". The plan of organization and the procedures and records that are concerned with the safeguarding of as-

sets and the reliability of financial records and consequently are designed to provide reasonable assurance that:

a. financial transactions are executed in accordance with management's general or specific authorization;

b. such transactions are recorded in conformity with generally accepted accounting principles or other applicable criteria and to maintain accountability for assets;

c. access to assets is permitted only in accordance with management's authorization; and

d. the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

4. "Internal audit". An appraisal activity established by the management of an organization for the review of operations as a means of assuring conformance with management policies and the effectiveness of internal administrative and accounting controls, and conducted in conformance with generally accepted standards for internal auditing.

5. "State agency". Any state department, state university of New York, city university of New York, board, bureau, division, commission, committee, council, office or other governmental entity performing a governmental or proprietary function for the state, or any combination thereof as provided in subdivision two of section nine hundred fifty-one of the executive law, except any public authority or public benefit corporation, the judiciary or the state legislature.

6. "Judiciary". The courts and court-related programs, including the office of court administration, of the state-funded portion of the unified court system and all components thereof as provided in subdivision two of section two hundred forty-nine-a of the judiciary law.

7. "State legislature". The legislature of the state of New York, including all components thereof as provided in subdivision two of section ninety of the legislative law.

8. "Covered authority". Any public authority or public benefit corporation, other than a bi-state authority or public benefit corporation, a majority of whose members are appointed by the governor or serve as members by virtue of holding state offices to which they were appointed by the governor, or any combination thereof.

§ 4. Subdivision two-a of section eight of such law is amended by adding a new paragraph d to read as follows:

d. which is subject to such internal accounting controls as the comptroller deems necessary.

§ 5. Section eight of such law is amended by adding two new subdivisions two-b and two-c to read as follows:

2-b. For the purposes of the New York state governmental accountability, audit and internal control act of 1987, assist in the development and implementation of an audit program for the state by:

a. Either as part of one or more audits, or separately, conducting periodic audits of internal controls and operations of state agencies (other than those state agencies for which an audit is required pursuant to sections nine hundred fifty-three and nine hundred fifty-four of the executive law) and covered authorities. All such audits shall be performed in accordance with generally accepted auditing standards. Nothing in the New York state governmental accountability, audit and internal control act of 1987 shall be deemed to diminish or impair the comptroller's power to audit and authority to supervise accounts under articles V and X of the state constitution and this chapter. The audits shall identify internal control weaknesses that have not been corrected

and actions that are recommended to correct these weaknesses. If any such internal control weaknesses are significant or material with respect to the operations of the agency that is the subject of the audit, the comptroller shall so state. The comptroller shall make available to the public the results of any such audits.

b. Providing technical assistance to state agencies and covered authorities and, upon request, to the state legislature and the judiciary in the implementation of internal audit functions, which shall be consistent with generally accepted standards for internal auditing and, upon request, interpret such standards.

2-c. Provide technical assistance to state agencies and covered authorities and, upon request, to the state legislature and the judiciary in the implementation and periodic evaluation of internal accounting controls, which shall be consistent with generally accepted standards for internal accounting control and, upon request, interpret such standards.

§ 6. Section one hundred twelve of such law is amended by adding a new subdivision one-a to read as follows:

1-a. The system of accounting prescribed by the comptroller pursuant to the provisions of subdivision one of this section shall be subject to such internal accounting controls as the comptroller deems necessary.

§ 7. The executive law is amended by adding a new article forty-five to read as follows:

ARTICLE 45  
INTERNAL CONTROL RESPONSIBILITIES OF STATE  
AGENCIES

Section 950. Definitions.

951. Internal control responsibilities.

952. Internal audit responsibilities.

953. Independent audits of the executive chamber and the division of the budget.

954. Independent audits of the department of audit and control and the department of law.

§ 950. Definitions. As used in this article, the following terms shall have the following meanings:

1. "Internal controls". Internal controls encompass the plan of organization and all of the coordinate methods and measures adopted within an organization to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. Internal controls encompass both internal administrative controls and internal accounting controls.

2. "Internal administrative controls". The plan of organization and procedures and records that are concerned with the decision processes leading to management's authorization of transactions.

