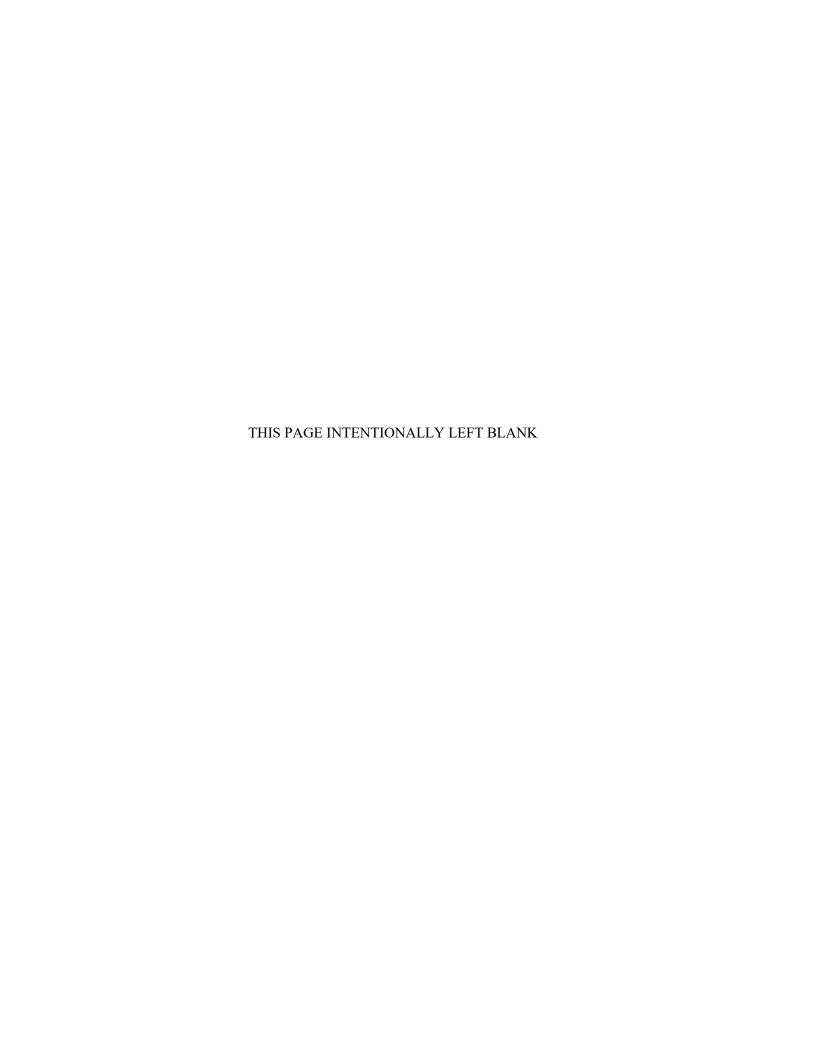# NORTH CAROLINA OFFICE OF STATE BUDGET AND MANAGEMENT

EXTERNAL QUALITY
ASSURANCE REVIEW
of the
CENTRAL INTERNAL AUDIT OFFICE

April 14, 2023

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April 14, 2023

Nels Roseland, State Controller/Council of Internal Auditing Chair
Kristin Walker, State Budget Director
Barbara Baldwin, Internal Auditing Director
Office of State Budget and Management, Raleigh, NC

Greetings:

We have completed the External Quality Assessment (Assessment) of the Office of State Budget and Management's (OSBM) Central Internal Audit Office (CIAO) as required every five years by the Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing (Standards). The objectives of the Assessment were to:

1. Assess conformance with the mandatory requirements of the Standards and Code of Ethics;
2. Assess Internal Audit's effectiveness in carrying out its mission; and
3. Identify opportunities for improving the Internal Audit function at the Agency.

Overall, it is our opinion that OSBM's CIAO **<u>Generally Conforms</u>** to the Standards. Within this report, we have noted opportunities for improvement that will enhance Internal Audit's conformance to the Standards and improve its overall effectiveness in carrying out its mission.

