

**GENERAL ASSEMBLY OF NORTH CAROLINA**



**Session 2007  
Legislative Fiscal Note**

**BILL NUMBER:** House Bill 1401 (First Edition)

**SHORT TITLE:** Internal Audit and Efficiency Review.

**SPONSOR(S):** Representative Crawford

<b>FISCAL IMPACT</b>					
	<b>Yes (X)</b>	<b>No ( )</b>	<b>No Estimate Available ( )</b>		
	<b><u>FY 2007-08</u></b>	<b><u>FY 2008-09</u></b>	<b><u>FY 2009-10</u></b>	<b><u>FY 2010-11</u></b>	<b><u>FY 2011-12</u></b>
<b>REVENUES:</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>
<b>EXPENDITURES:</b>					
<b>OSBM</b>	<b>\$407,902</b>	<b>\$307,902</b>	<b>\$307,902</b>	<b>\$307,902</b>	<b>\$307,902</b>
<b>In-House IA – Critical Need</b>			<b>\$9,536,213 - \$11,831,585</b> (See A&M)		
<b>In-House IA – Non-critical Need</b>			<b>\$23,599,452</b> (See A&M)		
<b>Shared IA Pool – Non-critical Need</b>			<b>\$209,848</b> (See A&M)		
<b>POSITIONS:</b>					
<b>OSBM</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>3</b>
<b>IA – Critical</b>			<b>106-131</b>		
<b>IA – Non Critical</b>			<b>265</b>		
<b>PRINCIPAL DEPARTMENT(S) &amp; PROGRAM(S) AFFECTED:</b> OSBM, All Cabinet and Council of State agencies, the Judicial System, and UNC.					
<b>EFFECTIVE DATE:</b> July 1, 2007					

**BILL SUMMARY:** This bill enacts a new Article 79 of G.S. Chapter 143 requiring state agencies that have an annual operating budget of more than \$10 million, have more than 100 full-time equivalent employees, or receive and process more than \$10 million in a fiscal year, to establish an internal auditing program. The bill states the General Assembly’s intent that state agencies perform internal audits to identify inefficient and ineffective programs, and to ensure agencies are safeguarding public funds and assets. The bill sets out requirements and standards for the auditing

programs and provides for the appointment of internal auditors and the agency director of internal auditing. The bill establishes the Council of Internal Auditing which consists of six named members and is supported by the Office of State Budget and Management, sets the council's duties, which include developing guides and best audit practices, administering a peer review system for audits, and conducting hearings when they are determined to be necessary by a majority of the council. The bill is effective July 1, 2007.

## **ASSUMPTIONS AND METHODOLOGY:**

### OSBM

This bill requires the Office of State Budget and Management (OSBM) to support the Council of Internal Auditing, which includes administrative, operational, and oversight responsibilities, training and professional development for IA staff located within State agencies, and the development of a shared IA program. Three positions, an Advanced State Management Analyst (\$113,701 – salary and benefits), an Internal Audit Manager (\$113,701 – salary and benefits), and a Research Assistant (\$60,000 – salary and benefits) will be required to perform the majority of functions required of HB 1401, but it does not include the IA staff needed to develop the pool of auditors. This pool will be discussed in the “Agency IA Needs” section. Additional recurring costs of \$20,500 will be incurred for operating and IT support. Additional nonrecurring costs of \$100,000 will be used to develop a central database, and IA guides, manuals, and best practices, and to purchase office equipment for the new employees. The total cost to OSBM is \$407,902 in FY 2007-08 and \$306,902 in future fiscal years.

