



February 3, 2015

The Honorable Mark Dayton, Governor
Governor's office
Veterans Service Bldg., Room 116
20 West 12th Street
St. Paul, MN 55155

The Honorable Roger J. Reinert, Chair
Legislative Audit Commission
325 State Capitol
75 Rev. Dr. Martin Luther King Jr. Blvd.
St. Paul, MN 55155

RE: Biennial Report on the System of Internal Controls and Internal Auditing in Executive Agencies

Dear Governor Dayton & Senator Reinert:

Please find enclosed a copy of the *Biennial Report on the System of Internal Controls and Internal Auditing in Executive Agencies* submitted pursuant Minnesota Statute Section 16A.057, Subdivision 7. The report was prepared by Minnesota Management and Budget's Internal Controls and Accountability Unit.

If you have questions regarding the enclosed report, please contact John Pollard, Minnesota Management and Budget, at john.pollard@state.mn.us or 651.201.8039.

Sincerely,

A handwritten signature in blue ink, appearing to read "Myron Frans".

Myron Frans
Commissioner

Enclosure

cc: James Nobles, Legislative Auditor
Legislative Audit Commission Members



**Biennial Report:
System of Internal Controls
and Internal Auditing
in Executive Agencies**

January 2015

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Introduction

We are pleased to present this report on the State of Minnesota's system of internal auditing and internal controls in executive agencies for 2013 and 2014. Executive branch agencies continue to review and improve their internal control systems, primarily through the efforts of the state's internal auditors, internal control professionals, and agency management.

Minnesota Management & Budget's Internal Control and Accountability Unit was created pursuant to M.S. Section 16A.057. The unit coordinates the efforts of those dedicated to strong internal controls by providing thought leadership and practical advice to strengthen controls throughout state government. Work done by the unit in the last two years includes the following:

- Developed statewide internal control related policies and procedures, including practical tools and agency guidance such as the *control environment self-assessment tool* and the *Guide to Risk Assessment and Control Activities*
- Promoted continuous process improvement by training agencies on internal controls and facilitating business process risk assessments
- Required annual executive branch agency internal control certifications, pursuant to M.S. Section 16A.057, Subdivision 8
- Increased awareness of internal controls through publications, consultation, and outreach, including the monthly internal controls bulletins
- Developed and deployed enterprise-wide ethics and code of conduct training to support the annual employee code of conduct certification process
- Reinforced the work of the Office of Legislative Auditor (OLA) by monitoring reports and findings, attending audit exit conferences and counseling agencies in their efforts to remediate outstanding audit findings
- Facilitated the statewide internal controls roundtable
- Promoted and sponsored fraud awareness and prevention activities
- Partnered with state agencies and government organizations to promote strong internal controls and best practices throughout the executive branch of state government



Figure 1 - Monthly internal controls bulletins are in their seventh year of publication

Internal Control and Accountability Unit Mission and Strategies

M.S. Section 16A.057, as passed by the 2009 legislature, made the Minnesota Management & Budget (MMB) commissioner responsible for the design, implementation, and maintenance of an effective system of internal controls and internal auditing for all executive branch agencies. As a result of the legislation, the Internal Control and Accountability Unit was created.

The primary mission of the unit is to improve internal controls in the executive branch of state government. The unit has the following statutory responsibilities:

- Adopt statewide internal control standards and policies
- Coordinate executive branch agency internal control training and assistance
- Promote and coordinate the sharing of internal audit resources
- Monitor Office of the Legislative Auditor (OLA) reports and corresponding corrective action plans
- Report biennially on the system of internal controls and internal auditing in executive branch agencies

Executive Agency Internal Audit and Internal Control Efforts

The state's internal auditors and other internal control professionals play a crucial part in promoting sound internal controls throughout the state. Within the executive branch, there are agencies that maintain audit departments, staffed by internal auditors whose primary job responsibilities focus on traditional assurance and compliance testing. However, there are also agencies that employ "internal control specialists" who work on behalf of management to facilitate risk assessments, train staff on internal controls, draft policies and provide management consulting.

