

Cost Benefit Analysis of Changes to State Statute as They Relate to the Office of the State Auditor (OSA)

Introduction

The Office of the State Auditor has an *unfunded* auditing mandate to audit all counties and first class cities. Because of budget constraints, 28 counties, including Hennepin County, were released from this unfunded auditing mandate for a three-year period and were, therefore, audited by private CPA firms for audit year 2006 to 2008. These counties have been released again for audit year 2009 to 2011. A private accounting firm has audited Hennepin County since 1970. Releasing counties from the unfunded auditing mandate means that the OSA allowed these 28 counties to privatize the auditing of their books. This free-market approach allows governmental entities to make a request for proposal (RFP), which is an invitation for competitive bids from CPA firms, instead of the unfunded OSA auditing mandate. This results in considerable savings in auditing costs, more timely audits and smaller government, but also results in a decrease in government oversight, which is within the policing powers of the State of Minnesota.

Audits performed by the state auditor cost more because the unfunded auditing mandate is a government monopoly. This results in over-auditing by the state auditor. By conspicuous contrast, governmental audits performed by private CPA firms without any government oversight may result in under-auditing and an increased risk to public assets. Correcting this problem to ensure public trust and integrity while protecting the public interest is as simple as establishing internal controls. These should include a supplemental peer review program administered by the state auditor in the public interest, rotating the private CPA firms who are auditing government entities, and enforcing auditing standards that do not allow a private CPA firm to compile and then audit the same financial statements.

The unfunded auditing mandate also includes all three first class cities (i.e., Minneapolis, St. Paul, and Duluth) but not small cities. Private CPA firms audit the small cities. Contrary to widely held belief; the OSA *does not* audit school districts. Interestingly, this exclusion includes Anoka Hennepin School District, even though this district is larger than any government entity audited by the OSA. CPA firms audit all Minnesota school districts. Neither the audits of small cities nor the audits of school district are subjected to the internal controls of a supplemental peer review program, rotation of auditors or the enforcement of auditing standards. The State would obviously benefit from a uniform system of auditing.

Minnesota State Statute 471.697 requires all cities, including cities of the first class, to report to the OSA within six months of fiscal year-end; however, in 2009, both Minneapolis and St. Paul, which are audited by the OSA, did not meet this six-month deadline for audit year ending December 31, 2008. The OSA also gives preferential treatment to government entities that are members of the Government Finance

Officers Association (GFOA) because they apply for the GFOA Certificate of Achievement for Excellence in Financial Reporting. The GFOA requires all GFOA Certificate audits to be issued within six months of fiscal year-end. So, the OSA puts GFOA members ahead in line at the expense of smaller non-GFOA counties. For audit year 2007, nineteen small counties had audits issued by the OSA more than twelve months after fiscal year-end with two audits, Lincoln and Pine Counties, issued April 28, 2009, with opinion dates of April 21, 2009 and April 22, 2009, respectively. That is sixteen months after fiscal year-end.

All government entities that receive over \$500,000 in federal grant expenditures are required to have a federal Single Audit. This is part of the unfunded OSA auditing mandate and the released audits performed by private CPA firms. The current Single Audit deadline is nine months after fiscal year-end. There were forty county audits subjected to the unfunded OSA auditing mandate that did not meet the federal Single Audit deadline for fiscal year-end December 31, 2008. Currently, there are no consequences for missing the Single Audit deadline. All released audits performed by private CPA firms met the federal Single Audit deadline.

Changes to State Statutes

6.48 EXMINATION OF COUNTIES; COSTS, FEES.

Minnesota State Statute 6.48 covers the examination of counties. The statute has been changed to:

1. Allow all counties the option to retain the state auditor or enter the free-market and hire a private CPA firm in the examination of the county's financial statements. This will significantly decrease the audit costs and help solve the timeliness problem.
2. Codify auditing standards and compliance with federal regulations. This will add clarity to the public's expectations.
3. Require the rotation of private CPA firms if the county decides to engage private CPAs. This is one of the three necessary internal controls needed to ensure public trust and integrity while protecting the public interest if a for-profit firm performs the examination. Another internal control is the supplemental peer review program administered by the state auditor (see 6.XX SUPPLEMENTAL PEER REVIEW PROGRAM). There will be an anticipated added cost to the examination each time the county rotates their auditors. This will be built into the request for proposal (RFP). There could also be *lower* cost by an efficient or aggressive firm with low overhead looking for business.
4. Codify and clarify the auditing standard that prohibits auditors from compiling and then auditing the same financial statements to comply with the standard of independence. This is the third internal control necessary to ensure public trust and integrity while protecting the public interest if a for-profit firm performs the examination. This audit standard has been often ignored in governmental auditing and the CPA profession is aggressively speaking out against the practice of compiling and auditing the same set of financial statements. This will

add cost for the county because counties will now have to hire a separate CPA firm to compile the financial statements or hire or train an employee to meet generally accepted accounting principles (GAAP). A county will likely have to offer higher compensation to attract a qualified employee with GAAP knowledge and offer higher compensation to retain an employee with GAAP knowledge.