### Methodology to Estimate Agencies' IA Needs

The methodology used in this fiscal note to assess the State's IA needs is based on the methodology developed by MGT of America, Inc. and presented to the North Carolina General Assembly on May 15, 2007 in its report “Establishing an Internal Audit Program in North Carolina's State Agencies.” The MGT report estimated the number of auditors needed based on operating expenditures in FY 2005-06, and established a risk assessment ranking to prioritize IA needs. It estimated the cost to fully staff agencies based on guidelines established by the Institute of Internal Auditors and recommended whether IA's should be housed within an agency or within a shared pool. The MGT study deducts the costs of existing IA functions from the total IA cost. This analysis accepts the MGT methodology with the exception of the baseline figure of operating expenditures as the most appropriate starting point to determine IA needs. The MGT report includes only expenditures funded by appropriations, and therefore omits expenditures funded by receipts, such as federal funds. The State is responsible for ensuring the proper use of all funds, regardless of source. This starting figure is based on the greater of total expenditures or total revenues in order to best capture the mission of an agency, thus the true target of an internal audit. Based on cash accrual, total expenditures include all personal and purchased services, supplies, property & equipment, other expenses & adjustments, aid & public assistance, and reserves for FY 2005-06. Total revenues include tax revenues, grants, investment income, sales, services and rentals, fees and licenses, fines, contributions and donations, miscellaneous items, and intergovernmental transactions for FY 2005-06. For example, the expenditures of the Department of the Secretary of State primarily capture its expense for personnel but its internal audit needs are largely based on its processing of fees, which are captured in its revenues. However, it was not logical to take the highest figure for three agencies. Revenues were used in place of expenditures

for the Department of Public Instruction and the University System since the money flows through to the Local Education Agencies or to universities where IA functions currently exist or will exist as a result of this bill. Expenditures were used for the Department of Insurance (DOI) since revenues are largely generated by collections from the insurance regulatory fee. The mission of DOI is best captured by its expenditures rather than its collection of this fee.

The MGT study recommends focusing resources based on the level of risk. The MGT report recommended each agency listed as a critical need should have internal audit functions located in-house. HB 1401 requires that the Council of Internal Auditing conduct its own risk assessment to recommend the number of IA's each agency needs and requires the Council to administer a program of shared IA's. It is my interpretation of the legislation that 1) the number and hiring of shared IA's is dependent upon the Council's risk assessment and 2) the Council shall recommend hiring IA's in high priority areas first. Therefore, based on the MGT risk assessment, it is assumed the development of this shared pool will occur after the in-house auditors located in critical need agencies are in place. Additionally, the MGT study recommended agencies with operating expenditures greater than \$70,000,000 have in-house IA's and agencies with less than \$70,000,000 in operating expenditures use the shared IA pool. This methodology was applied to the altered base amount used in this analysis unless the agency was located outside of Wake County.

The MGT study estimated the total cost for fully implementing internal auditing in State government is \$16.1 million, which equates to 179 positions.

#### Position Estimate of Agency IA Needs

The number of IA's needed is based on an average cost (including salary, benefits, and miscellaneous support) of \$90,000 per auditor. State government has five IA classifications: IA trainee (Grade 69), IA I (Grade 72), IA II (Grade 75), IA Manager I (Grade 78), and IA Manager II (Grade 80). Currently, the State employs no trainees, 28 IA I's, 57 IA II's, six IA Manager I's, and three IA Manager II's.

Based on the average cost of \$90,000 per auditor, the State will need to hire approximately 106 – 131 auditors to meet the State's critical IA needs and an additional 265 to meet the State's non-critical IA needs.

#### Cost Estimate of Agency IA Needs

In order to meet the needs of the Council, it is assumed that OSBM will need to fill the three positions listed above in FY 2007-08. The costs to hire in-house IA's and the shared IA pool may be implemented over a number of years. This analysis includes a breakdown of the total estimated cost for these three needs, with the assumption that the in-house IA's needed in high-risk agencies are the first priority. Figure One contains a list of agencies whose IA needs are listed as "critical needs" by the MGT report. Figure Two contains all other agencies that are covered by this bill. Two estimates are provided for the agencies in the "critical needs" breakdown. For some agencies,

the number of current IA's is greater than the number of IA's estimated to be needed. The Council may choose to redeploy these additional IA's to other agencies or to the shared pool or it may choose to maintain current staffing levels. Therefore, Figure One includes the estimated IA costs with and without the redeployment of these additional resources.

