

COUNCIL'S PEER REVIEW PROGRAM

EXTERNAL QUALITY ASSESSMENT

OF

**DEPARTMENT OF AGRICULTURE
AND CONSUMER SERVICES**

INTERNAL AUDIT FUNCTION

September 2017

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September 11, 2017

Commissioner Steve Troxler, Department of Agriculture and Consumer Services
Chief Deputy Commissioner David Smith, Department of Agriculture and Consumer Services
Derek Allred, Internal Audit Director, Department of Agriculture and Consumer Services

Greetings:

We have completed an External Quality Assessment (QA) of the Department of Agriculture and Consumer Services' Internal Audit Function as required every five years by the Institute of Internal Auditors (IIA) *International Standards for the Professional Practice of Internal Auditing (Standards)*. The objectives of the QA were:

1. To assess conformance with the mandatory requirements of the IIA *Standards*;
2. To assess the effectiveness of the Internal Audit activity in providing services to the management of the Department of Agriculture and Consumer Services; and
3. To identify opportunities for improving the Internal Audit Program at the Department of Agriculture and Consumer Services.

Overall, it is our opinion that the Department of Agriculture and Consumer Services' Internal Audit Function **Generally Conforms** to the IIA *Standards*, which is the highest rating. We noted opportunities for improvement that will enhance conformance with the *Standards* and improve the effectiveness of the Internal Audit Function. These are described in this report.



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EXECUTIVE SUMMARY

The *International Standards for the Professional Practice of Internal Auditing (Standards)* 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 Internal Audit 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. The Department of Agriculture and Consumer Services (DA&CS) requested Barbara Baldwin and Jordan Samuel as the qualified, independent external assessment team to conduct a full external assessment of the internal audit function (IA) of DA&CS.

The Department of Agriculture and Consumer Services is headed by the N.C. Board of Agriculture. The Commissioner of Agriculture chairs the Board. The DA&CS is responsible for providing services that promote and improve agriculture, agribusiness and forests; protect consumers and businesses and conserve farmland and natural resources for the prosperity of all North Carolinians. The DA&CS is a decentralized organization with staff located throughout the State. The IA function includes four positions, centrally located in Raleigh and the IA Director reports, both functionally and administratively, to the Chief Deputy Commissioner of Administration.

OPINION AS TO CONFORMANCE TO THE STANDARDS

It is our overall opinion that the DA&CS IA activity *Generally Conforms*. For a detailed list of conformance to individual *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 IA's conformance with the *Standards* and the Code of Ethics.
- Evaluate IA'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 IA; and

- Identify opportunities for continuous improvement to enhance the efficiency and effectiveness of the infrastructure, processes, and the value to their stakeholders.

SCOPE AND METHODOLOGY

As part of the preparation for the QA, the Internal Audit Director prepared documents with detailed information and sent surveys to DA&CS key stakeholders. A summary of the survey results (without identifying the individual survey respondent) has been furnished to DA&CS's Internal Audit Director. Prior to commencement of the onsite work by the peer review team on August 14, 2017, the team lead worked with the Internal Audit Director to gather additional background information related to IA governance, staff, management and processes. 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 provide useful audit tools and implement appropriate practices. Consequently, comments and recommendations are intended to build on this foundation already in place in IA.

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 below and detailed in the following section of this report:
 - Standard 2000 – Managing Internal Audit and Standard 2100 – Nature of Work: Enhancement within IA ensures proactive, value added services are provided to the Department.
 - Standard 2010 – Planning: The risk-based audit plan links to the agency strategic plan to ensure services will add value and improve the Department's operations.
 - Enhancements through Automation: The purchase of Active Data and Auto Audit has enhanced the efficiency and effectiveness of the audit process.
 - Practice Guide – Developing the Internal Audit Strategic Plan: Internal Audit developed a five-year strategic plan to establish goals and ensure achievement of those goals which the IIA highly recommends but is not mandatory.
- **Gaps to Conformance with the *Standards* or the Code of Ethics** – Areas identified during the QA where the assessment team 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. Gaps to conformance with the *Standards* or Code of Ethics identified during this QA are summarized below and detailed in the following section of this report:

- Standard 1100 – Independence or Objectivity: Enhance organizational independence through dual reporting.

● **Opportunities for Continuous Improvement** – Observations of opportunities to enhance the efficiency or effectiveness of IA’s infrastructure and/or 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 below and detailed in the following section of this report:

- Standard 2030 – Resource Management: Increase resources to improve risk coverage with the DA&CS.
- Communication Enhancement – Robust Website: Improve the internal audit website to enhance communication with DA&CS employees and the public.

DETAIL – SUCCESSFUL INTERNAL AUDIT PRACTICES

1. Value Added Services

Standard 2000 requires the effective management of internal audit to ensure it adds value to the Agency. Standard 2100 adds, internal audit’s value is enhanced when auditors are proactive and provide new insights and consider future impact.

