



Internal Auditing in the Great City Schools



Fall 2017

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The Council of the Great City Schools is the only national organization exclusively representing the needs of urban public-school districts. Composed of 69 large city school districts, its mission is to promote the cause of urban schools and to advocate for inner-city students through legislation, research, instructional support, leadership, management, technical assistance, and media relations. The organization also provides a network for school districts sharing common problems to exchange information and to collectively address new challenges as they emerge to deliver the best education for urban youth.

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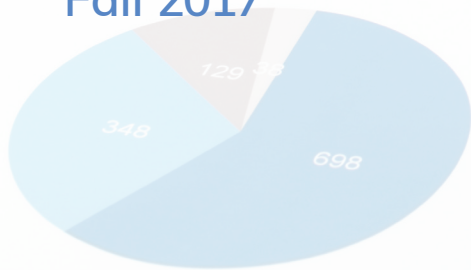


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Executive Summary

Education leaders often take a narrow view of their internal auditing functions, associating them solely with school-activity audits. However, internal audit departments can potentially provide value far beyond the traditional school audits required by many states. Internal auditing offers school boards and senior management an independent and objective source of information that can help them identify some of the most significant operational and compliance issues preventing them from meeting their goals.

The objective of this “white paper” is to describe best practices in internal auditing and demonstrate the value that an internal audit function brings to a school district. Based on this review, The Council of the Great City Schools and the task force of urban school specialists that assembled this document suggest that it is time to rethink the use of scarce internal audit resources to more effectively address high-risk areas affecting urban school districts.

Introduction

According to the Institute of Internal Auditors (IIA), internal audit is “an independent, objective assurance and consulting activity designed to help an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”

The roles and objectives of an internal audit function vary across the nation’s large urban school districts. This variation is attributable to the differing needs of districts and the general lack of understanding about the potential applications and value of internal auditing.

The *internal* audit function is often equated with or mistaken for an external audit function. However, while there are similarities between the two processes, the scope of an internal audit function goes well beyond the financial statements of an external auditor, incorporating a district’s risk management and control procedures. Furthermore, while an external audit typically stops at reporting problems, an internal audit often provides recommendations for continuous improvement.

The purpose of this document is not to duplicate the resources already available through the US Government Accountability Office (GAO) or the Institute of Internal Auditors (IIA), but rather to provide guidance on addressing some of the common challenges pertaining to internal auditing that the Council’s Strategic Support Teams typically identify in their peer reviews of the financial, business, and operational services of member districts.

Best practices, values, and standards for operating a school district internal audit function are described in the following sections:

- Department Reporting Structure
- Audit Committee Structure
- Risk Assessment and Audit Plan
- Auditing Standards
- Data Analytics and Fraud
- What Internal Auditors Do Not Do
- Non-audit Services
- Follow-up Activities
- Key Performance Indicators

Department Reporting Structure

The Institute of Internal Auditor's International Professional Practices Framework (IPPF) recommends that a Chief Audit Executive report functionally to an organization's board and administratively to the organization's Chief Executive Officer or other appropriate executive.¹ These reporting lines are meant to ensure that an auditor's work is independent, impartial, and objective so decision-makers can trust the audit's findings and recommendations. Examples of functional reporting include:

- Approval of the overall charter of the internal audit function
- Approval of an internal audit risk assessment and related audit plan
- Receiving communications from the Chief Audit Executive on results of internal audit activities or other matters that the Chief Audit Executive determines to be necessary
- Appointment or removal of the Chief Audit Executive
- Approval of the annual salary and benefits of a Chief Audit Executive
- Determining whether scope or budgetary limitations are impeding the internal audit function's ability to execute its responsibilities

Administrative reporting, on the other hand, entails the relationship within the organization's management structure that facilitates the day-to-day operations of the internal audit department. In accordance with Generally Accepted Government Auditing Standards (GAGAS), internal auditors who work under the direction of an audit entity's management are considered independent for the purposes of reporting internally if the head of the internal audit organization meets the following criteria:²

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- 1 Examples of major urban school districts where the internal auditor reports functionally to the school board include Orange County (Orlando), Fresno, Charleston, Miami-Dade County, Seattle, and others. (The Council conducted a survey of its members to determine which ones have internal auditors and to whom they reported. See appendix)
 - 2 Government Auditing Standards Exposure Draft, April 2017 revision, page 24.

