



KENTUCKY RETIREMENT SYSTEMS
William A. Thielen, Executive Director

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MEMORANDUM

Date: February 6, 2014

To: Bobby D. Henson, Chair
Audit Committee of the Board of Trustees

From: Connie A. Davis, CIA, CGAP, CRMA, 
Internal Audit Director

Re: Audit Report: **Self – Assessment Quality Assurance Review Report – 2013 with Independent Validation Statement**

Please see the attached report of **Self-Assessment Quality Assurance Review with Independent Validation Statement** for the KRS' Internal Audit Division for the FYE 2013. The report is dated March 31, 2013, the date in which sufficient self – assessment had been completed. The Independent Validation Statement is dated January 3, 2014, the date in which the validation was completed.

Additional copies are included for Mr. William A. Thielen, Esq., Executive Director; Ms. Karen D. Roggenkamp, Chief Operations Officer; Ms. Charlene C. Haydon, Chief Benefits Officer; Mr. David Peden, MBA, CFA, Interim Chief Investment Officer; Mr. Brian Thomas, Esq., General Counsel; Ms. Kathy I. Rupinen, Assistant General Counsel, Ms. Jennifer A. Jones, Assistant General Counsel; Mr. Todd E. Coleman, CPA, Controller; Ms. Ann M. Case, CGAP, CRMA, Deputy Controller; Mr. Mark McChesney, CISM, CISA, CISSP, CGEIT, CRISC, Information Security Officer; Mr. Jeff Luckett, Director of Information Technology; Ms. Marlane Robinson, PHR, Director of Human Resources.

KRS' internal audit activity "**generally conforms**" to the Institute of Internal Auditors' (IIA) *International Standards for the Professional Practice of Internal Auditing (Standards)* and the IIA's Code of Ethics. The self – assessment quality assurance report recommends nine opportunities and the Independent Validation Statement provides three additional opportunities for the Division of Internal Audit to improve the effectiveness and enhance the value of the Internal Audit activity and ensure its full conformity to the *Standards*.

Enclosures

cc: Sec. Timothy Longmeyer, Esq., Member
Audit Committee of the Board of Trustees

Self Assessment
February 6, 2014
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Dr. Daniel L. Bauer, Member
Audit Committee of the Board of Trustees

Mike Cherry, Member
Audit Committee of the Board of Trustees

J. T. Fulkerson, Member
Audit Committee of the Board of Trustees

File

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Kentucky Retirement Systems
Frankfort, Kentucky

DIVISION OF INTERNAL AUDIT
SELF-ASSESSMENT QUALITY ASSURANCE REVIEW REPORT-2013

MARCH 31, 2013

Executive Summary

The International Standards for the Professional Practice of Internal Auditing (Standards) issued by The Institute of Internal Auditors (IIA) require external quality assessment reviews (QARs) to determine the extent of the internal audit function conformance to Standards. Adherence to the Standards is essential for the professional practice of internal auditing. Within the IIA Standards are attribute Standards and performance Standards. The IIA states that *“Standards are the criteria by which the operations of an internal audit department are evaluated and measured. They are intended to represent the practice of internal auditing as it should be.”*

The IIA guidelines allow smaller audit shops to perform “self-assessment with independent external validation” as an alternative to the more comprehensive external QAR. The Kentucky Retirement Systems’ (KRS’) Division of Internal Audit has conducted a quality assurance self-assessment with independent external validation of the internal audit activity.

It is Internal Audit opinion that an adequate self-assessment quality assurance review with independent validation was performed and that KRS’ internal audit activity “generally conforms” to the Institute of Internal Auditors’ *International Standards for the Professional Practice of Internal Auditing (Standards)* and IIA’s *Code of Ethics*.

Objective

The main objective of the review was to evaluate the KRS Division of Internal Audit’s compliance with the Standards and Code of Ethics issued by the IIA.

Scope and Methodology

As part of the internal self-assessment process, the KRS’ Internal Audit completed the relevant quality assurance tools developed by the IIA.