3. "Internal accounting controls". The plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records and consequently are designed to provide reasonable assurance that:

a. financial transactions are executed in accordance with management's general or specific authorization;

b. such transactions are recorded in conformity with generally accepted accounting principles or other applicable criteria and to maintain accountability for assets;

c. access to assets is permitted only in accordance with management's authorization; and

d. the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

4. "Internal audit". An appraisal activity established by the management of an organization for the review of operations as a means of assuring conformance with management policies and the effectiveness of internal administrative and accounting controls, and conducted in conformance with generally accepted standards for internal auditing.

5. "State agency". Any state department, state university of New York, city university of New York, board, bureau, division, commission, committee, council, office or other governmental entity performing a governmental or proprietary function for the state, or any combination thereof as provided in subdivision two of section nine hundred fifty-one of this article, except any public authority or public benefit corporation, the judiciary or the state legislature.

6. "Judiciary". The courts and court-related programs, including the office of court administration, of the state-funded portion of the unified court system and all components thereof as provided in subdivision two of section two hundred forty-nine-a of the judiciary law.

7. "State legislature". The legislature of the state of New York, including all components thereof as provided in subdivision two of section ninety of the legislative law.

8. "Covered authority". Any public authority or public benefit corporation, other than a bi-state authority or public benefit corporation, a majority of whose members are appointed by the governor or serve as members by virtue of holding state offices to which they were appointed by the governor, or any combination thereof.

§ 951. Internal control responsibilities. 1. The head of each state agency shall:

a. establish and maintain for the agency guidelines for a system of internal controls;

b. establish and maintain for the agency a system of internal controls and a program of internal control review. The program of internal control review shall be designed to identify internal control weaknesses and identify actions that are needed to correct these weaknesses;

c. make available to each officer and employee of the agency a clear and concise statement of the generally applicable management policies and standards with which the officer or employee of such agency will be expected to comply;

d. designate an internal control officer to implement and review the internal control responsibilities established pursuant to this section;

e. implement education and training efforts to ensure that officers and employees within such agency have achieved adequate awareness and understanding of internal control standards and, as appropriate, evaluation techniques; and

f. periodically evaluate the need for an internal audit function.

2. In order to identify all state agencies and their responsibilities for the purposes of implementing the provisions of this article, the director of the division of the budget shall issue and, at his discretion, periodically revise a schedule which lists all state agencies.

§ 952. Internal audit responsibilities. 1. The director of the division of the budget, after reviewing the evaluation of the head of each state agency as to the need for an internal audit function, shall issue and, at his discretion, periodically revise a schedule of state agencies (other than the department of audit and control and the department of law) which are required to establish and maintain an internal audit

function. The comptroller and the attorney general or their designees shall determine, and periodically review such determination of, whether an internal audit function within their respective departments is required. Establishment of such function shall be based upon an evaluation of exposure to risk, costs and benefits of implementation, and any other factors that are determined to be relevant. The head of each state agency listed in the budget director's schedule, and the comptroller and the attorney general if they or their designees so determine, shall establish an internal audit function which operates in accordance with generally accepted professional standards for internal auditing. Any such internal audit function shall be directed by an internal auditor who shall report directly to the head of such state agency. Notwithstanding any other provision of law, each internal auditor shall be appointed by the head of the agency, and except in the case of the department of audit and control and department of law, such appointment shall be subject to the approval of the director of the budget. The position of internal auditor shall be an exempt position. For agencies for which an independent audit is not required pursuant to sections nine hundred fifty-three and nine hundred fifty-four of this article, the internal audit function shall evaluate the agency's internal controls and operations. The internal audit function shall also identify internal control weaknesses that have not been corrected and make recommendations to correct these weaknesses.

2. In the event the head of a state agency does not establish an internal audit function pursuant to subdivision one of this section, he or she shall nevertheless establish and maintain the program of internal control review required by section nine hundred fifty-one of this article.

§ 953. Independent audits of the executive chamber and the division of the budget. 1. At least once every two years, the independent certified public accountant or accountants selected pursuant to this section shall conduct audits of the internal controls of the executive chamber and the division of the budget, either as a single audit or separately. Such audits shall be performed in accordance with generally accepted auditing standards and shall include a report on whether the executive chamber and division of the budget's internal accounting controls and internal administrative controls are established and functioning in a manner that provides reasonable assurance that they meet the objectives of internal controls as defined in section nine hundred fifty of this article. The report shall identify the internal controls both evaluated and not evaluated and shall identify internal control weaknesses that have not been corrected and actions that are recommended to correct these weaknesses. If any such internal control weaknesses are significant or material with respect to the entity, the independent auditor shall so state. The governor and the director of the budget shall make available to the public the results of such audits, including any related management letters. The governor and director of the budget and any officer or employee of the executive chamber and the division of the budget shall make available upon request to such independent certified public accountants all books and records relevant to such independent audits.