We appreciate the courtesy and cooperation extended to the assessment team by OSBM's personnel. We will be pleased to respond to further questions concerning this report and to furnish any desired information.

David K. Barkhau

David Barkhau, CPA
Internal Auditor
Department of Information Technology
Lead Reviewer

David King, CPA
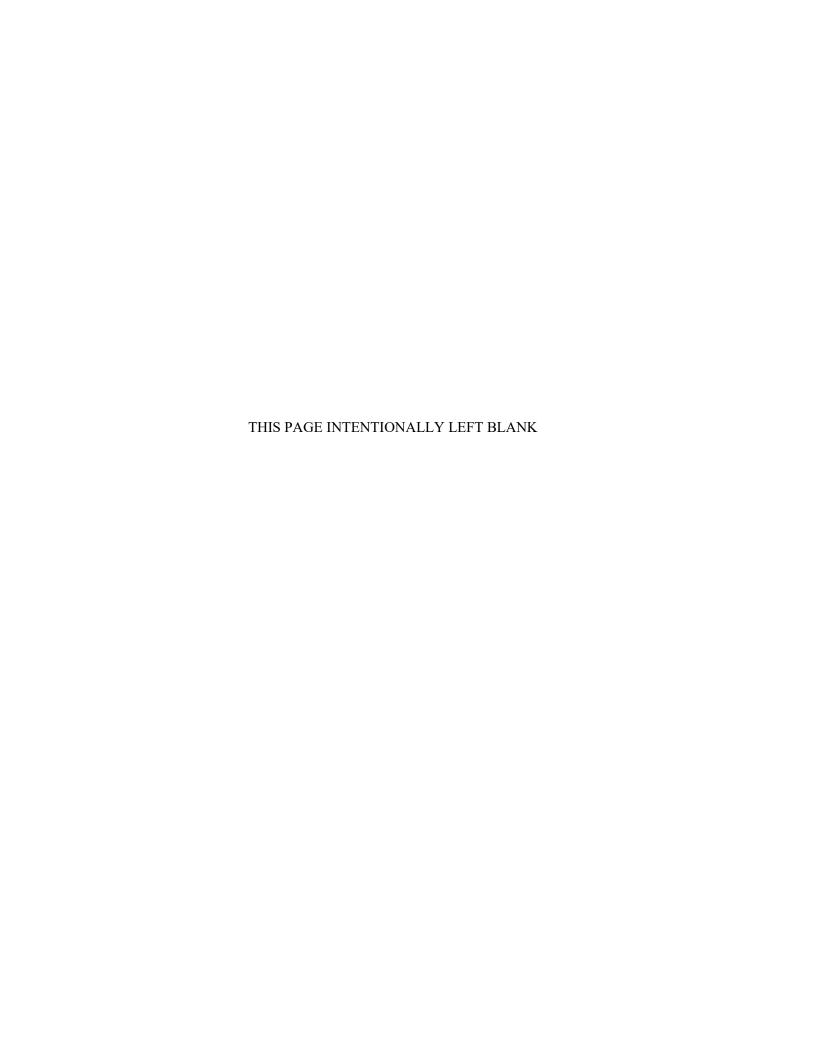Internal Audit Director
Community Colleges System Office
Team Member

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EXECUTIVE SUMMARY

The International Standards for the Professional Practice of Internal Auditing requires that an external quality assessment of an internal audit activity must be conducted at least once every five years by a qualified, independent assessor or assessment team from outside the organization. The qualified assessor or assessment team must demonstrate competence in both the professional practice of internal auditing and the quality assessment process. The quality assessment can be accomplished through a full external assessment or a self-assessment with independent validation.

