



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

County Audits

Special Review

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Office of the Legislative Auditor

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OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

February 3, 2016

Members of the Legislative Audit Commission

Members of the House State Government Finance Committee

Members of the Senate State Departments and Veterans Budget Division

The Honorable Rebecca Otto, State Auditor

County audits were a controversial issue during the 2015 Legislature. The controversy resulted in two provisions in the State Government Appropriations Law. One provision gave counties the option of having their annual audits conducted by either the Office of the State Auditor (OSA) or a CPA firm. The other provision directed the Office of the Legislative Auditor to assess the “efficiency” of county audits conducted by OSA.

This report is our response to the legislative directive. The Office of the State Auditor cooperated with our review, as did the Association of Minnesota Counties and many individual county administrators.

Cecile Ferkul, CPA, CISA, Deputy Legislative Auditor; Tyler Billig, CPA, Audit Coordinator; and Jennyfer Hildre, Staff Auditor, assisted in preparing this report.

Sincerely,

James Nobles
Legislative Auditor

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Introduction

Minnesota counties are required to have an annual audit.¹ Prior to a recent change in the law, the Office of the State Auditor (OSA) decided whether it would conduct the audit or allow a county to hire a CPA firm to conduct the audit. In recent years, OSA has conducted annual audits of 59 counties and allowed CPA firms to audit 28 counties.²

Counties have to pay for their annual audits, regardless if the OSA or a CPA firm conducts the audit. In recent years, some counties have complained to legislators that OSA's annual audits are too costly and not timely, and that the State Auditor would not allow them to use a CPA firm. In response, the 2015 Legislature amended state law to give *all* counties the option of hiring a CPA firm to conduct their annual audits.³

The State Auditor strongly opposed giving counties the option to choose their auditor and asked the Governor to veto the legislation. However, the Governor—a former State Auditor—signed the legislation into law. The State Auditor has indicated that she is considering legal action against the legislation.⁴

In addition to giving counties the option to choose whether OSA or a CPA firm conducts their annual audit, the 2015 Legislature directed the Office of the Legislative Auditor (OLA) to report on the “efficiency” of county audits conducted by OSA.⁵

This report is our response to the legislative directive. In Chapter 1, we address the issue of audit efficiency. In Chapter 2, we provide the perspective of county administrators. In Chapter 3, we present our own perspective on the county audit controversy and make a recommendation that we hope will help resolve the conflicts that have developed over the 2015 legislation.

¹ Prior to a 2015 change in the law, the annual audit requirement was not explicit in state law. The requirement resulted from a federal law (called the “Single Audit Act”) and requirements imposed by credit rating agencies that use a government's annual financial statements in determining the government's credit rating.

² A list of the counties OSA audited and CPA firms audited is in Appendix A.

³ *Laws of Minnesota* 2015, chapter 77, art. 2, sec. 3; codified at *Minnesota Statutes* 2015, 6.481. The 2015 law goes into effect on August 1, 2016, and it provides the following: “A county that plans to change to or from the state auditor and a CPA firm must notify the state auditor of this change by August 1 of an even-numbered year. Upon this notice, the following calendar year will be the first year's records that will be subject to an audit by the new entity. A county that changes to or from the state auditor must have two annual audits done by the new entity.” A copy of the 2015 legislation is in Appendix B.

⁴ Catherine Richert, “Otto likely to take auditor change to court,” *Minnesota Public Radio*, June 10, 2015.

⁵ *Laws of Minnesota* 2015 Regular Session, chapter 77, art. 2, sec. 84.

Report Preview

KEY POINTS

We were unable to reach a definitive conclusion about the efficiency of county audits conducted by the Office of the State Auditor (OSA).

For counties we considered similar, we found that OSA charged more than CPA firms did for an audit, but we could not conclude that the price differences were due to greater efficiency alone.

The price differences might also reflect the fact that OSA and CPA firms use different pricing methods. In addition, auditors must make professional judgments in deciding how to comply with audit standards, and those judgments can effect the hours needed to complete an audit and the cost. Finally, a county's financial structure and operations can affect the time required to complete an audit and the cost.

We believe the best test for whether CPA firms are more efficient than OSA will result from implementing the 2015 legislation. The law allows for price competition, but it also allows the State Auditor to ensure that CPA firms comply with audit standards. The State Auditor also retains significant authority to ensure that counties—and other local governments—are accountable for how they spend public money.

The county financial officials we surveyed and interviewed had generally positive opinions of the OSA audit teams that have audited their counties, but mixed opinions about the cost and timeliness of OSA county audits.

The county financial officials we surveyed and interviewed had strong negative opinions about how OSA has responded to the 2015 legislation.

If the 2015 legislation is not repealed by the Legislature or overturned by a court, we recommend that the State Auditor use the legislation as an opportunity to reassess OSA's audit schedule and prepare a strategic plan that ensures all local governments will receive adequate OSA oversight. The State Auditor should present the plan to the Legislature and include proposals for alternative funding of the State Auditor's audit responsibilities.

Chapter 1: Audit Efficiency

MEASURING EFFICIENCY

The classic measure of efficiency is a quantitative ratio of inputs to outputs. Being efficient means using fewer resources to produce the same amount of goods and services, or using the same amount of resources to produce more goods and services.

Efficiency is not an absolute measure, however; we need a point of comparison. We say a person performed an activity efficiently or inefficiently by comparing how other people performed the same activity under the same conditions, or by comparing the performance to an established benchmark.

