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January 31, 2007

The Honorable Tim Pawlenty
Governor
130 State Capitol Building

The Honorable Richard J. Cohen, Chair
Senate Finance Committee
121 State Capitol Building

The Honorable Loren Solberg, Chair
House Ways and Means Committee
443 State Office Building

Re: 2007 Internal Auditing Progress Report

Dear Governor Pawlenty, Senator Cohen, and Representative Solberg:

Pursuant to Minnesota Statutes, Section 16A.055 Subd. 1(7), we are reporting progress on maintaining standards for internal auditing. This letter highlights the accomplishments of the Minnesota State Government Internal Auditing Advisory Roundtable (the Advisory Roundtable)¹ and significant changes in state agency internal auditing offices during calendar years 2005 and 2006. It also underscores the increasing demand for certain internal auditing services among state agencies that presently do not have an internal audit function.

In the 2005 legislative report on internal auditing progress, the Advisory Roundtable delineated plans to promote voluntary implementation of best practices similar to key provisions of the Sarbanes-Oxley Act of 2002. Although the state is exempt from the Act (with one exception that makes it a criminal offense for any entity to destroy certain records), governmental oversight agencies, such as the U.S. Governmental Accounting Office, are contemplating requirements to extend similar provisions. Proactively incorporating these best practices into state government should enhance accountability and financial management processes, and place the state in a better position to respond promptly and effectively to any future mandates that might be imposed.

¹ The Minnesota State Government Advisory Roundtable (Advisory Roundtable) is comprised of the chief internal auditors of ten state agencies with internal audit functions. The Advisory Roundtable has been in operation since March 2001.

Thus the Advisory Roundtable authored the *State of Minnesota Operating Policy and Procedure 0103-01, Code of Conduct for Employees with Accounting, Auditing, Financial Reporting, or Tax Filing Duties*. This policy supplements the existing statutory code of ethics and is intended to ensure that the state maintains the integrity of its financial management processes. The policy contains provisions of the Act that make sense practically and economically for the state of Minnesota.

- The policy incorporates some features of the Act that have received universal acclaim, such as establishing a values-based code of conduct and a retaliation-free channel for employees to report perceived problems.
- It excludes features that have not yet proven to be cost beneficial, most prominently the Section 404 requirements for rigorous documentation and testing of internal controls.

According to the policy, commissioners and other agency heads must sign an affirmation to demonstrate their commitment to maintaining an environment that promotes integrity and effective internal controls. At a minimum, agency heads must provide assurances about material internal control cycles – revenue or spending programs that are significant to the state of Minnesota financial statements. Typically, these programs are readily identifiable because the Office of the Legislative Auditor examines them each year. Agency heads have the discretion to extend assurances beyond the material internal control cycles. To assist agency heads in gaining confidence in internal controls, key accounting, auditing, financial reporting, and tax personnel must also certify a statement affirming their willingness to abide by the code and carry out their duties properly.

Minnesota State Colleges and Universities and the Department of Corrections will pilot implementation of the Code of Conduct policy. These organizations will analyze the agency impact of performing the policy's action steps. Their participation in the pilot will help determine whether any policy refinements are necessary.

To supplement the Code of Conduct policy, the Advisory Roundtable significantly revised the *State of Minnesota Operating Policy and Procedure 0102-01, Internal Control*. This policy recognizes the state's adoption of the COSO² *Integrated Internal Control Framework*, a nationally recognized internal control model that has been in existence since 1992. According to this policy, all state employees are responsible for making important contributions for effective internal control. Ultimately, appropriate public officials (as defined by Minnesota Statutes, Section 10A.01, subd. 35) are responsible to ensure that managers, including agency heads, who report to them, fulfill

² COSO represents the Committee of Sponsoring Organizations of the National Commission on Fraudulent Financial Reporting (also known as the Treadway Commission). The sponsoring organizations include the American Institute of Certified Public Accountants (AICPA), the Institute of Management Accountants (IMA), the Institute of Internal Auditors (IIA), Financial Executives International (FEI), and the American Accounting Association (AAA).

their responsibility for establishing, implementing and maintaining a sound and comprehensive internal control system.

The Advisory Roundtable also played a key role in developing an internal control self-assessment guide. This guide is intended to facilitate managements' conversations with key financial personnel as they evaluate the effectiveness of internal controls over financial reporting and other key areas. The value of this tool is that it is designed to reinforce accountability and to identify areas where controls are missing or need improvement.

During the past two years, several changes within internal audit offices in state agencies occurred. State budget reductions and examination of priorities triggered the elimination of auditor positions in the Department of Finance. Likewise, restructuring efforts within the Minnesota Office of Higher Education and attrition within the Department of Natural Resources led to reductions in the size of the agencies' internal audit offices. In addition, the internal audit position (currently vacant) within the Department of Administration is now shared between the department and the Office of Enterprise Technology (formerly Intertechnologies, which was part of the Department of Administration). In response to these changes, internal auditors for the Departments of Administration and Natural Resources, and the Minnesota Office of Higher Education are facing new challenges to reassess their internal audit practices and to explore other strategies for optimizing service levels with existing resource allocations.

Changes in reporting lines also occurred within two internal audit offices. The Department of Human Services' Internal Audits Office is now under the direction of their newly established Office of Compliance. Department of Transportation's Audit Section presently reports directly to the Commissioner in accordance with Federal Highway Administration requirements.

An increased demand for internal auditing services among state agencies without internal audit functions has also occurred in the past two years. This movement may be indicative of a future trend as agency heads and managers fulfill their responsibilities to evaluate the effectiveness of internal control systems they maintain within their respective organizations. Types of audit requests include: assurances about the status of operations, investigations, internal control assessments, and validations of achieving outcomes of purchasing card pilot programs. Presently, the Department of Finance is monitoring these requests and prioritizing internal audit activities based on the department's available resources.

Currently there is an increased need for computer forensic services by all state agencies. The Department of Human Services has attempted to provide these services by allowing its forensic auditor to assist other state agencies with their personnel investigations.

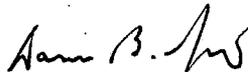
This report is the collaborative effort of several Minnesota state agencies.³ While the departments of Finance and Administration share statutory responsibility for publishing this report biennially, this report is possible only because of the assistance, cooperation, and dedication of Minnesota State Government Internal Auditing Advisory Roundtable members representing other state agencies. We extend our appreciation to these employees for their contributions and the time devoted to preparation of this report.

If you have any questions concerning this report, please contact Barb Ruckheim at (651) 201-8140 or Jeanine Kuwik at (651) 201-8148.

Sincerely,



Tom J. Hanson
Commissioner
Department of Finance



Dana B. Badgerow
Commissioner
Department of Administration

c: Senator Dennis R. Frederickson
Representative Marsha Swails
Matt Kramer, Chief of Staff

³ The cost of producing this report is \$1,200.