



Office of Budget and Management

Report to the State of Ohio Controlling Board: Office of Internal Auditing Implementation Plan

May 2008

Office of Internal Auditing *...the Implementation Plan*

Introduction

This plan presents the results and recommendations of a ten-week study by the Office of Budget and Management (OBM) with assistance from Deloitte Consulting LLP in collaboration with all 20 impacted agencies, eight of which provided input through participation on the Office of Internal Auditing (OIA) Internal Audit Advisory Committee.

HB166

HB166 required the Director of the Office of OBM to develop a plan to be submitted to the Controlling Board for approval regarding the implementation of the OIA within the OBM, to include:

- (1) Identify those existing employees within state agencies as defined in section 126.45 of the Revised Code who perform the function of an internal auditor and who will be transferred to the Office of Internal Auditing**
- (2) Establish funds and appropriation authority that is necessary for the efficient and effective operation of the Office of Internal Auditing**
- (3) Provide for a method to assess charges against the various state agencies for which the Office of Internal Auditing conducts internal auditing programs under sections 126.45 to 126.48 of the Revised Code so that the total amount of these charges is sufficient to cover the costs of the operation of the Office of Internal Auditing**
- (4) Provide for the appropriate reduction in the appropriation authority of the State agencies from which existing employees who perform the function of internal auditor are transferred.**

Approach

Deloitte Consulting LLP was engaged by OBM in January 2008 to assess the current status of internal auditing in State of Ohio agencies and to develop a roadmap and cost estimate for implementing the OIA in accordance with House Bill 166. The following methodology was used to complete this effort:



Value Added Outcomes

- Improved internal controls, risk management and governance processes
- Independent assessment of compliance with policies, procedures, and applicable laws
- Operational reviews focusing on process effectiveness and efficiency
- Consultative and advisory services for internal controls

Current State *...What We Heard from Ohio Agencies*

Definition of Internal Auditing

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps 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 Institute of Internal Auditors

The Role of Internal Auditing Includes		
<ul style="list-style-type: none"> Evaluating and improving the adequacy and effectiveness of risk management, control, and governance processes Validating employee compliance with policies, standards, procedures, and applicable laws and regulations Evaluating the management process to determine whether reasonable assurance exists that management objectives and operational goals are being achieved Providing process and managerial consulting to improve risk management, control, and governance processes 		
Associated Attest and Management Roles in Ohio Government		
Agency Management Functions	Auditor of State	Inspector General
<ul style="list-style-type: none"> Performing grant subrecipient monitoring Being accountable for the organizations’ actions, conduct, and performance to the owners, other stakeholders, regulators, and general public Setting policies and procedures to be adhered to by employees Implementing internal control structure and process improvements Preparing financial statements using GAAP principles 	<ul style="list-style-type: none"> Performing annual consolidated financial statement and compliance audit of the State issuing an audit opinion on the financial position and report on internal control and tests of compliance Conducting audits of federal programs in accordance with federal requirements Conducting audits of state agencies, boards and commissions focused on internal controls as well as compliance requirements Performing SAS 70, Medicaid 	<ul style="list-style-type: none"> Investigating complaints received Focusing on misconduct of state officials and employees Investigating fraud, waste, abuse, and corruption Investigating crimes and performing background checks

Traditional Internal Audit Activities

Our analysis of the activities of the 20 agencies within scope for HB 166 revealed that five of the agencies are conducting activities consistent with the definition of internal auditing.

The other 15 agencies are performing limited internal auditing activities, and primarily conduct management type activities that are essential to the operation of the agencies but do not represent the traditional internal auditing activities as defined by the Institute of Internal Auditors.

Performing Internal Auditing	Performing Managerial Functions
Bureau of Workers' Compensation	Dept. of Administrative Services
Dept. of Mental Health	Dept. of Alcohol and Drug Addiction Services
Dept. of Public Safety	Dept. of Agriculture
Dept. of Rehab and Correction	Dept. of Aging
Dept. of Youth Services	Dept. of Commerce
	Dept. of Development
	Environmental Protection Agency
	Dept. of Health
	Dept. of Insurance
	Dept. of Job and Family Services
	Dept. of Mental Retardation and Developmental Disabilities
	Dept. of Natural Resources
	Office of Budget and Management
	Dept. of Taxation
	Dept. of Transportation

Risk Assessment *...Identifying the Risk*

Introduction

As defined by the IIA, risk is *“The uncertainty of an event occurring that could have an impact on the achievement of objectives.”* Further, a risk based plan is needed to determine the priorities of Internal Audit. This plan should be based on a risk assessment, which involves the input of senior management.

