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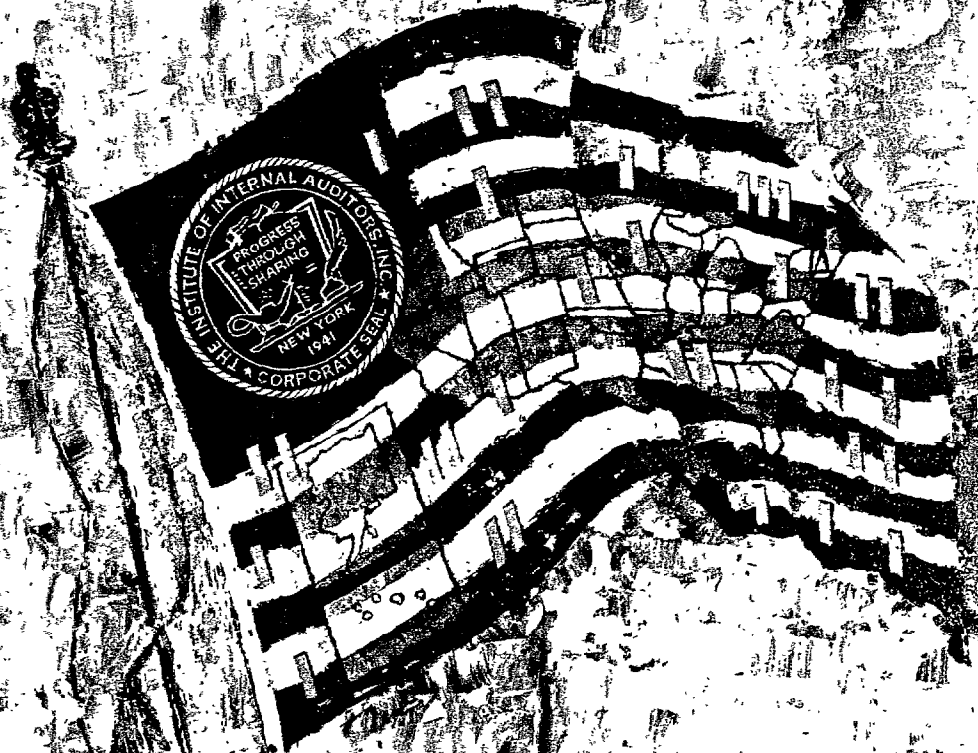
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# Internal Auditing in State Government



**A STUDY PREPARED BY:**  
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Washington Chapter  
The Institute of Internal Auditors



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## Introductory Note

Effective internal auditing has a key role to play in good management systems. For many years we in the United States General Accounting Office have recommended and encouraged the development of this function in federal agencies.

Federal financial assistance to state and local governments has increased greatly in recent years and it looks as though this trend will continue. For this reason, the General Accounting Office, as the independent auditor in the legislative branch of the federal government, is becoming increasingly interested in the caliber of state and local government management systems which also can benefit greatly from good internal audit systems.

I am, therefore, pleased that the Washington Chapter of The Institute of Internal Auditors has arranged to have the accompanying study made of internal auditing in state government operations. This study not only lays out principles and standards for comprehensive internal audit systems, but for the first time it provides a systematic review of the status of internal auditing in state governments, bringing out the need and the desirability for expanding and strengthening this important function.

A handwritten signature in black ink, which reads "Thomas A. Altsch". The signature is written in a cursive style with a large initial 'T' and 'A'.

Comptroller General  
of the United States



## Preface

Americans, looking at the astronomical figures being spent on all sides by their government and the resulting deeper dips into their pocketbooks by the tax collector, are beginning to demand that tax-supported programs be made more productive, service-oriented, efficient, and effective.

Because many broad-based programs derive their objectives and financial support from any of a number of sources, and the number of them has proliferated to an unwieldy total, internal auditing has played an increasing part in their control.

While internal auditing has been the subject of many discussions, little authoritative study has ever been made to identify critical issues or outline objectives of the internal auditing in state departments and agencies. Recognizing this problem, the Washington Chapter of The Institute of Internal Auditors decided in 1971 to sponsor and support a study in this important area.

An agreement was reached with Dr. Lennis M. Knighton, professor of accounting and public administration at Brigham Young University, Provo, Utah, to undertake this study. Funds were provided by the Washington Chapter for travel, secretarial and other support. This report is the result of that effort. While limited in many respects, it is the beginning exploration into the field and the basis for future research and additional studies. Such a study, however, is only possible with the combined and interlocking efforts of many people. We must assuredly name a few; but there are many who cooperated and helped, and much appreciation and gratitude are due them.

Of course, we must thank Brigham Young University, its faculty and particularly, the project director Dr. Lennis M. Knighton, and the other project members who contributed their time without remuneration.


Edward W. Stepnick, director, Audit Agency, U. S. Department of Health, Education, and Welfare, provided resources in staff time as well as general endorsement of the project.

Robert B. Brown, special assistant for Intergovernmental Audit Relations, of the same agency, originally identified the need for the study and provided consultation during the project.

Mortimer A. Dittenhofer, assistant director, Financial and General Management Studies Division, U. S. General Accounting Office, and chairman, Research Committee, Washington Chapter (1971-72), provided his personal guidance and brought together the unifying forces to make this an outstanding project.

Finally, we are deeply indebted to the other members of the Washington Chapter, especially those on the Research Committee (1971-72) for providing guidance and support — to Bruce A. Gibson, director of audits, U. S. General Services Administration; to David Legge, director, Municipal Audits, District of Columbia, and to Anthony M. Natelli, partner-in-charge, Washington Office, Peat, Marwick, Mitchell & Co.

As president of the Washington Chapter, I derive great satisfaction in seeing this significant study of Dr. Knighton and his research associates brought to fruition. This project is a major effort in carrying out my commitment of "SERVICE TO THE PUBLIC" — our chapter motto for the 1971-72 year.



Dale E. Knowles  
President 1971-72  
Supervisory Auditor, Audit Agency  
U. S. Department Health,  
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# 1

## Introduction

In recent years, the size and complexity of financial management problems in state governments have risen significantly. For example:

- State and local expenditures now account for approximately 15% of the total Gross National Product and over the past few years have increased at twice the rate of GNP.
- State and local government debt has risen over 600% since 1950 and now totals \$135 billion.
- In 1970, state and local governments had a revenue gap of \$10 billion, in spite of the fact that more than 450 tax increases were adopted in the preceding 12 years.
- Over 1,000 different federal programs, funded through some 430 separate authorizations, now disburse almost \$40 billion in federal aid to state and local governments, an increase of almost 2,000% in slightly over 20 years.
- There are approximately 90,000 units of state and local government in the United States today.

These statistics attest to the magnitude and complexity of state and local financial management problems. The time has clearly come to take a good hard look at state financial management systems to find every possible way to improve managerial effectiveness. Moreover, with the increased emphasis on revenue sharing and other federal assistance programs, there has never been a time when it was more important for federal and state financial management systems to articulate meaningfully with one another and to complement each other in securing the effective and efficient use of public finances.

A vital element of an effective management control system in any organization and a valuable means of obtaining timely feedback with

which to monitor program efficiency and effectiveness is an internal audit program. This fact is well recognized by financial management specialists in both the public and private sectors. Yet, with a few notable exceptions, internal auditing is misunderstood and ineffectively applied in the agencies of state governments today.

In the federal government, the need for effective internal auditing systems in the federal agencies was noted by Congress several years ago, and legislation was passed giving statutory support to such systems. In the Budget and Accounting Procedures Act of 1950, for example, Congress required the comptroller general of the United States to prescribe principles, procedures, rules, and regulations to give direction to the internal audit programs of federal agencies. The act also required the head of each agency to establish and maintain systems of internal control covering all of its funds and other resources, and it stipulated that such internal control systems were to include appropriate internal audit programs.

Responding to this act, the General Accounting Office issued in 1957 a statement of basic principles for internal auditing. This publication was revised and updated in 1968 and continues to serve as an important guide to the development of internal auditing in federal agencies.<sup>1</sup> To date, however, no major study has been undertaken or authoritative guideline issued to provide similar direction to the development of such programs in state government. This study is designed to help fill that gap.

## OBJECTIVES OF THIS STUDY

Three major objectives are pursued in this study. First, the nature, role and essential characteristics of an ideal internal audit program<sup>2</sup> are set forth. The legal and organizational arrangements, the nature and scope of audit efforts, the qualifications of those appointed to the staff, and the relationship of the internal audit program to other elements of management control are all matters of interest here. The purpose of this discussion is to inform administrators, legislators, interested citizens, and others who wish to inquire into these matters of the ideal arrangements and the full potential of such a program in state government. This understanding is essential if one is charged with the responsibility of deciding whether or not to set up an internal audit program, or of evaluating the appropriateness of an existing program.

<sup>1</sup>*Internal Auditing in Federal Agencies* (Washington, D.C.: U. S. General Accounting Office, 1968).

<sup>2</sup>The word *program* is used here and throughout this study to refer to the structural arrangement and policies for internal auditing in an agency, not the detailed plan of action to be followed in conducting an audit examination and preparing an audit report.

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Second, the current status of internal auditing in the states is described. Statistical tables and other summaries are provided to assist those who wish to examine the evidence in depth. However, the description is written in such a way that those who are not technically oriented or highly sophisticated in auditing matters can still get a clear picture of conditions as they exist today.

Third, some alternatives are advanced to help overcome existing problems so that the full potential of internal auditing might be more fully realized. Also, material is included in the appendices which illustrates some of the points made in the study.

This study is intended to be an introductory or pioneering effort, not a comprehensive and exhaustive one. Its focus is on audit systems and programs, including audit concepts and policies. It is not a study of audit procedures, practices, or methods.

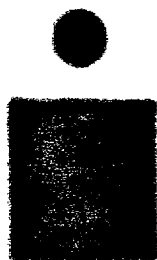
Finally, this study presents a general summary of internal auditing in state government, not a catalog of individual state experiences. This limitation, however, does not preclude the use of examples, illustrations, and other specific references in the study.

## METHODOLOGY

Initially, a thorough search of the literature involving audit philosophy, objectives, programs, methods, and arrangements was undertaken to synthesize the principles and concepts of internal auditing.

Approximately 500 questionnaires were mailed to selected state agency administrators, executive officials, state legislators, independent auditors, and heads of internal audit staffs in state agencies. Every state was included in the survey.

Personal interviews were conducted in Idaho, Utah, California, Illinois, Texas, Wisconsin, and Alabama. Persons interviewed included selected state officials, legislators, independent state auditors, budget directors, comptrollers, agency heads, and internal auditors. Auditors and officials of several other states were contacted by telephone to obtain additional information, to clarify questionnaire responses, and to validate the survey data.



# 2

## The Ideal Internal Audit Program for a State Agency

The purpose of this chapter is to set forth the concepts and conditions essential in the development and implementation of an ideal internal audit program in state agencies, and to do so in such a way that legislators, administrators, and auditors alike can understand them. A central thesis of this chapter is the proposition that it is a management responsibility to establish internal audit programs, consistent with and encouraged by the policies of the legislature. It is not the duty of accountants or other financial executives and should not, therefore, be left to them. Thus, it is imperative that administrators understand the nature of such audits, how they relate to the management function, and what conditions must prevail in order to insure the successful achievement of audit objectives.

### THE NATURE OF AN AUDIT

The first step in developing a conceptual model of an internal audit is to formulate an acceptable definition of auditing. It has been customary to think of an audit as an examination of accounting records, conducted by an independent professional accountant for the purpose of determining the accuracy and reliability of the information contained in financial statements. This concept has application to audits undertaken by certified public accountants in the private sector of our society, but it does not express the major purposes of audits in the public sector. It is far too restrictive.

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A more comprehensive, flexible, and non-traditional definition of auditing, and one that is more appropriate for the purposes of this study, follows:

... An examination of records or other search for evidence, conducted by an independent authority, for the purpose of supporting a professional evaluation, recommendation, or opinion concerning (a) the adequacy and reliability of information and control systems, (b) the efficiency and effectiveness of programs and operations, (c) the faithfulness of administrative adherence to prescribed rules and policies, and/or (d) the fairness of financial statements and performance reports that purport to disclose the present condition and the results of past operations of an organization or program.<sup>3</sup>

It is possible to divide the comprehensive audit concept into sub-concepts or elements. Briefly, the elements can be classified as follows:<sup>4</sup>

**Comprehensive Audit:** An all-inclusive, umbrella-like concept, encompassing all audit policies and programs, and including both financial audits as well as performance audits, as outlined below.

**Financial Audit:** An examination restricted essentially to financial records and controls, for the purpose of determining that funds are legally and honestly spent, that receipts are properly recorded and controlled, and that financial reports and statements are complete and reliable.

**Performance Audit:** An examination of records and other evidence to support an appraisal or evaluation of the efficiency of government operations, the effectiveness of government programs, and the faithfulness of responsible administrators to adhere to legislative requirements and administrative policies pertaining to their programs and organizations.

- **Compliance Audit:** That portion of the performance audit which pertains to the faithfulness of administrative adherence to legislative requirements and administrative policies.
- **Operational Audit:** That portion of the performance audit which pertains to the efficiency of operations — focusing primarily on operating policies, procedures, practices, and controls; including the utilization and control of non-financial resources, such as property, equipment, personnel, supplies, etc.<sup>5</sup>

<sup>3</sup>Lennis M. Knighton, "An Integrated Framework for Conceptualizing Alternative Approaches to State Audit Programs," *The Federal Accountant* (March 1971), p. 8.

<sup>4</sup>*Ibid.*, pp. 6-23.

<sup>5</sup>The comptroller general has recently set forth a similar set of classifications, and he uses the term "management audit" in the same sense operational audit is used above. This term is retained here, however, because of its usage in state government and in industry.

- **Program Audit:** That portion of the performance audit which pertains to the effectiveness of government programs — focusing essentially on the management control system and the reliability of data contained in performance reports that purport to disclose the results of operations in terms of program accomplishment.<sup>6</sup>

An audit may be conducted by personnel within an organization or by someone outside of the organization. When the auditor is located within the organization, he is known as an internal auditor. When he is located outside of the organization, he is generally referred to as the independent or outside auditor. The scope of the audit undertaken by either of these auditors may be comprehensive or restricted. Therefore, the concepts and definitions set forth apply equally to both types of audit programs.

