

AUDIT MEMO

SUBJECT: State Entity Audit Compliance Requirements	NUMBER: 23-02
REFERENCES: Government Code Sections 13886.5 and 13887 Government Auditing Standards, Sections 2.17, 2.18, 3.30, 3.44, 5.60, and 5.84 International Standards for the Professional Practice of Internal Auditing, Sections 1100, 1110, 1300, 1311, and 1321	DATE ISSUED: August 29, 2022

TO: Agency Secretaries
State Entity Directors
State Entity Audit Management

FROM: CALIFORNIA DEPARTMENT OF FINANCE

DISTRIBUTE TO APPROPRIATE STAFF WITHIN YOUR STATE ENTITY

PURPOSE

This Audit Memo reminds and informs state entities and their related audit organizations of the requirement to comply with audit standards, maintain structural independence, and obtain periodic peer reviews.

REQUIREMENTS

I. Audit Standards

All state entity audit organizations must comply with audit standards, in accordance with Government Code section 13886.5, when performing either internal or external audit activities.

Government Code Requirement

To ensure the quality of audit work conducted by the state, Government Code section 13886.5 requires the following:

- The Controller, the Director of Finance, and the respective staffs thereof, and all state entities that have their own internal auditors or that conduct internal audits or internal audit activities, shall conduct internal audit activity under the general and specified standards of internal auditing prescribed by the Institute of Internal Auditors (IIA) or Government Auditing Standards issued by the Comptroller General of the United States (GAGAS), as appropriate.

Defining Internal Audit Activities

For the purpose of Government Code section 13886.5, internal audit activities are considered to be all audits conducted by state employees that provide independent, objective assurance. This includes state employees performing internal or external audit activities. For audit activities following IIA standards and/or GAGAS, the placement of the audit organization within the state entity is a critical component to maintaining independence.

II. Structural Independence

State entity audit organizations must maintain structural independence in compliance with IIA and/or GAGAS audit standards during the performance of their internal and/or external audit activities.

Independence impairments for those following IIA and/or, GAGAS, or other applicable standards, may diminish the credibility, functionality, and usefulness of audit activities within the state entity and the ability to place reliance on the results of the audit activities performed.

IIA Standards

For state entity internal audit organizations complying with IIA standards, the chief audit executive (CAE) must report to a level within the state entity that allows the internal audit activity to fulfill its responsibilities (IIA section 1110) of conducting independent, objective audits. Additionally, Implementation Guidance (IG) for section 1100 states the CAE would not typically report to an individual who directly oversees an area subject to audit. The IIA recommends the CAE report administratively to a chief executive, both so that the CAE is clearly a senior position, and the audit organization is not positioned within a function that is subject to audit.

For state entities overseen by a governing body, the CAE shall be accountable to the audit committee of the governing body. For state entities not reporting to a governing body, the CAE shall be accountable to the head or deputy head of the state entity. For state entities either with or without a governing body, audit activities shall be organizationally outside of management functions subject to audit (Government Code section 13887).

When the audit organization resides within other functions in a state entity, it is not considered independent of that function which is subject to audit (IIA section 1100). For example, if the CAE reports to a Chief Compliance Officer (CCO), areas overseen by the CCO are not considered to be independent of the audit organization.

If the CAE has functional responsibilities broader than internal audit activities, such as risk management or compliance, the audit organization would not be considered independent of these additional functions which are also subject to audit. The IIA recommends the CAE not have operational responsibilities beyond internal audit activities, as these other responsibilities may, themselves, be subject to audit.

GAGAS

Structural independence is a component of GAGAS General Requirements that audit activities must be independent from the functions subject to audit (GAGAS section 3.18). The placement of an audit organization within the state entity can impact the audit organization's ability to perform work and report results objectively (GAGAS section 3.52).

For internal audit organizations complying with GAGAS, to be structurally independent, the CAE must be accountable and report engagement results to the head or deputy head of the state entity (or those charged with governance), located organizationally outside the functions subject to audit, and sufficiently removed from

pressures so the audit organization can conduct engagements and report results and conclusions objectively, without fear of reprisal (GAGAS section 3.56). GAGAS also requires auditors to evaluate threats to independence, both in mind and appearance, including structural threats at the organizational level (GAGAS section 3.30).

III. Peer Reviews

An important component of both IIA standards and GAGAS is obtaining periodic external peer reviews/assessments, which ensure high-quality services are provided and increase trust in those services. While IIA refers to these reviews as “assessments,” they are considered to be peer reviews within the context of this memo. External peer reviews involve experienced auditors from a separate organization reviewing the audit organization's quality control system and a selection of audits to determine compliance with applicable standards. As summarized in the table below, audit organizations following IIA standards and/or GAGAS are required to obtain a peer review no less than once every five years and three years, respectively.

Internal Audit Organization Activities, Standards, and Peer Reviews		
Audit Activity	Applicable Standards	Peer Review Timing
Audits of units/programs within the same organization as those conducting the audit	IIA Standards (Red Book)	Every five years
Audits of organizations, entities, or businesses separate from those conducting the audit (i.e. external entities)	GAGAS (Yellow Book)	Every three years

State entity audit organizations should cite the audit standards followed when reporting audit results. However, the CAE needs to ensure the audit organization is in compliance with applicable audit standards reporting requirements prior to stating audit standards were followed while conducting the audit.

Citing Standards

Audit organizations following IIA standards may only communicate their activity conforms with IIA standards if the results of internal and external peer reviews support such statement. Specifically, the audit report may only indicate the organization is operating in conformance with standards if the audit organization has been in existence at least five years and has completed an external peer review. An audit organization that has been in existence fewer than five years may indicate that it is operating in conformance with standards only if a documented internal peer review supports that conclusion. Internal peer reviews include ongoing monitoring of internal audit activity and periodic self-assessments of work performed to ensure compliance with applicable standards. (IG for section 1311 and 1321).

Audit organizations conducting engagements in accordance with GAGAS are required to obtain an external peer review no less than once every three years (GAGAS sections 5.60 and 5.84). Organizations that have not obtained a timely external peer review shall issue a modified compliance statement disclosing in the report the applicable requirement(s) not followed, the reasons for not following the requirement(s), and how not following the requirement(s) affected or could have affected the engagement and the assurance provided (GAGAS sections 2.17 and 2.18).

Peer Review Responsibilities

It is the responsibility of the individual state entities to ensure that any peer reviews obtained meet the requirements of IIA standards or GAGAS, as applicable. Peer reviews must be conducted using existing resources.

The California Department of Finance assists state entities in complying with peer review requirements by tracking and monitoring state entities' peer review compliance status. Please be prepared to provide recent audit reports and external peer reviews, if requested.

Peer Review Resources

External peer reviews may be obtained by a variety of means. Finance and Certified Public Accounting firms may provide these services for a fee. In addition, the California Association of State Auditors (CASA) conducts external peer reviews through an exchange of resources with other state entities. The exchange of resources is accomplished through a Memorandum of Understanding. To obtain more information about this program, please contact CASA through the CASA website at <http://www.casa1.org/>. If state entity audit organizations have not had a peer review obtained as required, Finance may conduct a peer review in accordance with Government Code section 13070.

Please distribute this Audit Memo to state entity management, state entity audit organization staff, and others as appropriate. If you have any questions, please contact Becky McAllister, Assistant Chief, Finance, Office of State Audits and Evaluations, at (916) 322-2985.

/s/ Cheryl McCormick

Cheryl L. McCormick, CPA
Chief, Office of State Audits and Evaluations
California Department of Finance