The risk model incorporated seven risk factors on which each process subject to audit was rated. The seven risk factors, and their assigned weights, were developed using IIA guidance, knowledge of the State of Ohio, as well as best practices in internal audit.

Risk Factors	Weight
Agency & Process Size/Complexity	15%
Stakeholder Concerns	20%
Change: System, Process, People	10%
Financial/Operational Reporting	20%
Controls Environment	15%
Prior Audits	10%
Potential for Fraud, Waste, and Abuse	10%

Risk Rating

A risk rating was assigned to each agency process across the seven risk categories. The risk rating contemplated both likelihood and consequence.

Audit Frequency

The audit frequency is directly correlated to the process risk rating. Each process should be reviewed at least once every four years.

Audit Effort

The extent of audit effort is typically linked to the level of risk, size and complexity of each process.

	Low Risk	Moderate Risk	Neutral Risk	Sensitive Risk	High Risk
Risk Rating	1	2	3	4	5
Audit Frequency	Every 4 years		Every 2.5 years		Annually
Audit Effort	Extra Small	Small	Medium	Large	Extra Large

Risk Assessment Output

The risk assessment produced two major outputs that will guide the OIA implementation.

- The risk assessment identified both enterprise-wide and agency specific risks. These audit risk ratings drive the audit frequency and level of effort required. The table to the right highlights the enterprise-wide processes and associated risk ratings, which are an aggregate of approximately 1500 auditable processes that were identified that would be subject to audit.
- The risk assessment determined the audit staffing necessary to adequately address all risks over a four year cycle across the agencies. Ultimately, the required audit effort for all processes will drive the number of audit staff needed.

Risk Categories	Risk Rating
Asset Management	Yellow
Budget Management	Yellow
Claims Management	Yellow
Financial Reporting	Red
Information Technology	Red
Payroll	Red
Personnel & Organizational Support	Yellow
Program Management	Yellow
Procurement/Expenditure Management	Red
Revenue Management	Yellow

Implementation *...to the Desired State*

Introduction

The analysis of the current state of internal audit within state agencies, combined with the statewide risk assessment, formed the foundation for the OIA Implementation Plan. The Implementation Plan is segmented into four separate phases:

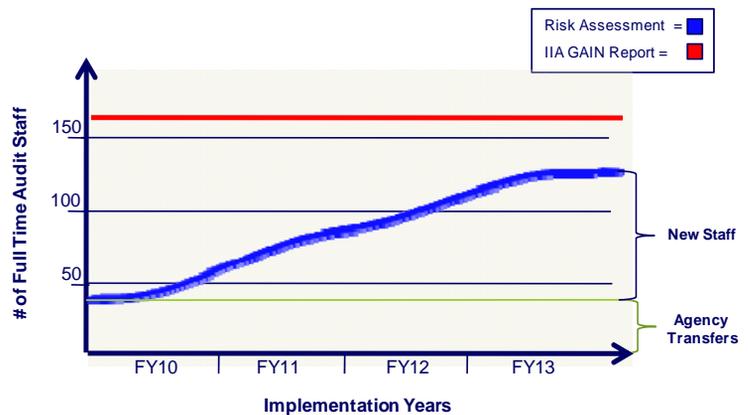
- **Phase 1: Establishing the Office of Internal Auditing**
- **Phase 2: Addressing the Enterprise Risks**
- **Phase 3: Executing the Audit Plan**
- **Phase 4: Conducting Evaluation and Continuous Improvement**

Phase One: Establishing the OIA

The first phase of the Implementation Plan is to establish the requirements for people, processes, and technology to start up the Office of Internal Auditing. This phase, in parallel with Phase Two, will lay the foundation for addressing the State risk universe.

