O L A **OFFICE OF THE LEGISLATIVE AUDITOR**
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Office of the State Auditor

Internal Controls and Compliance Audit

January 2011 through June 2013

November 15, 2013 **Report 13-28**

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OFFICE OF THE LEGISLATIVE AUDITOR
State of Minnesota • James Nobles, Legislative Auditor

November 15, 2013

Senator Roger Reinert, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

The Honorable State Auditor Rebecca Otto
Office of the State Auditor

This report presents the results of our internal controls and compliance audit of the Office of the State Auditor for the period from January 1, 2011, through June 30, 2013. The objectives of this audit were to determine if the office had adequate internal controls for its financial operations and complied with finance-related legal requirements.

We discussed the results of the audit with the office's staff at an exit conference on November 4, 2013. This audit was conducted by Scott Tjomsland, CPA, CISA (Audit Manager), Kayla Borneman, CPA, CFE (Auditor-in-Charge), and auditors Sandy Ludwig and Carmen Marg-Patton.

We received the full cooperation of the office's staff while performing this audit.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

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Report Summary

Conclusion

The Office of the State Auditor generally had adequate internal controls to ensure that it safeguarded its financial resources, accurately paid employees and vendors in accordance with management's authorizations, complied with finance-related legal provisions, and created reliable financial data. For the items we tested, the office complied with finance-related legal requirements. However, the office had some internal control weaknesses in its safeguarding of fixed assets.

Finding

- The Office of the State Auditor did not have sufficient internal controls to safeguard its fixed assets. (Finding 1, page 7)

Audit Objectives and Scope

Objectives
- Internal controls
- Legal compliance

Period Audited
January 1, 2011, through June 30, 2013

Programs Audited
- Payroll expenditures
- Selected administrative expenditures
- Selected receipts

Office of the State Auditor

Agency Overview

The Office of the State Auditor is a constitutional office in the executive branch of state government.[1] The office states as its mission the oversight of local government finances by helping to ensure financial integrity and accountability in local governmental financial activities. It performs audits of local governments' financial statements and reviews documents, data, reports, and complaints reported to the office. The State Auditor serves on six state boards: the State Executive Council, State Board of Investment, Land Exchange Board, Minnesota Housing Finance Agency, Public Employees Retirement Association, and Rural Finance Authority Board.

The State Auditor is elected for a four-year term. Rebecca Otto was first elected as the State Auditor in November 2006 and was re-elected in November 2010. The office has organized its responsibilities into six divisions. On its Web site, the office provides the following information about its divisions:

- The **Audit Practice** Division performs approximately 150 financial and compliance audits and reviews approximately 400 single audits per year. This division establishes uniform reporting standards and provides technical assistance and education to local units of government, which strengthens accounting practices and promotes good government at the local level.

- The **Constitutional Office** oversees all the activities of the Office of the State Auditor and its divisions and supports the State Auditor serving on six boards for the state.

- The **Government Information** Division collects and analyzes local government financial data, which is assembled in regular reports provided to the Legislature and the public. It also conducts a Best Practices Review of local government operations. The reports assist the Legislature with planning and policy-making decisions related to local governments.

- The **Legal/Special Investigations** Division investigates allegations of theft or misuse of public funds. It also provides legal compliance information and training to local government officials and legal compliance expertise to staff within the Office of the State Auditor.

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[1] *Minnesota Constitution* Article V.

- The **Pension** Division reviews investment, financial, and actuarial reporting for approximately 730 public pension plans. Its objective is to ensure compliance with state statutes governing the administration of plans covering approximately 20,000 members.

- The **Tax Increment Financing** Division promotes legal compliance and accountability through examination and review of political subdivisions' use of tax increment financing (TIF). The division reviews TIF plans and annual financial reports from approximately 2,100 TIF districts; responds to questions regarding tax increment financing from citizens and government officials; and provides training on compliance with state TIF laws.

The office received a General Fund appropriation to finance the majority of its operating activities. While the office operated its audit division with this General Fund appropriation, statutes required the office to bill for the audits at a rate sufficient to cover these costs and to deposit audit fees back into the General Fund as nondedicated receipts.[2, 3]

The office also received a special revenue fund appropriation to operate its Tax Increment Financing Division and collected other miscellaneous fees that it deposited into a special revenue fund as dedicated receipts.[4]

The office has several locations throughout the state. Staff in the main Saint Paul office performed the office's accounting and human resources duties.

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[2] Nondedicated receipts revert to the General Fund and are not available to fund the office's operations. Dedicated receipts are available for agency activities.

[3] For fiscal year 2014, *Minnesota Statutes* 2013, 6.581, established the state auditor enterprise fund. The statute directs the office to deposit audit fees into the fund and annually appropriates those receipts to the office to pay the costs and expenses related to the examinations performed, including, but not limited to, salaries, office overhead, equipment, authorized contracts, and other expenses.

[4] A special revenue fund contains money paid by counties to the state, as directed by *Minnesota Statutes* 2013, 469.177, to provide resources for the operations of the office's Tax Increment Financing Division, as allowed by *Minnesota Statutes* 2013, 469.1771, subd. 1.

Table 1 summarizes the office's financial activities for fiscal years 2012 and 2013.