An important point to underscore here is that one cannot begin to describe or understand the nature and purpose of internal auditing in the agencies of state governments without recognizing that the objectives which can be pursued through an internal audit program are inseparably tied to the scope of audit inquiry. The ideal internal audit system for state agencies, as with any other type of organization, must be comprehensive if a major objective of the audit is to assist management in a meaningful way. As stated by The Institute of Internal Auditors,

*The objective of internal auditing is to assist all members of management in the effective discharge of their responsibilities, by furnishing them with analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor is concerned with any phase of business activity where he can be of service to management. This goes beyond the accounting and financial records to obtain a full understanding of the operations under review. The attainment of this overall objective of service to management involves such activities as:*

- *Reviewing and appraising the soundness, adequacy and application of accounting, financial and operating controls, and promoting effective control at reasonable cost.*
- *Ascertaining the extent to which company assets are accounted for and safeguarded from losses of all kinds.*
- *Ascertaining the extent of compliance with established policies, plans, and procedures.*
- *Ascertaining the reliability of management data developed within the organization.*
- *Appraising the quality of performance in carrying out assigned responsibilities.*
- *Recommending operating improvements.<sup>7</sup>*

<sup>6</sup>This type of audit is sometimes referred to as an "effectiveness audit."

<sup>7</sup>Statement of the Responsibilities of the Internal Auditor (New York: The Institute of Internal Auditors, 1972), pp. 2-3.

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Similarly, the comptroller general of the United States has noted the necessity of a comprehensive internal audit program to meet the needs of managers at all levels of an organization.

*Internal auditing should extend to all agency activities and related management controls. Although it should include the audit of accounts and financial transactions, its scope of operation should not be restricted to accounting and financial matters. The internal auditor should also review operations and activities in order that he may provide management with information on the effectiveness, efficiency . . . with which they are carried out.*

*. . . An internal audit program should be structured to meet the needs of top management and also be designed to serve the needs of subordinate management levels.<sup>8</sup>*

## INTERNAL AUDITING IN THE MANAGEMENT CONTROL SYSTEM

Internal auditing has been described as an essential element of management control. Management, whether in the private or public sector, has the responsibility of providing direction to its organization through planning, organizing, and supervising all activities. In order for administrators to manage effectively, they must be able to control those activities for which they are responsible.

To comprehend the role of the internal audit as it relates to management control, one must understand what constitutes a management control system.

A system is a whole or unique unit composed of diverse parts or elements which are so interrelated and integrated that together they serve a common plan or purpose.

There are seven essential elements to an effective management control system, and each must articulate with and complement the others in order for the system to accomplish its objective of promoting improved efficiency and effectiveness in operations. These elements are:

- Stated goals and objectives
- Assigned responsibilities
- Performance indicators and standards
- Operating rules and policies
- Information flow and feedback
- Independent review, evaluation, and verification
- Corrective mechanisms

<sup>8</sup>U. S. General Accounting Office, *GAO Views on Internal Auditing in the Federal Agencies*, (1970), p. 4.



Every department or agency of government is established to fulfill a mission which is conceived and expressed in a set of long-range goals. When these goals are broken down into immediate objectives to be pursued by the organization, they comprise the first element of management control. Such objectives not only serve as the basis for program planning but also for program evaluation. Indeed, effectiveness is defined as the achievement of program objectives.

As programs are planned to accomplish the selected objectives, persons responsible for each phase of the operation must be identified and given specific charge concerning their areas of responsibility. Also, the criteria for indicating and evaluating progress toward the achievement of objectives must be identified, and specific performance standards should be set wherever possible to serve as the basis of evaluation and control.

Since it is important that all levels of managers have authority to make decisions in the areas of their responsibilities, it is also necessary as part of the management control system to establish appropriate operating rules and policies to give direction to such decisions and to set the bounds within which such decisions and the resulting actions are acceptable. Policies should promote orderliness, consistency, uniformity, and understanding in an organization.

All analyses, judgments, and decisions should be based upon the best information available. Therefore, one of the most important elements of a management control system is the flow of information relevant to decisions and analyses and the feedback of information disclosing the results of information. The accounting and reporting system comprises an important part of this element of management control. Information should be collected and reported on the basis of assigned responsibility, consistent with operating rules and policies, and relevant to decisions and evaluations based upon performance standards and program objectives established in the planning process.

In addition to the formal information flow and reporting process, it is important to have an independent review and evaluation of operating efficiencies and program effectiveness and an independent verification of the reliability of the information contained in the formal reports. Independence, as used in this sense, requires that someone other than the person responsible for the activity or serving under his direction examine and evaluate available evidence. He also should render a judgment on the matters to be evaluated. Such a review not only provides an independent appraisal of affairs but also permits the verification of reported data, thus adding to the degree of confidence

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It can be seen from an important role to perform effective in that role, scope. The internal auditors those whose programs must be sufficient to errors, make all necessary action in order to evaluate responsible. Where an effectiveness of the internal will be substantially reduced

## RELATIONSHIP OF EXTERNAL AUDITS

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In general, the chief auditor and that of outside and responsibility. management team, an integral part constant presence in the other interests, are often of their examination, and that often extend to several agencies, for example, an agency's operations the compliance by the management agreements.

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managers can place on it. When formally organized, this independent review, evaluation, and verification process is the internal audit.

It would do little good to have effective feedback of information and an independent appraisal of affairs if there were no way to correct or otherwise influence the course of events so that improved efficiency and effectiveness can result from program operations. Therefore, the final element of management control is the appropriate means by which such corrections and adjustments can be made.

It can be seen from this brief discussion that internal auditing has an important role to play in the management control system. To be effective in that role, internal auditing must be comprehensive in scope. The internal auditor must be organizationally independent of those whose programs and operations he must review. His authority must be sufficient to enable him to have access to all pertinent records, make all necessary inquiries, and review all aspects of an operation in order to evaluate and judge those matters for which he is responsible. Where any of these conditions are not present, the effectiveness of the internal audit as an element of management control will be substantially reduced.

## **RELATIONSHIP OF INTERNAL AND EXTERNAL AUDITS**

The question is often asked: What is the need for internal auditing when a comprehensive outside audit is conducted on a regular basis? To answer this question, it is necessary to understand not only the unique roles of the internal and outside auditors but also the different types of outside audits conducted. For any given state agency, several outside auditors may be assigned or have responsibility to examine its records. They include the chief state auditor, auditors from one or more federal agencies, auditors from one or more of the state's central financial agencies or departments, and non-governmental auditors such as certified public accountants.

In general, the chief difference between the role of the internal auditor and that of outside or independent auditors is one of perspective and responsibility. The internal auditor is a part of the management team, an integral part of the management control system, and a constant presence in the organization. Outside auditors represent other interests, are often much more selective in choosing the areas of their examination, and are present only for a brief time at intervals that often extend to several years. Auditors representing federal agencies, for example, are principally interested in those aspects of an agency's operations which are supported by federal grants and in the compliance by the agency with policies and restrictions of grant agreements.

The outside auditor whose work is generally felt to represent the greatest potential overlap or duplication of effort, of course, is the chief state auditor. However, when understood in its proper role, this type of audit should reinforce and complement the internal audit rather than duplicate it. The rationale underlying this assertion is simple and direct.

The primary purpose of any audit program is to promote better government in the form of improved efficiencies in operations, greater effectiveness in public programs, closer adherence to legislative, judicial, and administrative requirements, and more economical use of public funds and resources. Yet to find at the end of a project that improvements could have been made or that funds were improperly used does little to improve government unless the activity is repeated and improved later. Improvements come through management action, not audit findings. And for management to take action to affect the improvements, information must be timely, continuous and in a form relevant to the decisions and evaluations being made. Thus, the first priority in any audit program must be to get better information to managers so that better decisions can be made. And no outside audit program can be as effective in this role as an internal audit.

Therefore, to possess an ideal audit system, each state should first establish good internal audit programs in each of the agencies large enough to benefit from them. Obviously, small agencies with only a few employees would not need this type of program. These internal auditors would be given all of the requisite authority and tools to conduct comprehensive examinations of the agencies in which they are located. In short, they would function as an element of the management control system as previously outlined.

Secondly, the state should employ an independent chief state auditor to conduct comprehensive audits of all of the agencies and departments of the state. One of his chief responsibilities would be evaluating the extent and quality of internal auditing in each agency and recommending ways to strengthen and improve it. In most states, the chief state auditor is located in the legislative branch of government. The logical patterns of responsibility and control in state government dictate that this arrangement is superior to the practice still followed by some states of electing their chief state auditor.<sup>9</sup>

<sup>9</sup>The trend toward the creation of legislative post-audit programs in the states has been very strong in recent years. With it has come a strong trend to expand the scope of the audit examination along the lines outlined in this study. However, authorities are not unanimous in their feelings on these subjects, and the interested reader may wish to explore the issues surrounding this controversy. A sample of articles on this subject is contained in the bibliography to this study. See particularly articles written by Lennis M. Knighton, Robert V. Graham, and Mortimer A. Dittenhofer.

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Program is to promote better efficiencies in operations, greater adherence to legislative acts, and more economical use of funds at the end of a project that shows that funds were improperly used unless the activity is repeated through management action, or to take action to affect the activity, continuous and in a form that is being made. Thus, the first step is to get better information to management. And no outside audit program can replace an internal audit.

In each state, each state should first examine each of the agencies large and small, agencies with only a few employees. These internal audits are the authority and tools to control the agencies in which they are used as an element of the management system.

Independent chief state auditors should examine all of the agencies and define responsibilities would be defined for internal auditing in each agency and improve it. In most states, the chief state auditor is in the legislative branch of government, and control in state government is superior to the practice still in the hands of the chief state auditor.<sup>9</sup>

Audit programs in the states has a strong trend to expand the scope of this study. However, authorities are different, and the interested reader may find a variety. A sample of articles on this subject is given. See particularly articles written by James A. Dittenhofer.

The chief state auditor serves a broad role in state government. He has major responsibility to see that timely, relevant, and reliable information is available to the legislature for its decisions and analyses. He must review all programs administered by the executive departments and agencies to determine if they conform to legislative will and intent. He is also concerned with management, but he will be most effective in improving the quality of management as he makes recommendations to strengthen the elements of the management information and control system, including the internal audit. To the extent that competent internal auditing is performed in an agency, and the chief auditor has satisfied himself of that fact, he can proceed to evaluate the other matters for which he is responsible. Very likely he will be able to do this with considerably less work if an effective internal audit program exists. While the scope of the outside audit would remain as comprehensive as ever, the required depth and detail of the examination should be substantially reduced because of increased confidence on the reliability of the internal information system. Obviously, where an internal audit program is absent or materially deficient, the outside auditor has no choice but to conduct a detailed and thorough examination of evidence to satisfy himself, even though some audit effort may be duplicated.

It could be argued that if this type of audit network existed in each state, the tendency to proliferate outside audit responsibilities among several agencies and executive departments would cease. Moreover, not only would the system function more efficiently and effectively, it would avoid the misunderstandings and jealousies sometimes manifest among state audit officials.

Many government programs today are audited by certified public accountants. However, with few exceptions, CPAs do not extend their examination beyond financial areas and the related matters of compliance, legality, and fidelity in expenditures. Thus, the potential for overlap with internal audit work is greatly restricted, and the need for internal auditing in addition to such outside audits is obvious.

Finally, progress has been made in recent years to satisfy federal audit requirements through federal acceptance of state audits. Regardless of whether this trend continues or there is a continuation of extensive federal auditing of state agencies, the existence of good internal auditing in state agencies will reduce substantially the incidents of deficiency findings and other such problems.

In conclusion, internal auditing and independent or outside auditing complement each other. Each type of audit, in fact, will be better because of the other, and together they hold great promise as effective agents in promoting better management in government.

## THE NEED FOR AUDIT INDEPENDENCE

Audit independence, one of the cornerstones of auditing philosophy, is imperative if the integrity and quality of the audit is to be preserved. In fact, without audit independence there can be no audit. This fact is true by definition.

Professors Mautz and Sharaf, in their authoritative study of auditing philosophy, have defined the concept of audit independence in three parts. They are:

- *Programming Independence:* Freedom from control or undue influence in the selection of audit techniques and procedures and in the extent of their application. This requires that the auditor have freedom to develop his own program, both as to the steps to be included and the amount of work to be performed, within the overall bounds of the engagement.
- *Investigative Independence:* Freedom from control or undue influence in the selection of areas, activities, personal relationships, and managerial policies to be examined. This requires that no legitimate source of information be closed to the auditor.
- *Reporting Independence:* Freedom from control or undue influence in the statement of facts revealed by the examination or in the expression of recommendations or opinions as a result of the examination. The relationship of reporting to the examination has been neatly expressed in the following: "You tell us what to do and we'll tell you what we can write in our report; you tell us what you want us to say in our report and we'll tell you what we have to do."<sup>10</sup>

If the internal auditor is to render a report that fulfills the needs of agency administrators and serves as the basis for any decisions made by outside auditors or other state officials, these three types of audit independence must be present in every audit conducted.

Most of the responsibility for the internal auditor's independence actually rests with the agency head or chief executive. Administrators should desire completely factual and honest reports, and they should demonstrate that desire in all of their relationships with the internal auditor. Internal auditors can be expected to report and emphasize what they are encouraged to report and emphasize; and while the lack of full administrative support in no way relieves the auditor from the responsibility for personal honesty and integrity, his job is certainly much easier if he does not have to live in constant fear of reprisals stemming from a report containing unfavorable findings.

One of the most important steps that administrators can take to promote audit independence is proper location of the internal auditor

<sup>10</sup>R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing*, (Evanston, Illinois: The American Accounting Association, 1961), p. 206.

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Freedom from control or undue influences, personal relationships, and interests examined. This requires that the auditor be closed to the organization. Freedom from control or undue influence by the examination or in reporting to the examination. Following: "You tell us what you can write in our report; we'll tell you what our report and we'll tell

that fulfills the needs of the organization for any decisions made on these three types of audit to be conducted.

The auditor's independence from the executive. Administrators should have close relationships with the internal auditor to report and emphasize independence; and while the auditor should be relieved from the constant fear of reprisable findings.