People:

There are a total of 36 auditors across the 5 agencies that are recommended for organizational transfer into OIA. The remaining 89 auditors will be identified and hired in accordance with the phased Implementation Plan. OBM recognizes that acquiring the qualified auditors will be an ongoing challenge and flexibility will be required to adequately address the state agencies' risk. Most of the auditors will be physically located within the agencies but report functionally to the OIA; however, certain audit needs may require auditors to be centrally located within OIA.



IIA's Global Audit Information Network (GAIN) benchmarking report estimates 5 internal auditors per \$1 billion in revenue. The aggregate revenue budget of the 20 HB 166 agencies is \$32 billion, translating to a staffing level of 160 FTEs

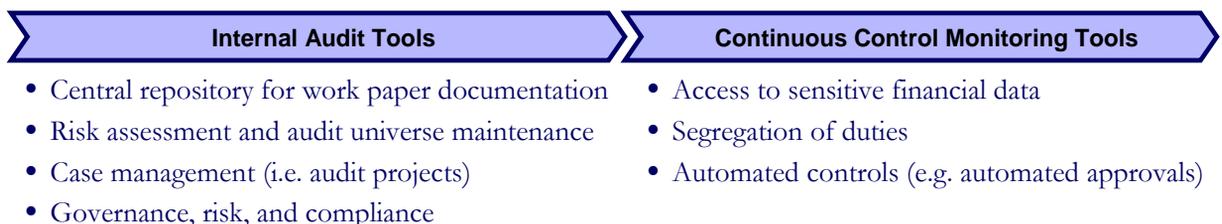
According to the initial risk assessment performed by the State of Ohio, it was determined that the recommended auditor staffing level of 125 FTEs to be a reasonable and prudent staffing level sufficient to operate the OIA. Staffing levels do not include the necessary support staff.

Process:

The OIA will develop the policies and procedures for internal auditing, controls and governance. These policies and procedures will be the standards and guidelines for use when conducting internal audits across the various agencies. The policies and procedures need to reflect current industry best practices as well as providing the flexibility needed to incorporate the specific intricacies of the State of Ohio.

Technology:

The OIA will obtain the required tools and software to efficiently execute internal audits across state agencies. Two types of tools will need to be identified and obtained:



Implementation *...to the Desired State (Continued)*

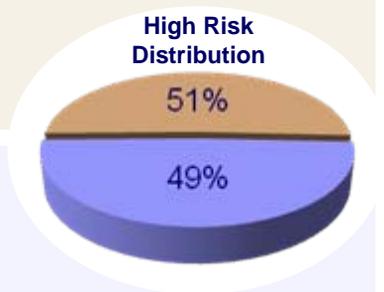
Phase Two: Addressing the Enterprise Risks

Ohio has significant internal control weaknesses in the following four enterprise-wide critical processes:

- Payroll
- Financial Reporting
- Procurement/Expenditure Management
- Information Technology

The State of Ohio is currently vulnerable to pervasive enterprise risk, and immediate action is needed to address this. These risks need to be fully evaluated to enable agencies to develop corrective action plans as soon as possible. Currently, the resources and expertise needed to address these immediate needs are not available within the state. Critical enterprise risks may take a while to correct once identified and will impact future OIA audit plans.

51% of the identified high risks can be addressed through enterprise-wide internal audits



Phase Three: Executing the Audit Plan

In addition to those high risks identified as enterprise-wide, there were also high risks identified at each agency involving financial, programmatic, and regulatory risks. These risks were comprised of the following six processes:

- Program Management
- Claims Management
- Revenue Management
- Personnel & Organizational Support
- Asset Management
- Budget Management

The OIA will develop agency specific audit plans to address each of these process categories. These plans will be updated annually, and revisited through the OIA risk assessment process. The audit plans will initially be rolled out by groups of agencies. Each agency group was determined based on agency factors such as; similar processes, geographic location, lines of business, level of risk, and shared clients.