The executive branch's internal audit and internal control offices and professionals work autonomously for individual state agencies. This decentralized structure is appropriate, as it allows audit and internal control professionals to focus attention and expertise solely on one state agency. These professionals are thoroughly familiar with the businesses, objectives, operating culture, and personnel in their own unique organizations.

To coordinate and support the state's internal audit/internal control offices and efforts, and to partner with those offices on the common mission of improving internal controls across state government, the Internal Control and Accountability unit facilitates a statewide Internal Controls Roundtable. The roundtable includes representatives from cabinet and non-cabinet executive agencies, the Minnesota State Colleges and Universities System, three retirement systems, the State Board of Investment, and the state courts system. The group has 84 members, comprised of internal auditors, audit managers, and audit directors, internal control specialists, chief financial officers, accounting managers and directors, and others who have internal control responsibilities as a primary job responsibility.

The roundtable serves as an effective vehicle for promoting strong internal controls throughout state government and for coordinating the state's internal audit and internal control efforts. The group meets every six weeks to discuss internal control and internal audit issues, provide networking opportunities, receive and provide training, and share ideas and promote best practices.

2014 Executive Agency Internal Control Structure Certification

The state's internal control standard has five components: control environment, risk assessment, control activities, information and communication, and monitoring¹. Control environment is the foundation of an effective internal control structure, setting the tone of the organization and influencing the control consciousness of its people. Establishing an organizational culture of honesty, integrity, and ethical behavior is management's most critical internal control responsibility. Risk assessment is also a critical element of an effective internal control system. Risk assessment is the identification and analysis of the risks relevant to the achievement of the organization's mission and objectives, which forms the basis for determining how the organization manages risk. During the risk assessment process, management must assess and implement control activities to manage the risk. Control activities are the actions put in place by management to address and mitigate risk to ensure that the organization's mission and objectives are achieved.

Pursuant to M.S. 16A.057, Subdivision 8, all executive branch agency heads are required sign annual internal control certifications by July 31. Currently, as outlined in statewide policies and procedures, this requires that all executive branch agencies, regardless of size, complete an assessment of their control environment, and also that all cabinet and other applicable agencies, based upon size and risk level, complete and submit a risk assessment plan annually with the internal control structure certification. Requiring agencies to annually certify and complete the control environment self-assessment and a risk assessment plan moves agencies closer toward the goal of eventually being able to certify to the status of the agency's complete internal control structure as is required by M.S. 16A.057, Subdivision 8. To fully meet the statutory requirements, executive agency heads will eventually have to certify that they have reviewed the agency's entire internal control systems.

Through the internal control structure certification process, the Internal Control and Accountability unit has continued to focus on strengthening the control environment and risk assessment presence in executive branch agencies - ensuring that agencies have a strong internal control foundation on which to build, increasing agency awareness of potential risks to organizational objectives, and encouraging mitigating strategies to eliminate or reduce those risks.

Control Environment Self - Assessments

The first component of the annual internal control structure certification is the control environment self-assessment. To help executive agencies assess their own control environments, the unit created a control environment self-assessment tool. The control environment self-assessment tool leads agency executives to reflect on 20 organizational goals, comment on what the agency is doing well, and highlight any action items for further work. For each goal, the tool links related Minnesota statutes, laws, rules, and policies that provide real-life expectations of the state legislature and executive branch management. The tool shows how seemingly disparate state requirements in areas such as budget monitoring, data practices, human resources, and management style all work together to create a healthy and effective organization. Table 1 on the next page lists the 20 goals and shows the averaged ranking for cabinet² and non-cabinet agencies for each goal for fiscal year 2014 and 2013.

¹ Through December 2014, the State of Minnesota used the Committee of Sponsoring Organizations of the Treadway Commissioner (COSO) *Internal Control – Integrated Framework* as its internal control standard. As of January 2015, the State of Minnesota has switched from the COSO framework to the U.S. Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government*, also known as the *Green Book*, as the state standard. The five components of internal control remain the same under both frameworks.