Administrators can take to promote the independence of the internal auditor of Auditing, (Evanston, Illinois:

within the organization structure. He should have direct access to the agency head, or at least to some top-level administrator whose responsibility is department-wide and whose work is not likely to be under constant audit examination. Therefore, he should not be placed under the agency controller or chief fiscal officer whose work is under constant review. In fact, the audit should be made as independent of these critical functions of the agency as possible. His support should come from the top. He must be able to communicate freely with the one individual in the organization who can take appropriate action to correct problems as they are discovered and reported.

In his efforts to ensure audit independence, however, the administrator must also keep in mind that the audit program will be most effective when the auditor functions as a part of a well-developed, well-coordinated, management team. The internal auditor should not be separated or isolated to such an extent that he is unable to participate effectively in the management process. While he is not the one with responsibility for making decisions concerning the direction of the organization or its programs, he should be a valuable source of information and a trusted consultant in the management process. He is in effect the eyes and ears of management to examine and evaluate the state of affairs in the organization, and managers must have confidence in the reliability and fairness of his assessments.

In addition to the location of the auditor in the organization structure, other important factors influence his audit independence. These include such items as outside interference which restricts or modifies the scope of the examination or the audit procedures to be used; denial of direct and free access to information; interference in selecting or assigning personnel; attempts to overrule or alter the content of the auditor's report; and undue restrictions on time or funds for conducting the examination. The need for the auditor to be free of encumbering restrictions was succinctly expressed by Ellsworth H. Morse, assistant comptroller general of the United States:

*We . . . do not think there should be any significant restrictions on the work of the internal auditor if he is to be fully effective as an important part of the management system. To be effective, the internal auditor must probe into areas sometimes considered sacrosanct . . . but he must do this in such a way as to develop in the people responsible for managing those areas a real appreciation for his ability to make a contribution.<sup>11</sup>*

Auditors must be alert also to the personal factors which affect their independence in judgment. Any relationship which might cause the auditor to limit the extent of his inquiry, to resist the disclosure of unfavorable findings, or to alter the language of his report so as to

<sup>11</sup>Ellsworth H. Morse, Jr. "Internal Auditing Principles and Concepts for Federal Agencies," *The Federal Accountant*, (March, 1970), p. 36.

lessen its impact may fall into this category. Similarly, preconceived ideas about such matters as the quality of a particular operation, the necessity of a particular program, or the integrity of individuals or groups whose work is subject to audit may impair the auditor's ability to be objective. These influences may be positive or negative. They may stem from family ties, personal friendships, political affiliations, religious convictions, group loyalties, or previous employment experience. Whatever the source, any influence which makes it difficult or impossible for the auditor to be impartial and objective in the collection and evaluation of evidence or in the formation of his conclusions and recommendations is a bias which causes him to lose some of his audit independence. No one is entirely free from all such influences, but an auditor has a professional and ethical responsibility to free himself as much as possible and to maintain a true independent mental attitude in his work.

### THE NEED FOR PROFESSIONAL COMPETENCE

The quality of an internal audit program can be no better than the quality of the audit staff. Therefore, any effort to establish by legislation or administrative directive an internal audit program in an agency without providing for a top quality staff is doomed to failure. Moreover, if a comprehensive audit is planned, it is imperative that the audit staff include individuals representing these disciplines and combinations of experience necessary for the formation of audit teams capable of undertaking such audits.

As a minimum, it would appear that an audit team assembled to conduct a comprehensive audit should have expertise in the following six areas:

- Basic knowledge of auditing theory and procedures, with the ability and experience to apply such knowledge in examining and evaluating financial, compliance, and performance matters of concern to federal, state and local governments, society and creditors;
- Basic knowledge of management systems and internal and operational control concepts, techniques and relationships, with the ability and experience to relate such knowledge to federal, state and local government organizations, operations and interrelationships;
- Knowledge of accounting theory, methodology and terminology, including the functions of accounting, concepts of accounting measurement and compilation, cost classification and cost behavior, techniques for communicating accounting data, and knowledge of related budgetary principles, with the ability and

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- An understanding of and the ability to use in governmental audit-  
ing the basic principles, methods and techniques of closely  
related professional or technical fields including, but not limited  
to, economics, statistics, business law, computer systems, and  
quantitative analysis;
- Knowledge of current legislative, judicial, and administrative  
requirements which are placed on governmental entities at fed-  
eral, state and local levels; and the ability to interpret these re-  
quirements so as to evaluate compliance therewith; and
- Knowledge of information theory and practice, including the  
development of information systems and an understanding of  
their purpose, use, and maintenance.<sup>12</sup>

Traditionally auditors have been thought of as being primarily ac-  
countants. Indeed, most audit staffs today are comprised of persons  
primarily trained and experienced in accounting. Moreover, a well-  
trained and professionally qualified accountant will have proficiency  
in many of the areas described. Yet it should be apparent that many  
persons other than accountants should be included on the internal  
audit staff.

Among the most prominent of the other disciplines needed for  
comprehensive audits are computer science, statistics, law, public  
administration, social psychology, economics, public finance, sys-  
tems analysis, administrative science, and organization theory. In  
an agency having major responsibility for engineering operations, the  
audit staff must include persons competent in the fields of engineer-  
ing. In agencies dealing primarily with educational programs, the  
audit staff should include persons with competence in educational ad-  
ministration, educational psychology, and educational media. Thus,  
each agency must select persons whose backgrounds enable them to  
understand and evaluate the operations and programs. Where the  
audit staff is small and all of the critical disciplines cannot be repre-  
sented, it is appropriate to enlist the services of outside consultants  
as other specialties are needed. However, it is not desirable to use  
consultants in lieu of strengthening the audit staff where such staff  
development is possible.

For any audit work performed, a team of auditors should be as-  
signed which can accomplish the objectives of the review. Various  
combinations may be used for reviewing different aspects of an  
agency's operations. A practice of rotation in assignment among the  
audit staff is considered desirable as long as there is sufficient carry-

<sup>12</sup>This list of areas of expertise was first suggested by an Interagency Audit Standards  
Study Group in an unpublished draft of audit standards applicable to the audit of  
federally-assisted programs.



over from the previous audit team to provide continuity and perspective in subsequent reviews.

## OTHER IMPORTANT CONSIDERATIONS

A few other items of importance should be understood by administrators and auditors if the internal audit is to achieve its full potential in state government.

First, the internal auditor fills a staff position and not one of top-level line management. His duty is to review, evaluate, and report. He should not be given authority to force his position on managers within the organization or to interfere with their managerial prerogatives. The enforcement of audit recommendations must come from the top-level administrator to whom the auditor reports. Thus, there will always be an opportunity for all sides of an issue to be heard and for administrators to determine the extent to which the auditor's recommendations are to be enforced or implemented. In some cases, the administrator may choose to reject the auditor's recommendation. That is his prerogative. However, if the audit program is to be effective, the auditor must always be able to count on fair and impartial support of his reviews and prompt follow-up to his recommendations and conclusions.

Second, the internal auditor is not the one to whom responsibility should be given for the development of new methods, systems, or procedures. He can be consulted for advice and counsel by those who are responsible, but he should not have responsibility for development and implementation. To do otherwise would impair his independence by requiring that he review his own work.

Third, the internal auditor's reports should be directed to management. Normally they are not available for public distribution any more than other internally-generated reports to top management are available to the public. Nothing precludes administrators from making public an internal audit report if they desire to do so, but such reports are not public documents in the same way that the chief state auditor's reports are.

Fourth, it is incorrect and inappropriate to label as an internal audit an examination of one agency's operations by auditors located in another agency. For example, when the internal audit staff of a state education agency conducts audits of local education agencies, they conduct independent audits, not internal audits. Such auditors come from outside of the agency being examined and as such are independent of the management control system of that agency. Only when auditors within an organization conduct a review of its operations for its management is it proper to designate the review as an internal audit. Too often, administrators pride themselves in having a good

internal audit program with a majority of their staff

Finally, while the organization to be organized also having a top-staff would be responsible officials in the responsible to the administrative personnel of the executive branch seeing that financial standards. In addition would be available by the governor. The internal audit work this group would include the internal auditor's view

## SUMMARY AND CONCLUSIONS

This chapter has discussed the internal audit system. It has not been to the subject is undertaken present the concept of management control systems exist if it is to achieve promoting better government

A central theme is to see that operations are managed. Therefore, it is management program and take necessary to secure these is complete without are denied a valuable reinforcing control

This study strongly being by far the most operations. To limit the overlook some of the audit program can result in fiscal affairs; programs as well. A mented internal audit in achieving these ends

provide continuity and perspective.

## CONCLUSIONS

It should be understood by administrators that the purpose of the internal audit is to achieve its full potential.

The internal auditor's position and not one of top-down view, evaluate, and report. He should be in a position to advise his position on managers and to give them advice with their managerial prerogatives. Recommendations must come from the auditor's reports. Thus, there should be an opportunity for the auditor's views on an issue to be heard and the auditor's recommendation to be implemented. In some cases, the auditor's recommendation should be followed. The purpose of the internal audit program is to be effective and to count on fair and impartial work-up to his recommendations.

The internal auditor should be the one to whom responsibility for the development of new methods, systems, and procedures should be directed. He should give advice and counsel by those who have responsibility for decisions. Otherwise, it would otherwise impair his ability to do his own work.

The internal auditor should be directed to management rather than to top management are available to administrators from making decisions. He should be free to do so, but such recommendations should be made in the same way that the chief state auditor does.

The internal auditor should be labeled as an internal auditor. The internal audit functions by auditors located in the internal audit staff of a state agency. In the case of state educational agencies, they should be independent audits. Such auditors come from the ranks of the agency and as such are independent of that agency. Only when the internal auditor is given a review of its operations for the purpose of the review as an internal auditor should they themselves in having a good

internal audit program when, in fact, their auditors spend the vast majority of their time looking into the affairs of other agencies.

Finally, while this study describes internal auditing as being a function to be organized within the agencies of the state, there is merit in also having a top-level, executive-branch, internal audit staff. Such a staff would be responsible to the governor and other top-level executive officials in the same way that agency internal auditors would be responsible to the agency head. Its duties would include overseeing administrative performance throughout all departments and agencies of the executive branch of the state. It would also be responsible for seeing that financial and performance reports are timely and prepared in accordance with executive policy and accepted reporting standards. In addition, this small, well-trained, and experienced staff would be available for special studies and investigations as requested by the governor. This group of auditors need not be large if effective internal audit work is carried out at the agency level, for the work of this group would include a review but not a duplication of the agency internal auditor's work.

## SUMMARY AND CONCLUSION

This chapter has outlined the essential characteristics of a good internal audit system for an agency of state government. Its purpose has not been to describe conditions as they presently exist; that subject is undertaken in the next chapter. The purpose has been to present the concept of an internal audit, identify its role in the management control system, and point out the conditions which must exist if it is to achieve its full potential as an aid to management in promoting better government.

A central theme has been that it is a management responsibility to see that operations are efficient and programs are effective. Therefore, it is management's responsibility to establish an internal audit program and take whatever other steps are appropriate and necessary to secure these ends. No agency's management control system is complete without a good internal audit program. In fact, managers are denied a valuable source of information as well as an effective reinforcing control when such a program does not exist.

This study strongly endorses the comprehensive audit concept as being by far the most appropriate and valuable for state agency operations. To limit the scope of audit inquiry to financial matters is to overlook some of the most important contributions that an internal audit program can make. It is not enough to have honesty and integrity in fiscal affairs; we must have efficient operations and effective programs as well. A well-staffed, properly supported, and fully implemented internal audit program will do much to assist administrators in achieving these ends.



# 3

## The Current Status of State Internal Auditing

Table 1 SUF

### States Reporting

Arizona  
California  
Florida  
Georgia  
Hawaii  
Idaho  
Illinois  
Kansas  
Louisiana  
Maryland  
Michigan  
Minnesota  
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Missouri  
Montana  
Nebraska  
Nevada  
New Hampshire  
New Mexico  
New York  
North Carolina  
North Dakota  
Pennsylvania  
South Carolina  
South Dakota  
Tennessee  
Texas  
Utah  
Vermont  
Virginia  
Washington  
West Virginia  
Wisconsin  
Wyoming

34 States

### ASCERTAINING CURRENT CONDITIONS

A questionnaire was sent to selected state officials in every state to (1) identify state agencies currently having an internal audit program, (2) to obtain the names of the individuals responsible for such work in each agency, and (3) to identify other officials, groups, or legislative committees which might directly use information gathered from the internal audit. For the purpose of this initial survey, an internal audit was defined as "an independent appraisal of the activities and programs of an organization, conducted by a staff of that organization, and including an examination of (a) financial records and controls, (b) the efficiency of operations, and/or (c) the effectiveness of programs."

From this preliminary questionnaire, 115 individuals among the 50 states were identified as internal auditors according to the above definition.

### Internal Auditors Surveyed

A second questionnaire was then sent to the 115 chief internal auditors identified. The purpose of the second questionnaire was (1) to verify the information taken from the first questionnaire regarding

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\*\*As compiled from inform  
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**Table 1 SURVEY OF CHIEF INTERNAL AUDITORS**

**States and Internal Audit Units\***

States Reporting	Units Reporting	States Not Reporting But Identified As Having Internal Audits**	States Assumed To Have No Internal Audit Units***
Arizona	1	Alabama	Colorado
California	9	Alaska	Connecticut
Florida	1	Arkansas	Delaware
Georgia	1	Iowa	Indiana
Hawaii	1	Kentucky	Maine
Idaho	1	New Jersey	Massachusetts
Illinois	2	Ohio	Oklahoma
Kansas	1	7 States	Oregon
Louisiana	1		Rhode Island
Maryland	1		9 States
Michigan	6		
Minnesota	6		
Mississippi	1		
Missouri	1		
Montana	1		
Nebraska	1		
Nevada	1		
New Hampshire	1		
New Mexico	3		
New York	1		
North Carolina	1		
North Dakota	1		
Pennsylvania	1		
South Carolina	1		
South Dakota	1		
Tennessee	3		
Texas	5		
Utah	2		
Vermont	1		
Virginia	1		
Washington	1		
West Virginia	1		
Wisconsin	3		
Wyoming	1		
<b>34 States</b>	<b>64 Units</b>		

\*The internal audit units of state supported colleges and universities were not included in this survey.

\*\*As compiled from information responses on first questionnaire.

