

Approved: 1/31/95
Date

MINUTES OF THE SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION

The meeting was called to order by Chairperson Al Ramirez at 1:30 p.m. on January 17, 1995 in Room 531-N- of the Capitol.

All members were present except: Senator Vidricksen - Excused

Committee staff present: Julian Efird, Legislative Research Department
Fred Carman, Revisor of Statutes
Jacqueline Breymeyer, Committee Secretary

Conferees appearing before the committee: Nicholas Kramer, Internal Audit Manager,
Kansas Department of Revenue

Others attending: See attached list

Chairman Ramirez called the meeting to order at 1:35 p.m. He introduced the new Vice Chairperson, Marian Reynolds, who replaces Senator Bogina. The new committee member is Senator Don Steffes.

The Chairman introduced Nicholas Kramer, Internal Audit Manager, Kansas Department of Revenue, who was present to give the presentation on Internal Audit from Reinventing Kansas Government Phase II.

Mr. Kramer introduced team members Randy Tongier, Legislative Post Audit; Rita Barnard, SRS Internal Audit; and Gene Robben, Department of Transportation, Office of Inspector General. Rolando Mayans, Bank IV, has taken a position in Minnesota.

Mr. Kramer began with the project overview and spoke of the difference between internal auditing and external auditing. He gave a walk-through of the audit report, directing the committee to the various pages as he went along.

Mr. Kramer stated that the team was proud to report that the Quick Hit Initiative, The Kansas State Internal Auditors Forum, has already been accomplished.

Mr. Kramer expounded on the three major initiatives - The Governor's Executive Order, Enhancing EDP Audit Capabilities, and Establishing More Stringent Educational and Experience Requirements.

In conclusion, Mr. Kramer stated that the Internal Audit team found the project to be very worthwhile. They stand ready to assist in making state government more responsive and efficient.

Mr. Kramer had copies of his presentation distributed. (Attachment 1)

Several questions relating to internal audit procedures were asked of Mr. Kramer. He was asked if the former governor had signed an Executive Order relating to this phase of the project. It was determined that the former governor had not signed an executive order.

After a few further comments, the meeting was adjourned.

The next meeting is scheduled for January 18, 1995.

For: Senate Committee on Government Organization
Chairman: Senator Ramirez
From: Nicholas Kramer, Internal Audit Mgr., Ks Dept of Revenue
Subject: Reinventing Kansas Government - Internal Audit
Date: January 17, 1994

Thank you, Mr. Chairman, members of the committee. On behalf of the Reinventing Kansas Government - Internal Audit team, I would like to express our appreciation for the opportunity to visit with you about internal auditing in Kansas State Government today. First, permit me to introduce the team members:

Randy Tongier, Legislative Post Audit
Rita Barnard, SRS Internal Audit
Gene Robben, Department of Transportation, Office of Inspector General.
Rolando Mayans, Bank IV, has taken a position in Minnesota.

My presentation is structured to accomplish three goals:

- to provide some background for the committee regarding the mission of internal auditors in state government
- to briefly highlight some of the testwork and information included in our report
- to discuss the findings and recommendations contained therein.

Project Overview

It is important to distinguish between *internal auditing* and *external auditing*. The purpose of external auditing is primarily to express an opinion on the organization's financial statements. For example, the State of Kansas enters into a contract with an accounting firm to examine its books, as a whole, to determine whether the financial statements present fairly the revenues, expenses, and fund balances for the State's combined financial statements. To accomplish this, the external auditors use a variety of substantive tests and will review financial controls over those transactions which could have a material impact on the financial statements.

Internal auditors on the other hand, work *within* an organization and perform a much wider range of functions.

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1 *Attachment 1*

Our work is performed to determine whether --

- acceptable policies and procedures are followed,
- established standards are met,
- resources are used efficiently and effectively,
- and the agency's objectives are being achieved.