5. Require the posting of the financial statements and management letter(s) on the Internet within six months of fiscal year-end. The posting on the Internet will increase transparency and does not add any costs to the county, but the six-month deadline will add costs to the county. Timeliness does not come without a cost. CPA firms will have to charge more for timely audits because their employees will experience idle time after the six-month deadline. The CPA firms should not be able to use county audits as a dumping ground for their employees until the Single Audit deadline of September 30 at the expense of transparency to the taxpayer. Allowing this practice creates an incentive for private CPA firms to low-ball and under-audit the counties. The OSA already requires cities and school districts to meet a six-month deadline. This codifies the deadline on counties, too. State Statute does not require a six-month deadline for counties because of the unfunded auditing mandate. Once the unfunded mandate is eliminated, there should be no difference between the treatment of counties and cities and school districts. The OSA already has this administrative authority and *could* impose a six-month deadline and probably *will* if the unfunded mandate is eliminated, but this change codifies the deadline in state statute. A six-month deadline has become the industry standard for governmental audits, and that is why the GFOA uses a six-month deadline as a bench mark of excellence in their certificate program. If the county and the private CPA firm cannot meet the six-month deadline, there must be a problem, and there should be a consequence. The consequence will be having the state auditor come in and over-audit the county for one three-year audit cycle.
6. Reestablish the state auditor's revolving fund. This is necessary for *independence in fact and in appearance* from political influence. An appropriation from the general fund has political consequences. The function of the state auditor is proprietary in nature and should be accounted for in a proprietary fund. The accounting profession has established a set of proprietary fund accounting principles for a reason. The revolving fund is a proprietary fund. The general fund is not.

There should be cost savings to counties who have already hired and/or trained employees with GAAP knowledge and who already compile their own financial statements. Most of those counties are large Metro counties that already apply for the GFOA Certificate. There are some large rural counties and some small rural counties that have also taken the initiative to hire and/or train their employees to compile their own financial statements. Unfortunately, there will be added costs to many small rural counties who have not taken ownership of the county's financial statements. The recommended changes in statute are designed to reward counties who have taken ownership of their financial statements, give counties the option of hiring one private CPA firm to compile the county's financial statements and another private CPA firm to audit the compilation, or continuing to engage the state auditor to compile and audit

the county's financial statements. Eventually, the true cost of compiling and auditing the county's financial statements will be uncovered if market forces are allowed to work without government intervention.

6.49 CITIES OF FIRST CLASS.

Minnesota State Statute 6.49 covers the examination of Minneapolis, St. Paul and Duluth. The statute has been changed to:

1. Allow all cities of the first class the option to retain the state auditor or enter the free-market and hire a private CPA firm in the examination of the cities' financial statements. This will significantly decrease the audit costs. Timeliness is not a problem with the cities of first class because all three cities have employees educated in GAAP and apply for the GFOA Certificate. It is true that Minneapolis and St. Paul did not meet the GFOA deadline in 2009 but that was because both implemented a new computer accounting software system. Such an explanation qualified them for an extension to the six-month GFOA Certificate deadline and should also exempt them from the state auditor's six-month deadline at the state auditor's discretion.
2. Codify auditing standards and compliance with federal regulations. This will add clarity to the public's expectations.
3. Require the rotation of private CPA firms if the city decides to engage private CPAs. This is one of the three necessary internal controls needed to ensure public trust and integrity while protecting the public interest if a for-profit firm performs the examination. Another internal control is the supplemental peer review program administered by the state auditor (see 6.XX SUPPLEMENTAL PEER REVIEW PROGRAM). There will be an anticipated added cost to the examination each time the city rotates their auditors. This will be built into the request for proposal (RFP). There could also be *lower* cost by an efficient or aggressive firm with low overhead looking for business.
4. Codify and clarify the auditing standard that prohibits auditors from compiling and then auditing the same financial statements to comply with the standard of independence. This is the third internal control necessary to ensure public trust and integrity while protecting the public interest if a for-profit firm performs the examination. This should not be a problem for the cities of first class and should not add any cost to the audit. The wording was added so that 6.49 would have similar wording and clarity as 6.48.
5. Require the posting of the financial statements and management letter(s) on the Internet within six months of fiscal year-end. The posting on the Internet will increase transparency and not add any cost to the city. State Statute 471.697 already requires a six-month deadline for cities, but this change codifies the deadline in Chapter 6. A six-month deadline has become the industry standard for governmental audits, and that is why the GFOA uses a six-month deadline as a bench mark of excellence in their certificate program. If the city and the private CPA firm cannot meet the six-month deadline, there must be a problem, and there should be a consequence. The consequence will be having the state auditor come in and over-audit the city for one three-year audit cycle.