\*\*\*No response received from these states on either questionnaire sent.

the existence of an internal audit staff in the agencies and departments reported to have such a unit, and (2) to ask specific questions of the chief internal auditors regarding their work in four selected areas:

- The extent and scope of internal audit work within the auditor's department,
- The size and composition of the audit staff, including areas of expertise,
- The policies and principles followed by the internal audit unit, and
- The organizational arrangement and its relation to the independence of the internal auditor as viewed by the internal auditor.

Of the 115 questionnaires mailed, a reply was received from 64 auditors. Of these 64, two respondents said that an internal audit unit did not exist within their department. Table 1 identifies those states from which a reply was received and the number of units reporting from each state. Also identified are those states whose internal audit units did not reply to the questionnaire. The third column of the table identifies those states where information was insufficient to determine whether there was an internal audit unit in any department of the state.

Oral interviews were held with the chief internal auditors of seven departments of the State of California, including the head of the Audits Division, State Department of Finance, whose audit programs extend throughout the executive branch of California state government. Interviews were held (1) to discuss in more depth the information reported on the second questionnaire, and (2) to discuss with the auditors what they believe is the ideal role of an internal auditor in state government. The State of California was selected for these interviews because of the advanced status of internal auditing in the agencies of that state. (See Appendix B)

### **Heads of Organizations Surveyed**

A separate questionnaire was sent to the department head of each of the 115 agencies identified as having an internal audit program. The purpose of this questionnaire was essentially threefold:

- To obtain their opinions on the contributions of their internal audit programs,
- To obtain their opinions on the weaknesses of their internal audit programs,
- To assess the relative importance to them of internal auditing in general.

Of these 17 responded to the program at the respond.

Personal interviews were held (1) to discuss questionnaire responses as to the system. These views of chief

### **Small State**

It became clear that these are most frequent surveys of internal audit in larger states. A significant dimension here. Therefore, questionnaires were sent

The two states selected because of the nature of their internal audit programs, Montana, New Hampshire, and Virginia. These related states to this question: selected officials and departments

**Table 2** SURVEY

State
Montana
New Hampshire
North Dakota
Rhode Island
Vermont
West Virginia
<b>TOTAL</b>

staff in the agencies and departments (2) to ask specific questions regarding their work in four selected

audit work within the auditor's

audit staff, including areas of

covered by the internal audit unit,

and its relation to the independence of the internal auditor.

A reply was received from 64 states said that an internal audit unit. Table 1 identifies those states and the number of units reporting those states whose internal audit. The third column of the table was insufficient to determine audit unit in any department of

chief internal auditors of seven states, including the head of the Finance, whose audit programs of California state government in more depth the informant, and (2) to discuss with the role of an internal auditor in California was selected for these interviews of internal auditing in the agencies

and to the department head of each an internal audit program. The initially threefold:

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Of these 115 questionnaires, 77 were returned. Five officials who responded said their organizations do not have an internal audit program at the present time. Forty-three department heads did not respond.

Personal interviews were also conducted with seven agency or department heads in the State of California. These interviews were held (1) to discuss further the information reported on the survey questionnaires, and (2) to obtain additional insights from these executives as to the most important elements of an ideal internal audit system. These interviews were designed to correlate with the interviews of chief internal auditors.

### Small States Surveyed

It became apparent early in this study that internal audit programs are most frequently found in the states with larger populations. The surveys of internal auditors and the heads of organizations having an internal audit program were therefore directed primarily to these larger states. However, it was felt that this study would lack an important dimension if the views of smaller states were not represented here. Therefore, two small states were studied in depth and questionnaires were sent to six others.

The two states studied in depth are Utah and Idaho. They were selected because of their geographical proximity, the contrasting nature of their independent audit systems and policies, and the lack of internal auditing done in each one. The states surveyed were Montana, New Hampshire, North Dakota, Rhode Island, Vermont, and West Virginia. These were chosen as a representative sample of less populated states across the country. Table 2 shows the response to this questionnaire. Seven questionnaires were sent to each state to selected officials and the heads of some of the larger state agencies and departments.

Table 2 SURVEY OF SMALL STATES

State	Sent	Received	% Returned
Montana	7	5	71%
New Hampshire	7	2	29
North Dakota	7	2	29
Rhode Island	7	3	43
Vermont	7	3	43
West Virginia	7	4	57
<b>TOTAL</b>	<b>42</b>	<b>19</b>	<b>45%</b>

## Chief State Auditors Surveyed

In an effort to obtain the views of chief state auditors (those constituting the supreme audit authority in each state), a questionnaire was sent to every state. In states where more than one auditor might be considered to be the "supreme audit authority," a questionnaire was sent to each one. Responses were obtained from 35 of the 50 states. Follow-up interviews with several of those who responded were held either in person or by telephone. These interviews and the questionnaire were designed to ascertain these auditors' opinions on a number of issues and points which may be summarized in the following four categories:

- The value of an internal audit program to an agency.
- The key factors in developing an internal audit program in an agency.
- The ideal characteristics of an internal audit program.
- The relationship of internal auditing to the work of the independent auditor.

## Other Legislative and Executive Officials Surveyed

Still another questionnaire was sent to legislative committees, selected legislative officials, and executive officials whose responsibilities include financial management programs to obtain their views and learn of their experiences with internal audit programs in their states. These officials were not among the 115 heads of organizations having internal audit programs who were surveyed. They are those officials whose responsibilities would naturally lead them to consider in general the need and purpose of internal auditing in state agencies.

A total of 100 questionnaires were sent, but only 41 were returned. Of those returned, only 38 contained usable responses. Most of those responding, moreover, indicated little experience with internal audit programs.

## Other Sources of Information

In addition to the surveys and interviews, several state audit reports, internal publications, special studies, audit manuals, and other materials were reviewed to obtain a feeling for the current status of the work. Of particular help, for example, was a study undertaken in the State of Florida which gives an overview of internal auditing in state highway departments throughout the country.<sup>13</sup>

<sup>13</sup>State of Florida, Department of Transportation, Internal Audit Office, *An Informational Guide for Internal Review in State Highway Departments*, 1971.

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## PURPOSE , INTERNAL ,

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From all of these sources, the material which follows in this chapter is summarized and condensed so as to reflect the present status of internal auditing as it is practiced and to give the views and opinions of those who are presently involved in one way or another in such work.

The limitations of both time and budget have not permitted the extensive correlation of information that might have been made in a more comprehensive study, and much needs to be done to further validate and complete the survey data presented here. This study does, however, represent a monumental first step in identifying the status of internal auditing as it exists today — and the picture presented is one of great contrasts. The limited extent to which such work is presently undertaken is disappointing, yet the progress in some states and agencies is both encouraging and exemplary.

### PURPOSE AND BENEFITS OF CURRENT INTERNAL AUDITS

In the previous chapter, the comprehensive audit concept was explained. It is comprised of two major parts — the financial audit and the performance audit. The performance audit was shown to have three major components — the operational audit, the compliance audit, and the program audit.

In order to determine the extent to which actual practice follows each of these audit concepts, internal auditors were asked to indicate the nature of the audit work presently undertaken in their organizations. Table 3 is the tabulation of these responses. As can be seen, many internal audit units perform more than just a financial audit of records and controls, as was customary in the past. Following the recent trends in other types of audit programs in government, internal audits are increasingly being used to improve management control and provide management information.

Table 3 CURRENT SCOPE OF INTERNAL AUDITING

Elements of Comprehensive Audit	Extent Undertaken			Planned for Future
	Regularly	Sometimes	Not Now	
Financial	36	22	5	2
Performance —				
Compliance	47	9	3	7
Operational	41	16	7	6
Program	28	18	13	10

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### Officials Surveyed

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Much of the movement in state government away from performing solely fiscal or financial audits corresponds with but cannot be directly related to the emphasis in recent years on developing Planning-Programming-Budgeting-Systems (PPBS).<sup>14</sup> California represents an interesting example of this trend.

In 1964, California began to develop a program budget. Subsequently, the chief of the Audits Division, Department of Finance, received instructions to minimize all fiscal audits, to cease operational audits, and to focus on major problems, policy options, organizational change, and program efficiency and effectiveness. Today, however, California seems to be readjusting back to a more stable relationship between financial and program audits from the apparent overemphasis on program auditing. According to the director of the Audits Division, his staff currently devotes approximately 40 per cent of its time to financial audits and 60 per cent to cost-effectiveness and program-effectiveness studies.

The central thought expressed by chief internal auditors throughout this study was that the purpose of internal auditing is to provide information on the financial conditions, operating controls, and program accomplishments of their departments. Specifically, three audit objectives regarding internal audit purposes were evaluated in the interviews with these chief internal auditors. There were:

- To strengthen the internal control system of the operating entity,
- To test the reliability of information reported by the responsible officials of the reporting entity, and
- To provide information to responsible decision-makers by which the performance of the entity or operation can be judged.

In all cases, respondents said these three objectives described what they felt to be the purpose of the internal audit function.

The responses from the heads of organizations and from members of state legislatures indicated that both groups felt strongly that a major purpose of internal audit work is to review compliance with legislative and/or administrative policies and regulations. However, both groups also indicated in their judgment the internal audit should be less concerned with the appraisal of the performance of individual personnel in relation to established policies and regulations than with other aspects of compliance.

<sup>14</sup>See Allen Schick, *Budget Innovation in the States* (Washington: The Brookings Institution, 1971).

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Virtually all of the heads of organizations believe that internal audit is essential to effective management control. Some officials cautioned, however, that internal audit has the potential of becoming so involved with itself that it may appear as the "tail wagging the dog." Sometimes, officials said, the internal audit becomes too much of a detective device. When he does not approach his work carefully, the internal auditor may be viewed as simply another independent auditor checking up on any mistakes which have been made. The department heads expressed their desire to see the internal audit programs better serve unit managers by helping them to oversee their responsibilities.

Many officials reported that internal auditing aids in early identification of problem areas; consequently, it allows for corrections to be made at appropriate times. Management generally felt as though internal auditing was of great assistance to them in fulfilling their legal responsibilities as well as maintaining good internal control of their various field offices.

One official mentioned that internal auditing provides the opportunity and also the avenue to exchange outstanding and unique procedures between operating units. Besides improving communication, the internal audit is seen as a vehicle to coordinate the independent auditor's recommendations and to provide technical advice necessary for smooth organizational performance.

Another response given by heads of organizations was that internal auditing gave them better control over the finances for which they are responsible. Several mentioned that internal auditing gives them necessary information concerning expenditures and receipts. It likewise gives them information needed to aid in cash control. In relation to these two areas, it was mentioned that internal audit helps to protect against employee fraud.

Still another frequent response given by government officials was that internal audit aids in investigating compliance with management as well as government-wide regulations and policies. Internal audit in some states appears to give management a psychological control over operations, because the employees know their work will be audited. It is also felt that internal audit aids in reviewing systems and procedures and provides other information essential to management to enable effective functioning of the department. In this sense the audit is a measure of the effectiveness of the current operations, and it has the capability of informing management when changes are needed.

The interviews with chief internal auditors in California revealed several additional examples of the benefits of current internal audit

programs in the California state agencies. For example, internal auditing has provided a valuable check on department policies and the accomplishment of departmental goals. One chief internal auditor mentioned that his unit not only checked on goal accomplishment but also helped the audited agency to work out alternative programs where existing ones were inadequate. When his report went to the department director, it would include not only what was found but also what the agency was going to do to remedy the situation. The internal audit unit also followed up on its recommendations.

Another chief internal auditor wrote about a current practice he found to be illegal regarding welfare recipients in one county of his state. In essence he discovered that a fund to pay welfare recipients was set up so they could receive welfare payments the first day they applied and during the time their application was being reviewed and processed. Under the law of the state, all such cash funds over \$500 must be approved by the state administration board. The state is currently paying presumptive eligibility welfare payments out of a cash fund that far exceeds that amount. This cash fund has not been approved by the state administration board, and the payments are being illegally made. The internal auditor is now suggesting steps he feels will remedy the problem.

Yet another chief internal auditor has found, through computer analysis, that many state employees are receiving pay for two state jobs because of a technicality in the state's salary payment policy. He is currently working on a solution to remedy the situation.

Internal auditing has also been of some help to federal audit agencies which rely on the internal auditor's working papers to validate the use of federal funds by agencies and departments which are federal grant-in-aid recipients. A set of standards for the audit of federally-assisted government programs is now being developed that should provide the means for an increased coordination of state and federal government audits in the future.

These and many more examples could be cited. The fact is that internal audit programs today are achieving many successes, and it is the opinion of almost every authority in the field that a still more important role lies ahead for the internal auditor who is capable of catching the vision of his full potential as an integral part of the management control system.

To ascertain the attitude of the chief state (independent) auditors on these issues, they were asked to express agreement or disagreement with three statements about the internal audit. These statements and the responses to them follow:

**1. The internal audit shows**

Strongly Agree: 5  
 Frequency: 26  
 Percentage: 74%

**2. Internal audit program**

Strongly Agree: 5  
 Frequency: 23  
 Percentage: 66%

**3. The internal audit is a**

Strongly Agree: 5  
 Frequency: 25  
 Percentage: 71%

From the responses of they feel internal audit is for management in state C state auditors confirmed that internal audit provide performance appraisal and m

**EXTENT, SCOPE, AND OF INTERNAL AUDIT**

In the survey of internal that the audits most regula. cial, operational, and compl findings generally supporte these audits seemed to diffe nancial audits are still the pr tional and compliance a the financial audit and are pe audit procedures included t There have been attempts some states; but it appears t oped an advanced form of pr come to a point of equilibrium diting procedures. Until recei focused on the outputs of pro ity of financial statements. Int not only the effectiveness or e gree of program accompli standards.

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**1. The internal audit should be an effective management tool.**

Strongly Agree:	5	4	3	2	1	Strongly Disagree
Frequency:	26	7	2	0	0	
Percentage:	74%	20%	6%	0%	0%	(Average: 4.69)

**2. Internal audit programs should be more prevalent in state governments.**

Strongly Agree:	5	4	3	2	1	Strongly Disagree
Frequency:	23	10	2	0	0	
Percentage:	66%	29%	6%	0%	0%	(Average: 4.60)

**3. The internal audit is a necessary program in state government.**

Strongly Agree:	5	4	3	2	1	Strongly Disagree
Frequency:	25	7	1	2	0	
Percentage:	71%	20%	3%	6%	0%	(Average: 4.57)

From the responses of the independent auditors, it is evident that they feel internal audit is an important, necessary, and effective tool for management in state government. Personal interviews with chief state auditors confirmed this general feeling. State auditors declared that internal audit provided information that was essential for performance appraisal and management control.