2. The governor and the director of the budget, either separately or jointly, shall request proposals from independent certified public accountants for audits of the internal controls of the executive chamber and the division of the budget. The requests for proposals shall include a reference to the requirements for audits conducted pursuant to subdivision one of this section. The governor and the director of the budget

shall select such independent auditor or auditors in accordance with a competitive procedure including an evaluation, based on quality and price factors, of those proposals received in response to such requests for proposals. No contract for an independent auditor may extend for more than four years.

§ 954. Independent audits of the department of audit and control and the department of law. 1. At least once every two years, the independent certified public accountants selected pursuant to this section shall conduct audits of the internal controls of the department of audit and control and the department of law, respectively. Such audits shall be performed in accordance with generally accepted auditing standards and shall include a report on whether the departments' internal accounting controls and internal administrative controls are established and functioning in a manner that provides reasonable assurance that they meet the objectives of internal controls as defined in section nine hundred fifty of this article. The report shall identify the internal controls both evaluated and not evaluated and shall identify internal control weaknesses that have not been corrected and actions that are recommended to correct these weaknesses. If any such internal control weaknesses are significant or material with respect to such departments, the independent auditors shall so state. The comptroller and the attorney general shall make available to the public the results of such audits, including any related management letters. The comptroller and attorney general and any officer or employee of such departments shall make available upon request to such independent certified public accountants all books and records relevant to such independent audits.

2. The comptroller and the attorney general shall request proposals from independent certified public accountants for audits of the internal controls of their respective departments. The requests for proposals shall include a reference to the requirements for audits conducted pursuant to subdivision one of this section. The comptroller and attorney general shall select such independent auditors in accordance with a competitive procedure including an evaluation, based on quality and price factors, of those proposals received in response to such requests for proposals. No contract for an independent auditor may extend for more than four years.

3. Whenever the comptroller or his appointee is a member of any board, commission, committee, council, or corporation, which constitutes a state agency, the governing body of such board, commission, committee, council, or corporation shall select an independent auditor for the purpose of conducting audits of internal controls in accordance with this section.

§ 8. Article six and sections ninety and ninety-one of the legislative law are renumbered article seven and sections one hundred and one hundred one and a new article six is added to read as follows:

#### ARTICLE 6

##### INTERNAL CONTROL RESPONSIBILITIES OF THE STATE LEGISLATURE

##### Section 89. Definitions.

90. Internal control responsibilities.

91. Internal audit responsibilities.

92. Independents audits.

§ 89. Definitions. As used in this article, the following terms shall have the following meanings:

1. "Internal controls". Internal controls encompass the plan of organization and all of the coordinate methods and measures adopted within an organization to safeguard its assets, check the accuracy and reliability



**APPENDIX M**  
**COMMONWEALTH OF VIRGINIA**  
**Internal Auditing Statute (revised 1990)**

**CODE OF VIRGINIA**

**CHAPTER 14.1.**

**DEPARTMENT OF THE STATE INTERNAL AUDITOR.**

<b>Sec.</b>		<b>Sec.</b>	
2.1-234.29.	Department created; appointment of State Internal Auditor.	2.1-234.32.	Duties of the Department.
2.1-234.30.	Qualifications and personnel status of the State Internal Auditor.	2.1-234.33.	Responsibility for administrative support.
2.1-234.31.	General powers of the Department.	2.1-234.34.	Review of these provisions.

§ 2.1-234.29. Department created; appointment of State Internal Auditor. — There is hereby created a Department of the State Internal Auditor. The Department shall be an agency under the direction of the Secretary of Finance. The State Internal Auditor shall be selected by and report directly to the Secretary.

The Department of the State Internal Auditor is established to provide for the development and maintenance of internal audit programs in state agencies in order to ensure that the Commonwealth's assets are subject to appropriate internal management controls. Appropriate internal management controls assist in safeguarding assets, ensuring accurate accounting and reporting of financial transactions, and in providing effective and efficient management. (1985, c. 72.)