**Table 1 – 2014 Agency Control Environment Self-Assessment Results Average
(on a 3 point scale where a ranking of 1.00 is Excellent and 3.00 is Inadquate)**

Goal No.	Control Environment Goal Description	FY 14 Cabinet ²	FY 13 Cabinet	FY 14 Non-Cabinet	FY 13 Non-Cabinet
1	Agency management fosters and encourages an agency culture that emphasizes the importance of integrity and ethical values.	1.58	1.79	1.46	1.54
2	The agency's positive culture promotes appropriate moral and ethical behavior in dealings with co-workers. Employees know what kind of behavior is acceptable.	1.64	1.84	1.56	1.61
3	Management has a sound basis for setting and monitoring budgets and does not pressure employees to circumvent budget statutes, rules, and instructions.	1.61	1.69	1.30	1.42
4	The agency provides the legislature and other oversight bodies with timely and accurate information to allow monitoring of agency activities.	1.57	1.61	1.30	1.35
5	Existing agency employees have a clear understanding of the organization's mission, goals, and objectives.	1.47	1.69	1.26	1.33
6	Employees understand how their job duties and responsibilities help to promote a strong internal control environment.	1.84	1.99	1.59	1.58
7	Management looks externally for opportunities to improve the internal control process.	1.57	1.73	1.62	1.72
8	The agency's organizational structure facilitates coordination and flow of information throughout the agency.	1.79	1.84	1.43	1.48
9	The agency is able to maintain its priority services during an event that might threaten to disrupt those services.	2.07	2.12	1.83	1.83
10	The agency delegates authority and assigns responsibility to the proper personnel to achieve the agency goals and objectives.	1.77	1.86	1.55	1.64
11	Management ensures that agency information is appropriately protected against loss, corruption, and misuse.	1.88	1.99	1.57	1.64
12	Valuable assets are appropriately safeguarded.	1.78	1.83	1.48	1.58
13	Agency facilities are protected against unauthorized physical access.	1.73	1.81	1.42	1.49
14	Agency management strives to recruit and retain competent people to carry out agency mission, goals, and objectives.	1.65	1.70	1.52	1.57
15	Management ensures new hires have the appropriate level of knowledge and skills needed to satisfactorily perform their jobs.	1.54	1.59	1.36	1.46
16	New hires are made aware of the agency's mission, goals, objectives and expected ethical behavior. They clearly understand their responsibilities and the expectations of their jobs.	1.70	1.78	1.38	1.43
17	The agency continually seeks to improve, maintain, and support new and existing employee knowledge and skills.	1.86	1.93	1.66	1.70
18	Management values opportunities to improve internal controls and correct deficiencies.	1.80	1.87	1.61	1.70
19	Management performs top-level reviews of actual performance.	1.76	1.95	1.61	1.73
20	The agency actively engages with the legislature, oversight committees and/or oversight boards. and/or oversight boards.	1.54	1.68	1.34	1.39

² Cabinet level agencies are those designated as *Departments of the State* in M.S. Section 15.01 and the following additional agencies: Housing Finance Agency, Iron Range Resources and Rehabilitation, Bureau of Mediation Services, MN.IT Services, Office of Higher Education, and Pollution Control Agency.

For both 2013 and 2014, 70 out of 70 (100%) executive branch agencies completed and submitted a control environment self-assessment. In the 2014 certification, cabinet agencies reported overall improvement in all 20 goal areas as compared to 2013 rankings. Cabinet agencies improved the rankings for Goals 2, 8, 10, 12, 13, and 19 in 2014, so much so, that these goals are no longer areas of high concern. However, for the second year in a row, cabinet agencies identified Goals 6, 9, 11, 17, and 18 as areas still in need improvement. Non-cabinet agencies reported improvement in all but 2 out of 20 goal areas in 2014 as compared to 2013 rankings. The ranking scale is as follows: 1.00 – Excellent, 2.00 – Adequate, 3.00 – Inadequate.