In auditing, the primary quantifiable input is the number of work hours auditors use to perform an audit, and the quantifiable output is the result, the audit report. For our review, we compared OSA county audits with CPA county audits.

We sought information from OSA and CPA firms on how many hours they required to conduct county audits in 2012, 2013, and 2014. Because OSA bills counties based on staff hours and hourly rates (specific to each level of auditor), we were able to obtain information on hours from OSA. But because CPA firms often bill counties using an agreed-upon flat fee, we were not able to obtain sufficient information on the number of hours CPA firms required to complete county audits. We did obtain, however, how much counties paid CPA firms for their audits.

COMPARING THE PRICE OF COUNTY AUDITS

Using OSA and individual county data, we compared how much OSA charged to audit eight counties with the amounts CPA firms charged to audit eight counties with similar populations and budgets. We asked OSA to review our county comparisons and identify distinctions that would explain the differences in the audit charges. Table 1 shows the eight pairs of counties and comments we received from OSA. The table illustrates the challenges of finding comparisons that can be used to make valid judgments about audit efficiency.

Table 1
Office of the State Auditor
Comparisons of Selected Counties' Audit Costs for
Calendar Years 2012, 2013, and 2014 with
Additional Information Provided by OSA

<u>County</u>	<u>Auditor</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Cass	OSA	\$84,342	\$108,743	\$106,990
Hubbard	CPA firm	\$30,500	\$ 30,500	\$ 30,500
<ul style="list-style-type: none"> OSA did not agree that audit costs for these counties were comparable because Cass County had four to five audited federal programs each year while Hubbard County had only one to two each year. In addition, Cass County's governmental revenues and expenditures were approximately double that of Hubbard County. OSA identified the following factors affecting the increase in OSA audit costs between 2012 and 2013: increased billing rates primarily due to state negotiated bargaining agreements, including insurance costs; new accounting principles; increased number of federal programs audited as major; new trial balance package; new/changed audit forms and documentation; and the mix, levels, and duties of staff assigned. 				
<u>County</u>	<u>Auditor</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Cottonwood	OSA	\$63,277	\$74,833	\$58,669
Jackson	CPA firm	\$57,890	\$60,340	\$58,550
<ul style="list-style-type: none"> OSA identified the following factors affecting the increase in OSA audit costs between 2012 and 2013: increased billing rates primarily due to state negotiated bargaining agreements, including insurance costs; new accounting principles; increased number of federal programs audited as major; and changes in County operations and investments requiring additional review. 				
<u>County</u>	<u>Auditor</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Freeborn	OSA	\$70,521	\$77,378	\$81,632
Mower	CPA firm	\$62,300	\$86,300	\$71,100
<ul style="list-style-type: none"> OSA identified the following factors affecting the increase in OSA audit costs between 2013 and 2014: increased billing rates primarily due to state negotiated bargaining agreements, including insurance costs; additional time required for the County's first year expanded comprehensive reporting related to the Government Finance Officers Association's Certificate of Achievement for Excellence in Financial Reporting Program; and additional review of issues with independence and with assessments. 				
<u>County</u>	<u>Auditor</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Lac Qui Parle	OSA	\$52,659	\$49,193	\$53,535
Swift	CPA firm	\$58,244	\$59,700	\$59,700
<ul style="list-style-type: none"> OSA cost for each year was less than the CPA firm's cost. 				
<u>County</u>	<u>Auditor</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Norman	OSA	\$63,752	\$71,497	\$68,392
Red Lake	CPA firm	\$27,920	\$29,500	\$29,500
<ul style="list-style-type: none"> OSA did not agree that audit costs for these counties were comparable because each year Norman County required audits of federal programs and Red Lake County did not. In addition, Norman County's governmental revenues and expenditures were approximately double that of Red Lake County. 				

Continued on Next Page

Table 1 (Continued)
Office of the State Auditor
Comparisons of Selected Counties' Audit Costs for
Calendar Years 2012, 2013, and 2014 with
Additional Information Provided by OSA

<u>County</u>	<u>Auditor</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Itasca	OSA	\$86,933	\$92,804	\$94,626
Beltrami	CPA firm	\$64,500	\$61,500	\$64,500
<ul style="list-style-type: none"> OSA did not agree that audit costs for these counties were comparable because Itasca County had more federal programs requiring audit in 2012 than Beltrami County; Itasca County's governmental revenues and expenditures, long-term liabilities, capital assets, and cash and pooled investments are notably higher than Beltrami County; Itasca County has three enterprise funds and Beltrami County has none; an opinion in relation to Itasca County's basic financial statements is provided for three budgetary schedules, and Beltrami County has no such budgetary schedules; and Itasca County has Other Post Employment Benefits and Beltrami County does not. These all have an impact on the extent of audit work required. 				
<u>County</u>	<u>Auditor</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Nicollet	OSA	\$55,780	\$59,603	\$66,364
Le Sueur	CPA firm	\$56,993	\$59,693	\$61,578
<ul style="list-style-type: none"> OSA costs for 2012 and 2013 were less than the CPA firm's costs. OSA identified the following factors affecting the increase in OSA audit costs between 2013 and 2014: increased billing rates primarily due to state negotiated bargaining agreements, including insurance costs; additional federal program and cost allocation testing; and a change in county staff integral to preparation of information needed to audit and for financial reporting. 				
<u>County</u>	<u>Auditor</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Scott	OSA	\$64,866	\$63,776	\$92,897
Wright	CPA firm	\$61,000	\$58,600	\$60,500
<ul style="list-style-type: none"> OSA did not agree that audit costs for these counties were comparable because Scott County's governmental revenues and expenditures have gotten progressively larger than Wright County each year; Scott County has expanded comprehensive reporting to the Government Finance Officers Association's Certificate of Achievement for Excellence in Financial Reporting Program and Wright County does not; Scott County has internal service funds and Wright County does not; an opinion in relation to Scott County's basic financial statements is provided for five budgetary schedules and Wright County has no such budgetary schedules; and Scott County's long-term liabilities and capital assets are significantly larger than that of Wright County. These all have an impact on the extent of audit work required. OSA identified the following factors affecting the increase in OSA audit costs between 2013 and 2014: increased billing rates primarily due to state negotiated bargaining agreements, including insurance costs; increased number of federal programs audited as major; the availability of county staff integral to preparation of information needed to audit and for financial reporting; and the mix, levels, and duties of staff assigned. 				