- Is accountable to the head or deputy head of the government entity or to those charged with governance
- Reports engagement results both to the head or deputy head of the government entity and to those charged with governance
- Is located organizationally outside the staff or line-management function of the unit under audit
- Has access to those charged with governance, and
- Is sufficiently removed from political pressures to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisal.

GAGAS also states, “When internal audit organizations perform audits of external parties, such as auditing contractors or outside party agreements, and no impairments to independence exist, the audit organization can be considered independent as an external audit organization of those external parties.”

Best Practices

The Council of the Great City Schools recommends that the Chief Audit Executive and the internal audit office report functionally to the school board, ideally through an audit committee. If functional reporting to the school board is not possible, a less preferable, but acceptable, reporting structure entails having the Chief Audit Executive report to the Superintendent or Deputy Superintendent, with access to those charged with governance (school board). In either case, the Council recommends that school districts maintain an independent internal audit function.

Value

A reporting structure that preserves the internal audit function's independence will add value to a school district by ensuring that the auditors' work is impartial and objective, so decision-makers and other key stakeholders can trust internal audit findings and recommendations.

Audit Committee Structure

The primary role of an Audit Committee is to provide advice to a school board on audit, finance, and risk management. An Audit Committee can also oversee an internal audit function, and act as a liaison between the school board and the Chief Audit Executive. Examples of roles and responsibilities of a school district Audit Committee include:

- Reviewing and approving an Internal Audit Charter
- Providing expertise on risks affecting the school district and approving an annual internal audit plan
- Ensuring that internal auditors have unrestricted access to school district personnel, facilitates, vendors, data, and documents
- Assisting in determining if management has placed any restrictions on the scope of internal audits and investigations
- Receiving completed internal audit reports, investigations, and other communications deemed necessary by the Chief Audit Executive
- Monitoring follow up on reported internal audit findings to ensure corrective actions are taken
- Engaging and overseeing the work of external auditors
- Reviewing audit findings by state and federal agencies to determine the school district's action on recommendations
- Reviewing the effectiveness of systems for monitoring compliance with laws and board policies and regulations
- Reviewing and making recommendations to the school board on matters affecting the adequacy of internal controls, accounting procedures, technology systems, and financial reporting in accordance with laws and regulations
- Approving all decisions regarding the appointment or removal of the Chief Audit Executive
- Providing input on the Chief Audit Executive's evaluation
- Approving the annual salary and compensation adjustments of the Chief Audit Executive

- Serving on behalf of the school board to oversee the internal audit function
- In conjunction with the Chief Audit Executive, providing an annual report to the school board
- Performing other oversight responsibilities as assigned by the school board

Best Practices

To promote the success of an internal audit function, an Audit Committee should ensure that individual school board members, the superintendent, and other school district staff do not impair, prevent, or prohibit internal audit staff from initiating, carrying out, or completing independent and objective audits and investigations. To accomplish this, an Audit Committee should ensure that the internal audit office is free of political pressure and other impairments to independence.

In order to ensure an internal audit office's objectivity and independence, the Council recommends that a school district's Audit Committee be comprised of individuals who are independent of the school district and who are experts in auditing, finance, risk management, and government.³ An Audit Committee that includes experts who do not have authority over the school district's operations or decision-making process can shield the internal audit staff from actual or perceived pressure to compromise their objectivity and independence. This structure is also supported by the Institute of Internal Auditors.

Value

An Audit Committee structured to ensure the internal audit function's independence and objectivity will ensure that internal auditors are free to conduct their work without fear of retaliation, retribution, or political pressure. This will also ensure fair and impartial internal audit results that can be relied upon by the school board, school district management, and the public.

3 Some large urban school districts have audit committee comprised solely of school board members; some also include external experts; and some have external "investment committees" that do not conduct internal auditing functions per se but advise the district on managing its investment portfolio.

Risk Assessment and Audit Plan

The Institute of Internal Auditor's International Professional Practices Framework (IPPF) requires that an organization, such as a school district, "establish a risk-based plan to determine the priorities of the internal audit activity..."

Depending on the size and structure of a school district and its internal audit function, the Council recommends that a detailed risk assessment be performed at a minimum of every three years.⁴ Regardless of how often an internal audit office conducts a detailed analysis, the risk assessment and audit plan should be modified or updated annually to reflect any new or changing risks affecting the school district.