As in previous years, both cabinet and non-cabinet agencies continue to identify Goal 9 as an area of high concern and in need of the most improvement. Table 2 lists the 6 Recommended Controls associated with Goal 9 and shows the averaged ranking for cabinet and non-cabinet agencies by individual Recommended Control for fiscal year 2014 and 2013.

Table 2 – 2014 Control Environment Self-Assessment Goal 9 Recommended Control Average Rankings (on a 3 point scale where a ranking of 1.00 is Excellent and 3.00 is Inadquate)

Goal 9: The agency is able to maintain its priority services during an event that might threaten to disrupt those services.					
Rec. Control	Recommended Control Detail	FY14 Cabinet	FY13 Cabinet	FY14 Non-Cabinet	FY13 Non-Cabinet
A	The agency has performed a risk assessment and business impact analysis on its operations to identify critical functions, recovery timeframes and necessary resources, such as staffing, IT, equipment and physical location requirements.	2.09	2.09	1.72	1.67
B	The agency's recovery strategy has been tested to ensure it meets recovery time and recovery point objectives.	2.26	2.27	2.04	2.02
C	The agency's continuity plans are documented and periodically reviewed, tested and updated.	2.13	2.18	2.12	2.07
C	The agency has identified, prioritized and ranked their government services according to MN.IT guidance.	1.91	1.95	1.73	1.74
E	The agency understands its role and responsibility in the event of a disaster or prolonged disruption of government services.	1.91	2.00	1.61	1.65
F	Employees have been educated and informed of their role or responsibility during a disaster or prolonged disruption of government services.	2.13	2.23	1.76	1.80
Overall Average Ranking:		2.07	2.12	1.83	1.83

From 2014 to 2013, cabinet agencies reported an overall 2 percent improvement in Goal 9, while non-cabinet agencies reported no change from 2014 to 2013. For the second straight year, cabinet agencies ranked Recommended Control B as needing the most improvement for Goal 9. Also, for the second year in a row, non-cabinet agencies ranked Recommended Control C as needing the most improvement. Agency comments regarding Goal 9 indicated the need for more training, as well as the need to develop, implement, update, and test agency specific continuity of operations plans (COOP plans). Executive branch management is aware of these issues and is currently working on enterprise solutions to assist agencies with their efforts to maintain priority services in the event of a disruption.

Annual Risk Assessment Plans

In addition to completing the annual control environment self-assessment, agencies that meet specific size and risk level criteria were required to submit annual risk assessment plans beginning in 2013. Each applicable executive branch agency must create and maintain a comprehensive risk assessment plan. The plan ensures that agencies perform and document formal risk assessments on all high profile, key risk business processes in an effort to mitigate current or potential control weaknesses and gaps, which is critical for the evaluation of the status of the agency's overall internal control structure. For the 2014 certification, 35 of 35 (100%) of the agencies subject to the risk assessment plan requirement completed and submitted risk assessment plans.

Agency plans must identify the specific business processes risk assessments that will be performed within their agency, give a timeline for completion, and identify agency personnel responsible for completing each risk assessment named in the plan. Agencies may document their risk assessment plans in a format of their own choosing. The number and type of business processes identified in the individual agency risk assessment plans are based upon the agency's own qualitative and quantitative analysis of the highest risk processes within the agency. Due to the varied agency size and diversity of business processes, agency risk assessment plans differ greatly in format and function. Identified business processes included both programmatic and functional areas, and the implementation phase of the actual risk assessment plans vary greatly between agencies.

The next step for most agencies is to implement their risk assessment plans, by performing the detailed risk assessments contemplated in their individual plans. The Internal Control and Accountability Unit assisted by facilitating formal risk assessments at a number of executive agencies over the last two years. The primary objective of these projects is to train agency managers and staff about the theory and importance of completing risk assessments, and to demonstrate the mechanics of how to complete a formal risk assessment by working with agency teams to complete one business process risk assessment from the agency's risk assessment plan. The risk assessment plan requirement is key to the agency head's future ability to certify the status of the agency's entire internal control structure, pursuant to M.S. 16A.057, Subdivision 8.

