

INTERNAL CONTROLS AND INTERNAL AUDIT FUNCTION

Based on a review of current law and discussions with specialists in the area, the Audit Committee has reached the following conclusions about internal controls and internal audit for New York State public authorities.

I. Internal Controls

Internal controls are the steps that an entity takes to provide reasonable assurance that the entity's objectives are achieved through effective and efficient operations, reliable financial reporting and compliance with applicable laws and regulations.

Summary of Current Law:

New York state law sets forth specific requirements for internal controls for state agencies in the Internal Control Act, Article 45, Section 950-951 and for certain public authorities in Public Authority Law (Article 9), Title 8, Section 2930-2931. Both laws contain similar requirements. With respect to "covered authorities", the law requires the governing board of each covered authority to establish and maintain internal control guidelines and a system of internal control, designate an internal control officer and implement education and training of officers, directors and employees.¹ Only "covered authorities", which are authorities and public benefit corporations controlled by the governor, are subject to internal control requirements.²

The Budget Policy and Reporting Manual, B-350, "Governmental Internal Control and Internal Audit Requirements", issued October 21, 2003, elaborates on the requirements stated above. The manual requires the head of each covered State agency and public authority to certify compliance with internal control requirements by March 31 of each year and submit an annual Internal Control Summary of the related activities undertaken during the previous year.³ The manual clarifies that state agencies and covered authorities must design and maintain internal control standards in conformance with generally accepted professional standards, including

¹ Article 9, Title 8, Section 2931 states:

The governing board of each covered authority shall:

1. establish and maintain for the authority guidelines for a system of internal controls that are in accordance with this article and internal control standards;
2. establish and maintain for the authority a system of internal control and a program of internal control review. ...
3. make available to each member, officer and employee a clear and concise statement of the generally applicable managerial policies and standards with which he or she is expected to comply. ...
4. designate an internal control officer, who shall report to the head of the authority, to implement and review the internal control responsibilities established pursuant to this section; and
5. implement education and training efforts to ensure that members, officers and employees have achieved adequate awareness and understanding of internal control standards and, as appropriate, evaluation techniques.

² A "covered authority" is "any public authority or public benefit corporation, other than a bi-state authority or public benefit corporation, a majority of whose members are appointed by the governor or serve as members by virtue of holding state offices to which they were appointed by the governor, or any combination thereof." Article 9, Title 8, Section 2930. A list of "covered authorities" and agencies subject to internal control requirements can be found in Attachment A to Budget Policy and Reporting Manual, B-350.

³ Detailed instructions for certification can be found in Budget Bulletin B-1171, Re: 2004-5 Internal Control Certification and Reporting.

standards promulgated by the Office of the State Comptroller in his *Standards for Internal Control in New York State Government*.⁴ The Comptroller's *Standards for Internal Control* discusses internal control extensively in a general manner but does not set forth specific standards or procedures to be followed. This document was last revised in 1999, but a new draft version is currently circulating for comment.⁵

Proposed Legislation

The proposed Public Authority Accountability Act would not change which entities are required to implement internal controls under current law. The proposed legislation does require every state authority to submit to the governor, state comptroller and certain legislators on an annual basis "an assessment of the effectiveness of internal control structure and procedure."⁶ In addition, the Act states that it is the role and responsibility of board members of state and local authorities to "understand, review and monitor the implementation of fundamental financial and management controls."⁷

Committee Conclusions and Recommendations

The Committee notes that the standards for internal control are fairly well articulated in New York state law and the related documents discussed above. In addition, the Committee notes that the legislature, the office of the budget, and the comptroller's office are all involved in setting and articulating internal controls standards. The Committee concluded the involvement of several branches of government in setting rules for internal control and the reference of current law to current professional standards should ensure that the standards for internal control for agencies and authorities in New York State will remain consistent with the industry's best practices.⁸

The Committee concluded that the standards for internal control set forth in law governing state agencies and covered authorities are sufficient and a new framework is probably not warranted. The Committee understands that large, state-wide public authorities would generally be subject to internal control standards as "covered authorities" under existing law. The Committee recommends, however, that the internal control standards set forth in Public Authorities Law (Article 9), Title 8, Section 2930-2931 be extended to cover all New York State public authorities. We noted that some smaller authorities may require specific advice on how to set up internal control functions beyond the general recommendations set forth in the Comptroller's *Standards* report.

II. Internal Audit

An internal audit is a review of an entities policies and practices in order to determine the risks of loss of financial resources, noncompliance or other control risks.

⁴ The manual also lists as a reference (without discussing) *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), a set of nationally recognized standards for internal control.

⁵ The draft version retains the general treatment of the earlier document as well as adding guidelines for the proper management of information technology.

⁶ Section 2800(9).

⁷ Section 2824(1).

⁸ As discussed above, current law and the budget manual's require that internal control standards be conducted "in accordance with generally accepted professional standards for internal auditing."

Summary of Current Law

State law also sets forth requirements for establishing and maintaining an internal audit function with respect to state agencies and covered authorities. Specifically, with respect to state agencies, Section 952 requires the director of the division of the budget to specify which state agencies are required to establish and maintain an internal audit function.⁹ The law further requires, that such evaluation be based upon an “evaluation of exposure to risk, costs and benefits of implementation, and any other factors that are determined to be relevant.”

With respect to public authorities, state law requires that the governing board shall determine and periodically review whether an internal audit function within the covered authority is required.¹⁰ As for agencies, the law states that evaluation should be based on exposure to risk, costs and benefits of implementation and the audit should be conducted in accordance with “generally accepted professional standards for internal auditing.”

Budget Policy and Reporting Manual, B-350 refers agencies and authorities to the *Institute of Internal Auditor’s Standards for the Professional Practice of Internal Auditing*.

Proposed Legislation

The proposed Public Authority Accountability Act would not alter current law with respect to the internal audit function.

Committee Conclusions and Recommendations

The Committee concluded that the standards for internal audit set forth in current law are well articulated and a new framework is probably not warranted.¹¹

The Committee recognizes that internal audits may not be cost effective for all public authorities and notes that current law requires the board to make a cost-benefit analysis as to whether to adopt an internal audit. The Committee recommends Public Authorities Law (Article 9), Title 8, Section 2932 be changed to require all boards of public authorities, not just the boards of covered authorities, to decide on an annual basis whether to adopt an internal audit. Furthermore, the Committee recommends that any board that does not adopt an internal audit must explain why an internal audit is not required or feasible.

The Committee also suggested that it should be considered whether an oversight body for public authorities could develop teams to conduct internal audits for smaller authorities (which would otherwise lack the resources to conduct internal audits).

⁹ A list of agencies required to maintain an internal audit function can be found in Attachment B to Budget Policy and Reporting Manual, B-350.

¹⁰ Public Authorities Law (Article 9), Title 8, Section 2932. Note that the Budget Policy and Reporting Manual, B-350, does not include a list of authorities that must maintain an internal audit function and the Committee was not able to locate a publicly available list of such authorities.

¹¹ The Committee was further satisfied in this regard by Manual B-350’s specific reference to *Institute of Internal Auditor’s Standards for the Professional Practice of Internal Auditing*.