Sources: Office of the State Auditor billing data, CPA billing invoices from counties, and comments from the Office of the State Auditor.

REASONS FOR PRICE DIFFERENCES OTHER THAN EFFICIENCY

Differences in Pricing Methods

The pricing methods used by OSA and CPA firms are significantly different, and they may be a factor in how much counties pay for audits. Statute requires the OSA to bill to recover the cost of each audit. The cost of an audit is primarily determined by multiplying the time it took to conduct the audit by a rate that reflects the auditor's experience in performing the work. That rate typically includes the auditor's compensation along with an allocation of other costs related to the auditor's work, such as equipment, supplies, and other office costs. We present OSA's hourly rates and how they are established in Appendix C.

CPA firms have greater flexibility in pricing. While a CPA firm must ultimately be profitable to stay in business, it may not have to make every audit a profitable engagement. As one firm executive told us, "We price to the market, and government work is a very different market than our corporate market. Even within the government market there are submarkets, and you just decide and price depending on whether you want particular clients in those submarkets. And over time, if we cannot make money in a market or with a particular client, we don't bid again."

CPA firms also generally have a greater diversity of business than OSA, and that too can affect their pricing. For example, a firm may want a particular government client and be willing to recover a potential short-term loss through its other work, such as income tax preparations, or in the expectation of increased future revenue from the government client. Finally, a firm may consider having certain government clients as a way to develop visibility and good will in the community.

Auditor Judgment

Auditors must make professional decisions throughout an audit, and those judgments can affect the number of hours required to complete the audit and the price. While all audits must comply with generally accepted auditing standards, the standards leave considerable room for auditors to exercise judgment.⁶ For example, audit standards say an auditor must obtain "sufficient and appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit."⁷ But the standard allows the auditor to

⁶ Audits of counties are subject to various sets of audits standards: (1) Generally Accepted Auditing Standards established by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA); and (2) Generally Accepted Government Auditing Standards established by the United States Government Accountability Office (GAO). In addition, the federal government has established audit requirements for "Single Audits" in U.S. Office of Management and Budget (OMB) *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*. All of these audit standards and requirements, as well as additional guidance, are contained in the *Audit Guide for Financial and Compliance Audits of Minnesota Counties* established by the Office of the State Auditor. *Minnesota Statutes* 2015. 6.481, subd. 3, states that county audits performed by a CPA firm "must meet the standards and be in the form required by the state auditor."

⁷ Statements on Auditing Standards, AU-C sec. 500.01, *Audit Evidence*, (AICPA, Codification of Statements on Auditing Standards, as of January 2015).

use his or her professional skill, training, and experience to decide how much and what kind of evidence is sufficient and appropriate.

More specifically, audit standards do not prescribe how auditors test financial transactions or how many transactions they test. Instead, auditors determine the type and number of tests they believe are necessary based on their professional judgement. In addition, some auditors may rely less on testing specific financial transactions and more on analytical techniques to address a risk, while other auditors may decide to conduct more time-consuming tests of detailed transactions. Neither approach is wrong; they simply reflect professional judgments based on the auditors' experiences, their assessments of risk, and what they believe is required to meet the audits' objectives.

Financial Environment

Variations in the financial structure and operations of the organizations being audited can also affect the number of hours required to complete an audit and the cost. Auditors commonly refer to this as the "financial environment." While some may see Minnesota counties as having homogenous environments simply because they are all county governments, Minnesota counties actually have significant differences specifically related to their financial environments. They vary in terms of the size and nature of the expenditures, revenues, federal grant programs, internal service funds,⁸ and enterprise funds.⁹ Some counties have sold bonds or completed a construction project that requires additional disclosures or a unique accounting presentation.

In addition, in any audit, the skills and experience of the financial and management staff of the organization being audited can affect the number of hours required to complete an audit and the cost. Counties are not an exception. If a county's financial and management staff have designed and implemented strong internal controls (policies or procedures used to minimize financial risks), an audit will generally take less time. Audits will also generally take less time if the county's financial staff have adequately prepared in advance the documents and data auditors will need to conduct the audit.

⁸ Organizations use an internal service fund to report financial activity related to goods or services the government provides to its other funds, departments, or agencies on a cost reimbursement basis. For example, a government may operate a motor pool to provide vehicles to employees for work-related travel.

⁹ An enterprise fund is used to report financial activity related to goods or services the government provides to external users for a fee. For example, the OSA uses an enterprise fund to account for the financial activity related to its audit services division.