The OSBM CIAO Internal Audit Director (Director) discussed the form and frequency of the quality assessment, as well as the independence and qualifications of the external assessor or assessment team, including any potential conflicts of interest with the appropriate oversight. David Barkhau, CPA and David King, CPA were selected as the qualified assessors to conduct a full external assessment of the internal audit division (IA).

The OSBM CIAO serves as the IA function of the Council of Internal Audit (Council). The Council was created in response to the Internal Audit Act of 2007. The Internal Audit Act,§ 143-175 requires that all state agencies having operating funds exceeding ten million dollars and having more than one hundred full-time equivalent employees, or receiving and processing more than ten million dollars in cash in a fiscal year shall establish a program of internal auditing. Per §143-747, the Council of Internal Auditing will recommend staffing guidelines needed by each state agency; develop internal audit guides; administer an independent peer review program for each state agency's internal audit activity; provide central training sessions, and administer a program for sharing internal auditors among State agencies needing temporary assistance.

In addition to supporting the Council, OSBM's CIAO also has the responsibility of supporting the following organizations by providing governance, risk management, and internal control audit services to assist each in achieving stated goals and objectives:
- Commission of Banks;
- Office of the State Auditor;
- Office of the Governor;
- Office of State Budget and Management; and
- Office of State Human Resources.

Opinion as to Conformance with the Standards

It is our overall opinion that OSBM's CIAO **_Generally Conforms_** to the Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing (Standards). Please see Attachment A.

The IIA's *Quality Assessment Manual for the Internal Audit Activity* suggests a scale of three rankings when opining on the internal audit function: "Generally Conforms," "Partially Conforms," and "Does Not Conform." The ranking of "Generally Conforms" means that an IA has a charter, policies, and processes that are judged to be in conformance with the *Standards* and the Code of Ethics. "Partially Conforms" means that deficiencies in practice are noted and are judged to deviate from the *Standards* and the Code of Ethics; however, these deficiencies did not preclude the IA from performing its responsibilities in an acceptable manner. "Does Not Conform" means that deficiencies in practice are judged to deviate from the *Standards* and the Code of Ethics, and are significant enough to seriously impair or preclude the IA from performing adequately in all or in significant areas of its responsibilities. A detailed description of conformance criteria can be found in attachment A.

Objectives

The principal objectives of the Quality Assessment (QA) were to:

- Assess CIAO's conformance with the *Standards* and the Code of Ethics.
- Evaluate CIAO's effectiveness in carrying out its mission (as set forth in the internal audit charter and expressed in the expectations of management);
- Identify successful internal audit practices demonstrated by CIAO; and
- Identify opportunities for continuous improvement to enhance the efficiency and effectiveness of the infrastructure, processes, and the value to CIAO stakeholders.

Scope and Methodology

As part of the preparation for the QA, the Internal Audit Director (Director) prepared documents with detailed information and sent surveys to a representative sample of the CIAO's key stakeholders. A summary of the survey results (without identifying the individual survey respondents) has been furnished to the Director. Prior to commencement of the onsite work by the peer review team, the team lead worked with the Director to gather additional background information related to the IA governance, staff management and process. During the onsite fieldwork, extensive interviews were conducted with stakeholders and IA staff. We also reviewed IA's risk assessment and audit planning processes, audit tools and methodologies, engagements and staff management processes, and a representative sample of IA's working papers and reports.

Summary of Observations

The IA environment where the external assessment was performed is well structured and progressive, where the *Standards* are understood, the Code of Ethics is being applied, and management endeavors to implement appropriate practices. Consequently, comments and recommendations are intended to build on this foundation already in place.

Observations are divided into three categories:

- **Successful Internal Audit Practices** – Areas where IA is operating in a particularly effective or efficient manner when compared to the practice of internal auditing demonstrated in other internal audit functions. Successful internal audit practices identified during this QA are summarized and detailed in the following section(s) of this report:
    - o Standard 1210 – Experienced Staff with Diverse Skill Sets – The IA staff has experience and diverse skill sets allowing the internal audit function to provide value in a wide range of areas.
    - o Standard 2000 – Adding Value to the Organization – Results from engagements, interviews, and surveys confirmed that IA is adding value to the organizations it serves.
    - o Standard 2100 – Trusted Advisor & Valued Partner – Internal audit is considered a valued partner and a trusted advisor whose input is sought by the organizations it serves.