§ 2.1-234.30. Qualifications and personnel status of the State Internal Auditor. — The State Internal Auditor shall be either a certified public accountant or a certified internal auditor. The State Internal Auditor, in order

to provide continuity to the state's internal audit program, shall be a classified position subject to the provisions of the Virginia Personnel Act (§ 2.1-110 et seq.). (1985, c. 72.)

§ 2.1-234.31. General powers of the Department. — The Department shall have the following general powers:

1. To employ such personnel as may be required to carry out the purposes of this chapter;
2. To make and enter into contracts and agreements necessary or incidental to the performance of its duties and execution of its powers under this chapter;
3. To accept grants from the United States government and agencies and instrumentalities thereof and any other source. To these ends the Department shall have the power to comply with such conditions and execute such agreements as may be necessary, convenient, or desirable; and
4. To do all acts necessary or convenient to carry out the purposes of this chapter. (1985, c. 72.)

§ 2.1-234.32. Duties of the Department. — The Department shall have the following duties:

1. To establish state policies, standards, and procedures which will ensure an effective internal audit program in all state agencies;
2. To provide technical information to state agencies concerning trends and new techniques in internal auditing;
3. To develop evaluative tools and other modern methods to assist agency internal auditors in performing audits;
4. To assist state agencies in developing and implementing automated data processing internal audit programs in the Commonwealth;
5. To provide general technical and audit assistance to agency internal auditors and to the Auditor of Public Accounts and the Governor on request;
6. To assist agency heads and collegial bodies in establishing and operating internal audit organizations;
7. To assist in the professional development of agency internal auditors by developing and conducting training programs;
8. To examine the adequacy of agency internal audit programs through periodic assessments of such programs and provide Governor's Secretaries and agency heads with the results of such assessments;
9. To develop, in conjunction with the State Comptroller, the Auditor of Public Accounts, the Joint Legislative Audit and Review Commission, and other appropriate state officials, a plan for accommodating the internal audit needs of agencies that do not require full-time internal auditors; and
10. To prepare a biennial report for the Governor, Governor's Secretaries, Auditor of Public Accounts, and appropriate agency heads on the status of agency internal audit programs generally, and on agency adherence to other legislative requirements on internal auditing.

The provisions included above shall not infringe upon responsibilities assigned to the Comptroller, the Auditor of Public Accounts, or the Joint Legislative Audit and Review Commission by other provisions of the Code of Virginia. (1985, c. 72.)

§ 2.1-234.33. Responsibility for administrative support. — The Secretary of Finance shall assign responsibility for the Department's administrative support services to one or more state agencies within the executive responsibility of the Secretary. (1985, c. 72.)

§ 2.1-234.34. Review of these provisions. — Five years from the effective date of this chapter, the Department of the State Internal Auditor shall be reviewed by the Secretary of Finance to determine if the duties of the Department should be restructured or eliminated. A report of the Secretary of Finance's determination shall be provided to the Governor and the General Assembly. (1985, c. 72.)

CHAPTER 14.1.

DEPARTMENT OF THE STATE INTERNAL AUDITOR.

Sec.

2.1-234.32. Duties of the Department.

2.1-234.34. Review of these provisions.

§ 2.1-234.32. Duties of the Department. — The Department shall have the following duties:

1. To establish state policies, standards, and procedures which will ensure an effective internal audit program in all state agencies;
2. To provide technical information to state agencies concerning trends and new techniques in internal auditing;
3. To develop evaluative tools and other modern methods to assist agency internal auditors in performing audits;
4. To assist state agencies in developing and implementing automated data processing internal audit programs in the Commonwealth;
5. To provide general technical and audit assistance to agency internal auditors and to the Auditor of Public Accounts and the Governor on request;
6. To assist agency heads and collegial bodies in establishing and operating internal audit organizations;
7. To assist in the professional development of agency internal auditors by developing and conducting training programs;
8. To examine the adequacy of agency internal audit programs through periodic assessments of such programs and provide the Governor, Governor's Secretaries, the State Comptroller, the Director of the Department of Planning and Budget, and agency heads with the results of such assessments;
9. To develop, in conjunction with the State Comptroller, the Auditor of Public Accounts, the Joint Legislative Audit and Review Commission, and other appropriate state officials, a plan for accommodating the internal audit needs of agencies that do not require full-time internal auditors; and
10. To prepare a biennial report for the Governor, Governor's Secretaries, Auditor of Public Accounts, and appropriate agency heads on the status of agency internal audit programs generally, and on agency adherence to other legislative requirements on internal auditing.