- 1. Total Cost for Agencies - Critical Needs: \$11,831,585 with redeployment  
(all IA's recommended as In-House) \$9,536,213 without redeployment
- 2. Total Cost for Agencies – Non-critical: \$23,599,452  
(In-House)
- 3. Total Cost for Agencies – Non-critical: \$209,848  
(Shared Pool)

Figure 1: Estimated IA Priority Needs - All In-House									
Assumed Salary/Benefits/Misc: \$90,000									
MGT Risk Rank		REVENUES	EXPENDITURES	Based on Highest Element (Unless denoted with *)	Rate	Estimated New Positions (less current positions)	Current IA Positions	Estimated IA Cost (with redeployment of existing resources)	Estimated IA Cost (without redeployment of existing resources)
1	DHHS	\$18,058,203,915	\$13,515,673,950	\$18,058,203,915	0.0366%	69.44	4	\$6,249,303	\$4,518,958
1	DOT (including DMV)	\$4,351,156,604	\$3,711,056,449	\$4,351,156,604	0.0395%	(3.90)	23	(\$351,293)	\$0
2	ITS NOT COVERED BY BILL			\$0					
3	Public Instruction	\$2,790,460,049	\$8,232,608,678	* \$2,790,460,049	0.0689%	20.36	1	\$1,832,627	\$1,018,876
4	DOC	\$207,242,253	\$1,278,703,971	\$1,278,703,971	0.0858%	(3.81)	16	(\$342,872)	\$0
5	Revenue State Treasurer	\$58,611,365	\$123,887,735	\$123,887,735	0.3004%	3.14	1	\$282,159	\$211,698
5	Treasurer	\$8,075,956,482	\$5,069,915,881	\$8,075,956,482	0.0386%	33.64	1	\$3,027,319	\$2,549,976
6	Justice	\$44,376,071	\$114,797,927	\$114,797,927	0.3004%	3.83	0	\$344,853	\$315,782
6	Juvenile Justice & Delinquency Prevention	\$13,307,807	\$150,112,115	\$150,112,115	0.3004%	2.01	3	\$180,937	\$179,087
7	AOC	\$213,272,574	\$469,561,472	\$469,561,472	0.1296%	6.76	0	\$608,552	\$741,836
<b>TOTAL</b>		<b>\$33,812,587,120</b>	<b>\$32,666,318,178</b>	<b>\$35,412,840,270</b>		<b>131.47</b>	<b>49.00</b>	<b>\$11,831,585</b>	<b>\$9,536,213</b>