- **Gaps to Conformance with the *Standards* or the Code of Ethics** – Areas identified during the QA where the assessment team has concluded that IA is operating in a manner that falls short of achieving one or more major objectives, with the *Standards* or the Code of Ethics that results in an opinion for an individual standard of "partially conforms" or "does not conform." These items will include recommendations offered by the external assessment team for actions to be implemented for achieving "generally in conformance" with the standard and will include an IA response and an action plan to address the gap.
    - o No conformance gaps identified.

- **Opportunities for Continuous Improvement –** Observations of opportunities to enhance the efficiency or effectiveness of IA's infrastructure of processes. These items do not indicate a lack of conformance with the *Standards* or the Code of Ethics, but rather offer suggestions on how to better align with criteria defined in the *Standards* or the Code of Ethics. They may also be operational ideas based on the experiences of the external assessment team from working with other internal audit activities. A management response and an action plan to address each opportunity for continuous improvement noted are normally included. Opportunities for continuous improvement identified during this QA are summarized and detailed in the following section(s) of this report:
    - o Standard 1220.A2 – Continue Implementing Technology-Based Audit Tools – continue implementing tools to help drive efficiency and innovation within the internal audit function.
    - o Standard 2210.A1 – Enhance Engagement Risk Assessment Workpapers – enhance engagement risk assessment workpapers by connecting engagement objectives to identified risks.

DETAILED OBSERVATIONS

SUCCESSFUL INTERNAL AUDIT PRACTICES

1. **Experienced Staff with Diverse Skill Sets**
   <u>Standard 1210 – Proficiency</u> states, *"Internal auditors must possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively must possess or obtain the knowledge, skills, and their competencies to perform its responsibilities."*

   Internal audit has developed an experienced staff with a diverse set of skills and certifications. The function has four members who have been together for several years. This core group holds CPA, CIA, CFE, and CISA certifications. Additional staff come from a diverse set of academic and professional backgrounds. This diversity allows the function to participate in a variety of engagements and to be agile in providing services to the organizations it serves.

2. **Adding Value to the Organization**
   <u>Standard 2000 – Managing the Internal Audit Activity</u> states, "*The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization.*"

   The internal audit function has 94% of its recommendations accepted by management. FY 2022 data shows the department met its goal of ten-to-one cost-savings compared to IA operating costs. Interviews and surveys with clients and managers consistently show organizations feel internal audit is adding value.

3. **Trusted Advisor & Valued Partner**
   <u>Standard 2100 – Nature of Work</u> states, *"The internal audit activity must evaluate and contribute to the improvement of the organization's governance, risk management, and control processes using a systematic, disciplined, and risk-based approach. Internal audit credibility and value are enhanced when auditors are proactive and their evaluations offer new insights and consider future impact."*

   The Central Internal Audit Office (CIAO) is viewed as a supportive trusted advisor and valued partner to the organizations it serves and not as a reactionary or punitive watchdog function. Administrators clearly recognize the importance of the internal audit function and see internal audit as a valued resource. The CIAO has made substantial investments in customer communications and fosters an image of helpfulness and accessibility through their day-to-day operations. Customers share a very positive view of the CIAO as noted in the surveys and interviews conducted during this review. During FY 2022, 40 engagements were completed based upon requests from management. The internal audit function provided an additional 350 hours of technical assistance during FY 2022.

Feedback from the interviews and surveys with senior management and external clients indicated a high level of satisfaction with the results of the engagements.

GAPS TO CONFORMANCE WITH THE *STANDARDS* OR CODE OF ETHICS

1. No areas were identified during the QA where the assessment team concluded the CIAO is operating in a manner that falls short of achieving one or more major objectives with the *Standards* or the Code of Ethics that results in an opinion for an individual standard of "partially conforms" or "does not conform."