Best Practices

The risk assessment and audit plan should provide or perform audit and allowable non-audit services for various departments, functions, and activities of a school district. Factors that should be taken into consideration include:

- Financial impact
- Time since last audit engagement
- Audits to be performed by other audit entities
- Perceived quality of internal controls
- Likelihood of occurrence
- Degree of change or stability in management
- Complexity
- Requests and expectations of the school board, senior management, and other stakeholders
- Opportunities to achieve operating benefits

4 The auditing standards followed by the internal auditor may require more frequent risk assessments.

- Changes to and capabilities of audit staff
- Work of the Enterprise Risk Management team (if this function exists in a school district)⁵

The audit plan should describe what audit and non-audit activities are to be performed, the scope of work, and the time and staffing resources required to complete the work. An audit plan should be flexible enough to accommodate minor mid-plan adjustments and, if a substantial adjustment is required (e.g., based on a senior management request), the changes should be approved by the school board and/or Audit Committee.

Common and emerging areas for audit and non-audit services that might be included in the plan include:

- Operational performance audits (to assess cost-beneficial internal controls, efficiency, effectiveness, contract oversight, and compliance)
- School internal fund and school-based audits (could include student FTE and tangible personal property work)
- Charter school audits and fiscal oversight (the IA function is uniquely qualified to add value in this significant and growing sector)
- Facilities construction and maintenance audits and oversight
- Contract audits
- Information technology audits
- Forensic accounting and investigative audits
- Healthcare insurance-related audits (especially for large self-insured districts)
- Acting as a liaison for external audit entities
- Identifying emerging risks (adding value by alerting the school board and management of audit findings and trends occurring at similar entities)
- Promoting awareness of fraud policies and internal controls (controls created and owned by management, not the internal audit function)

5 See Council of the Great City Schools (2016). *Enterprise Risk Management in the Great City Schools*. Washington, DC: Council of the Great City Schools, Spring 2016.

While the internal audit function should be housed organizationally with a district's Chief Audit Executive and staff, the Chief Audit Executive should consider outsourcing or co-sourcing with external entities, under the Chief Audit Executive's oversight, when the internal audit staff lacks expertise or when a specialized audit is infrequent and/or irregular.

Value

An objective risk assessment by an internal audit function provides the school board and senior management value by communicating risks associated with the school district's various business and operational functions. An audit plan based upon a comprehensive risk assessment ensures that internal audit resources will be strategically allocated to address the most significant and likely risks affecting the school district. The results of completed audits will provide management with actionable recommendations to meet its goals and objectives, and will provide the school board with valuable information to assist in its governance.

Auditing Standards

The US Government Accountability Office (GAO) and the Institute of Internal Auditors (IIA) are two reputable organizations recognized for issuing professional auditing standards that provide a framework for conducting audits.

Best Practices

The Generally Accepted Government Auditing Standards (GAGAS), issued by the GAO and commonly referred to as the “Yellow Book,” articulates requirements for financial audits, performance audits, and attestation engagements in government, including school districts, which receive federal funds.

The Institute of Internal Auditors (IIA) has also issued standards in its International Professional Practices Framework, commonly referred to as the “Red Book,” which are often implemented along with the performance audit requirements of GAGAS. Audit organizations following either the Yellow Book or the Red Book standards are required to reference the standards in their completed audit reports.

The Council does not promote one set of standards over another, but it does recommend that each school district adopt a professionally recognized set of auditing standards.

Value

By following a professionally recognized set of auditing standards, an internal audit organization will add value to its district. Senior management and the school board will have a greater appreciation for an internal audit function knowing that it is following prescribed auditing standards.

Data Analytics and Fraud

Data analytics can be used by internal audit staff to identify transactions that could present potential risks of fraud in financial and operational areas, including accounts payable, purchasing, payroll, and benefits. It is important that the school district has clear policies about fraud and its consequences, and that an internal audit office has an effective fraud risk assessment program to address the risks in these operating areas and to ensure public trust.

Best Practices

The Association of Certified Fraud Examiners (ACFE), the Institute of Internal Auditors (IIA), and the American Institute of Certified Public Accountants (AICPA) advocate data monitoring and analysis to guide risk assessment and direct the annual audit planning process on the materiality of potential audit areas, identify unusual trends or fluctuations, and evaluate high risk areas being considered for auditing.

The use of data analytics also allows for continuous monitoring of potentially fraudulent transactions. When employees are aware that all transactions in the district's data systems are monitored for signs of fraud, it provides a meaningful deterrent. This is particularly important since business processes, which have become more reliant on IT systems and automation, have significantly reduced human oversight, which previously acted as a fraud control.