Executive Branch Audit Report Monitoring

Resolving audit findings in a timely manner is a crucial component of a strong internal control system. Unresolved audit findings represent weaknesses that can lead to serious problems, such as unrealized objectives, fraud, waste and abuse. The Internal Control and Accountability unit works with executive branch agencies to promote prompt resolution of all Office of the Legislative Auditor (OLA) audit findings. The unit's involvement includes attending the exit conferences held between the OLA and agency management. This allows the unit to better consult with agency management, if necessary, and to assist them in understanding the audit issues involved in order to work towards implementing resolution.

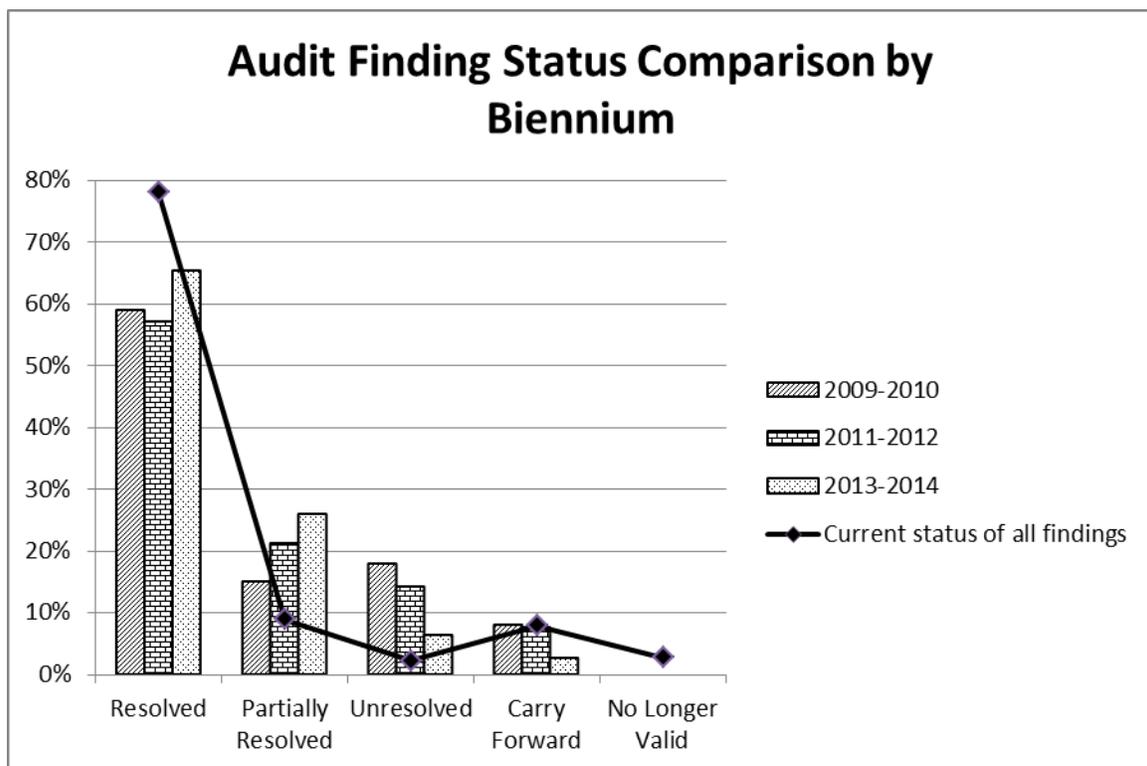
Minn. Stat. Section 16A.057, Subdivision 5 provides authority for the Internal Control and Accountability unit to "review audit reports from the Office of the Legislative Auditor and take appropriate steps to address internal control problems found in executive agencies." The unit accomplishes this endeavor using a tracking database to monitor each executive branch agency's progress in resolving outstanding audit findings.