OPPORTUNITIES FOR CONTINUOUS IMPROVEMENT

1. **Continue Implementing Technology-Based Audit Tools**
    <u>Standard 1220.A2 – Due Professional Care</u> states, *"In exercising due professional care internal auditors must consider the use of technology-based audit and other data analysis techniques."*

    The CIAO has taken significant steps within the last few years to build a data analytics program, which has demonstrated effective results and efficiency gains within the internal audit function. However, it's important to note that implementing technology such as data analysis and audit tools is not a one-time event but rather an ongoing process that requires continuous monitoring and improvement. Auditing tools come in many forms, including software, applications, and other technologies that can be used to gather and analyze data to identify potential areas of risk and inefficiency.

    Auditing tools are essential for ensuring the integrity and efficiency of an organization's operations. They allow auditors to gather and analyze large amounts of data quickly and accurately, and to identify potential risks and areas for improvement that might otherwise go unnoticed.

    Here are some of the ways that technology-based auditing tools are commonly used:

    -   Risk Assessment: Assessing the level of risk associated with different business processes, systems, and transactions. This can help auditors prioritize their work and focus on areas that are most vulnerable to fraud, errors, or other types of problems.

    -   Data Analysis: Analyzing large amounts of data to identify patterns and anomalies that may indicate potential issues or risks. For example, auditors may use data analytics tools to detect unusual spending patterns or unauthorized access to sensitive data.

    -   Compliance Monitoring: Evaluating compliance with laws, regulations, and internal policies. For example, auditors may use tools to ensure that financial statements are accurate and

comply with accounting standards, or to verify that employee payroll records are accurate and comply with labor laws.

- Process Improvement: Identifying areas of inefficiency or waste in business processes, and to suggest ways to improve those processes. For example, auditors may use tools to analyze the flow of goods or services through a company's supply chain, or to identify ways to streamline internal processes to reduce costs and improve productivity.

Recommendation: The CIAO should continue implementing technology-based audit tools to help drive efficiency & innovation within the internal audit function.

Management Response:

The CIAO will continue to identify ways to improve efficiency and innovation through the use of automated tools. Currently, under development is automating the processes to calculate the CIAO's key performance indicators at year end.

2. **Enhance Engagement Risk Assessment Workpapers**
   Standard 2210.A1 – Engagement Objectives states, *"Internal auditors must conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives must reflect the results of this assessment."*

   Risk assessments and audit objectives are closely related, as the primary purpose of a risk assessment is to ensure that the audit process is focused on areas of greatest risk and that audit objectives are effectively achieved. Therefore, connecting audit objectives to risk assessments is essential to ensure efforts are focused on areas of greatest risk.

   The CIAO utilizes a risk-based auditing approach where engagement objectives and testing procedures are designed based on an assessment of the risks associated with the organization's operations. However, engagement-level risk assessment workpapers do not document how engagement audit objectives and testing procedures are directly connected with identified risks. An opportunity exists to better document this connection and demonstrate how risks are tied to engagement objectives.

   Recommendation: The CIAO should consider enhancing engagement risk assessment workpapers by connecting engagement audit objectives to identified engagement risks. By identifying and evaluating risks, and linking them to the relevant audit objectives, the CIAO can ensure their efforts are focused on areas of greatest risk and provide relevant and reliable assurance.

Management Response:

The CIAO will improve documentation surrounding the use of the engagement risk template.

