Agency Policies and Procedures

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External Auditing

Policy Objectives:

This multi-purpose policy is intended to:

- Define the role of Admin's commissioner, managers, supervisors, and staff relative to external audits and offer guidance in successfully managing external auditor relationships,
- Define the scope of the external auditor's work,
- Ensure an external audit of Admin's financial statements is performed annually,
- Ensure communications with the Office of the Legislative Auditor relating to code of ethics violations, including misuse of long-distance telephone service, and
- Promote effective coordination of internal and external audit efforts.

Background Information:

The Government Finance Officers Association publication *Governmental Accounting, Auditing and Financial Reporting,* also commonly known as the blue book, defines an audit as the "systematic review or examination of the assertions or actions of a third party to evaluate conformance to some norm or benchmark." In the broadest sense, many different types of audits occur in a governmental entity. Examples include financial audits, fraud audits, compliance audits, economy and efficiency audits, and program results audits. Internal and external auditors perform these engagements. Both are uniquely qualified professionals and subscribe to professional standards and codes of professional ethics to guide their work.

People often confuse the external auditor with the internal auditor. Principle distinctions between the two professional classifications exist, as detailed below:

- The external auditor is an independent contractor, typically an employee of a public accounting firm or of another governmental entity. The internal auditor is an employee of the organization he/she serves.
- The external auditor serves third parties that need reliable information; whereas the internal auditor serves his/her employer organization.
- The external auditor generally reviews historical financial data; whereas the internal auditor reviews all operational activities and is more future-focused.
- Professional auditing standards require the external auditor to be independent of management in fact and appearance. The internal auditor must be independent of any activities he/she audits, but remain readily responsive to management's needs.
- Lastly, the external auditor usually performs one engagement periodically (i.e. annual financial audit); whereas the internal auditor performs audits on a continual basis.

Admin's involvement with external auditors include interactions with professional auditors representing the Office of the Inspector General (OIG) of any Federal agency, the Occupational Safety and Health Administration (OSHA), the Office of the Legislative Auditor (OLA) for the State of Minnesota, and the Minnesota Pollution Control Agency (PCA). This list is not all-inclusive.

Under the Inspector General Act of 1978, as amended, the OIG of any Federal agency may audit or investigate any program, function, or activity administered by that agency. This potential for review extends only to those organizations that are performing activities sponsored in whole, or in part, under a grant award by the Federal agency. Most often, this Act requires the OIG to rely on the audit work performed by independent, nonfederal auditors like the OLA audit staff.

The OLA's Financial Audit Division, as part of its Annual Statewide Financial Audit, audits Admin's internal service fund financial statements to determine whether or not they comply with generally accepted accounting principles. The OLA also performs "special reviews" in response to allegations that state resources are misused. When evidence of substantial misuse of state resources is found, the OLA is responsible for reporting this activity to the attorney general, the appropriate county attorney, and the Legislative Audit Commission. The OLA's jurisdiction extends to all Admin divisions and to the numerous boards and councils to whom Admin provides fiscal and administrative support.

In performing these financial statement audits, the OLA follows the standards of the yellow book, *Governmental Auditing Standards.* The yellow book is more commonly referred to as generally accepted governmental auditing standards. It is published by the Comptroller General of the United States who oversees the General Accounting Office (GAO). Office of Management and Budget Circular A-87, *Cost Principles for State and Local Governments*, guides the OLA auditors in determination of allowable costs under various grant awards.

The OLA's Program Evaluation Division conducts studies to whether state-funded activities and programs are accomplishing their goals and utilizing resources effectively. This division also performs best practice reviews of selected government services.

Regulatory agencies such as OSHA and PCA perform audits to ensure compliance with pertinent laws and regulations. Audit findings from these entities may result in recommendations for immediate corrective action, fines, penalties, and/or criminal charges, etc.

Other organizations may perform courtesy audits. The objective of these audits is to educate the audit subject and to ensure compliance with pertinent laws and regulations. Should findings result during these audits, the auditors will make recommendations for improvements. Adverse consequences, i.e. fines, penalties, and/or criminal charges, etc., will not result. Audits subsequent to a courtesy audit, however, may result in more severe consequences for the audit subject's failure to demonstrate compliance, especially when the audit subject had prior knowledge of applicable laws and regulations.