Audit findings are entered into the tracking database when the OLA issues a financial audit report. Each audit finding is assigned an initial status based on the agency response contained in the audit report. The initial status is confirmed with the applicable agency. The database status categories are:

- Resolved: audit finding is completely resolved
- Partially resolved: some actions have been taken, other actions are yet to be completed
- Unresolved: actions have yet to occur and may still be in the analysis and planning stages
- Carried forward: repeat findings from prior audits have been “carried forward” to current audits and are no longer tracked
- No longer valid: federal compliance audit findings the OLA designated as “no longer valid or no longer warrant further action”

Quarterly, the unit generates reports of partially resolved and unresolved audit findings and requests status updates from each applicable agency. The database is updated accordingly based on agency responses. The quarterly update process reminds agencies of their responsibilities to review and resolve outstanding audit findings promptly.

Figure 2 - OLA Findings by Status



Since implementation of the tracking database in 2009, the unit has input over 800 audit findings. Figure 2 shows the status of financial audit findings by biennium as well as the current status of all findings as of December 18, 2014. Agencies have resolved seventy-eight percent of “All Findings” for OLA audit reports issued between 2009 and 2014. This percentage is significantly higher than the individual biennium percentages, because the more complex audit findings may take several months, or even years, to completely resolve.

Overall, the status percentages by biennium show a positive trend, where resolved/partially resolved findings have increased from seventy-four percent at the end of 2010 to ninety-one percent at the end of 2014. Also encouraging is the drop in unresolved findings from eighteen percent in 2010 to six percent in 2014, as well as the drop in repeat findings carried forward to current audits from eight percent in 2010 to three percent in 2014. The unit will continue to monitor the resolution and implementation

status percentages of these findings, and will assist agencies in determining effective and realistic resolution plans, as needed.

In addition to tracking audit finding status, the Internal Control and Accountability unit has found other effective uses for the database. For instance, the database information is used to generate the annual “Status of Prior Federal Program Audit Findings” schedule for the annual State of Minnesota *Financial and Compliance report on Federally Assisted Programs* (i.e. Single Audit Report). Formerly, the MMB Financial Reporting Unit manually created and maintained this schedule. Incorporating the information needed for Single Audit into the unit’s quarterly audit report monitoring process has created significant efficiencies.

Also, the database contains classification functionality, such as audit type, agency name, business process area, and legal citations. The functionality allows the unit to identify areas of statewide concern, as well as trends in audit findings. Upon request from other agencies, the unit performs database queries on specific criteria. The most common query request is to identify other agencies being cited for a specific internal control concern, such as non-compliance with a state statute. The resulting information provides an opportunity for agencies to collaborate on best practices in addressing similar audit findings.

Fraud Awareness and Prevention

M.S. Section 16A.057 requires each executive agency to establish a system of internal controls that, in part, must “safeguard public funds and assets and minimize instances of fraud, waste, and abuse.” Fraud is a global problem that affects every business and every industry, including government. A study conducted by the Association of Certified Fraud Examiners (ACFE), an international organization of more than 70,000 professionals dedicated to reducing fraud, estimates that fraud costs organizations five percent of their annual revenues. If applied to the 2013 estimated Gross World Product, five percent of revenues equates to a projected global fraud loss of nearly \$3.7 trillion.

The ACFE study also identifies the government sector as the second most victimized by fraud, behind only banking and financial service organizations. Fraud against government entities presents an expensive burden on taxpaying citizens and businesses, resulting in the increased cost of governmental services, loss of public funds and resources, decreased confidence in public officials, and increased expenses associated with the investigation, prosecution, and eventual incarceration of those who commit fraud.

