



January 30, 2009

The Honorable Tim Pawlenty, Governor
State of Minnesota
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: 2007-2008 Biennial Internal Auditing Progress Report

Dear Governor Pawlenty, Senator Cohen, and Representative Solberg:

This letter reports progress on coordinating and maintaining internal auditing standards for Minnesota state agencies. It is required by Minnesota Statutes, Section 16A.055, Subd. 1(7). This report:

- Underscores the nationwide emergence of internal control best practices impacting internal audit offices,
- Emphasizes the demand for internal control expertise within state government,
- Summarizes the roles and challenges facing internal audit offices within Minnesota state government, and
- Identifies changes to individual state agency internal audit offices during the last biennium.

Internal Control Best Practices Impacting Internal Audit Offices

Two national initiatives have emerged as internal control best practices models for Minnesota state government. The first is contained in several new auditing standards promulgated by the American Institute of Certified Public Accountants (AICPA). The second is the ongoing effect of the Sarbanes-Oxley Act of 2002. Both of these initiatives will continue to have a large impact on the state's internal auditors, as state agencies evaluate and implement these models as best practices.

New Auditing Standards

The new auditing standards issued by the AICPA enhanced auditors' focus on internal controls. The standards, often referred to as the "risk assessment suite" of auditing standards, require auditors to gain a deeper understanding of state agency operating environment and controls, using the control framework contained in *Internal Control – Integrated Framework*, published by the Committee of Sponsoring

Organizations of the Treadway Commission (COSO Report). The COSO Report defines five interrelated components of internal control, including control environment, entity risk assessment, information and communication, control activities, and monitoring.

Because internal controls are primarily the responsibility of agency management, best practices dictate agencies address all five interrelated components of internal control as defined above, and also adequately document each of these five components. *State of Minnesota Operating Policy and Procedure 0102-01, Internal Control* also requires agencies to implement an internal control system consistent with the COSO internal control framework. This policy recognizes the state's adoption of the COSO internal control framework and was updated and endorsed by the Minnesota State Government Internal Auditing Advisory Roundtable as a best practice in 2006. Although many agencies have implemented some components of Policy and Procedure 0102-01, agencies need to recognize that review of internal controls is a continuous process, requiring constant monitoring and evaluation.

Sarbanes-Oxley Act

Key provisions of the Sarbanes-Oxley Act of 2002 continue to affect state agencies and state internal audit offices. Although the state is exempt from the Act (with one exception that makes it a criminal offense for any entity to destroy certain records), there are important provisions of the Act that represent best practices for strong financial management. In addition, governmental oversight agencies, such as the U.S. Governmental Accountability Office (GAO), are contemplating requirements to extend similar provisions to recipients of federal government assistance, such as the State of Minnesota.

To strengthen Minnesota state government's financial management and to place the state in a better position to respond promptly and effectively to any future mandates, the Internal Auditing Advisory Roundtable authored *State of Minnesota Operating Policy and Procedures 0103-01, Code of Conduct for Employees with Accounting, Auditing, Financial Reporting, or Tax Filing Duties* in 2006. This proposed 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 proposed policy also provides formal evidence of an appropriate control environment and sets a positive "tone at the top" by agency heads, as required by the COSO Report.

The Department of Corrections, Minnesota State Colleges and Universities, the Department of Education, and Minnesota Management and Budget (MMB) have all implemented the code of conduct as pilot projects. The Departments of Human Services and Transportation have also begun piloting the code of conduct within their agencies. With the support and assistance of the Internal Auditing Advisory Roundtable, MMB is recommending full implementation of the *State of Minnesota Operating Policy and Procedures 0103-01, Code of Conduct for Employees with Accounting, Auditing, Financial Reporting, or Tax Filing Duties* by all state agencies by the end of the next biennium.

Need for Internal Control Expertise within State Government

Minnesota Management and Budget expects state government to have sufficient internal controls in place so operations are effective and efficient, financial reporting is reliable, applicable laws and regulations are followed, the state's assets are adequately safeguarded, and public confidence is

maintained. The COSO Report provides state agencies with an internal control framework to reasonably assure that these objectives are met. These expectations, along with the new audit standards and the Sarbanes-Oxley Act, increasingly require agency management to have or to obtain a working knowledge of the COSO framework, including the ability to set objectives, assess risks, and periodically evaluate internal controls. All state agencies should fully implement the provisions of *State of Minnesota Operating Policy and Procedure 0102-01, Internal Control*. As required in *Policy and Procedure 0102-01*:

Each agency head must develop a plan for establishing, implementing and maintaining an effective internal control system. This plan, at a minimum, should require documentation of internal control procedures over financial management activities, analysis of relevant risks, and periodic evaluation of these control procedures, with the assistance of internal auditors as needed, to satisfy management that these procedures are adequately designed, properly implemented, and functioning effectively.