ATTACHMENT A: Evaluation Summary and Rating Definitions

	GC	PC	DNC
OVERALL EVALUATION:	X		

IIA Code of Ethics	GC	PC	DNC
Code of Ethics	X		

Attribute Standard (1000 – 1300)	GC	PC	DNC
1000 **Purpose, Authority, and Responsibility**	X		
1010 Recognition of the Definition of Internal Auditing	X		
1100 **Independence and Objectivity**	X		
1110 Organizational Independence	X		
1111 Direct Interaction with the Board	X		
1112 Chief Audit Executive Roles Beyond Internal Auditing	X		
1120 Individual Objectivity	X		
1130 Impairments to Independence or Objectivity	X		
1200 **Proficiency and Due Professional Care**	X		
1210 Proficiency	X		
1220 Due Professional Care	X		
1230 Continuing Professional Development	X		
1300 **Quality Assurance and Improvement Program**	X		
1310 Requirements of the Quality Assurance and Improvement Program	X		
1311 Internal Assessments	X		
1312 External Assessments	X		
1320 Reporting on the Quality Assurance and Improvement Program	X		
1321 Use of "Conforms with the *International Standards for the Professional Practice of Internal Auditing*"	X		
1322 Disclosure of Nonconformance	X		

Performance Standards (2000- 2600)	GC	PC	DNC
2000	**Managing the Internal Audit Activity**	X		
2010	Planning	X		
2020	Communication and Approval	X		
2030	Resource Management	X		
2040	Policies and Procedures	X		
2050	Coordination	X		
2060	Reporting to Senior Management and the Board	X		
2070	External Service Provider and Organizational Responsibility for IA	X		
2100	**Nature of Work**	X		
2110	Governance	X		
2120	Risk Management	X		
2130	Control	X		
2200	**Engagement Planning**	X		
2201	Planning Considerations	X		
2210	Engagement Objectives	X		
2220	Engagement Scope	X		
2230	Engagement Resource Allocation	X		
2240	Engagement Work Program	X		
2300	**Performing the Engagement**	X		
2310	Identifying Information	X		
2320	Analysis and Evaluation	X		
2330	Documenting Information	X		
2340	Engagement Supervision	X		
2400	**Communicating Results**	X		
2410	Criteria for Communicating	X		
2420	Quality of Communications	X		
2421	Errors and Omissions	X		
2430	Use of "Conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*"	X		
2431	Engagement Disclosure of Nonconformance	X		
2440	Disseminating Results	X		
2450	Overall Opinions	X		
2500	**Monitoring Progress**	X		
2600	**Communicating the Acceptance of Risks**	X		

Rating Definitions

GC – "Generally Conforms" means that the assessor or the assessment team has concluded that the relevant structures, policies, and procedures of the activity, as well as the processes by which they are applied, comply with the requirements of the <u>individual</u> standard or elements of the Code of Ethics in all material respects. For the <u>sections</u> and <u>major categories</u>, this means that there is general conformity to a majority of the individual Standard or element of the Code of Ethics and at least partial conformity to the others within the section/category. There may be significant opportunities for improvement, but these should not represent situations where the activity has not implemented the *Standards* or the Code of Ethics, and has not applied them effectively or achieved their stated objectives. As indicated above, general conformance does not require complete or perfect conformance, the ideal situation, or successful practice, etc.

PC – "Partially Conforms" means that the assessor or assessment team has concluded that the activity is making good-faith efforts to comply with the requirements of the <u>individual</u> standard or elements of the Code of Ethics or a <u>section</u> or <u>major category</u>, but falls short of achieving some major objectives. These will usually represent significant opportunities for improvement in effectively applying the *Standards* or the Code of Ethics and/or achieving their objectives. Some deficiencies may be beyond the control of the internal audit activity and may result in recommendations to senior management or the board of the organization.

DNC – "Does Not Conform" means that the assessor or assessment team has concluded that the internal audit activity is not aware of, is not making good-faith efforts to comply with, or is failing to achieve many or all of the objectives of the <u>individual</u> standard or element of the Code of Ethics or a <u>section</u> or <u>major category</u>. These deficiencies will usually have a significantly negative impact on the internal audit activity's effectiveness and its potential to add value to the organization. These may also represent significant opportunities for improvement, including actions by senior management or the board.