This self-assessment process examined internal audit work performed for the fiscal year ended June 30, 2013. During this period, Internal Audit tested compliance with the Standards, the Code of Ethics, the Division of Internal Audit’s policies, procedures, practices, work papers, audit reports and performed limited tests of the self-assessment to validate the results and verified the indicated level of conformity to the Standards. Audit charters and reporting relations were examined during the self-assessment review. The objectivity of the work performed was reviewed to determine the independence of the Division of Internal Audit. Audit staff’s knowledge, skills, abilities, performance evaluation process and training were evaluated by the staff survey and unit’s work. An inventory of current audit work and associated working papers was reviewed, the scope and performance of planned and completed audit work was also evaluated. The annual internal audit planning

process was reviewed along with a review of the policies and procedures for planning, documenting, communicating audit results and audit recommendation follow-up. Minutes of meetings and approvals of Board/Audit Committee for the Internal Audit budget, Auditors' Conflict of Interest Statements, Internal Audit policies and procedures manual, and Annual Audit Plan were reviewed.

The review was based on the IIA's Practice Advisory 1312-2, External Assessments: Self-Assessment with Independent Validation. This methodology, which is described in the IIA Quality Assessment Manual and associated tools, is used by most IIA members in performing quality assessment reviews. Tools 2A, 5, 12, 13, 14, 15, 17, and 19 were used in developing the overall opinion. We determine conformity to each of the Standards and the rolled those determinations into an overall conclusion. According to the IIA Quality Assessment Manual, conformance with standards was determined using the following rating methodology.

GC – “Generally Conforms” means the evaluator has concluded that the relevant structures, policies, and procedures of the activity, as well as the processes by which they are applied, comply with the requirements of the individual *Standard* or element of the Code of Ethics in all material respects. For the sections and major categories, this means that there is general conformance to a majority of the individual *Standards* or elements of the Code of Ethics, and at least partial conformance to the others, within the section/category. There may be significant opportunities for improvement, but these must not represent situations where the activity has not implemented the *Standards* or the Code of Ethics, has not applied them effectively, or has not achieved their stated objectives. As indicated above, general conformance does not require complete/perfect conformance, the ideal situation, “successful practice,” etc.

PC – “Partially Conforms” means the evaluator has concluded that the activity is making good-faith efforts to comply with the requirements of the individual *Standard* or element of the Code of Ethics, section, or major category, but falls short of achieving some major objectives. These will usually represent significant opportunities for improvement in effectively applying the *Standards* or Code of Ethics and/or achieving their objectives. Some deficiencies may be beyond the control of the activity and may result in recommendations to senior management or the board of the organization.

DNC – “Does Not Conform” means the evaluator has concluded that the activity is not aware of, is not making good-faith efforts to comply with, or is failing to achieve many/all of the objectives of the individual *Standard* or element of the Code of Ethics, section, or major category. These deficiencies will usually have a significant negative impact on the activity's effectiveness and its potential to add value to the organization. These may also represent significant opportunities for improvement, including actions by senior management or the board.

Opinion

Based on the work outlined above, it is Internal Audit's opinion that the Division of Internal Audit of Kentucky Retirement Systems generally conforms to the Standards and the IIA's Code of Ethics. This opinion means that the review found policies, procedures, and/or practices in place that implement professional internal auditing standards.

Self-Assessment Observation and Comments

The remainder of this report includes the quality assessment for each major area of professional guidance and recommended actions for the Division of Internal Audit to build a more effective internal audit organization. Presented on the following pages are the results on compliance, by assessment area:

- The IIA Standards (Attribute and Performance Standards)
- The IIA Code of Ethics

International Standards for the Professional Practice of Internal Auditing (Standards)

Attribute Standards:

➤ **1000 – Purpose, Authority, and Responsibility**

The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the *Standards*. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

➤ **1100 – Independence and Objectivity**

The internal audit activity must be independent, and internal auditors must be objective in performing their work.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

➤ **1200 – Proficiency and Due Professional Care**

Engagements must be performed with proficiency and due professional care.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

Opportunity for improvement #1:

Audit work programs were documented with audit objectives but preliminary assessment of risks and/or assessment of possibility of fraud/errors relevant to the specific engagement activity were not documented in some examined audit workpapers. Engagement objectives reflect the results of the assessment. The documentation of these assessments in audit workpapers ensure that each audit is planned in accordance with the *Standards 1220.A1 and A3; 2201; 2210.A1; and 2240.A1*. Audit workpapers provide evidence of due professional

care in the conduct of work performed. There should be an evidence of a risk assessment of the audit engagement in audit workpapers.