Figure 2: Estimated IA Needs Excluding Priority Needs

<u>In-House vs. Shared Pool</u>		<u>REVENUES</u>	<u>EXPENDITURES</u>	<u>Based on Highest Element (Unless denoted with *)</u>	<u>Rate</u>	<u>Estimated New Positions (less current positions)</u>	<u>Current IA Positions</u>	<u>Estimated IA Cost</u>
In-House Shared Pool	Governor's Office/OSBM	\$237,705,269	\$85,608,205	\$237,705,269	0.3004%	7.93	0	\$714,067
In-House Shared Pool	Secretary of State	\$57,781,746	\$9,564,961	\$57,781,746	0.3004%	0.93	1	\$83,576
In-House Shared Pool	State Auditor	\$3,724,781	\$14,445,444	\$14,445,444	0.3004%	0.48	0	\$43,394
In-House Shared Pool	Agriculture	\$136,132,349	\$134,479,569	\$136,132,349	0.3004%	3.54	1	\$318,942
In-House Shared Pool	Labor	\$23,442,799	\$27,589,270	\$27,589,270	0.3004%	0.92	0	\$82,878
In-House	Insurance	\$597,061,714	\$69,995,417 *	\$69,995,417	0.3004%	2.34	0	\$210,266
In-House	Administration	\$191,600,676	\$208,775,075	\$208,775,075	0.3004%	6.97	0	\$627,160
In-House	Environment and Natural Resources	\$800,370,060	\$698,624,993	\$800,370,060	0.1303%	10.59	1	\$952,882
In-House	NC Wildlife Resources	\$194,888,636	\$96,545,479	\$194,888,636	0.3004%	6.50	0	\$585,445
In-House	Commerce	\$446,109,742	\$388,268,396	\$446,109,742	0.1296%	4.42	2	\$398,158
In-House	Cultural Resources	\$21,311,275	\$91,864,450	\$91,864,450	0.3004%	2.07	1	\$185,961
In-House	Crime Control & Public Safety	\$677,548,433	\$441,028,172	\$677,548,433	0.1296%	9.76	0	\$878,103
In-House	UNC-General Admin	\$749,446,610	\$964,617,837 *	\$749,446,610	0.1303%	9.85	1	\$886,529
In-House	UNC-Hospitals	\$650,811,501	\$650,758,973	\$650,811,501	0.1296%	9.37	0	\$843,452
In-House	UNCCH	\$13,810,245,351	\$8,639,563,271	\$13,810,245,351	0.0376%	53.70	4	\$4,832,652
In-House	NCSU	\$2,590,418,031	\$3,672,435,468	\$3,672,435,468	0.0417%	12.02	5	\$1,081,406
In-House	UNCG	\$882,164,831	\$999,838,489	\$999,838,489	0.1303%	12.48	2	\$1,122,790
In-House	UNCC	\$1,259,424,057	\$1,157,148,185	\$1,259,424,057	0.0858%	9.01	3	\$810,586
In-House	UNC-Asheville	\$171,359,524	\$261,672,475	\$261,672,475	0.3004%	8.73	0	\$786,064
In-House	UNC-Wilmington	\$658,773,522	\$921,677,698	\$921,677,698	0.1303%	12.34	1	\$1,110,946
In-House	ECU	\$1,659,108,932	\$2,289,073,509	\$2,289,073,509	0.0689%	13.52	4	\$1,217,172
In-House	NC A&T SU	\$786,119,002	\$890,265,587	\$890,265,587	0.1303%	10.89	2	\$980,016
In-House	WCU	\$363,535,919	\$527,662,661	\$527,662,661	0.1296%	6.60	1	\$593,851
In-House	ASU	\$692,816,580	\$846,872,102	\$846,872,102	0.1303%	11.26	1	\$1,013,474
In-House	UNC-Pembroke	\$170,678,605	\$281,730,490	\$281,730,490	0.3004%	8.40	1	\$756,318
In-House	Winston-Salem SU	\$188,656,110	\$333,443,439	\$333,443,439	0.1296%	2.80	2	\$252,143
In-House	Elizabeth City SU	\$142,618,292	\$242,189,574	\$242,189,574	0.3004%	7.08	1	\$637,537
In-House	Fayetteville SU	\$217,930,692	\$315,233,761	\$315,233,761	0.1296%	3.54	1	\$318,543
In-House	NCCU	\$635,033,031	\$808,759,494	\$808,759,494	0.1303%	10.71	1	\$963,814
In-House	NC School of S&M	\$3,312,731	\$17,795,255	\$17,795,255	0.3004%	0.59	0	\$53,457
In-House	NC School of Arts	\$155,698,270	\$154,028,945	\$155,698,270	0.3004%	5.20	0	\$467,718
<b>TOTAL</b>		<b>\$29,175,829,071</b>	<b>\$26,241,556,644</b>	<b>\$31,997,481,682</b>		<b>264.54</b>	<b>36.00</b>	<b>\$23,809,300</b>

**SOURCES OF DATA:** Office of the State Controller, Office of State Budget and Management, Office of State Personnel

**TECHNICAL CONSIDERATIONS:**

1. The definitions in G.S. 143-738 (a) establish the list of agencies that are impacted by HB 1401. These definitions exclude several agencies that justifiably should be included. Agencies omitted include the General Assembly, Housing Finance Agency, ITS, the Office of the State Controller, the Employment Security Commission, the Board of Elections, the Community College System Office, and the Education Lottery. It is my assumption that these agencies were omitted erroneously. Therefore, I have conducted a similar fiscal impact for these omitted agencies. It should be noted that ITS is listed in the MGT report as a critical need. If the legislation is amended to include these agencies, the expected costs will increase by \$621,595 for the one critical agency and \$1,660,084 for non-critical agencies. These figures, which translate into 28 additional positions, do not include the redeployment of existing resources. See Figure 3 for details.