Chapter 2: County Perspective

As we noted in the Introduction, the Legislature’s recent action concerning county audits was in reaction to complaints from some county officials. Therefore, we thought it important to obtain input from as many county officials as possible to learn about their experiences with the State Auditor’s Office as well as experiences with CPA firms.

To obtain that input, we had individual interviews and a group discussion with several county administrators during the annual meeting of the Association of Minnesota Counties (AMC) on December 7, 2015. The following week, we sent a questionnaire to an administrator in each of Minnesota’s 87 counties. Because Minnesota’s counties are organized in different ways, we asked AMC to assist us in determining which county official would be the most appropriate to contact in each county.

Given the sensitivity of the issues and relationships involved—and the fact that we asked officials to be candid—we agreed not to report their responses and comments in a way that would identify the county or individual. In addition, we also classified as “not public” information in our work papers that could identify an individual administrator or county.

We identified the following themes from individual interviews, our group discussion, and the survey of county administrators:

County administrators were generally satisfied with the OSA audit teams who have conducted audits of their county.

On the survey, we asked: How satisfied have you been with the OSA auditors who have conducted annual audits of your county? Of the 44 administrators who offered an opinion, 16 were very satisfied, 24 were satisfied, and 4 were unsatisfied.

Among the comments administrators added were the following:

- *The auditors assigned to [our] county have been thorough, responsive, and professional.*
- *Reasonably satisfied. They review our processes and procedures and do appropriate random sampling of our financial transactions to ensure compliance with government financial accounting standards.*

County administrators had mixed opinions on the timeliness of OSA annual audits.

On the survey, we asked: How satisfied have you been with the timeliness of OSA's annual audits of your county? Of the 44 administrators who offered an opinion, 8 were very satisfied, 22 were satisfied, 13 were unsatisfied, and 1 was very unsatisfied.

Among the comments administrators added were the following:

- *They have consistently worked to meet the timelines we have needed.*
- *Audits are delivered in September/October – too late to be useful financial management tool for development of the next year's budget and auditing cycle.*
- *On average, it takes 2-3 months longer than our private CPA firm to have the final audited financial statements.*

County administrators also had mixed opinions about the cost of OSA audits.

On the survey, we asked: How would you characterize how much OSA has charged your county for annual audits? Of the 37 administrators who offered an opinion in our survey, 3 said the costs were very reasonable, 19 said they were reasonable, 13 said unreasonable, and 2 said very unreasonable.

Among the comments administrators added were the following:

- *The charges appear to be reasonable for the amount of work and skill level necessary. However, we have not done an RFP for comparison.*
- *I have worked as a county administrator for two counties. One was served by a private auditor, the other by OSA. The counties have similar finances and federal programs (total dollars, funds, departments, transactions, services/programs), but the cost with OSA is about 15k more.*
- *OSA claims that our costs are directly related to our audit prep work, but our costs don't decrease when we take on more work. Costs are inconsistent from year to year and across similar counties.*

County administrators have generally negative opinions about the State Auditor's response to the 2015 legislation.

On the survey, we asked: How satisfied are you with how OSA is implementing the 2015 law that allows counties to choose either a CPA firm or OSA to conduct an annual audit? Of the 47 administrators who offered an opinion, 8 administrators said they were very satisfied, 7 satisfied, 11 unsatisfied, and 21 very unsatisfied.

Among the comments administrators added were the following:

- *The OSA is attempting to place counties in the middle of their dispute with the Legislature. Their response has been too heavy handed.*
- *The communication has not been good. At some point, they need to get past "not agreeing with the legislation" and figure out how to implement it the best way possible. Good communication would have helped that immensely. Now there seems to be a lack of trust with the state office as a result.*
- *We have tried to ask questions and received vague or non-responses. We have been told we MUST sign a three-year engagement letter; when in the past they were always one-year commitments.*
- *Repeated attempts to intimidate us in to a 3 year contract has left us with doubts about our previously good relationship with [OSA].*

The comments administrators made in individual interviews and during our group discussion were consistent with the comments on the survey. For example, administrators said:

- *The letter telling us we had to sign up with the State Auditor for three years was "end run" around the new law. Frankly, my county considered the letter "disrespectful, unprofessional, and insulting."*
- *I am concerned about the OSA's use of public dollars to hire outside legal counsel to potentially litigate against counties who refuse to sign up for three years with the State Auditor's Office.*

Chapter 3: OLA Perspective

We conclude with our perspective on the county audit controversy and a recommendation that we hope will help resolve the conflicts that have developed over the 2015 legislation.

STATE AUDITOR'S AUTHORITY

A key element in the county audit controversy involves the impact of the 2015 legislation on the State Auditor's authority. As legislators and others address that issue, we think the following facts are relevant:

- The Legislature has always defined the duties and authority of the State Auditor.¹⁰ The Minnesota Constitution created the office of Auditor in 1857, but the authors of the constitution left it for the Legislature to assign duties and authority to the Auditor.¹¹
- During the State Legislature's first meeting, a state law was enacted on July 23, 1858, that made the Auditor the state's chief controller and official bookkeeper.¹² Those remained the Auditor's primary duties for approximately 115 years.
- The State Auditor did not become the auditor of local governments until 1973. That year, the Legislature abolished the Office of the Public Examiner, which had been the auditor of state and local government since the Legislature created that office in 1913. The Public Examiner became the first Legislative Auditor and assigned to audit state government. The State Auditor was assigned to audit local governments.¹³
- Since that time, the Legislature has assigned a wide range of duties and authority to the State Auditor.¹⁴

¹⁰ The exception are four constitutional amendments that assign certain non-audit duties to the State Auditor. See Footnote 14 for more details.

