It’s an Inside Job: Developing an Internal Audit Function

May 19, 2019

Los Angeles, California

Shakeel Yusuf
Comptroller, Fairfax County Public Schools

Bert Nuehring, CPA, CGMA
Partner, Crowe Horwath LLP

Jim Olds, CPA, CIA
Audit Director, Port of Los Angeles

David Sundstrom, CPA
Board Member, Governmental Accounting Standards Board (GASB)
Why Internal Audit?

Internal Audit plays an important role in helping management to maintain a comprehensive framework of internal controls.
Internal Audit Defined (IIA)

- Independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.
COSO Cube (2013)
Monitoring Activities (Per COSO)

16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.

17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.
Audit Committee – Every Government Should Have one

The audit committee should:

• Provide oversight over the government’s system of internal controls
• Monitor controls performed directly by senior management, as well as controls designed to prevent or detect senior-management override of other controls;
• Be formally established by charter, enabling resolution, or other appropriate legal means
• Be directly responsible for the appointment, compensation, retention, and oversight of the work of any independent accountants
Audit Committee – Continued

The audit committee should (con’t):

• Have access to the services of at least one financial expert
• Have no fewer than three members
• Have access to internal auditor reports and annual internal audit work plans;
• Present annually to the full governing body a written report of how it has discharged its duties and met its responsibilities
• Establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters.
• Be able to meet privately with the independent auditors, as needed.
Internal Audit – Every Government Should Have the Function

• Particularly valuable for those activities involving a high degree of risk (e.g., complex accounting systems, contracts with outside parties, a rapidly changing environment).

• If it is not feasible to establish a separate internal audit function, a government is encouraged to consider either 1) assigning internal audit responsibilities to its regular employees or 2) obtaining the services of an accounting firm (other than the independent auditor) for this purpose.

• Work should be conducted in accordance with the professional standards contained in the GAO Yellow Book, including independence.
• The CAE should possess a college degree, relevant experience and appropriate certifications (CIA, CPA, CISA).

• All reports of internal auditors, as well as the annual internal audit work plan, should be made available to the government audit committee or its equivalent.

• Function should be established formally by charter, enabling resolution, or other appropriate legal means.
Internal Audit Charters

• Objectives and Scope
• Authority
• Independence
• Responsibilities and Accountability
• Professional Standards and Guidance
• Relationship to Risk Management and Internal Control
• Ability to Procure Outside Expertise
Standards: Yellow or Red?
California Government Code Section 1236

Either Yellow Book or Red Book is REQUIRED. Both Require:

(1) That auditors should be independent of the activities they audit.
(2) That audits should be performed with proficiency and due professional care.
(3) That the scope of the 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.
(4) That audit work should include planning the audit, examining and evaluating information, communicating results, and following up.
(5) That the chief auditor should properly manage the auditing department.
Plan Risk Management Cycle

1. Set Objectives
2. Identify Risks
3. Define Success Criteria
4. Assess Risks
5. Produce Control Plan
6. Implement Plan
7. Monitor & Review

Plan Risk Management Cycle
### Likelihood Criteria

<table>
<thead>
<tr>
<th>Likelihood that the risk event will occur in the next year</th>
<th>Very Unlikely (0% - 20%)</th>
<th>Unlikely (20% - 50%)</th>
<th>Likely (50% - 80%)</th>
<th>Very Likely (80% - 100%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

### Impact Criteria

<table>
<thead>
<tr>
<th>Impact on programming if risk event occurs</th>
<th>Very Limited 1</th>
<th>Limited 2</th>
<th>Moderate 3</th>
<th>High 4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Very limited impact on development programming operations and outcomes. Consequences can be managed under normal operating conditions.</td>
<td>Limited impact on development programming operations and outcomes. Consequences can be managed with limited additional resources and/or managerial effort.</td>
<td>Moderate impact on development programming operations and outcomes. Consequences can be managed with moderate additional resources and/or managerial effort.</td>
<td>Significant impact on development programming operations and outcomes. Senior management required to make major adjustments to plans and/or resource allocations.</td>
</tr>
</tbody>
</table>
Factors for Assessing Likelihood

• How the control is performed and the skills of the person performing the control.

• What level of reliance can be placed on IT solutions if processes are automated?

• Whether or not a control is preventative or detective, i.e., whether it would stop something from happening or merely detect something that has already happened.

• The frequency and timeliness of a control process, e.g., daily/weekly reconciliations.

