

**MINNESOTA STATE COLLEGES AND UNIVERSITIES  
BOARD OF TRUSTEES**

**Agenda Item Summary Sheet**

**Committee:** Audit Committee

**Date of Meeting:** July 20, 2010

**Agenda Item:** Discuss Approach for Auditing Internal Controls

Proposed Policy Change       Approvals Required by Policy       Other Approvals       Monitoring

Information

**Cite policy requirement, or explain why item is on the Board agenda:**

This topic has carried over from the discussion with the Legislative Auditor at the June 2010 meeting.

**Scheduled Presenter(s):**

John Asmussen, Executive Director, Office of Internal Auditing  
Beth Buse, Deputy Director, Office of Internal Auditing

**Outline of Key Points/Policy Issues:**

- The Audit Committee was challenged to consider the following questions:
  - To what extent shall colleges and universities conduct risk assessments to examine the effectiveness of their internal controls?
  - To what extent should the Board of Trustees rely on the work of the CPA firms who audit the system-wide and institutional financial statements for assurances about internal controls?

**Background Information:**

- A financial audit conducted on St. Cloud State University by the Office of the Legislative Auditor was to presented to the Audit Committee at the June 15, 2010 meeting.
- Key issues were highlighted, including the responsibilities for assessing the adequacy of internal controls throughout the System.

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**BOARD INFORMATION**

DISCUSS APPROACH FOR AUDITING INTERNAL CONTROLS

**BACKGROUND**

At its June 15, 2010, meeting, the Audit Committee reviewed a financial audit which the Legislative Auditor had conducted on St. Cloud State University. Mr. James Nobles, the Legislative Auditor, highlighted the key issues cited in the audit report. The most prominent issue raised by Mr. Nobles centered on responsibilities for assessing the adequacy of internal controls throughout the System. He challenged the Audit Committee to consider the following questions:

- To what extent shall colleges and universities conduct risk assessments to examine the effectiveness of their internal controls?
- To what extent should the Board of Trustees rely on the work of the CPA firms who audit the system-wide and institutional financial statements for assurances about internal controls?

**Risk Assessments**

The first finding in the St. Cloud State University audit report claimed that the university “did not adequately assess its business risks or monitor the effectiveness of its internal controls.” Although the report acknowledged that the university had adequate internal controls over the financial cycles material to its financial statements, the finding stated that it was necessary for the university to extend its risk assessments beyond the financial statements. Mr. Nobles cited the other 16 audit findings in the report as evidence that the university did not employ sufficient risk assessment and monitoring procedures. The finding did not cite any departure from professional standards as the basis for its criticism. The audit also did not cite any findings resulting in a material failure of internal control and associated financial or reliability impacts.

Ms. Laura King, the Vice Chancellor – CFO, responded to the first audit finding on behalf of the System, and disagreed with the auditor’s judgment. She pointed to the significant investment that the System had made in executing its financial management and internal control program. The System had met, and surpassed, the provisions of the professional standards related to internal control structure<sup>1</sup>.

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<sup>1</sup> The widely accepted standard for internal controls is contained in a 1992 publication by the Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework*. It is augmented

Although Mr. Nobles argued that the System needed to reach beyond its financial statement audits for assurances about its internal controls, Ms. King countered that, in fact, the System already did so. The Office of the Internal Auditor, the General Counsel's office and the Finance Division have participated in a structured approach to risk assessment and mitigation that includes:

- Regular and repeated training programs available to the campuses concerning systems, policies, procedures and guidelines
- Cascading monitoring and reporting protocols that culminate in Board Audit and Finance and Facilities Committee oversight
- Regular identification and review of policy and procedures for refreshment and identification of new/emerging best practices and/or risks.

The Finance division also requires all colleges and universities, not just those institutions large enough to have a material effect on the financial statements, to document and assess their key internal control cycles. The program was weighed against the availability of scarce resources, though and designed to be a cost efficient approach. Indeed, internal controls are expected to provide reasonable, but not absolute assurances about their effectiveness.