Minnesota Management and Budget recognizes the increased demand for internal auditors and other internal control experts necessary to train agencies on the internal control framework and to assist agencies in fully implementing the provisions of *State of Minnesota Operating Policy and Procedure 0102-01, Internal Control*.

The Governor's recommended budget for the 2010/11 biennium addresses this need by including the creation of a new internal control support unit in Minnesota Management and Budget to strengthen the state's financial oversight capabilities. This initiative will build an internal control support team in MMB to augment existing training and support for all state agencies. This training would include areas such as internal controls, risk assessments and code of conduct. An element of this initiative will also enable the state to better oversee and deliver the state's expanding debt management tools, ensuring that funds are used according to statute, policy and legal covenants. In addition, the Governor's recommended budget includes additional funding for the Small Agency Resource Team (SmART) in the Department of Administration to provide additional small agencies, boards, and councils with centralized human resources and financial management services. Through the delivery of business support services, SmART supplies information and advice about state policies and procedures that result in timely, accurate, and efficient transaction processing. The guidance provided by SmART to small agencies, boards, and councils helps in the development of an environment of internal control.

Internal Audit Office Developments

Several state agencies continue to have internal audit offices. The following briefly summarizes progress and/or changes to individual internal audit offices during the past two years.

Department of Administration

Until late 2006, Administration and the Office of Enterprise Technology jointly shared internal audit resources. The incumbent accepted another position in state government. Administration has since completed limited internal audit work by rehiring a part-time retired state employee. Administration is not anticipating filling the permanent position, but will continue to look for alternatives to accomplish limited audit work.

Administration has also worked cooperatively with agencies on the development of policies that help agencies ensure processes that encourage an environment of internal control. Examples of these policies include: fleet cards, cell phones, and procurement of conferences, meetings and events.

Department of Corrections (DOC)

DOC Internal Audit Unit continues to perform follow-up audits in the areas of grants, cell phones, purchasing cards, travel and other areas.

Minnesota Judicial Branch

The Judicial Branch Office of Internal Audit conducts routine audits according to an annual schedule reviewed by Judicial Administrators and Directors and approved by the Judicial Council Finance Committee. Unanticipated investigations are performed when suspected thefts of Judicial Branch funds or assets are reported. In fiscal years 2007 and 2008, the Office of Internal Audit issued 13 routine audit reports, two investigative reports, and four limited reviews. In addition, the office began creating a series of audit compliance checklists in the areas of payroll, contracting, capital assets, receipts, collections, business expense reimbursements, human resources, and information technology. These checklists will eventually be used by Judicial Branch units to self evaluate between internal or external audits.

Department of Human Services (DHS)

DHS created an Office of Compliance and placed the internal audit functions within the compliance office. The Internal Audit Director reports directly to the Chief Compliance Officer (CCO). Although the compliance office is organizationally under the Operations Administration, the CCO has direct access to the Commissioner and Internal Audit reports are sent directly to the Commissioner. At the same time, the Internal Audits Office's functions were expanded by adding two units and a position to conduct program evaluations. One unit conducts recipient eligibility reviews for the Medical Assistance and Minnesota Care programs. The other unit manages the requirements of the federal government's Payment Error Rate Measurement (PERM) effort on the Medical Assistance and State Children's Health Insurance (SCHIP) programs in the areas of claims processing, medical necessity, and recipient eligibility.

DHS internal audit function continues to conduct investigations covering a variety of issues and provided computer forensic assistance in numerous investigations both within DHS and other agencies.

Department of Natural Resources (DNR)

DNR Internal Audit Unit has primarily been responsible for audits of Boat and Water Safety grants. Currently, the department is in the process of restructuring its internal audit unit function to assume a more active role in department-wide financial operations. The restructuring of the unit will: increase accountability; provide assurances to management on the appropriate sources and uses of funds; and initiate recommendations and develop improvements in department policies, procedures, practices and controls. During the upcoming year, DNR plans to develop an audit plan and an Internal Audit Committee to ensure internal audit work reflects management priorities. In addition, the Internal Audit

Unit will work within the department to address state policies pertaining to implementation of the Code of Conduct policy and entity level risk assessments of financial operations.

Department of Revenue (DOR)

DOR Internal Audit Office continues to issue audit reports focused on financial, operational, program, and systems general controls. Audits included the following: (1) programs audits to ensure compliance with statutes, rules, regulations, and management directives, (2) incompatible duties and separation of duties, (3) safeguarding receipts, prompt deposits and reconciliations (4) building access (5) refund processing.

Minnesota Colleges and Universities (MnSCU)

The Minnesota State Colleges and Universities (MnSCU) has continued to maintain a strong internal auditing office. The MnSCU Office of Internal Auditing fully complies with the professional practice standards promulgated by the Institute of Internal Auditors and successfully completed its first external quality assurance in March 2007. Accordingly, the office is structured to report functionally to the Board of Trustees in order to preserve its independence. The office is staffed with ten professionals who have extensive auditing experience and credentials. The office delivers a variety of assurance, investigative, and consulting services to the board, Chancellor, and system presidents. More information is available about the office at <http://www.internalauditing.mnscu.edu/>.