49% of the identified high risks must be addressed on an agency by agency basis through agency specific internal audits

Phase Four: Conducting Evaluation and Continuous Improvement

To ensure that the OIA continues to add value across agencies, the final phase of the Implementation Plan is to establish and institute the evaluation of OIA's value addition and to conduct continuous improvement processes. The purpose of the evaluation and continuous improvement phase is to ensure that the OIA is continuously:

- Evaluating the internal audit plan to identify new risks and re-assess current state
- Re-assessing the needs of resources and skills across the OIA
- Responding quickly and efficiently to state agency and management needs
- Identifying value added opportunities for management
- Assessing the enterprise risks and how they relate to agency specific needs
- Disseminating agency best practices
- Integrating and sharing with other oversight bodies
- Revising and updating the Audit Committee and Internal Audit Charters

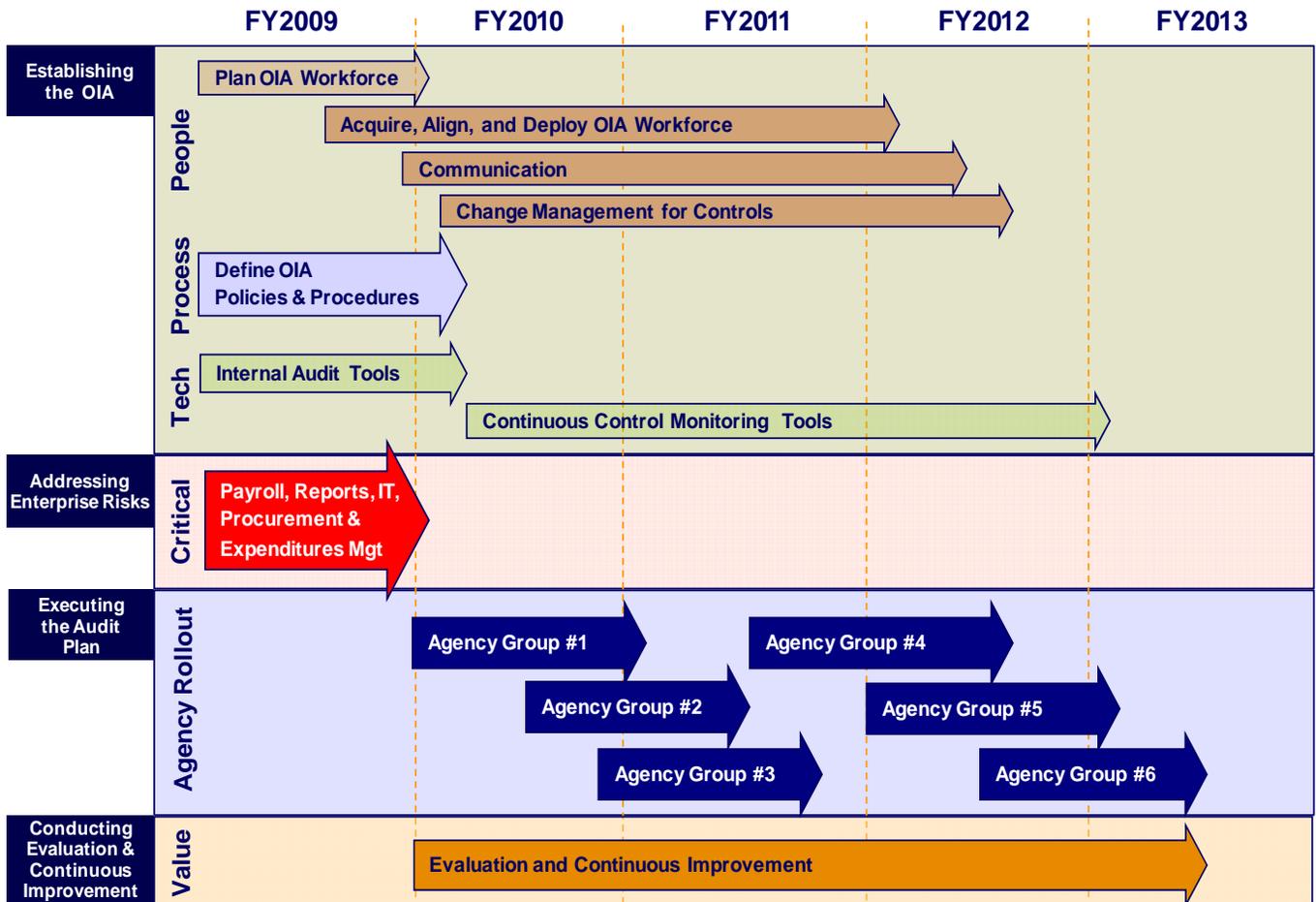
The OIA Roadmap *...the Plan to Reduce Risk*