Internal Audit has developed numerous processes to ensure value added services are provided to the agency. Some examples are:

- The “Voice of Customer Survey” is used at the beginning of each engagement seeking client input to ensure value added services are provided to engagement stakeholders.
- Two internal audit staff members are dedicated to program efficiency and effectiveness engagements (operational audits).
- Consulting services and technical assistance provided to stakeholders ensure Internal Audit contributes to the enhancement of organizational governance, risk management and controls.
- Management input during the risk assessment audit planning process ensures Internal Audit is addressing Management’s concerns related to risk within the DA&CS.

In addition, stakeholders indicated a very positive view of IA, evident by substantial investments made in customer communications and fostering an image of helpfulness and accessibility leading to value added services. Thirteen (81%) stakeholders responded to the survey. Rating options were strongly agree (4), agree (3), disagree (2), strongly disagree (1) and unknown if the respondent did not have adequate basis for evaluation of the particular statement. The overall rating was 3.6 which is very positive. Many respondents to the survey had positive comments related to Internal Audit’s value added services, and improved communication. In fact, an overall survey rating of 3.8 was

received for a question related to adding value and helping the organization accomplish its objectives.

In addition, many interviewees commented on internal audit being proactive, instead of reactive and how their evaluations identified risks that may have a negative effect on the DA&CS in the future.

2. **Planning**

Standard 2010 requires the establishment of a risk-based plan to determine the priorities of the IA function, consistent with the organization's goal.

Internal Audit has developed a robust risk assessment process for development of the risk-based audit plan. A systematic process is used to identify the auditable universe and identify relevant risks related to each auditable item. The process is clearly documented and conducted at least annually. Senior Management's input is sought and their expectations are considered throughout the process. The risk-based audit plan is linked to the agency's strategic goals to ensure engagements performed throughout the year will add value and improve the DA&CS's operations.

3. **Enhancements through Automation**

Data Analytics – Internal Audit has purchased Active Data for Excel and Office software for data analytics. Data analytics is a powerful tool that allows for the evaluation of large data sets for anomalies. The use of these tools in fraud prevention and trend analysis is very powerful and increases audit coverage dramatically. Internal Audit has the capabilities for a broad use of data analytics for testing large sets of data. Possible uses include: purchasing cards, vendor file analysis, payroll testing, fee collections, etc.

Productivity Software – The implementation of Auto Audit enables Internal Audit to transform their manual audit management processes into a framework, freeing auditors to focus on conducting audits. By automating internal audit procedures, it ensures adequate controls over the quality of audit work and conformance with IIA Standards. The issue tracking feature of this product will ensure identified unacceptable risks are being addressed timely.

4. **Strategic Plan**

Practice Guide – *Developing the Internal Audit Strategic Plan*: Practice Guides are strongly recommended and endorsed by the IIA; however, compliance is not mandatory. This Guide provides internal audit function a step-by-step approach to developing a strategic plan.

Internal Audit has developed a five-year strategic plan. This tool aids Internal Audit to perform in a better, more efficient manner by focusing its resources, energy and efforts in the right direction towards the attainment of strategic goals and objectives, mission and vision.

DETAIL – GAPS TO CONFORMANCE WITH THE STANDARDS OR CODE OF ETHICS

1. Dual Reporting Relationships

Standard: 1100 – Independence and Objectivity: The internal audit activity must be independent, and internal auditors must be objective in performing their work.

Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. *This can be achieved through a dual-reporting relationship.* Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels. Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others. Threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels. *[emphasis added]*

1110 – Organizational Independence: The Chief Audit Executive¹ must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity. Interpretation: Organizational independence is effectively achieved when the chief audit executive reports functionally to the board.

Condition: The DA&CS IA does not have a dual reporting structure. The IA Director reports functionally and administratively to the same person within DA&CS. Although there is no evidence that conditions exist that threaten the ability of the Internal Audit function to carry out internal audit responsibilities in an unbiased manner, a dual reporting requirement enhances organizational independence mitigating the appearance of an independence issue.

Often, the Chief Audit Executive (CAE) has a direct functional reporting line to the board and an administrative reporting line to a member of senior management. The reporting line to the board provides the CAE with direct board access for sensitive matters and enables sufficient organizational status. Administrative reporting to a member of senior management also provides the CAE with sufficient organizational status, as well as authority to perform duties without impediment and to address difficult issues with other senior leaders. The IIA recommends that the CAE report administratively to the Chief Executive Officer (CEO) so that the CAE is clearly in a senior position, with the authority to perform duties unimpeded².