Authority:

- **Minnesota Statutes**
  M.S. 3.972, subd. 2 *Audits of State and Semistate Agencies* – This statute authorizes the OLA to audit state agencies annually. (https://www.revisor.leg.state.mn.us/statutes/?id=3.972)
  M.S. 3.972, subd. 3 *Audit Contracts* – This statute requires each state agency, including Admin, to have the OLA review a proposed contract for a public accountant to perform an audit, prior to initiating a negotiation of contract terms for the desired services.
  (https://www.revisor.leg.state.mn.us/statutes/?id=3.972)
  M.S. 10.47 *Telephone Service; Oversight* – This statute requires Admin employees to report any evidence of misuse of long-distance telephone service to the Admin commissioner and to the OLA when appropriate. The OLA will investigate and report on the evidence of misuse, and where appropriate, refer the evidence to other authorities (attorney general or the appropriate county attorney).
  (https://www.revisor.leg.state.mn.us/statutes/?id=10.47)
  M.S. 43A.39, subd. 2 *Noncompliance* - This statute requires Admin's commissioner to report, in writing, when there is probable cause to believe a substantial employee code of ethics violation occurred.
  (https://www.revisor.leg.state.mn.us/statutes/?id=43A.39)
- **Inspector General Act of 1978**, as amended – Refer to paragraph four of the *Background Information.*

Business Risks:

- The lack of cooperation with external auditors may be perceived as an audit scope restriction. Scope restrictions may trigger the OLA to render a qualified or an adverse audit opinion on Admin's financial statements. Scope restrictions may also trigger the OIG to recommend suspension of continuation federal funding, termination of a grant award, or other sanctions deemed necessary under the circumstances.
- Noncompliance with statutory obligations may result from failure to report significant issues as required.
- Miscommunication of pertinent information to or from the external auditors may occur and adversely impact the audit results.
- Agency staff may be unaware of external auditor's presence, purpose of work, and results of audit efforts without someone fulfilling the responsibilities for coordinating and managing external audit activities.
- Errors or irregularities will persist without employees taking timely corrective action to remedy problems identified by external auditors.

Policies and Procedures:

1. <u>Roles and Responsibilities of All Admin Employees Relative to External Audits</u>

   A. Responsibilities of All Admin Employees – All Admin employees are responsible for the following actions:
      1. Being knowledgeable about restrictions and regulations governing the use of state resources,
      2. Complying with all financial, administrative, and audit requirements that arise from its role as a recipient of public funds, including complying with the terms and conditions of contracts, grants, and other funding agreements,
      3. Fully cooperating with external auditors,
      4. Communicating significant audit issues through the supervisor to the division manager, and
      5. Taking timely corrective action to implement the audit recommendations made by the external auditors at the supervisor's or manager's directions.

   B. Additional Responsibilities of Admin's Management Relative to External Audits:
      1. Communicating significant audit issues to appropriate personnel (i.e. deputy commissioner, assistant commissioner, or financial management director for financial audit issues),
      2. Drafting responses to the external auditor's report comments, or concerns,
      3. Taking timely corrective action to implement the audit recommendations made by the external auditors, and
      4. Promptly notifying financial management director (or designee) if contacted directly by an external auditor regarding an external financial audit matter.

   C. Responsibilities of Financial Management Director Relative to External Financial Audits - Financial management director (or designee) is responsible for the following duties:
      1. Serving as the official contact or entry point for all external financial audit engagements. When an external auditor wishes to do audit fieldwork in a particular Admin division, the financial management director (or designee) will notify appropriate agency personnel of the impending audit.
      2. Coordinating and managing the external financial audit engagement, especially the Annual Statewide Financial Audit, by:
         a. Arranging a formal entrance conference for all appropriate agency representatives to identify audit objectives, clarify the audit scope, and discuss audit procedures (including the process to report the audit results),
         b. Providing adequate work space and facilities within the agency divisions for the external auditors to perform their audit fieldwork,
         c. Co-signing each external audit engagement letter with the agency commissioner,
         d. Communicating with the external auditors throughout the audit engagement to keep apprised of the audit progress,
         e. Arranging an exit conference at the close of the audit fieldwork, to discuss the audit results and any findings and recommendations for improvements,

- f. Reviewing the content of the draft external auditor's report (or management letter) for accuracy, and communicating desired changes to the external auditor,
- g. Coordinating the agency's response to the external auditors' findings and recommendations,
- h. Monitoring agency progress towards implementing the external auditor's recommendations to ensure that appropriate division personnel take necessary corrective action on a timely basis,
- i. Periodically report progress towards implementing the OLA's recommendations to appropriate Department of Minnesota Management and Budget personnel, and
- j. Directing Admin's internal auditor to follow-up and report on agency progress towards implementing other external, non-OLA auditor's recommendations, through coordination with appropriate division staff.