**EXTENT, SCOPE, AND FREQUENCY OF INTERNAL AUDITING**

In the survey of internal auditors in state agencies, it was reported that the audits most regularly performed are those defined as financial, operational, and compliance audits. (See Table 3.) The interview findings generally supported this report, but relative frequency of these audits seemed to differ slightly from the reported statistics. Financial audits are still the primary type of auditing performed. Operational and compliance audits appear to be sub-functions of the financial audit and are performed concomitantly only as financial audit procedures included them in the audit scope.

There have been attempts to move away from financial audits in some states; but it appears that even in California, which has developed an advanced form of program auditing, the movement has now come to a point of equilibrium between the financial and program auditing procedures. Until recently, internal auditors in California have focused on the outputs of programs more than on checking the validity of financial statements. Internal auditors are expected to analyze not only the effectiveness or efficiency of operations, but also the degree of program accomplishment as judged by performance standards.

Concern was expressed by some department heads that the financial focus of internal audits is too narrow. Some felt, for example, that auditors often display "tunnel vision" in their activities. One official stated that internal auditors in his agency still maintained that financial procedures are more important than operating procedures. Another official stated that his internal audit is limited to balance-sheet auditing rather than including organizational or operational items. The difficulty of sufficiently covering all areas of an operation was in many cases related to a lack of staff.

Respondents from California say legislators are interested in budgets, not balance sheets. Therefore, the California Audits Division of the Department of Finance changed its internal audit from what was mostly a financial audit to a performance audit, largely excluding financial transactions. The change to performance auditing helped promote interest in auditing as well as budgeting. Some legislators felt the change went too far in excluding financial items, however, and insisted on a better balance between the two.

Legislators disagreed on whether greater cooperation was possible between independent and internal auditing. Some felt it would be desirable to have greater cooperation and that this cooperation would help save time and money. Others, however, felt that such cooperation would be undesirable.

A majority of legislators felt that the scope of internal audit should not be limited other than when it may be assigned certain specific responsibilities by the agency or executive head. Those who would limit the audit scope selected operational functions of the agency as the areas they would limit the most.

The feelings of many chief state auditors are characterized by the comment of one official who said: "Unfortunately, even now the internal auditing that is being done is primarily financial auditing with very limited amounts of operational auditing." Another official reported that in ten state agencies internal audit staffs are only performing financial audits, two or three agencies are conducting operational audits in addition to their financial audits, and no agency is auditing for program effectiveness. A third official commented that although his state is supposedly one of the leaders in internal auditing, the work is only in its beginning stages. Many agencies are not doing internal auditing at all, and those that are doing it are only auditing financial activities.

In responding to a question asking for their assessment of the ideal scope of the internal audit, a majority of chief state auditors felt that internal audit should include operational efficiency, program effectiveness, and financial activities.

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**Table 4 SUGGESTED FF**

How often do you feel an agency or for a program e

**Time Period**

- 6 months
- 12 months
- 18 months
- 24 months
- Other\*

\*Some auditors responded to another time

A final area of discussion is the degree to which it is agencies in the United State programs. If such programs question arises as to why ment. Some legislators report ment was a significant facto their states. Lack of understa auditing was also rated by all factor. Closely related is the gram. One official expressed that in some instances "it is c internal audit; consequently,

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An area relating to the extent and scope of audits is that of audit frequency. As shown by Table 4, the majority of internal auditors felt that an internal audit should be conducted annually on programs administered by an agency within their department. The next highest response was in the column entitled, "Other." Reasons given for checking this column were varied and included such comments as "insufficient staff to perform a regular audit" and "audit frequency depends on the problems that may arise within the agency."

**Table 4 SUGGESTED FREQUENCY OF INTERNAL AUDITS**

How often do you feel an internal audit should be performed in an agency or for a program administered by your department?

Time Period	Number of Responses
6 months	2
12 months	33
18 months	4
24 months	11
Other*	17

\*Some auditors responded to another time period in addition to this one.

A final area of discussion regarding the extent of internal auditing is the degree to which it is found in the states today. Only 115 state agencies in the United States were identified as having internal audit programs. If such programs are as important as they seem to be, the question arises as to why there has not been more development. Some legislators reported that the lack of a legislative requirement was a significant factor for not having more such programs in their states. Lack of understanding of the role or purpose of internal auditing was also rated by all groups as a very significant contributing factor. Closely related is the lack of perceived need for such a program. One official expressed this situation well when he pointed out that in some instances "it is difficult to assess the direct value of the internal audit; consequently, it may be skipped over."

#### **MANAGEMENT SUPPORT OF INTERNAL AUDITING**

Table 5 describes the degree to which chief internal auditors feel that management supports the internal audit function. Most internal auditors felt that auditing data only would not provide management with sufficient information to effectively control the organization's operations. The auditors felt their job would become more useful and important as the use of program auditing became more prevalent.

Chief internal auditors in California who have conducted program audits, for example, considered themselves an important part of the management team of the department, with the specific task of providing relevant information to the decision-making process.

**Table 5** MANAGEMENT SUPPORT OF THE INTERNAL AUDIT FUNCTION

	Total	Very Strong	Strong	Weak	Non-existent
1. Would you characterize management's support of your function as	11	24	21	6	0
	<b>Enthusiastic</b>	<b>Receptive</b>	<b>Indifferent</b>	<b>Adverse</b>	
2. Would you characterize management's reactions to your audit reports in general as	10	50	2	0	
	<b>Enthusiastic</b>	<b>Receptive</b>	<b>Indifferent</b>	<b>Adverse</b>	
3. Would you characterize management's reactions and support of your recommendations as	6	50	3	2	

\* Two of the chief internal auditors surveyed did not respond to this section of the questionnaire

The heads of organizations were also asked to express their feelings as to the general importance of internal auditing to the management function. Table 6 summarizes their responses.

The percentages listed in Table 6 clearly indicate that the respondents feel internal auditing is an asset to management control. Several department heads said the internal auditor can address himself to problems more responsively than can personnel who deal with other controls. One official said that internal auditing is the tool to keep government running efficiently, that it must substitute for the competitive aspect found naturally in business.

Several officials cautioned, however, that internal auditing can turn into "nickel and dime" auditing. Finding small discrepancies does not significantly help management. Auditors should be careful not to lay heavy emphasis on insignificant matters. If the organization is running smoothly, they said, the auditor should say so and not dwell on trivia.

One recurring problem mentioned by officials was that it is difficult to get some line managers to follow-up on recommendations

**Table 6** THE (As

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**Table 6 THE IMPORTANCE OF THE INTERNAL AUDIT  
(As Viewed by Agency Heads)**

Question	Responses	Percentage
Do you consider an internal audit to be:		
1. Essential to management?	51	71%
2. Generally helpful to management control?	20	28
3. Not particularly helpful to management?	1	1
4. Definitely not helpful to management control?	0	0

made by internal auditors as vigorously as top management would like them to do. The reasons for the lack of follow-up varied. Some line managers felt that the internal audit is designed to discover every flaw in their area; consequently, they did not want to aid anyone in emphasizing those weaknesses. The attitudes of some internal auditors also seemed to cause friction between them and line managers.

### THE INDEPENDENCE OF INTERNAL AUDITORS

In Chapter II, the issue of independence was discussed at some length. The Audit Standards Work Group that sought to define standards for the audit of federally-assisted programs in state government identified a number of restrictions which they felt would limit the auditor's independence. Several of these restrictions were listed in a questionnaire sent to internal auditors to determine the extent to which these restrictions actually exist. Table 7 summarizes this data. Although the majority of the respondents indicated that these restrictions never occur, it does appear that, at least in some areas, these restrictions do cause problems to the internal auditors surveyed.

The issue of independence is closely related to the extent of managerial support for the internal audit program. If the auditor does not report to top management, his independence may be seriously impaired. He must never be in a position of auditing his own work or that of his immediate supervisor if true independence is to be maintained. Moreover, his effectiveness is diminished substantially when he is required to report to a lower-level administrator who has no overall authority to back up and enforce the recommendations made.

Table 8 summarizes the statistics gathered from the questionnaire to internal auditors regarding their location in the organization. These data show that internal auditors do report to the agency head in about 50 per cent of the cases, and that another 25 per cent report to an assistant or deputy. Only 25 per cent report to the agency controller.



**Table 7 RESTRICTIONS ON AUDITOR INDEPENDENCE\***

A. Restrictions on the scope of audit examination or inquiry\*\*

	Number of Responses		
	Always	Sometimes	Never
1. Auditee interference that eliminates, specifies, or modifies any portion of the scope of the audit.	0	14	46
2. Auditee interference in the selection and application of audit procedures, selections of activities to be examined or determination of the acceptability of evidential matter.	2	8	50
3. Denial of direct and free access to information.	0	6	54
4. Interference in the assignment of personnel.	0	1	59
5. Punitive restrictions placed on audit operations funds.	1	12	47
6. Attempts to overrule or to significantly influence the auditor's judgment as to the appropriate content of the audit report.	1	17	42
7. Influences that place the auditor's continued employment in jeopardy.	0	5	55
8. Excessive restrictions on time necessary to complete the audit assignment.	5	14	41

B. Position in hierarchy

1. Does your position in the organizational hierarchy in any way impair your independence as an auditor?	0	18	42
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C. Problems with regard to the independence of the audit staff\*\*

1. Relationships of an official, professional and/or personal nature that might cause your staff to limit the extent of inquiry, to resist disclosure, or lessen the impact of its finding in any way.	0	14	46
2. Preconceived ideas about the quality of a particular operation, or personal likes or dislikes of individuals, groups or the objectives of a particular program.	0	27	33
3. Previous involvement in the operations of the governmental entity in a decision-making or approval capacity.	0	13	47
4. Biases and prejudices which result from employment in or loyalty to a particular group, entity or level of government.	0	16	44
5. Actual or potential restrictive influence such as may occur when a member of your staff has performed preaudit work.	0	12	48

\*Questions adapted from "Standards For The Audit Of Federally Assisted Government Programs," Preliminary Draft, pp. 29-31.

\*\*Of the 64 respondents, 4 did not complete this section of the questionnaire.

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**Table 8 CHIEF OF ORGANIZATION**

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INDEPENDENCE*	
Inquiry**	
Number of Responses	Sometimes Never
14	46
8	50
6	54
1	59
12	47
17	42
5	55
14	41
18	42
14	46
27	33
13	47
16	44
12	48

And while this statistic is still too high, it is encouraging to find it this low.

An interesting comment was made by three chief internal auditors interviewed individually in California. When asked to name by office the official to whom they should report, they each declared "definitely not the controller." In agencies where the internal auditor reports to the controller, he is in effect reporting to an official whose programs he must regularly audit. No outside pressure is brought to bear upon the controller to change his policies if he is the highest authority to whom the internal auditor reports.

**Table 8 CHIEF INTERNAL AUDITOR—POSITION IN ORGANIZATIONAL HIERARCHY**

Reports to:	Title	Number
	Department Director	31
	Assistant or Deputy Director	17
	Controller	16
	Total	64

In California, several deputies may be appointed in an agency, each being responsible for a different area of operation. One deputy is usually designated to receive all audit reports. This arrangement seems to permit the internal auditor to be organizationally independent of most of the units he audits, but it also denies him the top-level enforcement power or backing that may be critical to his success. Only if the responsible deputy is given authority over other deputies is this fact not true.

Chief state auditors almost universally indicated that the internal auditor should report to the department or agency head. In commenting on the reporting of audit information directly to the department head, one state auditor explained: "The internal audit should provide the department or agency head with current information and management data. In turn, the department or agency head should be concerned with applying this information. This is the ideal." Another auditor commented: "In practice this [internal audit] information is rarely used, and top management rarely is reported to directly." A third state auditor added: "Although the internal auditor should ideally report to the department head, it is appropriate for him to report to an administrative assistant who is able to utilize this information."

## THE COMPETENCY OF INTERNAL AUDIT STAFFS

Public-sector internal auditors have to perform many different types of audits. An auditor may know all there is to know about financial auditing, yet he may not be an expert in program auditing. Moreover, auditing is often assumed to be the concomitant learning experience of one who becomes an accountant. In reality, however, the functions of accounting and auditing are as separate as are those of lawyer and jury. The accountant must present the facts; the auditor must evaluate their validity.

Table 9 shows the disciplines represented in the educational backgrounds of the chief internal auditors who responded to the questionnaire. An experience mean is also listed with the table. The relatively low experience mean coincides with other aspects of our research, indicating that the existence of internal audit units is a relatively recent development in state government.

**Table 9** BACKGROUNDS OF CHIEF INTERNAL AUDITORS

Educational Degrees*	Number
Accounting	43
Business Administration	19
Economics	5
Engineering	5
Law	3
Social Science	2
<b>Experience Mean of Chief Internal Auditors**</b>	
Experience mean —	2.42 years as a chief internal auditor

\*Only majors are listed unless a second major or second degree was listed by the respondent

\*\*The range of experience ran from 6 months to 32 years, with most of the respondents falling in the 1 to 10 year range. Only four chief internal auditors listed more than 10 years of experience. Their experience was 12, 14, 22, and 32 years respectively. The mean changed from 4.05 to 2.42 with the exclusion of these four individuals.

The effectiveness of any audit depends chiefly on the competence of the audit staff. Financial audits are likely to be performed most effectively, because effective auditing of financial data is directly related to the expertise of the accountant. As pointed out, the majority of chief internal auditors surveyed indicated that they had been trained as accountants. And the financial audit is the type of audit that accountants have traditionally done best.

Program auditing, however, is a rather new and undelineated field. It involves auditing all aspects of an organization's operations and requires that the auditor possess a knowledge of such areas as management control, systems analysis, public administration, econom-

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**Table 10** SL

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ics, law, and many other disciplines in addition to accounting. Of course, no one auditor can be expected to be an expert in all such areas; but in order to form effective audit teams, a competent audit staff must be assembled to meet the demands of the audits to be performed. Much additional development and preparation must yet take place before the internal audit staffs of most state agencies will be able to competently conduct full program audits.

Chief internal auditors were asked to list the areas of professional expertise they felt would insure a sufficiently competent staff to meet the audit requirements in their agencies. Table 10 summarizes their responses.