This definition embraces both opportunities and responsibilities. It elevates the internal auditor's sights, and it demands a management-oriented approach to audit appraisals.

Almost every private enterprise employs an internal audit staff for the same reasons that state government agencies employ them to --

- reduce the costs of operations,
- enhance productivity,
- improve efficiency,
- and streamline processes.

As internal auditors in the executive branch of state government, we review processes in our respective agencies each day to identify potential improvements which will allow us to better serve the citizens of Kansas. Instead of imposing additional controls or paperwork, we spend more time eliminating redundant procedures which increase cost and do not foster an entrepreneurial spirit among employees.

At the state and federal level, there are constant calls for eliminating bureaucracy and streamlining systems. The taxpaying public no longer wants to pay for programs that are overburdened with red tape and don't produce desired results. Internal auditors in government are uniquely positioned and possess the requisite knowledge and skills to evaluate programs and processes.

Walk-Through of the Audit Report

Now lets' discuss existing internal audit operations in the Executive Branch and the results of our study by taking a brief walk-through of the report.

Beginning on page 5, we list the benefits obtained through internal auditing, and on page 6 we list some of the typical testwork that we conduct.

Pages 6 and 7 show the different types of audits, although it is common to combine several objectives in one integrated audit. Cost reduction is always a concern. The box on page 7 shows just one example of how cost reduction can be achieved through an internal audit.

On page 9, we summarize our survey of state agencies that have an internal audit staff. The agency heads were unanimous in their opinion that internal auditing was useful to the agency, contributes to the overall agency mission, and that they personally use the results of audits in their decision-making process.

On page 12, we summarize the results from our survey of other states. Detailed survey information is presented in Appendix F. We asked the other states whether any used or considered a centralized approach, where all of the state's internal auditors would be housed under one agency. No other state, to our knowledge, is using this approach, although the State of Arizona has tried and abandoned this idea. Clearly, to provide effective service, internal auditors must report directly to the agency heads. We believe that the value of our audits increases over time, as we gain expertise in the specific functions that our agencies perform, whether it is building roads or issuing driver licenses.

Some states have enacted legislation that requires the establishment of internal audit units in large state agencies. Kansas does not have such legislation.

We also surveyed five companies in Topeka that employ internal auditors. On page 15, and again in Appendix G, we summarize the results of this survey. In talking with our counterparts, we learned that our processes, our methods, and our objectives are similar. We follow the same professional guidelines and we experience similar problems. Using these audit departments as a benchmark, we believe we are on the right track.

In contrast, however, the private companies tend to employ larger staffs, require their auditors to have more education, require their audit directors to hold professional certifications, report to higher levels of the organization, and include EDP auditors on their staffs.

On page 17, we list the key elements of our vision for the future, and on page 18 we show what internal auditors must do to accomplish this vision. On page 19, we list our ideas for what agency managers and elected officials can do to help us achieve our vision of providing greater service through internal auditing.

On page 21, we list our recommendations, which include a Quick Hit Initiative and 3 other Major Initiatives. Let's spend some time talking about these recommendations.

Quick Hit Initiative - The Kansas State Internal Auditors Forum

We are proud to report that our Quick Hit Initiative, true to its description, has already been accomplished. We have established the Kansas State Internal Audit Forum for the sharing of best practices. We soon will hold our second meeting,

As internal auditors, we share the same mission: to contain costs and help our agencies to become more effective and efficient. But many agencies have only one internal auditor. In many cases, it is not cost effective to provide training and to meet continuing education requirements for one or two auditors. We endeavor to help these auditors through a networking framework and through pooling our resources to provide training in new techniques used in such areas as fraud auditing, white-collar productivity analysis, performance measurement, and activity based costing.

By having all state internal auditors meet routinely, the Internal Auditors Forum will continue the RKG effort by continual review of internal audit functions and through sharing of best practices.

Major Initiative One - The Governor's Executive Order

Initiative Number 1 recommends that the Governor issue an Executive Order containing 5 subparts. I'll cover each of these subparts individually.