When using data analytics, it is critical that appropriate security protocols be put in place during the extraction and analysis of data to protect the integrity and confidentiality of source information.

Value

Performing data analysis is an effective way to help auditors be more proactive in the detection and reduction of fraud, waste, and abuse. Data analytics can also guide a school district's risk assessment and audit planning processes to ensure that internal audit resources are directed toward areas with the greatest materiality and risk for the district. With appropriate planning and consultation, school districts can employ technology tools that help their audit staff provide greater audit coverage in a more efficient manner.

What Internal Auditors Do Not Do⁶

As noted in the Department Reporting Structure section of this white paper, maintaining independence is imperative for an effective and credible internal audit function. In addition to having the proper reporting structure, internal audit functions must avoid even the appearance of a lack of independence by refraining from performing certain functions. Internal Auditors cannot be a part of the management of any function they audit, which means they should not:

- Take responsibility for the district's financial statements
- Authorize or execute transactions on behalf of any department other than their own
- Approve district budgets
- Prepare or make changes to source documents
- Assume custody of district assets, including maintenance of bank accounts
- Establish or maintain internal controls, including the performance of ongoing monitoring activities as part of the control process
- Supervise employees other than their own in the performance of normal recurring activities
- Report to the school board on behalf of management
- Serve as a general counsel
- Sign payroll tax returns on behalf of their district
- Approve vendor invoices for payment, other than those for their own department
- Design a district's financial management system or make modifications to source code underlying that system
- Hire or terminate employees, other than for their own department

6 Adapted for school districts from materials prepared by Gelman, Rosenberg & Freedman Certified Public Accountants. <http://www.grfcpa.com/resources/publications/auditor-responsibilities>

This list is not all-inclusive. But, in short, the internal auditor may not assume the role and duties of management, or implement anything that they will ultimately audit.

In addition, the school district should not expect the internal auditor to:

- Analyze or reconcile accounts
- “Close the books”
- Locate invoices, etc., for testing
- Prepare confirmations for mailing
- Select accounting policies or procedures
- Prepare financial statements or footnote disclosures
- Determine estimates included in financial statements
- Determine restrictions of assets
- Establish value of assets and liabilities
- Maintain permanent records, such as loan documents, leases, contracts and other legal documents
- Prepare or maintain minutes of school board meetings
- Establish account coding or classifications
- Determine retirement plan contributions
- Implement corrective action plans

Non-Audit Services

Non-audit services are advisory in nature, and are generally performed at the specific request of a client, which could include the school board, the audit committee, senior management, or the management of a particular unit or function within the district. The Chief Audit Executive should consider accepting proposed non-audit service requests based on the activity's potential to improve management of risks, add value, and improve the district's operations. The Institute of Internal Auditor's International Professional Practices Framework (Red Book) and Government Accountability Office's Government Auditing Standards (Yellow Book) recommend that an internal audit organization maintain its independence and objectivity and not assume management responsibilities when it provides non-audit advisory services. Both groups also recommend that advisory services be performed free of political pressure or perceived conflict of interest.

Best Practices

The nature and extent of non-audit services to be performed by the internal audit function should be included in the Internal Audit Charter and non-audit engagements accepted should be included in the annual audit plan. The school board acts to safeguard and protect the objectivity and independence of the internal audit function, in conjunction with the Chief Audit Executive, to ensure requests are suited to and appropriate for the internal audit function. Examples of advisory services that can be provided by internal audit staff include counsel, advice, facilitation, and training.

For instance, internal auditors can lend their expertise in analyzing risks and internal controls to advise management on better-informed decision making and to facilitate benchmarking and the identification of best practices that could enhance operational performance. Internal auditors can also support the school district in promoting ethical behavior and employee awareness of and commitment to internal controls.

Value

Performing non-audit services allows an internal audit function to provide just-in-time advice to school district management in cost effective ways, and to improve the district's governance, risk management, and control processes. Non-audit services can also improve relations with other district departments and provide internal auditors with greater exposure and enriched career opportunities.