➤ **1300 – Quality Assurance and Improvement Program**

The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

Opportunity for improvement #2:

A formal periodic assessments procedure for reviewing audit workpapers was established in the Internal Audit Procedures Manual, but not conducted per *Standard 1311-1(4)*. Audit workpapers should be reviewed at least annually for periodic quality assurance purpose in accordance with the Standard.

Performance Standards:

➤ **2000 – Managing the Internal Audit Activity**

The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

➤ **2100 – Nature of Work**

The internal audit activity must evaluate and contribute to the improvement of governance, risk management, and control processes using a systematic and disciplined approach.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

➤ **2200 – Engagement Planning**

Internal auditors must develop and document a plan for each engagement, including the engagement's objectives, scope, timing, and resource allocations.

Self-Assessment: The Division of Internal Audit partially conforms to the Standard.

Opportunity for improvement #3:

The audit work programs were reviewed and approved by the Director of Internal Audit during the review of audit work papers, but not prior to implementation of the audit. The work program should be approved prior to its implementation and any adjustments should also be approved promptly to ensure that audit is fully compliant with the *Standards 2240.A1*.

➤ **2300 – Performing the Engagement**

Internal auditors must identify, analyze, evaluate, and document sufficient information to achieve the engagement's objectives.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

Opportunity for improvement #4:

One examined audit workpaper was not reviewed and/or signed by the Director of Internal Audit. The same audit workpaper was also not signed by the auditor who prepared the workpapers. After reviewing, engagement workpapers should have review date and supervisor's initials. Proper document of supervision of work papers conforms that objectives are achieved and quality is assured per *Standard 2340*.

Opportunity for improvement #5:

A few examined workpapers did not have *Source* (the information obtained from whom) of the document and *Purpose* of the work paper to support the conclusion. Audit workpaper should have the source of the document and purpose of the establishment of the workpaper. According to the *Standard 2330-1*, workpapers document the information obtained from whom, the analyses made, and the support for the conclusions and engagement results.

Opportunity for improvement #6:

A few examined audits did not have the documentation of the results of the entrance and/or exit conferences/meetings. In accordance with the *Standard 2300* and Internal Audit Procedures Manual, auditor should document the results of its entrance and exit meetings in audit workpapers.

Opportunity for improvement #7:

Policies for retaining engagement records were established but policies for releasing of engagement records to internal and external parties were not developed and established. The Division of Internal Audit should consider the establishment of policies for the releasing of the engagement records to comply with any pertinent regulatory or other requirements and to ensure the conformance with *Standard 2330.A1-1 and 2*.

➤ **2400 – Communicating Results**

Internal auditors must communicate the results of engagements.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

Opportunity for improvement #8:

One examined audit final report was not signed by the Director of Internal Audit and was not issued through the Director of Internal Audit. The same audit report was not distributed to all appropriate parties such as Chief Executive Officer, Chief Operations Officer, Controller, and General Counsel. Final communication should be reviewed and/or signed by the Director of Internal Audit; reports should be signed by the auditor; and, the final results should be communicated to all appropriate parties according to the *Standards 2440; 2440.A1; and 2410-1(15)*.

➤ **2500 – Monitoring Progress**

The chief audit executive must establish and maintain a system to monitor the disposition of results communicated to management.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

Opportunity for improvement #9:

A few examined audits did not have documentation of the follow-up activities such as the evaluation of the status of the management efforts to correct observations and/or implement recommendations. The documentation of the follow-up activities ensures the conformity of the *Standard 2500*.

➤ **2600 – Communicating the Acceptance of Risks**

When the chief audit executive concludes that management has accepted a level of risk that may be unacceptable to the organization, the chief audit executive must discuss the matter with senior management. If the chief audit executive determines that the matter has not been resolved, the chief audit executive must communicate the matter to the board.

Self-Assessment: The Division of Internal Audit generally conforms to the Standard.

IIA's Code of Ethics

Principles: A code of ethics is necessary and appropriate for the profession of internal auditing, considering the trust placed in its objective assurance about risk management, control, and governance. The Institute's code of ethics extends beyond the definition of internal auditing to include principles and rules of conduct that are relevant to the profession and practice of internal auditing. Internal auditors are expected to apply and uphold the following principles:

- **Integrity**
The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.
- **Objectivity**
Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.
- **Confidentiality**
Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.
- **Competency**
Internal auditors apply the knowledge, skills, and experience needed in the performance of internal audit services.