Subpart A directs that the mission of the internal audit functions be more clearly defined. Our survey of internal audit directors in state government agencies, noted in Appendix E reflects that the agency internal audit groups operate under rules and guidelines established by the audit director and the agency itself. An internal audit charter

should be adopted to define the authority, accountability, and responsibility of the internal audit group in a more uniform and consistent manner across state agencies. The Institute of Internal Auditors has model charters that can be modified for state agency purposes.

Subpart B. provides for a proper reporting structure. Our survey shows that audit directors currently report to various levels of management within their respective agencies, as shown again in Appendix E. To ensure the auditors' independence and that audit recommendations are implemented, the internal audit director and the unit should report directly to the agency head. This auditing standard is dictated by Generally Accepted Auditing Standards and by the Institute of Internal Auditors. Private sector internal audit groups always report to the company president or an audit committee of the board of directors.

Subpart C calls for the creation of a Governor's Central Audit Group to assist agencies lacking an internal audit function. This central audit group would also serve to complement existing internal audit groups. Our study notes that there is a significant exposure in numerous executive branch agencies that is not being addressed on a current basis. The state's contracted external audit does little to address risks in these agencies.

As you can see, not all agencies have internal audit coverage. We are concerned that significant exposures are not being addressed at these agencies; procedures are not being reviewed, systems are not being evaluated, potential cost savings are not being discovered, and fraud may be going undetected.

At the bottom of the page, note the agencies that have large budgets, large staff sizes, and key responsibilities which have no internal audit coverage. Seven of these agencies have budgets exceeding \$30 million.

Smaller agencies that cannot use a full-time internal auditor would be able to use the services of the Governor's central audit group. Operating functions or processes that cross agency boundaries, such as purchasing, could also be reviewed by this group.

Subpart D establishes a Governor's Audit Committee to provide oversight and direction of audits conducted by the central audit group. As previously noted, private sector companies use audit committees to a large degree. The committee's duties would include assisting in evaluating audit risks in agencies that do not have internal auditors, approving the audit plan of the central audit group and reviewing the audit group's audit reports.

Subpart E directs the audit committee to recommend which additional state agencies should create internal audit groups. The IIA model legislation contains suggested criteria to use in determining which agencies should have internal audit groups.

Major Initiative Two - Enhancing EDP Audit Capabilities

Initiative Number 2 outlines our recommendation for enhancing EDP, electronic data processing, audit capabilities.

As you know, most of the processing of vital information in state government is accomplished using the computer. Many of the controls in a system are embedded in the computer applications, in the program logic as written by the programmer/analysts. To assess these controls, we need to employ specialized internal auditing skills.

Let me describe how EDP auditors help address specific concerns related to the widespread use of computers in the 1990's.

Safeguarding assets. The computer hardware is an expensive asset that we should safeguard. EDP auditors make recommendations to limit access to the computer room to only authorized state employees. What provisions are there to provide state services like tax refunds and driver licenses when we have lost the functionality of the computer?

Accuracy and reliability of management information. How do we know the printouts that our computers produce are accurate? When we look at a printout that says distribute \$50,000 of sales tax to Shawnee County, how do we know that the amount is correct? Without an effective EDP audit program, we really don't know.

Promoting Operational Efficiency. The first thing that comes to mind in the area of operational efficiency is the design and installation of new computer systems. Some systems have been developed and installed very successfully, but who would argue that improvement isn't necessary? We can list countless program acronyms, KBITS, KFIS, CAMA, CAESCES -- systems put in place by various state agencies which have been cited by Legislative Post Audit for having implementation problems. Common problems are that projects are not adequately planned, contracts with vendors are unclear and unenforceable, costs are underestimated, and problems are not discovered until it's too late.