This debate, thus, centers on how much and what kind of emphasis on internal controls is necessary and prudent. Should the System invest more in its internal control program or redirect some of its efforts? It is an important issue for the Board of Trustees to consider periodically. Its current expectations regarding financial administration are expressed in Board Policy 7.3. If the Audit Committee determines that the Legislative Auditor's recommendations regarding internal control warrant further consideration, it could ask the Finance & Facilities Committee to review the sufficiency of Policy 7.3. It could also ask the Finance division to prepare a cost benefit impact statement capturing the added costs and added benefits of extending the internal control environment more deeply into the colleges and universities.

### **Financial Statement Audit Strategy**

As part of his testimony to the Audit Committee, Mr. Nobles suggested that the Board of Trustees may wish to reconsider its external audit strategy. A key component of the System's financial management program includes hiring CPA firms to conduct annual audits of the financial statements for the System and twelve of its largest colleges and universities (a 13<sup>th</sup> college, Normandale Community College will be added to the program in fiscal year 2010). Those audits have produced evidence that the financial statements are reliable ("clean" audit opinions each year since 2001) and highlighted any deficiencies in internal controls that warranted the attention of the Board of Trustees, Chancellor, or Presidents.

Board Policy 7.4, Financial Reporting, contemplates that the System will have an external audit plan. Table 1 shows the series of actions taken by the Board of Trustees and its Audit Committee regarding an external audit plan. It shows that this issue has been subject to regular review and adaptation. Its early conception envisioned annual financial statement audits for the

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by Statement on Auditing Standards No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, released by the American Institute of Certified Public Accountants in 2007.

System and each of its individual colleges and universities. As the table illustrates, though, that expectation has been tempered to require annual financial statement audits for only 13 of the 32 colleges and universities. The remaining colleges have been subject to a financial audit every three years pursuant to a contract which the Office of the Chancellor had executed with the Legislative Auditor. By mutual agreement, the contractual arrangement with the Legislative Auditor ended in fiscal year 2010. To address this void in audit coverage, the Office of Internal Auditing will develop a recommended strategy for the Audit Committee to consider.

Mr. Noble’s challenged the Audit Committee to consider the value and role of obtaining annual financial statement audits for individual colleges and universities<sup>2</sup>. He based his challenge, in part, on questioning whether there were external audiences for whom these audits were prepared. The most comprehensive consideration of that question was addressed in a report prepared jointly by the Office of Internal Auditing and the Finance Division in January 2005 (see <http://www.internalauditing.mnscu.edu/committee/2005/january/plan-to-contract-cpa-firms-2005.pdf>). The report found sufficient benefits to justify the added costs associated with having the largest colleges and universities prepare audited financial statements. The primary benefits associated with the audited financial statements were the assurances provided to the Board of Trustees, Chancellor, and Presidents. In addition, the exercise helps establish a solid framework for the internal accounting discipline of those institutions and an enhanced understanding of their financial condition and operations.

The Audit Committee revisits the external audit plan each year, before authorizing audit contracts to be renewed. The next review is expected to occur in January 2011.

Table 1: History of External Auditing Plans

Date	Action
April 1999	Audit Committee required an analysis of the cost and effort associated with accelerating the preparation of audited financial statements (Note: Since the 1995 merger, the MnSCU System had been blended into the State of Minnesota financial statements. Changes in generally accepted accounting principles, though, meant that separate MnSCU system financial statements would be needed by fiscal year 2002.)
May 1999	Internal Auditing report issued on “Reliability of MnSCU Financial Data”
June 1999	Executive Director of Internal Auditing and Vice Chancellor – CFO proposed a plan for attaining audited financial statements.
July 1999	Board of Trustees approved following schedule for audited System and institutional financial statements: FY 2000 – Legislative Audit of MnSCU System Balance Sheet. FY 2001 – Legislative Audit of MnSCU System comprehensive financial statements. FY 2002 – Prepare plan for audits of institutional financial statements.
Dec 2000	Legislative Auditor delivered qualified audit opinion on FY 2000 System-wide Balance Sheet.

<sup>2</sup> The annual audit of the system-wide financial statements is not subject to discretion. It is required in order to support the preparation of the State of Minnesota financial statements. If the institutional financial statement audits were discontinued, the audit fees for the system-wide audit would increase dramatically.