The provisions included above shall not infringe upon responsibilities assigned to the Comptroller, the Auditor of Public Accounts, or the Joint Legislative Audit and Review Commission by other provisions of the Code of Virginia. (1985, c. 72; 1990, c. 467.)

The 1990 amendment, in subdivision 8. State Comptroller, the Director of the Department inserted "the Governor" and inserted "the ment of Planning and Budget."

§ 2.1-234.34. Review of these provisions. — On November 1, 1993, and every four years thereafter, the Department of the State Internal Auditor shall be reviewed by the Secretary of Finance to determine if the duties of the Department should be restructured or eliminated. A report of the Secretary of Finance's determination shall be provided to the Governor and the General Assembly. (1985, c. 72; 1990, c. 467.)

The 1990 amendment substituted "on November 1, 1993, and every four years thereafter" for "Five years from the effective date of this chapter."

**APPENDIX N**  
**INITIAL LETTER TO SENATOR BARRIENTOS**

2708 Kerrybrook Lane  
Austin, Texas 78758-6914  
February 13, 1991

Honorable Gonzalo Barrientos  
Texas State Senate  
State Capitol, Room 326  
P. O. Box 12068  
Austin, Texas 78711

Dear Senator Barrientos:

I am writing to you to express my concerns about the need to revise the Texas Internal Auditing Act of 1989, article 6252-5d., Vernon's Annotated Civil Statutes. Your sponsorship of Senate Bill 75 is admirable as this bill is an improvement on the current law.

I would like to offer my opinion as a constituent and as an audit professional on how Senate Bill 75 can be further strengthened. The opinions expressed in this letter are my own and may not necessarily represent the position of the state agency that employs me.

I am a member of the Institute of Internal Auditors and have spent over ten productive years in Texas state government internal auditing including a term as founding Chair of the Texas State Agency Internal Audit Forum.

In addition, I have recently initiated an applied research project that focuses on state government internal auditing laws. This is being done as part of a master of public administration program at Southwest Texas State University. My research project has focused on a comparative analysis of the 1989 Texas Internal Auditing Act with professional auditing standards and with statutes of selected other states. The objective is to assess the content and effectiveness of the Texas law.

I have reviewed the internal auditing statutes of some 16 states and have concluded that the Texas law is generally one of the better statutes in the country. In my opinion, with three modifications, it could be the best internal auditing statute in the United States.

The following are among the positive attributes found in the laws of other states that are not present in the Texas law:


- Audits should be conducted in line with the "generally accepted government auditing standards" promulgated by the United States General Accounting Office (in addition to the Standards of the Institute of Internal Auditors as the Texas law now requires).
- The chief internal auditor's experience requirement should include three or more years service in public sector internal auditing. (The current Texas law calls for "three years auditing experience." This would allow a CPA tax auditor with neither internal auditing nor public sector experience to be "qualified".)
- Alternatives should be provided to the Certified Internal Auditor/Certified Public Accountant certification requirement. (This would make the law more fair and equitable to many experienced, competent audit professionals who lack one of these two credentials.)

I have attached copies of the Florida and Illinois laws and highlighted sections that support the above recommendations. For example, the Florida law allows a master's degree in business administration or public administration with one additional year's experience needed for chief auditors who lack certification. This is certainly more fair than the current Texas statute! It should also be noted that several states require a bachelor's degree with no certification.

Please seriously consider the above changes which will strengthen the current Texas Internal Auditing Act and will provide greater fairness and equity to several incumbent auditors.

Please let me know if I can provide further information on this. Thank you in advance to any consideration you can give to this proposal.