6. Reestablish the state auditor's revolving fund. This is necessary for *independence in fact and in appearance* from political influence. An appropriation from the general fund has political consequences. The function of the state auditor is proprietary in nature and should be accounted for in a proprietary fund. The accounting profession has established a set of proprietary fund accounting principles for a reason. The revolving fund is a proprietary fund. The general fund is not.

There should be cost savings to cities of the first class because they have already hired and/or trained employees with GAAP knowledge and already compile their own financial statements.

6.50 CITIES OF SECOND, THIRD, OR FOURTH CLASS.

Minnesota State Statute 6.50 covers the examination of small cities. The statute has been changed to:

1. Require the rotation of private CPA firms if a small city decides to engage private CPAs. This is one of the three necessary internal controls needed to ensure public trust and integrity while protecting the public interest if a for-profit firm performs the examination. Another internal control is the supplemental peer review program administered by the state auditor (see 6.XX SUPPLEMENTAL PEER REVIEW PROGRAM). There will be an anticipated added cost to the examination each time a small city rotates their auditors. This will be built in the request for proposal (RFP). There could also be *lower* cost by an efficient or aggressive firm with low overhead looking for business.
2. Codify and clarify the auditing standard that prohibits auditors from compiling and then auditing the same financial statements to comply with the standard of independence. This is the third internal control necessary to ensure public trust and integrity while protecting the public interest if a for-profit firm performs the examination. This audit standard has been often ignored in governmental auditing and the CPA profession is aggressively speaking out against the practice of compiling and auditing the same set of financial statements. This will add cost to some small cities if they do not have knowledgeable employees because they will have to hire a separate CPA firm to compile the financial statements or hire or train an employee to meet generally accepted accounting principles (GAAP). A small city will have to offer higher compensation to attract a qualified employee with GAAP knowledge and offer higher compensation to retain an employee with GAAP knowledge.

There will be expected added cost to cities because of the rotation requirement. And, for some cities that are required to report according to GAAP, there will be added cost because they have not taken ownership of their financial statements. Eventually, the true cost of compiling and auditing the city's financial statements will be uncovered if market forces are allowed to work.

6.51 OTHER POLITICAL SUBDIVISIONS.

Minnesota State Statute 6.51 covers the examination of other political subdivisions, including school districts. The statute has been changed to:

1. Require the rotation of private CPA firms if a school district decides to engage private CPAs. This is one of the three necessary internal controls needed to ensure public trust and integrity while protecting the public interest if a for-profit firm performs the examination. Another internal control is the supplemental peer review program administered by the state auditor (see 6.XX SUPPLEMENTAL PEER REVIEW PROGRAM). There will be an anticipated added cost to the examination each time a school district rotates their auditors. This will be built in the request for proposal (RFP). There could also be *lower* cost by an efficient or aggressive firm with low overhead looking for business.
2. Codify and clarify the auditing standard that prohibits auditors from compiling and then auditing the same financial statements to comply with the standard of independence. This is the third internal control necessary to ensure public trust and integrity while protecting the public interest if a for-profit firm performs the examination. This audit standard has been often ignored in governmental auditing and the CPA profession is aggressively speaking out against the practice of compiling and auditing the same set of financial statements. This will add cost to some school districts if they do not have knowledgeable employees because they will have to hire a separate CPA firm to compile the financial statements or hire or train an employee to meet generally accepted accounting principles (GAAP). A school district will have to offer higher compensation to attract a qualified employee with GAAP knowledge and offer higher compensation to retain an employee with GAAP knowledge.

There will be expected added costs to school districts because of the rotation requirement. And, for some school districts that are required to report according to GAAP, there will be added costs because they have not taken ownership of their financial statements. Eventually, the true cost of compiling and auditing the school district's financial statements will be uncovered if market forces are allowed to work.