Date	Action
May 2001	Board of Trustees appointed CPA firm of Deloitte & Touche, LLP to serve as principal auditor of MnSCU system-wide financial statements for FYs 2001-2003.
Dec 2001	Deloitte & Touche, LLP delivered unqualified (“clean”) audit opinion on the FY 2001 System-wide comprehensive financial statements
Dec 2001	Board of Trustees accepted alternative plan for audited financial statements of individual colleges and universities: (1) 12 largest universities and colleges will be assessed for readiness to undergo a financial statement audit, (2) Based on the readiness assessments, institutions representing at least 40% of the System financial activity will be selected for FY 2002 financial statement audits to satisfy a clause in the contract with the principal auditor, (3) Financial statement audits for the remaining institutions will be phased in during FYs 2003 and 2004.
April 2002	Board of Trustees appointed two CPA firms ( <i>Larson, Allen, Weishair &amp; Co., LLP</i> and <i>Kern, DeWenter, Viere, Ltd.</i> ) to conduct financial statement audits of five universities and one college for FYs 2002-2004.
Dec 2002	Board of Trustees approved further modification to the external audit plan. The Dec 2001 plan is altered to add six additional institutional audits (remaining two universities and four more colleges) in FY 2003. This action will increase the proportion of financial activity audited as separate institutional audits to 60%; a further expansion to 75% of the financial activity was suggested for consideration in FY 2004.
Dec 2002	Contract with Legislative Auditor was refocused on colleges which would not receive annual financial statement audits per the Dec 2002 external audit plan.
April 2003	Board of Trustees appointed three CPA firms (adding <i>Virchow, Krause &amp; Company, LLP</i> to the other two firms selected in April 2002) to conduct financial statement audits of two universities and four colleges for FYs 2003-2005.
Dec 2003	Board of Trustees approved continuing the external audit plan as structured and to not add more audits of institutional financial statements, pending further study by the Office of Internal Auditing and the Finance Division.
April 2004	Board of Trustees appointed CPA firm of <i>Kern, DeWenter, Viere, Ltd.</i> to serve as principal auditor of MnSCU system-wide financial statements for FYs 2004-2006.
Jan 2005	Board of Trustees adopted a comprehensive external audit plan based on a study presented jointly by the Office of Internal Auditing and the Finance Division.
April 2005	Board of Trustees appointed three CPA firms to conduct financial statement audits of five universities and one college for FYs 2005-2007.
Jan 2006	Audit Committee reviewed external audit plan and made no changes. Process started to solicit proposals for audits of two universities and four colleges.
April 2006	Board of Trustees appointed three CPA firms to conduct financial statement audits of two universities and four colleges for FYs 2006-2008.
April 2007	Board of Trustees reappointed CPA firm of <i>Kern, DeWenter, Viere, Ltd.</i> to serve as principal auditor of MnSCU system-wide financial statements for FYs 2007-2009.
Dec 2007	Audit Committee reviewed external audit plan and made no changes. Process started to solicit proposals for audits of five universities and one college.

<b>Date</b>	<b>Action</b>
March 2008	Board of Trustees appointed three CPA firms to conduct financial statement audits of five universities and one college for FYs 2008-2010.
Jan 2009	Audit Committee reviewed external audit plan and added Normandale Community College as an annual financial statement audit. Process started to solicit proposals for audits of two universities and five colleges.
March 2009	Board of Trustees appointed three CPA firms to conduct financial statement audits of two universities and four colleges for FYs 2009-2011 and Normandale Community college for FYs 2010-2011.
March 2010	Board of Trustees appointed CPA firm of LarsonAllen to serve as principal auditor of MnSCU system-wide financial statements for FYs 2010-2012.

The goal of a well designed internal control system is to obtain reasonable assurance that the operating environment is free of material risks of error and /or malfeasance. This assurance is gained by application of multiple tools and methods which taken together limit the areas of exposure. Leadership in the public arena has a higher standard of care and due diligence since public funds are at risk. The question for the Audit committee concerns whether the current internal control system sufficiently balances the risk, the investment required and the obligation as a public steward.

*Date Presented to the Board of Trustee: July 20, 2010*