Figure 3: Estimated IA Needs for Agencies Not Covered by HB 1401

<u>In-House vs. Shared Pool</u>		<u>REVENUES</u>	<u>EXPENDITURES</u>	<u>Based on Highest Element (Unless denoted with *)</u>	<u>Rate</u>	<u>Estimated New Positions (less current positions)</u>	<u>Current IA Positions</u>	<u>Estimated IA Cost (with redeployment of existing resources)</u>	<u>Estimated IA Cost (without redeployment of existing resources)</u>
Shared Pool	General Assembly	\$13,895,828	\$46,280,045	\$46,280,045	0.3004%	0.54	1	\$49,025	\$48,981
In-House	NC Housing Finance	\$160,548,471	\$47,716,606	\$160,548,471	0.3004%	5.36	0	\$482,288	\$265,665
Shared Pool	OSC	\$33,541,467	\$25,092,916	\$33,541,467	0.3004%	1.12	0	\$100,759	\$64,291
In-House	Employment Security Commission	\$2,524,015,523	\$1,067,868,913	\$2,524,015,523	0.0689%	15.32	4	\$1,379,047	\$770,116
In-House	ITS	\$246,422,767	\$203,253,876	\$246,422,767	0.3004%	8.23	0	\$740,254	\$621,595
Shared Pool	Board of Elections	\$12,919,146	\$38,391,691	\$38,391,691	0.3004%	(2.72)	4	(\$244,671)	\$0
Shared Pool	Community Colleges Board	\$319,213,192	\$1,127,803,696	\$319,213,192	0.1296%	4.60	0	\$413,700	\$103,280
In-House	NC Education Lottery	\$233,805,881	\$149,828,555	\$233,805,881	0.3004%	7.80	0	\$702,353	\$652,793
<b>TOTAL</b>		<b>\$3,544,362,275</b>	<b>\$2,706,236,298</b>	<b>\$3,602,219,037</b>		<b>40.25</b>	<b>9.00</b>	<b>\$3,622,755</b>	<b>\$2,526,721</b>

2. Based on G.S. 143-738 (c), the Office of the Lieutenant Governor and the Office of Administrative Hearings are exempted from HB 1401.
3. G.S. 143-739(c) of this bill requires a bachelor’s degree and five years of experience for all internal auditors. However, the current classification system includes five IA positions, all of which have educational and training standards lower than the directive included in HB 1401. For example, the highest grade position of IA Manager II requires: “Minimum Education and Experience - Graduation from a four-year college or university with a major in accounting and three years of accounting/auditing experience in the preparation of interpretive or analytical accounting/financial statements and reports, one of which must

have been supervisory in nature; or a four-year degree in business administration or other field with twelve (12) semester hours in accounting and four years of progressive experience as specified above, one of which must have been supervisory in nature; or a two-year degree in accounting and six years of experience as specified above, two of which must have been supervisory in nature.”

It is unclear why this bill requires such a rigorous minimum level of education and experience. It is not known what will happen to the current internal auditors that have less than five years of experience or have a two-year degree in accounting but it is assumed that these auditors will not be applicable. It is assumed that OSP may use existing resources to reevaluate the job descriptions for all internal auditing positions to meet the new educational and experience standards this bill requires.

4. As defined by the Institute of Internal Auditors, 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.” However, HB 1401 muddies the line between the role of an internal auditor and a performance auditor. While both focus on achieving independence and objectivity, a performance auditor has an accountability function while the role of an internal auditor is “to provide reasonable assurance that the processes will enable the organization's objectives and goals to be met efficiently and economically.” It is the role of a performance auditor to evaluate the most practical way to conduct programs, regardless of any legal constraint, while it is the role of an internal auditor to ensure that the law is followed, not to question the applicability of the law as implied in HB 1401. It is also the role of an internal auditor to implement internal controls that safeguards public funds and assets and minimizes incidences of fraud, waste, and abuse, not to evaluate a “programs necessity” as stated in HB 1401.
5. HB 1401 requires each applicable State agency to appoint a “Director of Internal Auditing.” However, it is unclear if this position is required to be an Internal Auditor. This position classification currently does not exist. Agencies with internal auditing functions to be performed by the shared IA pool are not exempt from this requirement.
6. HB 1401 requires OSBM to “designate one employee to serve as council administrator.” This wording implies that this designated employee should be an existing employee. However, this was not the intent of the bill drafter. Since it is not possible for OSBM to designate an existing staff member to serve this council, this new position is included in the Assumptions and Methodology section.
7. The council is composed of five elected Council of State members and the State Controller who is appointed for seven-year terms by the Governor. The Offices of the State Controller and the Chair of the Council – the Lieutenant Governor – are not covered by HB 1401. No cabinet members serve on the council.

8. Figure 3 uses the lower figure of revenues vs. expenditures for the Community College System Office to determine IA needs since money flows through to the local colleges where IA functions are the responsibility of the localities.

9. The date this bill becomes effective – July 1, 2007 – has passed.

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**DATE:** July 9, 2007



**Signed Copy Located in the NCGA Principal Clerk's Offices**