Rules of Conduct: Integrity, objectivity, confidentiality, and competency. Rules of conduct describe, in greater detail, the behavioral norms expected of internal auditors. The Rules of conduct are an aid to interpreting the principles into practical applications and are intended to guide the ethical conduct of internal auditors.

Self-Assessment: The Division of Internal Audit generally conforms to the Principles and Rule of Conduct.

Prepared by:

Alpa H. Vyas 5/8/13

Alpa H. Vyas, MBA, CIA, CRMA
Internal Auditor II

Reviewed and approved by:

Connie Davis 5-8-13

Connie A. Davis, CIA, CRMA, CGAP
Director of Internal Audit

INDEPENDENT VALIDATION STATEMENT

The validation team was engaged to conduct an independent validation of the Kentucky Retirement System (KRS) internal audit activity's self-assessment. The primary objective of the validation was to verify the assertions made in the attached self-assessment report concerning adequate fulfillment of the organization's basic expectations of the internal audit activity and its conformity to The Institute of Internal Auditors' (IIA's) *International Standards for the Professional Practice of Internal Auditing (Standards)*. Other matters that might have been covered in a full external assessment, such as an in-depth analysis of successful practices, governance, consulting services and use of advanced technology, were excluded from the scope of this independent validation by agreement with the chief audit executive.

In acting as validators, we are fully independent of the organization and have the necessary knowledge and skills to undertake this engagement. The validation, conducted during December 11-13, 2013, consisted primarily of a review and test of the procedures and results of the self-assessment. In addition, interviews were conducted with the Executive Director, Board Chair, Audit Committee Chair, Controller, other members of senior management, and the external auditors.

We concur fully with the internal audit activity's conclusions in the self-assessment report attached. Implementation of the recommendations contained in the self-assessment report will improve the effectiveness and enhance the value of the internal audit activity and support conformity to the *Standards*. Additionally, we have identified other opportunities for improvement, as listed below. We feel these opportunities will aid the internal audit activity in achieving its mission.

Recommendation #1: Internal audit activities can play two separate yet complimentary roles in an organization. The first role is that of assurance provider. The assurance provider focuses on what has already happened and conducts compliance-based audits. The second role, consultant, is proactive and focuses on real-time improvement. While the roles are different, they are both important. The Kentucky Retirement Systems internal audit activity has historically placed more emphasis on being an assurance provider, conducting compliance audits in key areas and providing valuable feedback. However, the internal audit activity could increase its role as consultant and further assist the organization in moving forward.

In order to increase its consulting presence, the internal audit activity needs the support and confidence of management. Based on our interviews with management, it is evident that the internal audit activity oftentimes is not seen as a consulting resource. The internal audit activity should be marketed as a resource to provide these services to its internal customers. Additionally, in order to be proactive in the consulting role, the internal audit activity should be included in executive management meetings in an advisory and information-seeking role. Maintaining an advisory, not decision-making, role within the executive management team will allow the internal audit activity to better understand current organizational risks and advise on internal controls without jeopardizing its independence.

Recommendation #2: While conducting interviews with internal audit's key stakeholders, it became apparent that the greatest area of concern was assurance within the information systems. The accuracy and reliability of KRS' information systems are heavily relied upon by all its customers, internal and

Kentucky Retirement Systems
Quality Assessment Review
Independent Validation Statement

external. Although external audits are performed annually to assess general controls, the consensus was that audits performed should include all areas of risk for all KRS' information systems on a regular, ongoing basis.

While information systems are included in the annual audit plan at a high level, the extent of management's concern for information systems assurance does not appear to be reflected on the plan. Internal audit should ensure that information systems are adequately populated on the audit universe and considered during the annual risk assessment process (Standard 2120 – Risk Management). The current skills, capabilities, and technical knowledge of the internal audit staff are appropriate for activities on the existing annual audit plan. However, current resources are not adequate for a more detailed review of information systems. Due to the critical nature of resources, the chief audit executive should maintain ongoing communications and dialog with senior management and the board on the adequacy of resources for the internal audit activity.