In addition to its internal auditing function, MnSCU hires CPA firms to conduct annual financial statement audits and contracts with the Legislative Auditor for periodic financial and compliance audits of its campuses. One of the essential responsibilities of the Office of Internal Auditing is to follow-up on all internal, external, and Legislative audit findings to ensure that timely corrective action is implemented.

The Minnesota State Colleges and Universities system also has made extraordinary efforts to strengthen its internal controls. Under the leadership of its Vice Chancellor for Finance, MnSCU has implemented a process to conduct risk assessments of major internal control cycles and obtained annual certifications from its senior officials and financial professionals regarding the accuracy of financial statements and the reliability of internal controls. In 2008, MnSCU also implemented a code of conduct for its employees and launched a system-wide code of conduct training program.

Minnesota Department of Transportation (Mn/DOT)

Mn/DOT strengthened its Internal Audit function during the past year. Auditors were added to the staff to provide continuous audit and oversight of employee business expenses, cell phone use, time sheet coding and approval, state issued credit cards, and asset inventory. The administration in Mn/DOT has been supportive of efforts to hold individuals and offices accountable and provide the additional funding necessary to aid in this goal.

This year, the internal and external audit function completed its required Yellow Book Peer Review and is in compliance with those audit standards. Also, during this past year, the internal audit function conducted the compliance part of the Single Audit on the Mn/DOT. This was accomplished through a Memo of Understanding with the Legislative Auditors Office. This will be Mn/DOT's 20th year in providing this service with the guidance from the Office of the Legislative Auditor.

Mn/DOT's staff is currently 20 auditors auditing all of Mn/DOT's grants and contracts with outside companies and other governmental entities, including rural transit grants, utility relocation contracts, railroad signal crossing installations, and consultant contracts, as well as Mn/DOT's internal functions. The internal audit group conducted investigations of employee wrongdoing, construction contract overruns, construction projects for compliance with construction specifications and the Northstar rail project. One of the essential responsibilities of the function is to follow-up on all internal, external, and Legislative audit findings to ensure that timely corrective action is implemented.

Mn/DOT reorganized last year after the appointment of the new Commissioner. As a result of this reorganization, the Internal Audit function now reports to the Commissioner/Deputy Commissioner as a team concept toward management instead of the Deputy Commissioner.

Mn/DOT Internal Audit function continues to maintain strong associations with our local Federal Highway Administration (FHWA) and the National American Association of State Highway Transportation Officials (AASHTO) Audit Subcommittee on Internal and External Audit where we are taking a leadership role in audit issues common to all state Department of Transportation Internal Audit Groups.

Minnesota Management and Budget (MMB)

Although budget pressures reduced resources for internal audit positions, MMB financial reporting staff continues to provide minimal internal audit services to state agencies as time permits.

MMB has also made significant progress in strengthening its internal controls over financial reporting. The financial reporting unit provided internal control training to individuals within MMB as well as intensive GAAP training to both staff within MMB and other agencies. This unit also performed a risk assessment of the major internal controls over the statewide comprehensive financial report. In addition, annual certifications from financial managers continue to be obtained from agencies submitting financial information to MMB for inclusion in the state's comprehensive annual report regarding the accuracy and completeness of financial information. In 2008, MMB also implemented the code of conduct policy.

Minnesota Office of Higher Education (OHE)

OHE Internal Audit Unit continues to conduct reviews of on the servicing of SELF loans by an outside vendor and to review the administrative capabilities of post-secondary institutions that participate in the office's financial aid and loan programs.

Internal Auditing Advisory Roundtable

The chief internal auditors in the state agencies with internal audit functions comprise the Minnesota State Government Internal Auditing Advisory Roundtable (Advisory Roundtable). The Advisory Roundtable seeks opportunities for internal audit to add value to state government, and monitors the direction of the profession, future mandates, and best practices for state government. As a result of this goal, an information packet has been developed as a resource to agencies interested in starting an internal audit office. Although the Advisory Roundtable has been inactive during the past biennium, several members are willing to offer advice, tools, and share resources to help agencies gain efficiencies.

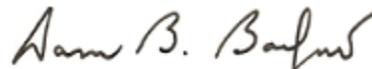
This report is the collaborative effort of several Minnesota state agencies. While Minnesota Management and Budget and the Department of Administration share statutory responsibility for publishing this report biennially, the report is only possible because of the assistance, cooperation, and dedication of the Internal Auditing Advisory Roundtable members representing several state agencies. We extend our appreciation to these employees for their contributions to this report and for the time devoted to making Minnesota government better through their auditing efforts.

If you have any questions regarding this report, please contact Barb Ruckheim at (651) 201-8140 or Jeanine Kuwik (651) 201-4148.

Sincerely,



Tom J. Hanson, Commissioner
Minnesota Management and Budget



Dana B. Badgerow, Commissioner
Department of Administration