¹¹ *Constitution of the State of Minnesota*, art. V, sec. 1.

¹² The law is codified as *Minnesota Statutes* 1858, chapter 5, sections 19-47.

¹³ The Legislature took these actions in response to recommendations from a "blue-ribbon" panel of management experts called the Loaned Executive Action Program (LEAP). LEAP recommended that the Legislature should create an Office of the Legislative Auditor and transfer all of the Public Examiner's audit duties and authority into that office. LEAP recommended that the office of State Auditor (and the office of State Treasurer) should be abolished by a constitutional amendment.

¹⁴ The duties and authority of the State Auditor are primarily in *Minnesota Statutes* 2015, chapter 6. In addition, four constitutional amendments have been adopted in recent years that assign various non-audit duties to the State Auditor. They are contained in the *Constitution of the State of Minnesota*, art. XI, section 6 (related to certificates of indebtedness), section 7 (related to state bonds), section 8 (related to the State Board of Investment), and section 10 (related to the exchange of public lands).

- While the 2015 legislation removed the State Auditor’s authority to decide whether counties receive an annual audit from OSA or a CPA firm, the State Auditor retains significant control over county audits and authority to ensure counties are accountable for their use of public money and other public resources. In fact, the 2015 law says:

All the powers and duties conferred and imposed upon the state auditor shall be exercised and performed by the state auditor in respect to the offices, institutions, public property, and improvements of several counties of the state. The state auditor may visit, without previous notice, each county and examine all accounts and records relating to the receipt and disbursement of the public funds and the custody of the public funds and other property. The state auditor shall prescribe and install systems of accounts and financial reports that shall be uniform, so far as practicable, for the same class of offices.

- The law also says that even if a CPA firm conducts a county’s annual audit, “The state auditor may make additional examinations as the auditor determines to be in the public interest.” In short, we believe the 2015 law left the State Auditor clear authority to ensure that counties are accountable for how they use public money.

THE STATE AUDITOR’S AUDIT STRATEGY AND SCHEDULE

We believe the 2015 law presents OSA with an opportunity to reassess its overall audit strategy and schedule, as well as how the state funds audits of local governments.

The Office of the Legislative Auditor reassessed its audit schedule issue several years ago and determined that annual financial statement audits are often not the most effective mechanisms for ensuring that public funds have been used appropriately. Financial statement audits have value, but they are high-level examinations of a county’s year-end financial reports. The information is dated, and it is presented in ways that are foreign to non-accountants. Financial statements and financial statement audits receive little attention from the public and often little attention from public officials.

In addition, CPA firms generally are well equipped to audit government financial statements since these audits do not typically require special legal authority that is granted to both the State Auditor and the Legislative Auditor. In recent years, OLA has asked the Legislature to reduce the number of financial statements we conduct so that we can focus more audit resources on internal controls and legal compliance audits. At the Minnesota Department of Management and Budget’s request, we have not asked the Legislature to repeal the mandate for OLA to audit the state’s annual financial statements, but we have implemented various efficiencies to reduce the number of hours we use to complete the audit.

The State Auditor clearly has the prerogative to assess what types of audits yield the greatest benefit. However, we believe the 2015 legislation presents OSA with an opportunity to reassess its overall audit strategy for achieving the most effective deployment of its audit resources and how those resources should be funded.

Recommendation

If the 2015 legislation is not repealed by the Legislature or overturned by a court, we recommend that the State Auditor use the legislation as an opportunity to reassess OSA's audit schedule and prepare a strategic plan that ensures all local governments will receive adequate OSA oversight. The State Auditor should present the plan to the Legislature and include proposals for alternative funding of the State Auditor's audit responsibilities.

Appendix A: Counties by Auditor

The following table shows counties audited by the Office of the State Auditor (indicated by a ✓ mark) and those audited by CPA firms for the years 2009 through 2014.

Table A-1
Counties Audited by the Office of the State Auditor or CPA Firms
2009 to 2011 and 2012 to 2014