Recommendation #3: Internal audit conducts annual risk assessments of the audit universe to determine which areas should be audited each year. To assess organizational risk, information is gathered in various manners, including previous audit issues, years since previous audit conducted, audit frequency (e.g. annual, bi-annual), and, most notably, feedback from senior management and the Board regarding their greatest areas of concern. Internal audit distributes a survey via email to solicit feedback from senior management and other key staff members. Internal audit should expand methods of receiving feedback from key stakeholders by conducting follow-up interviews, allowing for entity-wide feedback instead of focus of individual areas, and involve Board members more in the risk assessment process.



Jenni Schelling
Independent Validation Team Lead

04/03/2014

Date



Amanda Brown
Independent Validation Team Member

1-3-14

Date

Kentucky Retirement Systems Quality Assessment Review – December 2013 Evaluation Summary Independent Validation Results

(GC = Generally Conforms, PC = Partially Conforms, DNC = Does Not Conform)

Quality Assessment Evaluation Summary—Overall Evaluation	GC	PC	DNC
OVERALL EVALUATION	X		

Quality Assessment Evaluation Summary—Major/Supporting Standards		GC	PC	DNC
1000	Purpose, Authority, and Responsibility	X		
1010	Recognition of the Definition of Internal Auditing, the Code of Ethics, and the <i>Standards</i> in the Internal Audit Charter	X		
1100	Independence and Objectivity	X		
1110	Organizational Independence	X		
1111	Direct Interaction with the Board	X		
1120	Individual Objectivity	X		
1130	Impairment to Independence or Objectivity	X		
1200	Proficiency and Due Professional Care	X		
1210	Proficiency	X		
1220	Due Professional Care	X		

QUALITY ASSESSMENT REVIEW
EVALUATION SUMMARY
INDEPENDENT VALIDATION RESULTS

DECEMBER 2013

Quality Assessment Evaluation Summary—Major/Supporting Standards		GC	PC	DNC
1230	Continuing Professional Development	X		
1300	Quality Assurance and Improvement Program	X		
1310	Requirements of the Quality Assurance and Improvement Program	X		
1311	Internal Assessments	X		
1312	External Assessments	X		
1320	Reporting on the Quality Assurance and Improvement Program	X		
1321	Use of "Conforms with the <i>International Standards for the Professional Practice of Internal Auditing</i> "	X		
1322	Disclosure of Nonconformance	X		
2000	Managing the Internal Audit Activity	X		
2010	Planning	X		
2020	Communication and Approval	X		
2030	Resource Management	X		
2040	Policies and Procedures	X		
2050	Coordination	X		
2060	Reporting to Senior Management and the Board	X		
2070	External Service Provider and Organizational Responsibility for Internal Auditing	X		
2100	Nature of Work	X		
2110	Governance	X		

QUALITY ASSESSMENT REVIEW
EVALUATION SUMMARY
INDEPENDENT VALIDATION RESULTS

DECEMBER 2013

Quality Assessment Evaluation Summary—Major/Supporting Standards		GC	PC	DNC
2120	Risk Management	X		
2130	Control	X		
2200	Engagement Planning	X		
2201	Planning Considerations	X		
2210	Engagement Objectives	X		
2220	Engagement Scope	X		
2230	Engagement Resource Allocation	X		
2240	Engagement Work Program		X	
2300	Performing the Engagement	X		
2310	Identifying Information	X		
2320	Analysis and Evaluation	X		
2330	Documenting Information	X		
2340	Engagement Supervision	X		
2400	Communicating Results	X		
2410	Criteria for Communicating	X		
2420	Quality of Communications	X		
2421	Errors and Omissions	X		
2430	Use of "Conducted in Conformance with the <i>International Standards for the Professional Practice of Internal Auditing</i> "	X		

QUALITY ASSESSMENT REVIEW
 EVALUATION SUMMARY
 INDEPENDENT VALIDATION RESULTS

DECEMBER 2013

Quality Assessment Evaluation Summary—Major/Supporting Standards		GC	PC	DNC
2431	Engagement Disclosure of Nonconformance	X		
2440	Disseminating Results	X		
2450	Overall Opinions	X		
2500	Monitoring Progress	X		
2600	Communicating the Acceptance of Risks	X		
	The IIA's Code of Ethics	X		

Independent Validation performed by:
 Jenni M. Schelling, CIA, CRMA, CFE
 Amanda J. Brown, CIA