Sincerely,



David J. MacCabe  
Certified Internal Auditor

**APPENDIX O**  
**REPLY LETTER FROM SENATOR BARRIENTOS**



*The Senate of  
The State of Texas*

GONZALO BARRIENTOS  
STATE SENATOR

P.O. BOX 12068  
DISTRICT 14

AUSTIN, TEXAS 78711 (512) 463-0114  
HAYS & TRAVIS COUNTIES

March 4, 1991

Mr. David J. MacCabe  
2709 Kerrybrook Lane  
Austin, Texas 78758

Dear Mr. MacCabe:

Thank you for your thoughtful suggestions on the sunset legislation on public accountancy, S.B. 75. I have sent a copy of your letter to the staff on the Sunset Advisory Commission for their review and comment. I certainly appreciate all the positive ideas you have contributed on the field of internal auditing. When we decide whether to amend the bill or not, I will let you know.

Sincerely,

A handwritten signature in cursive script that reads "Gonzalo Barrientos".

Gonzalo Barrientos  
State Senator

GB/pdw

**APPENDIX P**  
**SENATE BILL 1168, 72ND TEXAS LEGISLATURE**  
**Proposing to Amend the Texas Internal Audit Act**

A BILL TO BE ENTITLED

AN ACT

relating to the definition of a state agency for purposes of internal auditing; and the qualifications of internal auditors.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. Section 1, Chapter 787, Acts of the 71st Legislature, Regular Session, 1989 (Article 6252-5d, Vernon's Texas Civil Statutes), is amended to read as follows:

Sec. 1. In this Act:

(1) "Agency" includes every state agency, department, board, bureau, institution, or commission that meets one or more of the following criteria:

(A) has an operating budget exceeding \$10 million annually; or

(B) has a staff of more than 300 employees;

(C) receives and processes cash items in excess of \$10 million annually].

(2) "Agency administrator" means the executive head of an agency.

(3) "Audit" means a financial audit, a compliance audit, an economy efficiency audit, an effectiveness audit, or an investigation as defined by Sections 321.0131 - 321.0136, Government Code.

SECTION 2. Section 5, Chapter 787, Acts of the 71st Legislature, Regular Session, 1989 (Article 6252-5d, Vernon's Texas Civil Statutes), is amended to read as follows:

Sec. 5. appointment of internal audit staff. The governing body of an agency or its designee, or the administrator of an agency without a governing board, shall appoint an internal auditor, [who shall be either a certified public accountant or a certified internal auditor and] who shall have at least [three] five years of internal auditing experience. Certification as a public accountant or internal auditor can substitute for two years of the required internal auditing experience. The agency shall employ such additional professional and support staff as the agency administrator determines are necessary to implement an effective program of internal auditing.

SECTION 3. EMERGENCY. The importance of this legislation and the crowded condition of the calendars in both houses create an emergency and an imperative public necessity that the constitutional rule requiring bills to be read on three several days in each house be suspended, and this rule is hereby suspended, and that this Act take effect and be in force from and after its passage, and it is so enacted.

## APPENDIX Q

### LETTER TO SENATOR LEEDOM

2708 Kerrybrook Lane  
Austin, Texas 78758-6914  
March 28, 1991

Honorable John Leedom  
Texas State Senate  
State Capitol, Room 328  
P. O. Box 12068  
Austin, Texas 78711

Dear Senator Leedom:

I am writing to you to express my support for Senate Bill 1168 revising the Texas Internal Auditing Act of 1989, article 6252-5d., Vernon's Annotated Civil Statutes. Your sponsorship of Senate Bill 1168 is admirable as this bill is a significant improvement on the current law.

The current Texas law needs to be more fairly structured to take into account qualifications other than just certification as an internal auditor or public accountant. There are many competent, experienced professionals who lack one of these credentials. Your bill appropriately qualifies professionals with five years service to be chief internal auditors while at the same time recognizes the substitution of certification (CIA or CPA) for two years service.

I would like to offer my opinion as an audit professional on how Senate Bill 1168 can be further strengthened. The opinions expressed in this letter are my own and may not necessarily represent the position of the state agency that employs me. I am a member of the Institute of Internal Auditors and have spent over ten productive years in Texas state government internal auditing including a term as founding Chair of the Texas State Agency Internal Audit Forum.

In addition, I am completing an applied research project that focuses on state government internal auditing laws. This is being done as part of a master of public administration program at Southwest Texas State University. My research project has focused on a comparative analysis of the 1989 Texas Internal Auditing Act with professional auditing standards and with statutes of selected other states. The objective is to assess the content and effectiveness of the Texas law.