• The process (or reporting mechanism) for flagging errors or control failures.
Risk Scoring

- **Likelihood of occurrence**
  - High likelihood
    - Low level of impact
  - Low likelihood
    - Low level of impact

- **Level of impact on the scheme (e.g., financial)**
  - High likelihood
    - High level of impact
  - Low likelihood
    - High level of impact
Audit Success - Using an Audit Pool to Leverage Your Resources
History of IA in Government

• The IA presence in government is fairly new
• Many Cities & Counties still lack IA capabilities

• Benefits of IA’s internal oversight:
  1. Assure management objectives are being met
  2. Find ways to improve operations
• Benefits of IA’s internal oversight:
  3. Identify means to reduce costs or raise revenues
  4. Ensure internal controls are in place and functioning as intended to protect the entity’s assets
  5. Perform special projects and assist with FYE audit
  6. Investigate “whistleblower” complaints
When to Use a Consultant “Pool”

- One way POLA maximizes its IA impact and leverages resources is to use consultants
- Contracted “as-needed” on-call basis when internal resources aren’t available or expertise needed
- Pools can range from 5 to 30+ firms
- In 2010, innovative contracts opened up relations with firms without committing funds
Consultant “Pool” Mechanics

• As needs arise, firms can bid and are selected based on a competitive process

• Notice to Proceed/Task Order commences job

• Managing the audit is similar – communication is key, need to stick to contract scope, set milestones and schedule progress reports. Payments should be tied to performance.
Advantages of Using Audit Pools

1. Convenient and fast – “as-needed” contracts
2. Responsive to management needs
3. Add expertise & independent perspective
4. Access to comparative data for benchmarking
5. Opportunity to train internal IA staff assisting
Disadvantages of Using Audit Pools With Government Perspective

1. Lots of work to set up government contracts
2. Less control over audit team doing fieldwork
3. Must change task order as changes occur
4. Contract payments must be processed
5. Auditor must adhere to insurance and other contractual requirements
When Not to Consult?

- Internal staff resources available
- Demonstrated internal expertise in audit topic
- When management wants to maintain a “low-profile”
- When more control of audit fieldwork is desired
How to start an internal audit function?

An Internal Audit function within a governmental entity can take several different forms. Large and small governments can take a difference approach to address respective needs. Sourcing decisions also can vary based on financial resources, organizational complexity and systems.
Starting an Internal Audit Function

• Internal Audit Charter
• Internal Audit Function
• Co-sourcing or Outsourcing
• Use of Technology
• Risk Assessment and Audit Plan
• Audits and Reporting
Internal Audit Function

• Formal Internal Audit – Recommended
  • Mandated by law, regulation or governing body
  • Activities with a high degree of risk
  • Complex systems
  • Rapidly changing environment

• Internal Audit Function - Alternatives
  • Assign responsibility to regular employees
  • Obtain services from a third party
  • External Audit Firm (Special Projects) – Avoid Independence Matters
Co-Sourcing or Outsourcing

• Co-sourcing
  • “Partnership” of Internal and External resources/personnel
  • Organizational control maintained with the ability to bring in technical skills for specific needs or projects
  • Rapidly changing environment provides some flexibility to meet audit needs

• Outsourcing
  • External resources provide services
  • Internal personnel must oversee and manage the vendor
  • Rely on vendor to address risk assessment, planning, auditing and reporting
  • Rapidly changing environment provides flexibility to audit and staffing needs
Use of Technology

• Data Extraction (self-service or existing systems)
• Anomaly Detection
• ERP Technology Tools
• Workflow and Dashboards
• Governance, Risk Management and Compliance Tools
• Staff Training
Risk Assessment, Planning & Reporting

- Authority from Governing Body
- Multi-year Risk Assessment
- Annual Audit Plans
- Audit Staffing
- Management Communication & Buy-in
- Reporting to Management and Board
- Responses from Management
What are the trends in internal audit?

Internal Auditing is rapidly changing due to technology advances, data and resources.
Internal Audit Trends

- Technology
  - IT Governance
  - Automation
  - Cybersecurity
    - Preparedness
    - Monitoring
  - Continuous Risk Assessment
  - Automating Assurance
  - Robotic Process Automation
  - Artificial Intelligence
Internal Audit Trends (continued)

• Auditing the Risks of Disruptive Technologies
• Social Media
• Continuous Risk Assessment
• Data
  • Data analytics
  • Data Governance
  • Data Privacy
  • Digitization
Internal Audit Trends (continued)

• General Data Protection Regulation (GDPR) Assessment (California Data Privacy Protection Act)
• Agile Audit Methods
• Enterprise Risk Management (ERM)
  • Integrated Assurance
  • Evaluating Culture
  • Ethics
  • Integrity
• Harassment and Inequality in the Workplace
• Workforce of the Future
Questions?