Regarding the need to ensure public trust and integrity while protecting the public interest, school districts are a high-risk audit area that has to be addressed because there is no government oversight and because of their June 30 fiscal year-end. School districts are a highly sought-after governmental audit by private CPA firms because of their June 30 fiscal year-end. The school districts' fiscal year-end is six months after the December 31 fiscal year-end of counties, cities and other conventional audits. As a result, private CPA firms may low-ball school district engagement in order to obtain the engagement and keep their employees busy during their off-season (i.e., slow-season). Low-balling an engagement means that the private CPA firm is willing to take a loss in order to keep their employees busy during their slow-season. Willing to take a loss creates an incentive to minimize the loss, and the most likely way to minimize the loss is to cut audit procedures (i.e., under-audit). The supplemental peer review program will create the necessary checks and balances to ensure school district audits are not under-audited. If a private CPA firm wants to continue to low-ball a

school district audit, that is their business. It is the business of government to make sure the private CPA firm does not under-audit the school district.

6.56 COSTS OF EXAMINATION, PAYMENT and 6.58 REVOLVING FUND.

Minnesota State Statute 6.56 covers the payment process for examination performed by the state auditor. The statute has been changed to reestablish the state auditor's revolving fund. This is necessary for *independence in fact and in appearance* from political influence. An appropriation from the general fund has political consequences. The function of the state auditor is proprietary in nature and should be accounted for in a proprietary fund. The accounting profession has established a set of proprietary fund accounting principles for a reason. The revolving fund is a proprietary fund. The general fund is not.

The unobligated balances in 6.58 of not less than \$315,000 and not more than \$350,000 as of June 30 of each fiscal year were the recommended balances when the revolving fund was eliminated in 1989. Those balances may have to be adjusted for 2011.

6.XX SUPPLEMENTAL PEER REVIEW PROGRAM.

Minnesota State Statute 6.XX is a new statute, which creates the final internal control necessary to ensure public trust and integrity while protecting the public interest if the examination of a political subdivision is performed by a for-profit firm. The CPA profession has its own peer review program to police its own interest, not the interest of the public (i.e., taxpayer). The supplemental peer review program should be funded with an annual appropriation from the general fund to the state auditor. It is the taxpayer's governmental entity whose integrity is being systematically assured with the audit process. It is in the taxpayer's interest to assure that a peer review program is operating to insure the integrity of the system that ensures the integrity of their government(s). Assuring the integrity of private sector firms auditing governmental entities within the State of Minnesota is a legitimate function of the executive branch of government. The state auditor is a member of the executive branch of government. The maintenance of a peer review function is among the most central and legitimate functions of government and is a legitimate policing power expenditure of tax revenues.

When dealing with an appropriation from the legislature, the supplemental peer review program is subject to the amount appropriated; therefore, there may not be enough money to peer review each firm. If that happens, the state auditor will have to risk rate the CPA firms and target the high-risk CPA firms. That is why the new state statute has the wording, "if funds and personnel permit" and "may".

The OSA currently performs a 'desk review' of county audits performed by private CPA firms. A desk review is not a peer review of the workpapers of a private CPA firm. A desk review is a glance at the financial statements. It is equivalent to a teacher marking up a term paper and not giving the term paper a grade. The comments go

back to the government entity. There is neither follow-up nor consequences. Desk reviews are valueless unless they are used to advance the supplemental peer review. A peer review is a detailed analysis of the workpapers supporting the audit. A peer review is not performed on all audits; it is done on a random selection of audits performed by private CPA firms. The goal of the supplemental peer review program is to peer review each private CPA firm auditing governmental entities at least once every three years. The desk review can help create the sample of audits that are peer reviewed. If a governmental entity is too small and never appears to get picked from the population but there are problems uncovered with the entity's financial statements during the desk review, then that entity should be placed within the peer review sample. Under a supplemental peer review administered by the OSA, a private CPA firm failing the supplemental peer review would have to prepare a corrective action plan and implement state auditor recommendations before bidding on future governmental audits.

Summary

The counties *must not* be released from the unfunded auditing mandate without instituting the internal controls of a supplemental peer review program, rotation of auditors, and the enforcement of auditing standards. The reason is that there is a risk that the audits of counties will go the way of school district audits, which is a high-risk audit area due to no government oversight. There *should not* be any difference between the treatment of counties, cities of the first class, small cities and school districts. It is strongly recommended that the fees collected by the state auditor be placed in a revolving proprietary fund in order to assure the public that the state auditor is independent *in fact and in appearance*.