3. When appropriate, contracting with a public accountant to perform internal audit services by:
   - a. Finding available financial resources to hire non-OLA or non-federal public accountants for specific scope engagements,
   - b. Following the proper procurement process for engaging a public accountant, including seeking OLA approval of the proposed contract with the public accountant, prior to initiating any negotiations of contract terms,
   - c. Sending the OLA a copy of the public accountant's report at the conclusion of the audit.

D. Reporting Substantial Code of Ethics Violations to the OLA - When evidence exists that an employee substantially violated the code of ethics for employees in the executive branch of state government (i.e. misused state resources such as the state's long-distance telephone service), Admin is statutorily responsible for reporting this action to the OLA.

1. If an Admin employee believes there has been a substantial violation of the code of ethics by a fellow staff member within one's division, the employee should report the allegation confidentially to his/her supervisor. The supervisor, manager, or division director should conduct an investigation, as appropriate, to determine (a) if a substantial violation did in fact occur, and (b) what disciplinary action would be appropriate. This should be done in consultation with financial management director, Human Resources (HR) personnel director, and internal auditor, as appropriate, based on the circumstances.
2. If an Admin employee believes there has been a substantial violation by someone outside the division, the employee should report this allegation confidentially to his/her supervisor, manager, or division director. Management should then report the allegation to the HR personnel director if the complaint has merit. Groundless allegations without merit should not be sent forward.
3. Financial management director and HR personnel director will review the evidence and assess if *substantial* misuse of state resources has occurred using the following criteria:
   - a. *The number of occurrences is high* – Evidence supports that a pattern of repeated occurrences of misuse of state resources (i.e. state funds, property, etc.) exists, or
   - b. *The dollar loss to the state is high* - Evidence exists indicating that Admin sustained a monetary loss totaling $500 or more (this is a criteria for use in reporting to the OLA only – Admin supports a zero-tolerance position for unethical conduct), or
   - c. *Misrepresentations to management occurred* – Evidence exists to show the employee intended to deceive Admin management by misstating or omitting facts, regarding the use of state resources or the commission of an illegal act, for personal gain or to the detriment of the agency. Such behavior is fraudulent in nature.
4. If *substantial* misuse of resources has occurred, the financial management director (or designee) should report the incident to the OLA director of Investigations. Financial management director (or designee) should discuss the sufficiency of the evidence obtained to date. If necessary, the OLA may decide to pursue the investigation further on their own accord or have Admin's internal auditor gather additional evidence.
5. If Admin pursues the investigation further, Admin's internal auditor is responsible for keeping the OLA apprised of the progress of the investigation and for reporting the investigation results, in writing, to the OLA. Admin's internal auditor will notify management of any OLA communications.
6. Management is responsible for taking appropriate disciplinary action towards the employee if evidence supports the allegations of misuse of state resources. Management is strongly encouraged to seek Admin's HR personnel director's advice on this matter prior to effecting any action.

2. Coordinated Audit Efforts – Admin recognizes that the roles of the external auditor and the internal auditor are distinct. Yet their responsibilities may overlap in some areas. Coordination of audit efforts of both external and internal auditors is strongly encouraged to prevent duplication of audit efforts and to promote efficient use of resources (time and money). Admin's internal auditor may help external auditors in two ways:

   A. The internal auditor may share relevant audit evidence from internal audit programs with the external auditor.
      1. The internal auditor is responsible for communicating to the OLA the activities the internal auditor examined in the fiscal year under the OLA's examination. This communication may occur at the entrance conference for the annual statewide financial audit.
      2. The external auditor may then rely on the internal auditor's work product to fulfill external audit objectives (i.e. limiting the time he/she spends in a financial audit studying a financial activity and testing transactions).

   B. The internal auditor, under the external auditor's supervision, may help to perform portions of a financial audit or gather evidence in an investigation.
      1. If the internal auditor plans to assist the external auditor *directly* in a financial audit, the internal auditor should clarify, in writing, the type of work to be performed, the estimated amount of time to be devoted to accomplishing the work, and the staff assigned to perform the work.
      2. Any internal auditor involvement in a financial audit requires the prior written approval of financial management director. The internal auditor can directly assist the external auditor in various ways. However, the internal auditor should not agree to perform any task that would violate professional internal auditing standards.

See Also:

FMR-1A-01, *Internal Control*
FMR-IB-01, *Internal Auditing*
Refer to the *Glossary* for definitions of the key terms listed below:

audit
audit findings
blue book
compliance audits
economy and efficiency audits
external auditor
financial audits
fraud
fraud audits
generally accepted accounting principles (GAAP)
generally accepted governmental auditing standards (GAGAS)
internal auditor
Office of Inspector General (OIG)
Office of the Legislative Auditor (OLA)
program results audits
public accounting
statewide financial audit
yellow book