Follow-up Activities

Government Auditing Standards (Yellow Book) and The Institute of Internal Auditors International Professional Practices Framework (Red Book) set standards for monitoring and determining whether management takes corrective action to address internal audit issues and findings or whether it accepts the risk of not acting. Specifically, auditors:

- Should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements. (*Yellow Book 6.36 Previous Audits and Attestation Engagements*)
- Must establish and maintain a system to monitor the disposition of results communicated to management. (*Red Book 2500-Monitoring Progress*)
- Must establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not acting. (*Red Book 2500.A1*)

Best Practices

Chief Audit Executives should collaborate with senior management to determine the timing and nature of corrective actions that will address issues and items identified in audit findings. Regardless of the methods used to monitor and assess the status of these corrective actions, leading internal audit departments use dashboards to indicate the nature of audit findings and prepare annual reports highlighting management's progress towards resolving past audit findings and recommendations.

Value

Follow-up activities provide assurance to senior management, the school board, and other stakeholders that audit findings are being taken seriously and that corrective actions are being implemented. Follow-up activities also provide a measure of accountability to the community that any noted weaknesses are being addressed and the district is committed to operating and using public funds in an efficient and effective manner.

Key Performance Indicators (KPIs)

Internal auditing is a value-added proposition that provides assurances, advisory services, efficiency audits, and strategic consultations to school boards and management. Increasingly, internal auditing is expected to take on more strategic, collaborative, and advisory roles without impairing objectivity and independence.⁷ The value-added proposition can be measured from a quantitative and qualitative perspective.

Best Practices

Leading internal audit departments are designing balanced scorecards using key performance indicators (KPIs) to set goals, measure performance, and provide information to stakeholders. School boards and senior managers are creating environments where expectations among various stakeholders are clearly defined and communicated. Common KPIs are also included in the Council's Performance Measurement and Benchmarking Project, which analyzes internal audit performance and provides a quality check on work being done across districts.

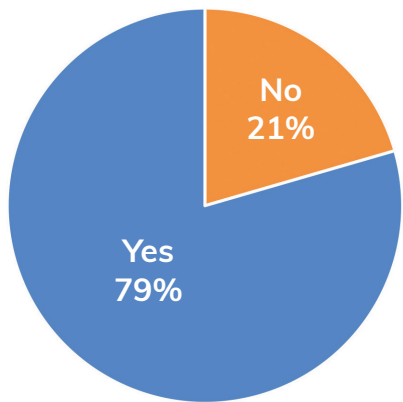
Value

The adoption of KPIs for an internal audit function can provide the school board, senior management, and the public with necessary information to evaluate whether the internal audit function is meeting its objectives and helping the school district accomplish its mission.

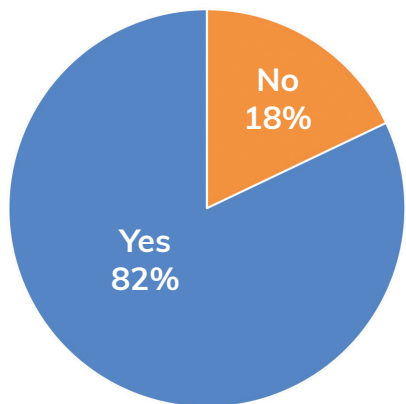
7 Shooting straight, How internal auditors can be strategic and collaborative—while maintaining independence and objectivity, Journal of Accountancy, Ken Tysiak, December 2013 - See more at: <http://www.journalofaccountancy.com/issues/2013/dec/20138669.html#sthash.DYdBm39r.dpuf>

Appendix⁸

Percentage of Districts with an Audit Committee

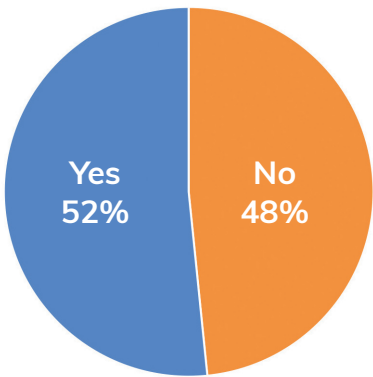


Internal Audit Departments that Report to the School Board



8 Based on self-reported data from 39 school districts as of May 5, 2017

Audit Committees Containing Community Volunteers as Voting Members



Average School District Investment in the Internal Audit Function	
Average Amount of the General Fund Budget Spent on the School District Internal Audit Function:	0.073%
Average Number of Internal Auditors for Every 1,000 Students Enrolled in a School District:	0.08
Average Number of School District Internal Auditors for Every \$100 Million in the General Fund	0.71

Task Force Members

The Council of the Great City Schools greatly appreciates the work of the Task Force, which produced this report. They included—

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