The organizational placement and status of the Internal Audit activity poses a practical constraint or a limit on the scope of internal audit services that can be appropriately undertaken by internal auditors. In general, the higher the reporting level, the greater the potential scope of engagements that can be undertaken by the internal audit activity while remaining independent of the audited

¹ Internal Audit Director

² IIA Implementation Guide 1100 and 1110

entity³. In addition, IIA Research Foundation’s publication entitled *Challenges in Government Auditing* noted, “The most important step that government agencies can take to reduce the number of severe challenges facing auditors is to ensure that an independent audit committee is in place.”

The optimal option to enhance organizational independence is to create an independent audit committee to serve as the functional report. An independent board member is not an employee, or member of the DA&CS. An independent board member may not carry out any other activities on behalf of the DA&CS. The N.C. Board of Agriculture is a statutory agency with members appointed by the Governor. The board is a policy and rule-making body that adopts regulations for many of the programs administered by the DA&CS. Since an oversight board exists, it may be possible to create an independent audit committee, as the functional report for the Internal Audit Director. This structure is a leading practice in the profession of internal auditing.

Another option to enhance organizational independence is to require the Internal Audit Director to report functionally to the head of DA&CS, in this case, the Commissioner of Agriculture and administratively to the Chief Deputy Commissioner of Administration. This reporting structure elevates IA; improves organizational status, and improves independence; however, is not considered the most optimal option.

Recommendation: Management should consider enhancement to Internal Audit’s organizational independence by creating a dual reporting structure. This may include consulting with the board about the creation of an audit committee.

Response: Management will require the Internal Audit Director to report out to the N.C. Board of Agriculture concerning Internal Audit Division activities and accomplishments during the fourth quarter of each calendar year.

DETAIL – OPPORTUNITIES FOR CONTINUOUS IMPROVEMENT

1. Resource Improvement

Standard 2030 – Resource Management: Requires the CAE to ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

Continuous Improvement: The DA&CS’s management is very supportive of Internal Audit which is evident by the increase in internal audit positions from one to four. At four positions, the minimal number of internal auditor positions is being met based on the Council of Internal Auditing staffing analysis. The Council’s review is a cursory review to identify the minimal number of internal audit positions needed, not the optimal. A more in-depth analysis, including the review of high and medium risk areas identified during the risk assessments, will help determine the optimal number of internal auditors needed to effectively mitigate risks within the Department.

³ IIA IPPF Practice Guide *Independence and Objectivity* 2011

Recommendation: To ensure adequate coverage of all high and/or medium risk areas identified in the risk assessment and the ability to address ad hoc items such as allegations and requests from management, the DA&CS management should consider providing additional resources to Internal Audit based on a more robust staffing analysis to reduce the risk exposure within the entities under the Internal Audit Director's authority.

Response: Management will consider the suggestion for additional Internal Audit Division resources based on a more robust staffing analysis.

2. Communication Enhancement

Sound Business Practice – Robust Website: One means to effectively communicate with all DA&CS employees and the public is through the DA&CS's website. Currently, the website for Internal Audit has limited information. It is common practice to communicate the audit charter allowing all employees to fully understand the purpose and responsibilities of Internal Audit. Other items that can be included on the website are: annual reports and audit plans, types of services provided, mission statement, core principles, audit planning and risk assessment processes or frequently asked questions.

Recommendation: To improve communication with DA&CS's employees and the public, Internal Audit should consider enhancement to the website.

Response: The Internal Audit Director will work with the Department's Information Technology Services Division to enhance both its external and internal websites based on the details provided in the improvement opportunity.

We appreciate this opportunity to be of service to the Department of Agriculture and Consumer Services. We will be pleased to respond to further questions concerning this report and to furnish any desired information.

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ATTACHMENT A: EVALUATION SUMMARY AND RATING DEFINITIONS

OVERALL EVALUATION:	GC	PC	DNC
	X		

IIA Code of Ethics		GC	PC	DNC
	Code of Ethics	X		

Attribute Standard (1000 – 1300)		Standards			Major Category		
		GC	PC	DNC	GC	PC	DNC
1000	Purpose, Authority, and Responsibility	X			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					
1120	Individual Objectivity	X					
1130	Impairments to Independence or Objectivity	X					
1200	Proficiency and Due Professional Care						
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 <i>International Standards for the Professional Practice of Internal Auditing</i> ”	X					
1322	Disclosure of Nonconformance	X					

Performance Standards (2000- 2600)		Standards			Major Category		
		GC	PC	DNC	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 <i>International Standards for the Professional Practice of Internal Auditing</i> ”	X					
2431	Engagement Disclosure of Nonconformance	X					
2440	Disseminating Results	X					
2450	Overall Opinions	X					
2500	Monitoring Progress	X			X		
2600	Communicating the Acceptance of Risks	X			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 individual standard or elements of the Code of Ethics in all material respects. For the sections and major categories, 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 individual standard or elements of the Code of Ethics or a section or major category, 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 individual standard or element of the Code of Ethics or a section or major category. 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.