<u>County</u>	<u>2009 to 2011</u>	<u>2012 to 2014</u>	<u>County</u>	<u>2009 to 2011</u>	<u>2012 to 2014</u>
Aitkin	✓	✓	Martin	✓	✓
Anoka	✓	✓	McLeod	✓	✓
Becker	Hoffman, Dale & Swenson	✓	Meeker	✓	✓
Beltrami	CliftonLarsonAllen		Mille Lacs	✓	✓
Benton	CliftonLarsonAllen	✓	Morrison	✓	✓
Big Stone	✓	✓	Mower	CliftonLarsonAllen	
Blue Earth	✓	✓	Murray	✓	✓
Brown	✓	✓	Nicollet	✓	✓
Carlton	✓	✓	Nobles	CliftonLarsonAllen	
Carver	✓	✓	Norman	✓	✓
Cass	✓	✓	Olmsted	✓	✓
Chippewa	✓	✓	Otter Tail	✓	✓
Chisago	✓	✓	Pennington	Hoffman, Dale & Swenson	
Clay	✓	✓	Pine	✓	✓
Clearwater	Hoffman, Dale & Swenson		Pipestone	✓	✓
Cook	✓	✓	Polk	Brady, Martz & Associates (09-12)/ Hoffman, Dale & Swenson	
Cottonwood	✓	✓	Pope	✓	✓
Crow Wing	✓	✓	Ramsey	✓	✓
Dakota	✓	✓	Red Lake	Hoffman, Dale & Swenson	
Dodge	✓	✓	Redwood	✓	✓
Douglas	✓	CliftonLarsonAllen	Renville	Baker Tilly Virchow Krause	
Faribault	✓	✓	Rice	CliftonLarsonAllen	
Fillmore	Baker Tilly Virchow Krause		Rock	✓	✓
Freeborn	✓	✓	Roseau	Hoffman, Dale & Swenson	
Goodhue	✓	✓	Scott	✓	✓
Grant	✓	✓	Sherburne	✓	✓
Hennepin	McGladrey (now RSM US, LLP)		Sibley	✓	✓
Houston	✓	✓	St. Louis	✓	✓
Hubbard	Hoffman, Dale & Swenson		Stearns	✓	✓
Isanti	✓	✓	Steele	CliftonLarsonAllen	
Itasca	✓	✓	Stevens	✓	✓
Jackson	Baker Tilly Virchow Krause		Swift	CliftonLarsonAllen	
Kanabec	CliftonLarsonAllen		Todd	CliftonLarsonAllen	
Kandiyohi	✓	✓	Traverse	✓	✓
Kittson	Hoffman, Dale & Swenson		Wabasha	✓	✓
Koochiching	Hoffman, Dale & Swenson		Wadena	✓	✓
Lac qui Parle	✓	✓	Waseca	Baker Tilly Virchow Krause	
Lake	✓	✓	Washington	CliftonLarsonAllen	
Lake of the Woods	Hoffman, Dale & Swenson		Watsonwan	✓	✓
Le Sueur	Baker Tilly Virchow Krause		Wilkin	✓	✓
Lincoln	✓	CliftonLarsonAllen	Winona	✓	✓
Lyon	✓	✓	Wright	CliftonLarsonAllen	
Mahnomen	✓	✓	Yellow Medicine	✓	✓
Marshall	Brady, Martz & Associates				

Sources: Office of the State Auditor and county staff.

Appendix B: The 2015 County Audit Law

The following is the full text of *Laws of Minnesota* 2015 Regular Session, Chapter 77, Article 2, Section 3 (codified as *Minnesota Statutes* 2015, 6.481):

Sec. 3. [6.481] COUNTY AUDITS. Subdivision 1. Powers and duties. All the powers and duties conferred and imposed upon the state auditor shall be exercised and performed by the state auditor in respect to the offices, institutions, public property, and improvements of several counties of the state. The state auditor may visit, without previous notice, each county and examine all accounts and records relating to the receipt and disbursement of the public funds and the custody of the public funds and other property. The state auditor shall prescribe and install systems of accounts and financial reports that shall be uniform, so far as practicable, for the same class of offices.

Subd. 2. Annual audit required. A county must have an annual financial audit. A county may choose to have the audit performed by the state auditor, or may choose to have the audit performed by a CPA firm meeting the requirements of section 326A.05. The state auditor or a CPA firm may accept the records and audit of the Department of Human Services instead of examining county human service funds, if the audit of the Department of Human Services has been made within any period covered by the auditor's audit of other county records.

Subd. 3. CPA firm audit. A county audit performed by a CPA firm must meet the standards and be in the form required by the state auditor. The state auditor may require additional information from the CPA firm if the state auditor determines that is in the public interest, but the state auditor must accept the audit unless the state auditor determines it does not meet recognized industry auditing standards or is not in the form required by the state auditor. The state auditor may make additional examinations as the auditor determines to be in the public interest.

Subd. 4. Audit availability; data. A copy of the annual audit by the state auditor or by a CPA firm must be available for public inspection in the Office of the State Auditor and in the Office of the County Auditor. If an audit is performed by a CPA firm, data relating to the audit are subject to the same data classifications that apply under section 6.715. A CPA firm conducting a county audit must provide access to data relating to the audit and is liable for unlawful disclosure of the data as if it were a government entity under chapter 13.

Subd. 5. Reporting. If an audit conducted by the state auditor or a CPA firm discloses malfeasance, misfeasance, or nonfeasance, the auditor must report this to the county attorney, who shall institute civil and criminal proceedings as the law and the protection of the public interests requires.

Subd. 6. Payments to state auditor. A county audited by the state auditor must pay the state auditor for the costs and expenses of the audit. If the state auditor makes additional examinations of a county whose audit is performed by a CPA firm, the county must pay the auditor for the cost of these examinations. Payments must be deposited in the state auditor enterprise fund.

Subd. 7. Procedures for change of auditor. A county that plans to change to or from the state auditor and a CPA firm must notify the state auditor of this change by August 1 of an even-numbered year. Upon this notice, the following calendar year will be the first year's records that will be subject to an audit by the new entity. A county that changes to or from the state auditor must have two annual audits done by the new entity.

EFFECTIVE DATE. This section is effective August 1, 2016.

Appendix C: The Office of the State Auditor Financial Information

In this appendix, we present information about the OSA's receipts and expenditures, its hourly rates, and how OSA established the rates.

REVENUES AND EXPENSES

In 2013 the Legislature reduced the office's dependence on a legislative appropriation from the General Fund and created the State Auditor Enterprise Fund.¹

Starting in fiscal year 2014, money collected from local governments for OSA audits is deposited into the State Auditor Enterprise Fund (rather than the General Fund) and is available to the office to pay its expenses related to OSA audits. While the change made the office less dependent on a legislative appropriation, it made the office more dependent on collecting money from local governments.