**Table 10 SUGGESTED EXPERTISE OF AUDIT STAFF\***

Fields of expertise (listed alphabetically)	Responses
Accounting	39
Auditing	19
Budgeting	3
Business Administration	5
Construction Inspectors**	3
Economics	2
E. D. P.	11
Engineering**	19
Financial Administration	7
Law	9
Personnel	3
Public Administration	3
Report Writing	4
Right of Way**	5
Statistics	5
Systems Analysis	15

\*Respondents (chief internal auditors) were asked to list all areas of professional expertise they felt would insure them a competent audit staff.

\*\*These fields of expertise were listed by state highway department chief internal auditors.

Legislative and chief state audit officials were also asked to indicate what experience most adequately qualified a candidate for selection as an internal auditor. The general feeling among these officials was that any practical experience in auditing was adequate to qualify a candidate for such a position. The second ranked qualifier was accounting experience. Management experience was thought to be the least adequate preparation for an internal auditor in relation to the various accounting experiences available.

Heads of organizations, responding to a question concerning the qualifications needed by internal auditors, cited accounting as the primary discipline desired. The present audit staffs in their organiza-

tions reflect the impact of that opinion. Moreover, the majority of those officials who felt a need to add staff with different academic disciplines would prefer to add personnel familiar with the particular type of work being undertaken. For example, highway department heads frequently suggested adding engineering staff. Other disciplines frequently recommended were data processing, systems analysis, and management analysis.

The weakness of state internal audit programs most frequently mentioned by department heads was the lack of sufficient staff to handle the work load. Consequently, many internal audits have been severely limited in scope and depth. The lack of staff has also contributed to the problem of insufficient time to constructively clear up exceptions and problems.

Another problem related to staffing, and one that was mentioned often, is the high degree of staff turnover due in great part to the low pay for auditors. Respondents said there is no place for a good internal auditor to advance within the internal audit section.

Finally, one official mentioned that although internal auditing is essential to the management function, there are no adequate measures of performance to indicate clearly what benefits the audit has accomplished. Consequently, the budget to provide for internal auditors is perhaps more easily trimmed than the budget for other areas.

## INTERNAL AUDITS AND INDEPENDENT AUDITS

Table 11 describes how chief internal auditors reacted to the use of internal audit reports by independent audit staffs.

**Table 11 USE OF INTERNAL AUDIT REPORTS BY INDEPENDENT AUDIT STAFFS\***

	Always	Often	Sometimes	Never
1. Are your internal audit reports used by the independent audit staff of the Chief Audit Officer of your state?	12	9	29	14
2. Are the internal audits performed by your staff thought to provide reliable information by the independent audit staffs who may use your audit reports?	23	21	20	0

\*As reported by internal auditors.

Table 12 shows whether or not the heads of the organizations felt that the work of the independent auditor duplicates the work of their internal auditors.

**Table 12 DUPLICATION OF A**

**Question:** Does the work of the independent auditor duplicate the work of your internal auditor?

Yes .....  
 No .....  
 Uncertain .....

Qualification of "Yes" Responses:\*

Unnecessary .....  
 Unavoidable .....  
 Valuable .....  
 Other .....

\*Some officials marked "no" plus a qualification.

The responses indicate that 60% of the independent auditors do not duplicate the work of the internal auditor. Of the 30% indicating a duplication, 10% felt the duplication was either unnecessary or unavoidable.

When asked about the possibility of combining internal and independent audit work, the respondents were unable to reach a consensus. Independent auditors and internal auditors reached their agreement or disagreement.

The function of the internal audit and independent audit.

Strongly Agree	5	4	3
Frequency:	5	5	6
Percentage:	14%	14%	17%

While the average of 2.69 indicates that independent auditors tend to disagree with the internal auditors' strong opinion one way or the other.

In personal interviews, the state officials felt there is a definite need for both internal and independent audit functions. Although to some degree between the two audit functions could complement each other, the existence of an effective internal auditor to do his job better despite the existence of a state auditor. Another said: "Although it makes the two audits more accurate, it is difficult to evaluate the effects of internal and independent audits."

**Table 12 DUPLICATION OF AUDIT WORK**

**Question:** Does the work of the independent auditor duplicate the work of your internal auditor?

	Responses	Percentage
Yes .....	22	30%
No .....	46	64
Uncertain .....	4	6
Qualification of "Yes" Responses:*		
Unnecessary .....	2	7
Unavoidable .....	15	52
Valuable .....	10	34
Other .....	2	7

\*Some officials marked "no" plus a qualification.

The responses indicate that 64% of the heads of organizations felt the independent auditor does not duplicate the work of their internal auditor. Of the 30% indicating a duplication in work, the vast majority felt the duplication was either unavoidable or valuable.

When asked about the possibility of overlap in the internal audit and independent audit work, the independent auditors were unable to reach a consensus. Independent auditors were asked to express their agreement or disagreement with the following statement:

**The function of the internal audit overlaps with that of the independent audit.**

Strongly Agree	5	4	3	2	1	Strongly Disagree
Frequency:	5	5	6	12	7	
Percentage:	14%	14%	17%	34%	20%	(Average: 2.69)

While the average of 2.69 indicates a very slight tendency for the independent auditors to disagree with this statement, there was no strong opinion one way or the other.

In personal interviews, the state independent auditors concurred there is a definite need for both internal and independent audit in state government. Although many conceded there is an overlap to some degree between the two audits, they felt that the two auditing functions could complement each other in generating necessary information on program costs and operational efficiency. "The existence of an effective internal audit should allow the independent auditor to do his job better despite the overlap," declared one chief state auditor. Another said: "Although some overlap may exist, this makes the two audits more accurate." Chief state auditors were also asked to evaluate the effects of internal auditing on the independent

audit and to comment on the overlap in functions between the two audits.

In evaluating the effects of the internal audit on the independent auditor, the chief state auditors appraised a number of factors which the internal audit could possibly effect in their states. The responses of the state independent auditors indicated they felt the internal audit function generally benefited them in their duties. The question and the responses of the chief auditor were as follows:

In your opinion, the existence of an internal auditing system in a state department or agency would: (Check the appropriate response for each letter)

	Yes	No	Uncertain
a. Reduce the time necessary to audit that agency by the independent auditor.	28 80%	2 6%	5 14%
b. Allow the independent auditor to reduce the size of his staff.	7 20%	16 46%	12 34%
c. Enable the independent auditor to audit a larger number of agencies.	26 74%	4 11%	5 14%
d. Permit the independent auditor to audit a different phase of agency activities.	28 80%	4 11%	3 9%
e. Have no effect on the work of the independent auditor.	3 9%	30 86%	2 6%
f. Increase the cost of the audit for the independent auditor.	0 —	34 97%	1 3%
g. Decrease the cost of the audit for the independent auditor.	19 54%	2 6%	14 40%

When state independent auditors were asked to comment on the impact of an internal audit system on their audit, their opinions concurred with their questionnaire responses. One auditor said: "The fact that it would take less time to audit the same portion of an agency's activities than it would otherwise take without the existence of an internal audit system may also enable the independent auditor to audit a different phase of agency activities as well."

In discussing other effects of the internal audit on an independent auditor, one state independent auditor explained: "The actual effect of the internal audit would vary with the agency audited." Other chief state auditors agreed.

The independent auditors felt they would be better able to determine the impact of a good internal audit system on their performance if they were not so understaffed. "At present the scope of our audits

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### KEY FACTOR. AUDIT SYSTE

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and the time we spend with each agency is limited because we are so understaffed," declared one chief state auditor.

In further commenting on the effect of the internal audit on their work, the chief state auditors were united in indicating that an effective internal audit system would allow them to become more involved with performance auditing. The chief state auditors particularly desired more involvement in operational auditing.

In general, an internal audit system in a state department or agency would, in the opinion of the state independent auditors responding, enable them to perform a better independent audit, take less time, audit more or different phases of the activities, and cost less than it would in an agency without an internal audit system.

## KEY FACTORS IN ACQUIRING AN INTERNAL AUDIT SYSTEM

Chief state auditors were also asked to rate the factors that are important in determining whether state departments and agencies acquire an internal audit system. From the questionnaires returned, the following responses were obtained.

In your view, how important are the following factors in determining whether state departments and agencies do or do not acquire an internal audit staff? (A *five* indicates that the factor is very important, a *one* indicates that it is not important at all.)

	5	4	3	2	1	
The agency head's desire to have an internal but independent appraisal of operation and/or program performance	71 49%	12 34%	4 11%	2 6%	0 —	Frequency Percentage
The agency administrator's knowledge of the role of internal auditing	10 29%	19 54%	2 6%	1 3%	3 9%	Frequency Percentage
The existence of qualified personnel to hire	15 45%	7 20%	8 23%	4 11%	1 3%	Frequency Percentage
The size of the agency	10 29%	17 49%	3 9%	0 —	5 14%	Frequency Percentage
The cost of the additional staff	6 17%	15 43%	8 23%	3 9%	3 9%	Frequency Percentage
State or federal regulations	11 31%	10 29%	8 23%	1 3%	5 14%	Frequency Percentage
			(Average: 3.6)			



The recommendation of the independent auditor	7 20%	13 37%	8 23%	3 9%	4 11%	Frequency Percentage
	(Average: 3.5)					
The size of the state	2 20%	7 37%	6 23%	5 9%	15 11%	Frequency Percentage
	(Average: 2.3)					
The fact that other states may or may not perform internal auditing	0 —	2 6%	7 20%	6 17%	20 57%	Frequency Percentage
	(Average: 1.7)					

The chief state auditors selected "the agency heads' desire to have an internal but independent appraisal of operations and/or program performance" as the most important factor in determining whether a state department or agency acquired an internal audit system. In commenting on the importance of this factor, one state independent auditor said that inner agency support at the agency-head level was of major significance if the internal audit function was to be of value to management. He added that many agency heads were only beginning to realize the value of information on operational efficiency.

The fact that the agency administrator's knowledge of the role of internal auditing was the second highest ranking factor in determining whether state departments or agencies acquire an internal audit staff substantiates the importance of the support of the internal audit function by the agency head.

The third ranked factor for acquiring an internal audit staff was the existence of qualified personnel to hire. In commenting on this factor, chief state auditors indicated that availability and cost were both important. "Statutory limitations on salary make attracting top qualified personnel very difficult," said one chief state auditor.

The size of the agency was rated fourth among factors listed. Chief state auditors said this was primarily because larger agencies employed more personnel, generally carried out more important functions, and handled larger amounts of money. The size of the agency was often determined by its function, commented one auditor. He felt that the size of the agency, therefore, was not as important as the function of the agency, a factor not included in the questionnaire. Contrasting the size of the agency with the size of the state as a factor, one state independent auditor commented: "Large states usually do more internal auditing than small states because their agencies are proportionately larger. However, it is the size of the agency and the functions that it carries out that are more important than the size of the state."

In rating the fifth factor, the cost of additional staff, one chief state auditor indicated that the cost was important primarily in a political

sense. State independent and independent internal and independent the costs required for because the need for to become an important State and federal of additional staff as agency perform internal the agency will have a On the other hand, state tions as being a very s

## THE SMALL STATE

In the previous discussion compare the various internal audit programs, or, as in audit programs, or, as in to examine the composition contrast those findings (related) states visited and

As an analysis of Tab significant internal audit vitally important. On a agreement and one representatives of these state as a management tool at feedback on program effectiveness agencies. They emphasize internal audit programs.

When asked if external compensates for not having of these officials was necessary suggestion that an interrelationship of the work of other auditors

These survey results confirm views in both Utah and Idaho the fundamental hypothesis the findings among all other job needs to be done state government. However such programs are valuable effective programs and good

Another interesting state response to the question of what required by law.

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sense. State independent auditors commented that the need for both internal and independent audit staff was usually not met because of the costs required for personnel. "The cost of staff becomes a factor because the need for better auditing does not have the political power to become an important issue," offered one auditor.

State and federal regulations were ranked closely with the cost of additional staff as a factor. "If a federal grant stipulates that an agency perform internal auditing to qualify, you can be sure that the agency will have an internal audit staff," noted one state auditor. On the other hand, state auditors did not rate their own recommendations as being a very significant factor.

### THE SMALL STATE PERSPECTIVE

In the previous discussions, an effort has been made to relate and compare the various responses of state officials who have internal audit programs, or, as in the case of independent chief state auditors, to examine the composite view of all states. It is also interesting to contrast those findings with the perspectives of the small (less populated) states visited and surveyed.

As an analysis of Table 13 will show, that the small states with no significant internal audit programs still feel that such a function is vitally important. On a scale of 1 to 5, with five representing strong agreement and one representing strong disagreement, the representatives of these states ranked the usefulness of internal auditing as a management tool at 4.63. They felt that such audits provide timely feedback on program effectiveness and benefit both large and small agencies. They emphatically deny that small states do not need internal audit programs.

When asked if external audits presently conducted by other auditors compensate for not having an internal audit system, the response of these officials was negative. They denied even more strongly the suggestion that an internal audit function is actually a duplication of the work of other auditors.

These survey results corresponded with the findings from the interviews in both Utah and Idaho. Moreover, these findings confirm again the fundamental hypotheses of this study, and they correspond with the findings among all other groups surveyed. It appears that a better job needs to be done to define internal auditing and its role in state government. However, there is agreement from all sectors that such programs are valuable tools of management in promoting effective programs and good government.

Another interesting statistic gathered from this survey is the response to the question of whether internal audit programs should be required by law.

**Table 13 VIEWS OF SMALL STATES**

Statements	Number of Responses					Mean Response
	Strong Agreement 5	4	3	2	Strong Disagree- ment 1	
The concept of an internal audit should be defined more explicitly.	4	6	6	1	2	3.47
An internal audit is useful as a management tool.	14	3	2	0	0	4.63
It provides timely feedback on effectiveness of programs.	6	4	3	4	2	3.42
It duplicates work of other audit agencies.	0	4	1	4	10	1.94
It is valuable, but cannot afford it.	0	2	8	2	7	2.26
It should be required by law.	3	0	4	4	8	2.26
Small states have no need for internal auditing.	1	1	3	2	12	1.78
Present audit system compensates for lack of internal audit.	2	2	3	4	8	2.26
Can benefit management in both small and large agencies.	9	6	3	1	0	4.21

Approximately one-third of the respondents felt *strongly* that such audits should be required by law, while not a single respondent indicated *mild* agreement. Another third were neutral on this issue, while the remainder were either mildly or strongly opposed to the idea. By contrast, legislative officials surveyed in another part of this study were asked if they felt that internal audit programs should be established by legislative provision. Almost 60% of them stated that such programs should be established by legislation, while only 20% opposed such an approach. The remaining 20% were uncertain.