Table 1
Office of the State Auditor
Appropriations, Receipts, and Expenditures
July 1, 2011, through June 30, 2013[1]

	Fiscal Years	
Appropriations	2012	2013
General Fund	$8,645,000	$8,645,000
Special Revenue Fund	816,031	725,865
Receipts		
Audit Fees – Nondedicated General Fund	$6,028,776	$5,608,007
Other Fees – Dedicated Special Revenue Fund	53,222	65,705
Total Receipts	$6,081,998	$5,673,712
Expenditures		
Payroll	$7,784,212	$7,684,250
Purchased Services[2]	826,802	848,982
Supplies/Equipment	200,887	149,786
Other Expenditures	86,429	70,408
Total Expenditures	$8,898,330	$8,753,426

[1] The scope of our audit also included fiscal year 2011 activity from January 1, 2011, through June 30, 2011.
[2] Purchased services included rent, printing, professional/technical contracts, computer services, communications, travel, and employee development.

Source: State of Minnesota's accounting system.

Our prior audit of the office did not report any internal control weaknesses or instances of noncompliance.[5]

Objective, Scope, and Methodology

The objective of our audit of the Office of the State Auditor for the period of January 1, 2011, through June 30, 2013, was to answer the following questions:

- Did the Office of the State Auditor have adequate internal controls to ensure that it safeguarded its financial resources, accurately paid employees and vendors in accordance with management's authorizations,

[5] Office of the Legislative Auditor's Financial Audit Division, Report 11-17, *Office of the State Auditor*, issued June 30, 2011. The report covered the period from January 2009 through December 2010.

complied with finance-related legal provisions, and created reliable financial data?

- Did the Office of the State Auditor comply with significant finance-related legal requirements?

To answer these questions, we gained an understanding of the office's financial policies and procedures. We considered the risk of errors in the accounting records and potential noncompliance with relevant legal requirements. We obtained and analyzed the office's accounting data to identify unusual trends or significant changes in financial operations. We examined samples of financial transactions and reviewed supporting documentation to test whether the office's controls were effective and if the transactions complied with laws, regulations, policies, and contract provisions.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective.

We used various criteria to evaluate internal control and compliance. We used, as our criteria to evaluate agency controls, the guidance contained in the *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission.[6] We used state laws, regulations, and contracts, as well as policies and procedures established by the office and the Department of Management and Budget as evaluation criteria over compliance.

Conclusion

The Office of the State Auditor generally had adequate internal controls to ensure that it safeguarded its financial resources, accurately paid employees and vendors in accordance with management's authorizations, complied with finance-related legal provisions, and created reliable financial data. For the items we tested, the office complied with finance-related legal requirements. However, the office had some internal control weaknesses in its safeguarding of fixed assets.

The following *Finding and Recommendations* provide further explanation about the exception noted above.

[6] The Treadway Commission and its Committee of Sponsoring Organizations were established in 1985 by the major national associations of accountants. One of their primary tasks was to identify the components of internal control that organizations should have in place to prevent inappropriate financial activity. The resulting *Internal Control-Integrated Framework* is the accepted accounting and auditing standard for internal control design and assessment.

Finding and Recommendations

Finding 1

The Office of the State Auditor did not have sufficient internal controls to safeguard its fixed assets.

The office did not segregate incompatible duties in its fixed asset inventory process and had not developed internal controls to mitigate the risk created by the incompatible duties. Four employees who had access to update the office's fixed asset inventory system also had physical custody of about 40 percent of the office's 966 fixed assets. Allowing employees to have these incompatible duties increased the risk that errors or theft could occur without detection. The value of these assets was nearly $878,000 – about half of the office's total fixed assets, valued at approximately $1,725,000. The office asserted that some of those assets were critical to performing daily business functions and believed it would be quickly aware of any removal of those critical assets.

In addition, the office's annual physical inventory was not complete because it omitted some assets. The omissions occurred because the asset list used to conduct the inventory only included assets that had been assigned to employees; however, some assets in the office's inventory system did not identify the employee to whom the asset had been assigned. As of August 2013, there were 26 assets in the office's inventory system that did not identify an employee to whom it had been assigned. We also observed that five of these assets did not have stickers on them identifying them as state assets and showing the fixed asset numbers. Performing complete periodic physical inventories is a fundamental internal control to safeguard fixed assets against theft and loss.

Recommendations

- *The office should segregate incompatible duties in its fixed asset inventory process or develop internal controls to effectively mitigate the risk.*

- *The office should ensure that it conducts its annual physical inventory with complete inventory records for all of its fixed assets.*

REBECCA OTTO
STATE AUDITOR

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November 8, 2013

Mr. James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
Saint Paul, Minnesota 55155

Dear Mr. Nobles:

Thank you for the opportunity to respond to the finding and recommendations included in the internal control and compliance audit of the Office of the State Auditor for the period January 1, 2011, through June 30, 2013.

Finding: The Office of the State Auditor did not have sufficient internal controls to safeguard its fixed assets.

Recommendations:

- The office should segregate duties in its fixed asset inventory process or develop internal controls to effectively mitigate the risk.

- The office should ensure that it conducts its annual physical inventory with complete inventory records for all of its fixed assets.

Response: The Office of the State Auditor (OSA) agrees that internal controls over the fixed asset inventory process are important. Even with limited staffing, the OSA has developed and implemented new procedures for compensating controls over our fixed assets. We have also completed the annual inventory, and have accounted for all assets.

Person Responsible: Matthew Lindemann, Director of Budget, Finance, & Technology

Implementation Date: Completed.

Thank you for the opportunity to respond to the finding and recommendations.

Sincerely,

Rebecca Otto
State Auditor