Table C-1 shows the Office of the State Auditor's revenue sources and expenses for fiscal years 2012 through 2015.

Table C-1
Office of the State Auditor
Appropriations, Receipts, and Expenditures
July 1, 2012, through June 30, 2015

	<u>Fiscal Years</u>			
<u>Appropriations</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
General Fund	\$8,645,000	\$8,645,000	\$2,070,000	\$2,121,000
Special Revenue Fund	816,031	725,865	673,923	987,713
Enterprise Fund	0	0	0	0
Total Appropriations	<u>\$9,461,031</u>	<u>\$9,370,865</u>	<u>\$2,743,923</u>	<u>\$3,108,713</u>
<u>Receipts</u>				
General Fund	\$6,028,776	\$5,608,007	\$ 990	\$ 0
Special Revenue Fund	53,222	65,705	363,972	67,471
Enterprise Fund	0	0	7,452,949	4,997,105
Total Receipts	<u>\$6,081,998</u>	<u>\$5,673,712</u>	<u>\$7,817,911</u>	<u>\$5,064,576</u>
<u>Expenditures</u>				
General Fund	\$8,238,054	\$8,059,887	\$2,139,229	\$1,867,280
Special Revenue Fund	660,277	693,791	851,968	770,294
Enterprise Fund	0	0	6,402,529	6,203,364
Total Expenditures	<u>\$8,898,331</u>	<u>\$8,753,677</u>	<u>\$9,393,726</u>	<u>\$8,840,938</u>

Source: State of Minnesota's accounting system.

¹ *Laws of Minnesota* 2013, chapter 142, art. 3, sec. 13; codified at *Minnesota Statutes* 2015, 6.581.

Table C-2 shows the Office of the State Auditor's revenue sources and expenses for fiscal years 2012 through 2015 for the State Auditor's Audit Practice Division.

Table C-2
Office of the State Auditor
Audit Practice Division Revenue Sources and Expenditures¹

	<u>Fiscal Years</u>			
	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
<u>Beginning Balance</u>				
Enterprise Fund	\$0	\$0	\$0	\$1,034,379
<u>Receipts</u>				
Audit Fees – General Fund	\$6,028,776	\$5,608,007	\$ 408.00	\$ 0
Audit Fees – Enterprise Fund	<u>0</u>	<u>0</u>	<u>7,452,949</u>	<u>4,997,105</u>
<i>Total Receipts</i>	<u>\$6,028,776</u>	<u>\$5,608,007</u>	<u>\$7,453,357</u>	<u>\$4,997,105</u>
<u>Expenditures</u>				
Payroll	\$5,454,056	\$5,282,643	\$5,834,581	\$5,698,486
Rent	181,322	184,157	232,789	238,012
Travel	102,861	105,123	109,627	90,920
Professional Technical Services	65,126	92,227	161,831	111,562
Supplies, Equipment, Repairs	31,562	124,959	85,282	38,709
Other Expenditures ²	<u>95,073</u>	<u>89,624</u>	<u>103,863</u>	<u>86,141</u>
<i>Total Expenditures</i>	<u>\$5,930,000</u>	<u>\$5,878,733</u>	<u>\$6,527,973</u>	<u>\$6,263,830</u>
<u>Carry Over</u>				
Enterprise Fund	\$0	\$0	\$1,034,379	\$80,398

¹ The Office of the State Auditor (OSA) recorded audit fees to the General Fund for fiscal years 2012 and 2013. A law change required OSA to record audit fees to its own Enterprise Fund for Fiscal Years 2014 and 2015. For expenditures, OSA used General Fund appropriations to pay administrative costs for the Audit Practice Division for Fiscal Years 2012 and 2013. As a result of the law change, the office was required to use the audit fees in its Enterprise Fund to pay administrative costs for Fiscal Years 2014 and 2015.

² Other Expenditures included Printing and Advertising, Communications, Employee Development, and Other Operating Costs.

Source: State of Minnesota's accounting system.

HOURLY RATES

Table C-3 shows the rates OSA established for calendar years 2009 through 2015.

Table C-3
Office of the State Auditor
Staff Hourly Billing Rates
By Position and Calendar Year

<u>Auditor Positions</u>	<u>Calendar Years</u>				
	<u>2009-2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Interns	\$36	\$36	\$37	\$ 40	\$ 40
Staff	50	51	53	57	60
Intermediate	59	60	61	65	68
Senior	65	66	68	73	76
Specialist	71	72	84	79	83
Specialist Senior	74	75	77	82	86
Director	78	80	82	88	92
Manager	92	94	96	100	105
Reviewer	92	94	96	100	105

Source: Office of the State Auditor's 2009 through 2015 Audit Hourly Rate documents submitted to the Department of Management and Budget for approval.

The office developed these rates using a consistent methodology from year to year. That methodology involved identifying and estimating the costs related to providing audit services. The largest of these costs is audit salaries, followed by rent and instate travel.

Table C-4 recaps the projected costs used to determine the billing rates for calendar year 2015 audits.

Table C-4
Office of the State Auditor
Projected Audit Services Costs
For Calendar Year 2015

<u>Cost Type</u>	<u>Projected Cost of Audit Services for 2015</u>
Salaries	\$6,007,893
Rent	241,507
Instate Travel ¹	110,000
Staff Training	60,000
Computer and Systems Services	75,000
Professional and Technical Services	85,000
Supplies, Materials, and Equipment	120,000
Miscellaneous Operating Costs	61,000
Total	<u>\$6,760,400</u>

¹ The office does not include audit related travel costs in its billing rates; it separately bills travel costs to the specific audits.