Thus, there are two contrasting views on this subject. On the one hand are those who feel that since internal auditing is intended pri-

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Mean Response
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marily to be a management tool, such programs should be instituted by management and suited to each manager's particular needs. On the other hand are those who advocate the creation of such programs through legislation. One of the arguments advanced for such a provision is that it would facilitate the acquisition of needed operating funds through the budgetary process. Another argument is that more uniformity could be established among programs. This approach would insure that the internal auditor is properly located in the organization and that he has sufficient authority to accomplish his objectives. Finally, there are those who simply believe that managers are a difficult group to sell on this issue until they have had some experience with such a program. By imposing the program on an agency through legislation, legislators at least insure that such programs are begun. Presumably, when managers have then had an opportunity to become acquainted with the resulting benefits, they will not want to see the program downgraded or eliminated thereafter.

It is difficult to assess whether either of these views is correct. It does appear that the best internal audit programs today are located in agencies where the agency head has a vital interest in the program. Thus, where administrators are willing and anxious to support such a program, there seems to be little need for legislation. In other instances, legislation may be desirable.

An attempt was made to determine why those states without an internal audit program have not established one. Respondents were asked to rate the importance of several items that have been suggested as being the principal reasons for this condition. Table 14 indicates their responses.

It is interesting to note that the lack of perceived need of such a program was ranked the highest. This response seems to conflict sharply with the earlier findings that showed an overwhelming consensus that internal audits are needed in all states. Apparently, while the responding official feels that such programs are greatly needed in his agency and state, he also feels that others in his state or organization do not share that view.

Tradition was listed as the second most important item, followed closely by the lack of legislative support and the lack of understanding of the role or purpose of internal auditing. The lowest three rankings were given to the lack of funds, the inability to get qualified personnel, and the lack of confidence by administrators in internal audit. This finding underscores the contention made earlier that the key to making internal auditing a more significant and meaningful part of management control in state government is an improved understanding of its role, its purpose, and its nature, not the lack of funds and personnel. This finding does not indicate that funding and per-

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**Table 14 REASONS FOR NOT HAVING AN INTERNAL AUDIT PROGRAM**

Reasons	Very Important					Mean Response
	5	4	3	2	Not Important at all 1	
1. Lack of funds	1	4	1	4	2	2.83
2. Lack of legislative support	3	3	3	2	1	3.41
3. Lack of perceived need of such a program	5	3	3	0	1	3.91
4. Lack of understanding of role or purpose of internal auditing	3	3	3	1	2	3.33
5. Lack of confidence by administrators in internal auditing	1	1	1	4	4	2.18
6. Inability to get qualified people for internal audit staff	1	2	2	3	3	2.54
7. Tradition	4	3	4	0	2	3.53

sonnel are not major problems, for they are both very important. But they are not as important as some other items. Indeed, funding such programs would be seen by all government officials as a very profitable investment if the nature and purpose of the programs were more fully understood by administrators and legislatures alike.

**SUMMARY**

In this chapter, an effort has been made to portray internal auditing as it exists today and as it is seen by administrators, legislators, and auditors in state government. The picture is one of great contrasts. While little such work is actually done, given the relatively small number of agencies having such programs compared to the large number which could have them, it is highly encouraging to find attitudes so positive and support so extensive. The greatest need seems to be for additional clarification of concepts, purposes, approaches, and arrangements. Hopefully, this study represents at least a significant beginning in filling the literary void on this important function at the state level of government. It would be encouraging to see additional, more exhaustive studies undertaken as a sequel.

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INTERNAL AUDIT

Not Important at all	Mean Response
1	
2	2.83
1	3.41
1	3.91
2	3.33
4	2.18
3	2.54
2	3.53



# 4

## Conclusions and Recommendations

The purposes of this study have been to develop an outline of a model or ideal internal audit system for agencies of state government in the United States (Chapter II) and to identify and describe the current status of internal auditing in state government (Chapter III).

Nearly every state in the nation provided significant information. Based on the study, it was noted that the state of California had advanced further than the other states in internal auditing. For example, internal auditors in the state agencies of California have now organized themselves into a group known as the California Association of Auditors for Management. The purposes of the association are to work on common problems and to promote improved professionalism. Of further interest is that the high quality of audits undertaken by these auditors have resulted in agency heads and legislators in California not only supporting their programs, but also showing very high regard for the reports issued by the internal auditors. This study has determined that the California model is the finest available among the states today. For this reason additional information is provided in the appendices to this study illustrating and describing these programs.

The findings of this study support the contention that internal auditing has an essential role to play in state government, and that such programs are beginning to receive broad support from every group of state officials surveyed. It would appear that the time is right for every state to move more quickly and forcefully to establish such programs.

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The establishment of good internal audit programs will require a strong mandate on the part of state administrators, legislators, and other decision-makers to give internal auditors the responsibility to conduct full comprehensive audits, not merely to review financial affairs. If the audit program is to be truly beneficial to management, the auditor's independence must be preserved and his staff must be of professional quality.

The literature is replete with good materials outlining the audit concepts to be followed in implementing a comprehensive audit program. The bibliography to this study contains a representative sample of such publications. Through activity in professional organizations, including The Institute of Internal Auditors, state internal auditors can keep abreast of the developments in their areas and learn from the experiences of auditors doing similar work in other organizations. Thus, it would appear that the greatest need today is to continue to sell the merits of internal auditing to responsible state officials who have authority to implement such programs, and then to push ahead in that implementation effort.

The decade of the sixties saw great progress in the fields of budgeting and program analysis. The decade of the seventies should see equally great strides made in the areas of accountability and program evaluation. No program is more critical to the success of this new emphasis than is internal auditing.



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# Appendices

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**Appendix A GENERAL INFORMATION ON THE TYPES OF  
AUDIT UNITS EXISTING IN THE  
STATE OF CALIFORNIA**

**Types of Audit Units in California**

Department	No. of Units	Internal Only	Unit Covers Internal & External	Separate Units for Internal: External	External Only
Agriculture	7			1	6
Consumer Affairs	1		1		
State Controller	4			1	3
Corporations	1				1
Criminal Justice	1		1		
Equalization	2			1	1
Fish and Game	1				1
Franchise Tax	1				1
Health Care Services	1				1
Human Resources					
Development	2		1		1
Justice	1				1
Mental Hygiene	1				1
Motor Vehicles	1		1		
Parks & Recreation	1		1		
Public Health	1				1
Public Utilities	1				1
Public Works	1		1		
Real Estate	1		1		
Rehabilitation	1		1		
Savings and Loan	1				1
Social Welfare	1				1
State Colleges	1	1			
University of California	1		1		
Water Resources	2			1	1
Internal	14	1	9	4	
External	22				12
Total	36				10
Total Departments	43				
Not Returned	- 3*				
Total Questionnaires Returned	40				
*Community Colleges					
Highway Patrol					
Insurance					
Audit Unit	24				
No Audit Unit	16				

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### I. OVERALL ANALYSIS OF DEPARTMENTS AND UNITS

Twenty-four departments with audit units responded to the questionnaire.

Within the 24 departments there are 36 different audit units. The count of departments does not include the Department of Finance and the California Highway Patrol.

#### Analysis of Audit Units

##### Internal Audit:

Internal audit of department activities only	5	
Internal audit units cover department activities and external activities	9	14

##### External Audits:

External audit units in department with separate internal audit unit in department	12	
External audit unit only in department	10	22
<b>Total Units</b>		<b>36</b>

Almost all units perform financial audits.  
Twelve audit units do management audits.

#### Analysis of Departments

1. Internal audit coverage only	1
2. Internal audit unit covers internal and external auditing	9
3. Department has separate units for internal audits and external audits	4
4. Department with external audit unit only	10
<b>Total Departments</b>	<b>24</b>

#### Analysis of Interested Departments

	Units	Departments
Total	36	24
Not Interested	- 4	- 2
	32	22
Interested but No Reply	+ 1	+ 1
	33	23

## II. AUDIT STAFF

The number of auditors included is approximately 2,068.

Analysis:

	Total	Unit Heads	Audit Staff
Internal Audits	105	15*	90*
External Audits:			
Information from Questionnaire	818	17	801
Not Included in Questionnaire:			
Equalization	601	1	600 (Approximate)
Finance	89	1	88
Human Resources Development	455	1	454
Sub-Total	1,963	20	1,943
Total	2,068	35	2,033

\*Includes Highway Patrol

## III. REPORTING

	Internal Audit	External Audit
1. For supervision, to whom does the head of the audit report?		
Below Division Chief	1	5
Division Chief	5	4
Assistant or Deputy Director	5	5
Director or Head of Department	2	1
Board of Directors	1	-0-
2. For audit action, to whom are audit reports addressed?		
Below Division Chief	3	9
Division Chief	2	-0-
Assistant or Deputy Director	3	-0-
Director or Head of Department	7	3
Board of Directors/Commission	1	-0-
Private Citizens	-0-	3
3. Formal audit reports?		
Yes	4	3
No	10	14

4. If no to question 3, what type of report is issued?

Annual Statistical	-0-	1
Form Report	1	-0-
Handwritten	1	1
Letter or Memorandum	5	6
Oral	-0-	1
Printed Format, Handwritten	-0-	1
Printed Format, Typed	1	-0-
Typed Report	4	3
Working Papers with Memorandum	-0-	1

5. "Outside" distribution or report?

Yes	12	8
No	2	9

If yes, to whom are audit reports sent?

Audits Division	9	-0-
Auditor General	5	2
State Controller	1	2
City Government	1	-0-
County	1	3
Federal	5	3
Contractors	-0-	-0-
Individuals	4	4

Other: Outside Organizations; Outside CPA Firms; Managers of Advisory Boards, Hospital Administrator; Parties Involved in Proceedings; Association Under Exam; Budget Analyst; Colleges; Trust Operations Under Director of Agriculture

IV. AUDIT STAFF

Head of Audit Unit Pay Range	Internal Audit	External Audit
20 \$1048	1	1
24 1273	4	4
26 1405	5	4
28 1548	-0-	3
29 1626	1	-0-
30 1708	1	1
31 1793	1	2
32 1882	-0-	-0-
Exempt 2117	1	-0-
35 2169	-0-	1
36 2288	-0-	1
Classifications used differ in the following number of cases	11	18

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**Professional Staff**

Pay Range		INTERNAL AUDIT		EXTERNAL AUDIT	
		Positions	Class	Positions	Class
15	\$ 821	8	2	58	3
16	863	1	1	-0-	-0-
20	1048	41	5	348	7
21	1100	-0-	-0-	12	1
23	1213	1	1	-0-	-0-
24	1273	30	7	197	6
25	1337	-0-	-0-	29	2
26	1405	4	3	10	3
28	1548	4	3	19	3
31	1793	-0-	-0-	2	1
32	1900	1	1	-0-	-0-
34	2076	-0-	-0-	1	1

**Clerical Staff**

	Internal Audit	External Audit
Number of units with clerical staff assistance	7	9

**Ratio of Audit Staff**

Areas of Audit Coverage	8	6
Departmental Expenditure Budget	2	2
Ratio of Personnel in Department	1	-0-
Comments	4	9

**V. GENERAL QUESTIONS**

	Internal Audit	External Audit
1. Year audit office was established:		
Less than 2 years (1969-1970)	3	2
Between 3 and 5 years (1966-1968)	1	3
Between 6 and 10 years (1961-1965)	2	1
More than 10 years	8	12
Oldest Unit	1941	1879
	Public Works	Controller
2. Anticipated future changes during current fiscal year?		
Yes	10	4
No	7	10

3. Changes in number of auditors on staff?		
Yes	6	7
No	8	10
If yes, up or down and year:		
Up: Current Year	3	1
1971/72 Fiscal Year	5	2
(2 departments-internal-indicated increases for both years)		
Down: Current Year	-0-	-0-
1971/72 Fiscal Year	-0-	1
4. Have office operating manual?		
Yes	8	13
No	6	4
5. Audit plan prepared and approved?		
Yes	11	9
No	3	7
6. Written summary prepared at year end?		
Yes	10	9
No	4	7
7. Training office within department? <b>Total Departments</b>		
Yes	18	
No	6	
8. Would training office help develop training? <b>Total Departments</b>		
Yes	16	
No	N/A	
Not Certain	2	

**Appendix B MEM  
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*In line with this study' agencies, the following an actual, practicable, c onstrates the fact that c comprehensive internal*

*The original memorand are not reproduced he agency involved and se*

**To:** Director  
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**From:** Chief Inter.  
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**Subject:** Appraisal c  
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**Dated:** July 16, 197

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**State Controller**

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**Appendix B MEMORANDUM OF THE CHIEF INTERNAL  
AUDITOR OF THE DEPARTMENT OF WATER  
RESOURCES IN THE STATE OF CALIFORNIA**

*In line with this study's recommendations on internal auditing for state agencies, the following memorandum is presented here as illustration of an actual, practicable, comprehensive internal audit program. It also demonstrates the fact that comprehensive internal auditing theory can become comprehensive internal auditing practice.*

*The original memorandum had some attachments as an appendix which are not reproduced here, as they pertain to the internal affairs of the agency involved and serve no useful purpose here.*

**MEMORANDUM\***

**To:** Director  
Department of Water Resources  
State of California

**From:** Chief Internal Auditor  
Department of Water Resources

**Subject:** Appraisal of the Department of Water Resources Audit  
Function and the Audit Plan for the 1971/72 Fiscal Year

**Dated:** July 16, 1971

To meet the increasing demands for audit coverage within the Department, significant changes will have to be made in the manner in which the Internal Audit Office organized and the manner in which the audit function is carried out.

In developing an audit plan for the 1971/72 fiscal year, the audit function carried out by the various audit organizations that provide audit services for the Department was appraised. While there are many organizations auditing the Department of Water Resources records, my review was limited to those audit organizations that provide an audit service requested by the Department. I refer to the audit effort that is designed to protect the interests of the state and the Department of Water Resources. These organizations are the State Controller's Office, the Department of Finance Audits Division, the Contract Audit Unit in the Comptroller's office, and the Internal Audit Office.