I have reviewed the internal auditing statutes of some 16 states and have concluded that the Texas law is generally one of the better statutes in the country. In my opinion, with two additional modifications to Senate Bill 1168, we could have the best internal auditing statute in the United States. The following recommendations will further enhance Senate Bill 1168:

Government Auditing Standards--Audits should be conducted in line with the "generally accepted government auditing standards" promulgated by the United States General Accounting Office (in addition to the standards of the Institute of Internal Auditors as the Texas law now requires).

Recommendation: Revise section 8 of the law to add the GAO's Government Auditing Standards.

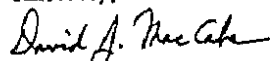
Alternatives to Certification--A master's degree in either business administration or public administration should be allowed to substitute for two years internal auditing experience. Presence of the MBA or MPA should be given similar status to the CIA/CPA credential.

Recommendation: Revise section 5 of the law to allow the MPA/MBA substitution for two years of the required internal auditing experience.

I have attached copies of the Florida and Illinois laws and highlighted sections that support the above recommendations. For example, the Florida law allows a master's degree in business administration or public administration with one additional year's experience needed for chief auditors who lack certification. This is certainly more fair than the current Texas statute!

Please consider the above changes which will strengthen the current Texas Internal Auditing Act and will provide greater fairness and equity to several incumbent auditors. Please let me know if I can provide further information on this. Thank you for your interest in this important subject and your consideration of these ideas.

Sincerely,



David J. MacCabe  
Certified Internal Auditor

**APPENDIX R**  
**SECOND LETTER TO SENATOR BARRIENTOS**

2708 Kerrybrook Lane  
Austin, Texas 78758-6914  
March 28, 1991

Honorable Gonzalo Barrientos  
Texas State Senate  
State Capitol, Room 326  
P. O. Box 12068  
Austin, Texas 78711

Dear Senator Barrientos:

Thank you for your March 4th letter acknowledging my letter providing suggestions on Senate Bill 75. This pertains to the Texas Internal Auditing Act of 1989, article 6252-5d., Vernon's Annotated Civil Statutes. As an audit professional and a constituent, I appreciate your interest in this important area and your sponsorship of Senate Bill 75.

This week I learned of Senator Leedom's filing of Senate Bill 1168 that proposes to change the qualification requirements of chief internal auditors. I believe Senator Leedom's bill is a significant improvement on the current law and urge your support and/or co-sponsorship.

The current Texas law needs to be more fairly structured to take into account qualifications other than just certification as an internal auditor or public accountant. There are many competent, experienced professionals who lack one of these credentials. Senate Bill 1168 appropriately qualifies professionals with five years service to be chief internal auditors while at the same time recognizes the substitution of certification (CIA or CPA) for two years service.

I have offered Senator Leedom my opinion as an audit professional on how Senate Bill 1168 can be further strengthened and wanted to share the following information with you.

I have reviewed the internal auditing statutes of some 16 states as part of a graduate research project. My conclusion is that the Texas law is generally one of the better statutes in the country.

In my opinion, with two additional modifications to Senate Bill 1168, we could have the best internal auditing statute in the United States. The following recommendations will further enhance Senate Bill 1168:

Government Auditing Standards--Audits should be conducted in line with the "generally accepted government auditing standards" promulgated by the United States General Accounting Office (in addition to the standards of the Institute of Internal Auditors as the Texas law now requires).

Recommendation: Revise section 8 of the law to add the GAO's Government Auditing Standards.

Alternatives to Certification--A master's degree in either business administration or public administration should be allowed to substitute for two years internal auditing experience. Presence of the MBA or MPA should be given similar status to the CIA/CPA credential.

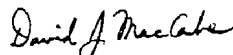
Recommendation: Revise section 5 of the law to allow the MPA/MBA substitution for two years of the required internal auditing experience.

I have attached copies of the Florida and Illinois laws and highlighted sections that support the above recommendations. For example, the Florida law allows a master's degree in business administration or public administration with one additional year's experience needed for chief auditors who lack certification. This is certainly more equitable than the current Texas statute!

Please consider the above changes which will strengthen the current Texas Internal Auditing Act and will provide greater fairness and equity to several incumbent auditors.

Please let me know if I can provide further information on this subject. Thank you for your interest in this important topic and your consideration of these ideas.

Sincerely,



David J. MacCabe  
Certified Internal Auditor

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