Source: Office of the State Auditor's 2015 Audit Hourly Rate documents submitted to the Department of Management and Budget for approval.

Table C-5 shows the projected cost of audit services the office used to determine billing rates for 2012 through 2015.

Table C-5
Office of the State Auditor
Projected Costs of Audit Services
By Year

<u>Year</u>	<u>Projected Cost of Audit Services</u>
2012	\$6,462,995
2013	6,643,866
2014	6,573,531
2015	6,760,400

Source: Office of the State Auditor's 2012 through 2015 Audit Hourly Rate documents submitted to the Department of Management and Budget for approval.

Based on staffing and audit positions, the office estimates the number of hours it anticipates it will bill to counties for audit services, and determines whether rates are sufficient to cover the projected costs. For example, Table C-6 shows for calendar year 2015 the hourly rates, the anticipated billable hours, and the projected billings.

Table C-6
Office of the State Auditor
Projected Audit Services Billings
Calendar Year 2015

<u>Auditor Positions</u>	<u>Hourly Rate</u>	<u>Billable Hours</u>	<u>Projected Billings for Audit Services</u>
Interns	\$ 40	3,300	\$ 132,000
Staff	60	4,611	276,675
Intermediate	68	36,563	2,486,307
Senior	76	21,224	1,613,004
Specialist	83	10,021	831,743
Specialist Senior	86	0	0
Director	92	10,614	976,465
Manager	105	49	5,145
Reviewer	105	3,174	333,218
Billed Travel Expenses	-	-	110,000
Total Projected Billings			<u>\$6,764,556</u>

Source: Office of the State Auditor's Audit 2015 Hourly Rate documents submitted to the Department of Management and Budget for approval.



REBECCA OTTO
STATE AUDITOR

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February 1, 2016

Mr. James Nobles
Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, Minnesota 55155-1603

Dear Legislative Auditor Nobles:

We appreciate the opportunity to include a letter of response to the Office of the Legislative Auditor's ("OLA's") special review.

I want to thank you and your staff for the work the OLA did on this special review on "the efficiency of examinations conducted by the state auditor under Minnesota Statutes, section 6.48," as required by 2015 Minnesota Laws, chapter 77, article 2, section 84. We share the goal of the OLA to maximize efficiency while also ensuring appropriate safeguards and transparency for taxpayers.

Based on our review of your report, we understand that the OLA was not able to measure the efficiency of the county examinations performed by the Office of the State Auditor ("OSA"). It appears that a significant impediment was the OLA's inability to obtain information from private CPA firms. We share your concern that you, as an auditor, were not able to obtain the number of hours private CPA firms required to complete Minnesota county audits or the experience level of their auditing teams. We also observed that you were unable to obtain information on the private CPA firms' fee structures for Minnesota county audits. Due to this lack of information and the absence of comparable benchmarks, no evaluation of the efficiency of audits conducted by the OSA or conclusions regarding audit efficiency were possible, as concluded in your report.

That being said, the report made some valuable points. As you noted, the audit rates charged by the OSA and the requirement that the Office must bill to recover the cost of each audit are not in our control. Both items are controlled by the State - State bargaining agreements and State statute.

The report includes results of a survey of county personnel. While surveys may be useful to gather opinions, a list of comments may not be helpful if the bases for the comments are not substantiated. Many of the comments listed in the report are not substantiated or relevant to efficiency--the focus of this special review.

We appreciate the affirmation that the county personnel surveyed have positive opinions of the OSA audit teams that audit their counties (91% of respondents satisfied), the timeliness of their audits (68% of respondents satisfied), and the costs (59% of respondents satisfied). We have highly trained, independent professional audit staff members conducting the work on behalf of all Minnesotans.

We appreciate your suggestion and support of the OSA's continued focus on adequate oversight of all local governments on behalf of the people of Minnesota. The OSA takes great pride in the independent, thorough, professional, timely, and efficient audits we conduct on behalf of the taxpayers of Minnesota.

Finally, we appreciate that the OLA may have a perspective on recent legislative matters, including the 2015 county audit privatization law. As the Legislative Auditor, you are appointed by and serve the Legislative Branch regarding its policy initiatives. The OLA's inclusion of commentary on the 2015 county audit privatization law is outside of the scope of the Legislature's mandate that the OLA "report on the efficiency of the examinations conducted by the state auditor under Minnesota Statutes, section 6.48." Needless to say, we respectfully disagree with the OLA's statements regarding the OSA's history and authority, which are inaccurate and incomplete. The Minnesota Constitution plainly contemplated auditing of State tax dollars, including those expended by counties, by the constitutional Office of the State Auditor, a function the OSA and its predecessors have been performing since the nineteenth century. As noted in the OLA's report, the OSA retains a broad authority to perform necessary auditing. As also noted in the special review, the vast majority of the OSA's receipts are now derived from the State Auditor Enterprise Fund, most of which consists of the fees paid by counties for OSA audits, a core function of this Office.

As an independent elected Constitutional Officer in the Executive Branch, I am committed to serving the best interests of the People of Minnesota, who have three times elected me to this Office. I have a responsibility to protect the taxpayers and the Minnesota Constitution and the role of the State Auditor, and I take that responsibility very seriously.

Again, thank you for the efforts of your Office.

Sincerely,



Rebecca Otto
State Auditor