Yet, the state has never hired and assigned an individual with EDP audit expertise to work on these projects. Almost all private companies of any size that rely heavily on the computer, as the state does, choose to mitigate the risks inherent in using computers by hiring EDP auditors. Recall from page 14 that 22% of the internal audit work performed in the private enterprises we surveyed is devoted to EDP considerations. Every private company surveyed, as shown on page 49, has an EDP audit function.

The costly problems in system development that the state has experienced are exactly the problems that EDP auditors are trained to address. If we're spending millions of dollars on new systems, shouldn't we spend 1% of cost of these projects to ensure that the other 99% is spent wisely and that the system delivers what it is designed to accomplish?

Private companies focus on the bottom line. They employ EDP auditors because it is cheaper in the long run to avoid the problems the State has experienced and stop spending money on systems that don't work. I'm happy to report that the Department of Revenue has recognized this need and has hired the State's first EDP auditor. Her primary responsibility will be to evaluate and lend her expertise to the Department's reengineering effort which will initiate this spring.

Major Initiative Three - Establishing More Stringent Educational and Experience Requirements

Our final initiative, presented on page 30, is that the State establish more stringent educational and experience requirements for internal audit positions.

To achieve our vision -- that is, making a significant contribution to ensuring that the citizens of Kansas receive the maximum benefits and services paid for by their tax dollars -- we see a need for internal auditors with a skill level significantly higher than that contemplated by current applicable personnel classifications.

Currently, the state's internal auditors are classified together with other state auditors, such as revenue auditors and school district auditors. We contend that the skill levels needed for those other state audit jobs are not always adequate to accomplish what we expect from the state's internal audit function. A higher skill level is needed, (1) because internal auditing is not routine and (2) because internal auditing involves rapidly evolving technology.

Again, internal auditing is not routine. For example, internal auditors are called upon to evaluate:

- Compliance with legal requirements.
- Efficiency of operations.
- Adequacy of accounting and control procedures.
- Special areas as directed by the agency head.

Second, internal auditing involves rapidly evolving technology, not only as something that has to be reviewed and tested by internal auditors, but also as a tool for the auditors to use in their work. In particular, knowledge of current developments in electronic data processing, as we alluded to in the previous initiative, is a key concern.

The higher skill level needed is acquired and demonstrated through education, experience, and professional certification. To address these specific areas of concern, we recommend on page 30 of our report that the state recognize the need for greater skills by establishing more stringent educational and experience requirements for internal audit positions. Our specific suggestions are consistent with the practices of the private sector internal audit operations that we reviewed: These practices are summarized in item number nine on page 51 of the report.

We would suggest a minimum requirement of a bachelor's degree in accounting, business administration, or public administration, with specific course work in auditing or evaluation. Current regulations qualify individuals holding **any** degree for the civil service list.

When hiring internal auditors, we are currently required to interview individuals from this list.

Further, we might suggest that prior experience in professional auditing would be much more relevant than other types of experience, such as general financial management or bookkeeping experience.

Finally, we suggest that directors of large internal audit staffs hold a professional certification.

Conclusion

To summarize, the Internal Audit team found the Reinventing Kansas Government project to be a very worthwhile study. We took away several important lessons. We learned that our focus, our methods, and our qualifications are comparable to that of our private sector counterparts. In short, we provide the same level of expertise and assistance to managers of our agencies as private industry internal auditors provide to their CEO's. The similarities far outweigh the differences. We now find that internal auditors and other state financial managers are frequently hired by private industry for their talent and expertise.

Make no mistake about it, internal auditing in a state government environment provides the same opportunities for improving operations that are provided in private enterprise. If anything, the public demand for responsive, efficient, well-run government institutions - and the commitment of elected officials to provide it for them - increases the demand for effective internal audit functions. To right-size government entails careful analysis, program review, and the design of processes that are effective without being costly, redundant, and burdensome on the public. Internal auditors support the call for improvement. We stand ready to assist you in this endeavor.

' This concludes my presentation. My colleagues and I will be happy to answer any questions that you may have.