In the past two years, MMB has increased efforts to raise fraud awareness across the executive branch, and developed tools and training materials to educate state employees about fraud prevention, detection, and reporting, with emphasis placed on the need for proactively fighting fraud to safeguard state assets and resources. MMB has employed the following strategies to help agencies meet their fraud prevention responsibilities under M.S. Section 16A.057:

- 1) MMB developed and implemented two new Code of Conduct/Ethics training webinars for statewide use. The new webinars replace training materials that had been in effect since approximately 2007 and had become outdated, largely ineffective due to the number of times tenured employees had viewed the materials, and did not include any substantive information regarding the state’s ethics laws. The new webinars are available for agencies to train new and existing employees, including managers and senior leaders, about the state’s ethics laws and code of conduct policies and procedures, both essential components of a strong control environment and important vehicles for informing employees that fraud and other inappropriate

behaviors are not acceptable. Critically important, the new training materials outline employee responsibilities to report fraud, other suspicious or inappropriate activities, and significant internal control weaknesses that could be exploited. It also discusses the need for communication channels to be available for making those reports.

- 2) The Internal Control and Accountability Unit revised the *Statewide Operating Procedure 0102-01.2, Risk Assessment*, and the *Guide to Risk Assessment and Control Activities* in 2014, in part, to include more guidance on how agencies can proactively assess and mitigate fraud risks. Specifically, that agency management must consider the risk of fraud in its business processes when developing the agency's formal risk assessment plan, and that fraud risks and the control activities in place to mitigate those risks, be assessed and evaluated for effectiveness when completing the individual risk assessment projects pursuant to the risk assessment plan. These concepts were a key focus and conversation topic with agency management teams during the Internal Control and Accountability Unit's 2014 internal control certification outreach meetings.
- 3) When facilitating formal risk assessments, the Internal Control and Accountability Unit facilitators stress the importance of identifying and evaluating fraud risks and controls. The unit expects to continue facilitating risk assessments in the future and will train agency staff to consider fraud risks and controls for each business process risk assessment they complete.
- 4) Governor Dayton formally proclaimed the week of November 16-22, 2014 as "Fraud Awareness and Prevention Week in the State of Minnesota" and, for the first time, the Minnesota Executive and Judicial Branches signed-up as official supporters of "International Fraud Awareness Week," an annual promotion sponsored by the ACFE. This was a week dedicated to raising state employee awareness of the fraud problem, including educating and training employees about fraud prevention, detection, and reporting techniques. MMB partnered with members of the Statewide Internal Control Roundtable to coordinate the following fraud week training and promotion activities:
 - A fraud week newsletter containing fraud-related information and training vignettes to increase employee fraud awareness and to provide training and guidance regarding fraud prevention, detection, and reporting.
 - A fraud week kick-off memo from the MMB Commissioner to all agency heads and other senior leaders urging employees to participate in fraud week activities.
 - A full-day *Fraud Risk Management* training course for approximately 70 state employees. An ACFE instructor who had more than 30 years of governmental fraud-fighting experience taught the course.
 - A fraud week poster campaign - posters were placed within elevator lobbies throughout the capitol complex and within common areas at participating agency offices.

The Internal Control and Accountability unit, in conjunction with Statewide Internal Control Roundtable, plans to continue coordinating annual fraud week promotions and activities to promote fraud awareness and provide continuing fraud-related training and education to state employees.

Conclusion

The Internal Control and Accountability Unit was formed by legislation in 2009. Over the past six years, there has been a recognizable culture shift in agencies from random acts of internal control to full ownership of internal controls by agency leadership, management, and employee

at all levels. There has also been substantial growth and maturity of agency internal control understanding and efforts. Many agencies have hired internal auditors or internal control professionals, who have worked along with the Internal Control and Accountability Unit to enhance the state's risk awareness culture and move toward proactive assessment and remediation of internal control weaknesses. We look forward to continued growth, with full certification of agency internal control systems, as required by M.S. Section 16A.057, Subdivision 8 in the next few years.

For more information on any of the topics presented in this report, please visit [the internal control website](http://www.mmb.state.mn.us/fin/ic) (<http://www.mmb.state.mn.us/fin/ic>).