**State Controller**

The State Controller's Office performs audits of expenditures incurred by local agencies under the Davis-Grunsky Program, the flood relief program, and the flood control program. The State Controller's Office conducts the audits upon request and sends copies of their audit reports to the Department for any action necessary. This arrangement with the State Controller's Office has permitted an audit function to be performed without additional audit staff on the Department of Water Resources payroll. These

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audit services are paid through the state pro rata administrative charges. I feel that no change should be made in this arrangement with the State Controller's Office.

#### **Audits, Division, Department of Finance**

The Audits Division has the assigned responsibility to audit all state agencies. They conduct fiscal compliance audits in examining the financial statements and the books and records of account for both the General Accounting Office and the Utility Accounting Office. These audits are performed as a matter of responsibility rather than requests by the Department of Water Resources. In the areas of audit that should be considered a service to the Department, the Audits Division covered the inter-agency agreement with the Division of Highways where funds were advanced to the Division of Highways for the right of way acquisition. They also covered [Federal Agency] records to insure that the state's share of expenditures are properly allocated. Within the Department, the Audits Division has spent considerable time in the construction contract area auditing progress payments, retentions, liquidated damages, and contractors' claims.

As pointed out in my memorandum of April 13, 1971 [to the Chief of Audits Division] relating to presentation to the executive staff, the Audits Division has reduced their audit coverage from approximately 20,000 man-hours, or over 10 man-years, to somewhat less than two man-years. The Audits Division does not anticipate resumption of their fiscal compliance audits, and at present, the audit is on contractors' claims.

With this change in the audit emphasis by the Department of Finance, the most significant area of audit void involves the audit of construction contracts. At least two more fiscal years of audit coverage in this area should be made.

With the dropoff in the number of construction contracts there is no longer a need for the 20,000 man-hours previously expended. I estimate that three man-years, in addition to the time spent by the Audits Division staff, is necessary in this area.

#### **Contract Audit Unit, Comptroller's Branch**

The audit responsibilities assigned to the Contract Audit Unit include the examination of contractor's records in connection with relocation agreements and force account change orders. This audit function was assigned to the Accounting Office because certain phases of the audit involved a preaudit of invoices from the contractors. The unit was also assigned the responsibility to examine the records of local agencies that have entered into cooperative agreements with the Department. Three positions were assigned to the unit until June 30, 1970. One position was deleted due to the reduction in workload. The audit effort expended by the unit has been concentrated on the audit of contractor's records on relocation agreements. Some dropoff of audit coverage was noted when the auditors were assigned to other line duties. No actual audits of local agencies' records involving cooperative agreements have been conducted to date.

The audit functions carried out by the Contract Audit Unit are an essential feature of the internal controls established within the Department.

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Significant amounts of funds are involved and the unit should not experience any dropoff in workload for at least two more full fiscal years.

The possibility of consolidating the Contract Audit Unit with the Internal Audit Office was discussed [with the Department Comptroller] earlier this year. In addition, an independent accounting firm has conducted an organizational review of the Comptroller's Branch. In their preliminary draft, they recommended that the Contract Audit Unit be moved into the Internal Audit Office. The organizational placement of the Contract Audit Unit in the Internal Audit Office provides an opportunity to meet the audit void caused by the reduction in the Audits Division audit effort. The Contract Audit staff can be used to fill the void in the coverage of construction contracts when the workload in the relocation agreement area drops off.

#### **Internal Audit Office**

The audit responsibilities assigned to the Internal Audit Office include coverage of all organizational units, departmental operations, accounting records, and other financial controls. Each year the Internal Audit Office develops an audit plan showing the areas where there is a need for audit coverage. This optimum need is matched with the existing staff and priorities are assigned to the most significant areas of audit work . . . The Internal Audit Office authorized positions have lagged behind the number of positions needed to meet the audit requirements. This means that many audit areas have been deferred from year to year. An upswing in the number of positions needed to fill the audit need was caused by the fact that new responsibilities and duties had been assigned to the Internal Audit Office. These responsibilities include additional work in computer controls, the need for expanded audit coverage because of delegating responsibilities to line units, such as equipment inventory and contract approval delegations. The consolidation of the Reclamation Board with the Department has placed additional responsibilities in the verification of rental revenues. The change in the Audits Division, Department of Finance audit emphasis has placed added responsibilities on the Internal Audit Office in the audits of fiscal compliance area and in the construction contract area. Exhibit A, Schedule 1, contains a summary of the different types of audits planned . . .

#### **Analysis of the Types of Audit Coverage and the Internal Audit Plan**

To portray the various types of audits conducted by the audit organizations, an analysis of the various types of examinations was made showing the audit organization performing the audit coverage . . .

The various types of audits performed are as follows:

- Organizational Audits
- Functional Audits
- Program Audits
- Accounting and Fiscal Compliance Audits
- Computer Systems and Programs
- Control Checks
- Special Assignments

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### **Organizational Audits**

... The organizational audits have been identified as covering those units in the headquarters location in Sacramento, and those units subject to audit in decentralized locations of the Department. In conducting an organizational audit, the objective of the audit is to determine how well the organization is performing selected activities. We also determine how well management and other controls are functioning.

To provide coverage with a minimum staff, organizational audits are scheduled once every two years . . . In the past years the ten mobile equipment shops were not covered by audit. The emphasis on the decentralized locations revealed that headquarters organizations had not been subjected to audit. While there is a certain degree of risk involved, I feel it is not essential to audit the various district organizations once every two years. In the audit pattern of conducting an audit in one year and conducting a follow-up audit in the next fiscal year, there should be adequate coverage in this area. Also, areas of fiscal responsibility, such as the revolving fund, purchasing, contracts, and others can be covered under our functional audits on an annual basis.

Because of the heavy audit interest in the field divisions, it was felt that it was essential that an audit of certain aspects of the headquarters operations of the Division of Operations and Maintenance should be conducted during this next fiscal year. Only the San Luis Field Division is scheduled in 1971/72. The Southern Field Division has not been audited, but was deferred until they are closer to being operational.

Because, in most cases, audits of the field location will be a repeat audit, it is felt that the audit hours for each of those scheduled could be reduced significantly without impairing the audit coverage.

### **Functional Audits**

Functional audits are those audits conducted with the objective of determining how well the Department as a whole is performing a certain function. Using statistical sampling or other sampling techniques, we have been able to identify problem areas or assure ourselves that procedures are being adequately handled.

Audit experience has shown that functional audits in many ways provide significant benefits to the Department in terms of improved procedures, cost reduction, and assurance that management controls are working.

The 1971/72 audit plan shows an increase in audit coverage on a functional basis. This will help reduce the number of areas of audit verification performed in the field organizational audits. This, in turn, will reduce the number of audit hours and will reduce audit office travel expenses.

Functional audits, for the most part, should be conducted each year to assure that controls do not deteriorate in an area of high risk or significant expenditures . . .

### **Program Audits**

... Program audits are those audits that are designed to determine how well a manager is administering his program. The audit goes into the management of the program, the reliability of records, and other financial aspects. No audit time is budgeted in the 1971/72 fiscal year (at the sug-

gestion of the assistant the programs receive a conference and that handled by the Program

### **Accounting, Fiscal Co**

Fiscal compliance au Department. This is pri data originate in operat was expended by the Internal Audit Office ir records of account for counting Offices. The will no longer conduct Audit Office has not c 1968/69. The examinac mine compliance with necessary from time to audit time would be bet include time in this are

Audit time in the va significant expenditure. effort for 1971/72 repres

To fill the void left by t Department of Finance, two years could be spen

### **Computer Systems and**

This is an area of incre Audit Office. In part, this bilities for the office to new systems. These add puter edits and controls .

One audit staff membe computer systems and pr support to each audit whe will participate in the aud for the computer, prepa statistical sampling from

The audit plan does r the numerous areas that is, in part, due to the fact number or area where ne the year.

### **Control Checks**

The various areas whe during the fiscal year are mated to cover these ar degree of risk or the sig small, part-time audits th power by providing short

gestion of the assistant director and the deputy director). It was felt that the programs receive a very thorough review at the time of the program conference and that any problems involving the programs could be handled by the Program Analysis Office.

#### **Accounting, Fiscal Compliance**

Fiscal compliance audits are spread fairly evenly throughout the entire Department. This is primarily because many supporting records and other data originate in operating units. At one time, the significant audit effort was expended by the Audits Division, Department of Finance, and the Internal Audit Office in reviewing the financial statements, books and records of account for both the General Accounting and the Utility Accounting Offices. The Department of Finance has indicated that they will no longer conduct this type of fiscal compliance audit. The Internal Audit Office has not conducted any type of audit in this area since 1968/69. The examination of the books and records of account to determine compliance with the State Administrative Manual requirements is necessary from time to time, but in terms of significance of audit benefit, audit time would be better spent in other areas. The audit plan does not include time in this area.

Audit time in the various areas... represents areas of high risk or significant expenditure. The estimated man-months for Internal Audit effort for 1971/72 represents a significant change in audit effort.

To fill the void left by the reduction in audit effort by the Audits Division, Department of Finance, it is estimated that 36 man-months for the next two years could be spent in the audit of construction contracts.

#### **Computer Systems and Programs**

This is an area of increased significance in the operation of the Internal Audit Office. In part, this is due to the assignment of additional responsibilities for the office to evaluate internal controls and audit trails in the new systems. These added responsibilities also call for monitoring computer edits and controls in existing systems.

One audit staff member will be designated as responsible to cover the computer systems and programs. This staff member will provide technical support to each audit where computer systems are used. The man assigned will participate in the audits in such areas as describing the audit programs for the computer, preparing computer Athena retrieval, and setting up statistical sampling from the computer systems.

The audit plan does not show any specific time budgeted for any of the numerous areas that we will be covering during the fiscal year. This is, in part, due to the fact that we are unable to determine at this time the number or area where new systems or programs will be developed during the year.

#### **Control Checks**

The various areas where identified control checks will be conducted during the fiscal year are shown... A total of three man-months is estimated to cover these areas. The areas were selected because of the degree of risk or the significance of expenditure. These audits will be small, part-time audits that will assist in the management of audit manpower by providing short audit assignments between major assignments.

It is expected that the tests will be conducted on a scheduled systematic basis throughout the year . . .

**Conclusions**

The study of the audit function within the Department of Water Resources and the development of the audit plan indicate that the duties and responsibilities of the Internal Audit Office are expanding at a time when the operations of the Department as a whole are decreasing. In view of the cutbacks in many areas of the Department, no additional audit positions should be requested in the budget for 1972/73 fiscal year. No reduction in the seven authorized positions should be made.

Assignments to the audit staff to carry out the 1971/72 fiscal year audit plan should be based on priority of greatest significance to management of the Department.

The possible consolidation of the Contract Audit Unit with the Internal Audit Office will provide an opportunity for a greater portion of the audit requirements to be met without an increase in the overall staff of the Department.

**Recommendation**

I recommend approval of the audit plan for the 1971/72 fiscal year as presented . . .

**Approved:**

Signed by \_\_\_\_\_  
Director

Date: Dated 8/18/71 \_\_\_\_\_

Attachments

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EXHIBIT I  
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**EXHIBIT A  
Schedule 1**

**Department of Water Resources  
Internal Audit Office**

**Summary of Types of Audits and Comparison with  
Authorized Internal Audit Staff  
1971/72 Audit Plan**

<b>REFERENCE EXHIBIT B SCHEDULE</b>	<b>Man-Months</b>	<b>Man-Months</b>	<b>Man-Months</b>
1 Organizational Audits	16	24	22
2 Functional Audits	33	19	27
3 Program Audits	-0-	-0-	-0-
4 Accounting, Fiscal Compliance	30	22	30
4 (Construction Contracts)	36	36	24
5 Computer Systems and Programs	12	12	12
6 Control Checks	3	3	3
7 Operation of Internal Audit Office	24	24	24
7 Consultation and Follow-up	6	6	6
7 Special Assignments	4	4	4
<b>Total Man-Months</b>	<b>164</b>	<b>150</b>	<b>152</b>

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EXHIBIT A  
Schedule 2

Department of Water Resources  
Internal Audit Office  
Analysis of Planned Assignments for  
Authorized Staff  
1971/72 Audit Plan

	Man-Months	
	Estimated 1971/72	Authorized Staff
Organizational Audits	16	16
Functional Audits	33	15
Program Audits	-0-	-0-
Accounting, Fiscal Compliance	30	22
Construction Contracts	36	-0-
Computer Systems and Programs	12	6
Control Checks	3	3
Operation of Internal Audit Office	24	18
Consultation and Follow-Up	6	4
Special Assignments	4	-0-
Man-Months	164	84
Man-Years	13.75	7.0

Appendix C

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**Article II — Sta**

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**Appendix C BYLAWS OF THE CALIFORNIA ASSOCIATION  
OF AUDITORS FOR MANAGEMENT**

**BYLAWS**

**Article I — Name**

The name of this organization is CALIFORNIA ASSOCIATION OF AUDITORS FOR MANAGEMENT.

**Article II — Statement of Objectives**

A. The California Association of Auditors for Management seeks to promote better management auditing as an integral part of management through expansion of audit capability. To achieve this goal, the Association has as its objectives:

1. Promote the understanding and use of management audit services by management.
2. Provide training in management auditing techniques.
3. Promote coordination of management audit effort.
4. Provide a forum for exchange of management audit experience, information, and ideas.
5. Provide counseling service to members and groups in the area of professional placement.

**Article III — Membership**

Membership shall be extended to all heads of audit units serving as audit managers or their designees interested in participating in the development of management auditing within the State of California government. The audit managers included in the membership shall serve as the Executive Board responsible for directing the activities of the California Association of Auditors for Management. All auditors employed by the State of California may participate in Association activities such as workshops and training sessions when nominated by their unit head.

- A. Audit managers, or their designees, interested in participating in management auditing activities, shall submit an application containing their name and audit affiliation.
- B. Applications for membership will be acted upon at the next regular meeting of the Executive Board.

**Article IV — Meetings**

Executive Board meetings will be held monthly, or more often as needed. The monthly meetings will ordinarily be held on the fourth Friday for a period of two hours.

Prior notification of the exact time, location, and proposed agenda of the meeting will be mailed to all Board members.

The format of the meetings will follow Robert's Rules of Order.

The meetings will be held in Sacramento, California, unless changed by the Executive Board.

The meetings will be open to the public and to guests invited by the Board members.



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