OIA Roadmap of Activities

In addition to assessing the current state of internal auditing in Ohio and determining the overall risk profile, the Deloitte team examined the change management, business transformation and technology activities necessary to establish and support the Office of Internal Auditing. Based on risk and the anticipated workforce transition needs, the Deloitte and OBM team recommend an Implementation Plan spanning five years. The Implementation Plan is segmented into four distinct sets of activities.

- **Phase 1: Establishing the OIA** – Providing the people, process, and technology to support the OIA.
- **Phase 2: Addressing the Enterprise Risks** – Conducting internal audits of statewide enterprise risks in payroll, financial reporting, expenditure/contract management, and information technology.
- **Phase 3: Executing the Audit Plan** – Initiating internal audits at agencies according to individual audit plans.
- **Phase 4: Conducting Evaluation and Continuous Improvement** - Establishing and instituting the evaluation of OIA's value addition and to conduct continuous improvement processes.

The proposed Roadmap provides the process and tools necessary to support a sustainable and flexible plan to bring the Office of Internal Audit to its full staffing level within five years.



Costs and Funding *...an Investment in Accountability and Controls*

Start – Up Funding

The Deloitte and OBM team examined multiple cost scenarios for the roll-out of the OIA. The recommended five-year Implementation Plan minimizes the required start-up funding while still providing for the initiation of the audit plan in state agencies.

Staff Transfers

The staff transfers will represent a reduction in the agencies' salary and wages budget, but a resulting increase in budget for inter-agency charges for the cost of the audit activities. As previously mentioned, 36 staff are expected to transfer from the affected state agencies into OIA. Most of these transfers will occur in FY10 as the OIA infrastructure necessary to absorb them is in place. In the interim, OIA may execute inter-agency agreements to facilitate the on-boarding of select staff to assist with the development of OIA's infrastructure and to assist with the performance of the internal audits of the enterprise-wide risk areas.

Method for Charges

Funding for the ongoing operations of Office of Internal Audit will come from a chargeback to agencies. The annual agency fees will be based upon the agency risk assessment and annual audit plan, both of which determine the number of hours required annually to provide internal auditing services to each agency. Agencies will be billed for actual hours utilized in the performance of that agency's audits for the year. The billing rate will be calculated every two years and will be approved by the U.S. Department of Health and Human Services' Division of Cost Allocation in accordance with the requirements for establishing billing rates for state general or shared services.

Overall Costs

The cost to implement in FY09 will be between \$7million – \$10million. Upon review of this plan, OBM will generate a Controlling Board request for an increase in appropriation authority in FY09. The future budget requirements will be built into the operating budget accordingly.

Summary

Agency internal auditors are not sufficient to cover the risk-based needs of the Office of Internal Auditing. In addition, critical enterprise-wide risks exist that are currently unable to be reviewed with existing resources. Furthermore, State agencies are currently at risk and resources are needed to address these risks.

Given the economic climate, OBM will move forward in a thoughtful yet expeditious manner. OBM will achieve this by addressing critical enterprise-wide risks in FY09, using a combination of state agency personnel and contracted services. In FY10, the execution of the audit plan will begin through the transferred internal audit personnel and the hiring of new staff. In FY10-11, OBM will address the larger agency specific risks through the executive budget. Eventually, all costs associated with operations of OIA will be charged back through the agencies.

FUNDING OVERVIEW	
Required Start-Up Funding in FY09	\$7M – 10M
Remaining Start Up Funding in FY10 & FY11	\$8M – 10M
Direct Annual Charge Back to Agencies When OIA is fully Implemented	\$18M – 21M

Agency Staff to be Transferred	# of Staff
Bureau of Workers' Compensation	14
Department of Rehab & Correction	8
Department of Public Safety	7
Department of Mental Health	3
Department of Youth Services	4
TOTAL	36