



Office of the State Auditor: County Audits

Special Review
January 19, 2018

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

**State of Minnesota
Office of the Legislative Auditor**

Special Reviews

This report is the result of legislation passed in 2017. Specifically, *Laws of Minnesota 2017*, First Special Session, chapter 4, art. 1, sec. 2, subd. 4, states:

No later than January 15, 2018, the legislative auditor must complete an assessment of the adequacy of the county audits performed by the state auditor in calendar year 2016. The standards for conducting the assessment must be identical to those described in the report of the state auditor dated March 2017, titled “Assessing the Adequacy of 2015 County Audits Performed by Private CPA Firms.”

We did not release this report on January 15, 2018, because we wanted more time to review additional documents provided to us by the State Auditor’s Office.

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OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

January 19, 2018

Members of the Legislative Audit Commission

The Honorable Rebecca Otto, State Auditor

This report presents the results of our assessment of the adequacy of the county audits performed by the Office of the State Auditor (OSA) in calendar year 2016, as required by law. We concluded that OSA performed adequate audits of the counties in calendar year 2016.

During our review, we also examined OSA's assessment of the adequacy of 2015 county audits performed by CPA firms. We concluded that OSA did not thoroughly support its findings. Furthermore, OSA did not treat the CPA firms it reviewed with the standard due process and professional courtesy that is normally practiced in the audit industry.

This audit was conducted by Lori Leysen, CPA (Audit Coordinator); and assisted by Michelle Bilyeu; Jordan Bjonfald, CPA; Dan Holmgren; April Lee; and Ali Shire, CPA.

Sincerely,

A handwritten signature in black ink that reads "Jim Nobles".

James R. Nobles
Legislative Auditor



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Office of the State Auditor

Background

In 1973, the Legislature enacted a major change in who audits local governments, including counties. Previously, the Office of the Public Examiner audited all local governments. The 1973 Legislature moved that authority to the Office of the State Auditor (OSA).¹

In 2015, the Legislature made another significant change. It gave counties the option of having their annual audit conducted by either the State Auditor or a CPA firm.² The change reflected the fact that the State Auditor had already been allowing certain counties to use a CPA firm rather than OSA.³ The change also was in response to claims by counties that CPA firms conduct audits more efficiently and, therefore, charge counties less than OSA.⁴

Although the 2015 law gave counties the option of hiring a CPA firm to conduct audits, it also specified that OSA has oversight authority over county audits. According to the law, “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 the audit or its form does not meet recognized industry standards.”⁵

¹ *Laws of Minnesota* 1973, chapter 492, sec. 7. The 1973 law also created the Office of the Legislative Auditor and transferred to that office responsibility to audit state agencies, courts, and various other organizations.

² *Laws of Minnesota* 2015, chapter 77, art. 2, sec. 3, subd. 2.

³ For more information about which counties were audited by OSA and which were audited by CPA firms in the time periods 2009 to 2011 and 2012 to 2014, see Office of the Legislative Auditor, Special Reviews/Investigations, *County Audits* (St. Paul, 2016), 19.

⁴ Given these claims, the 2015 Legislature also directed the Office of the Legislative Auditor to report on the “efficiency” of the county audits conducted by OSA. In response, we released a special review, *County Audits* (St. Paul, 2016). In the review, we said we were unable to reach a definitive conclusion about the efficiency of county audits conducted by the OSA. However, we recommended that “the State Auditor use the [2015] 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.”

⁵ *Minnesota Statutes* 2017, 6.481, subd. 3.

On February 4, 2016, State Auditor Rebecca Otto filed suit in Ramsey County Court challenging the constitutionality of the 2015 law.⁶ The State Auditor argued that the law violated the Separation of Powers clause in the Minnesota Constitution by eliminating a core function of a constitutional office, and violated the constitutional requirement that legislative enactments address a single subject.⁷ The Court ruled that auditing counties is a core function of OSA but upheld the 2015 law saying it merely modified that function.⁸ The Court also ruled the 2015 law did not violate the Single Subject Clause.⁹

The State Auditor appealed to the Minnesota Court of Appeals. A three-judge panel upheld the district court's ruling by a vote of 2 to 1.¹⁰ The State Auditor then petitioned the Minnesota Supreme Court, which granted a review. The Minnesota Supreme Court is expected to rule on the case by summer 2018.¹¹

In March 2017, the OSA released a report titled *Assessing the Adequacy of 2015 County Audits Performed by Private CPA Firms*. In the report, the State Auditor expressed significant concerns about the county audits OSA reviewed that were performed by CPA firms.

In response to the OSA report, the 2017 Legislature directed the Office of the Legislative Auditor (OLA) to complete an assessment of the adequacy of the county audits performed by OSA in calendar year 2016. The law said that the standards for conducting the OLA assessment must be identical to those described in the OSA report.¹² This report is our response to the legislative directive.

⁶ The State Auditor originally filed suit against Becker County, Ramsey County, Wright County, and the State of Minnesota, but the Office of the Attorney General contended that the State was not a proper party to the lawsuit. The State Auditor then voluntarily dismissed her claims against the State of Minnesota.

⁷ *Minnesota Constitution*, art. III, sec. 1, and art. V, sec. 1; and *Minnesota Constitution*, art. IV, sec. 17.

⁸ *Otto v. Wright County, et al.*, No. 62-CV-16-606 (Ramsey County Dist. Ct. September 2, 2016) (order granting in part and denying in part motion for summary judgment).

⁹ *Ibid.*

¹⁰ *Otto v. Wright County, et al.*, 899 N.W.2d 186, 198-99 (Minn. Ct. App. 2017).

¹¹ The Minnesota Supreme Court held oral arguments in *Otto v. Wright County, et al.*, on January 3, 2018.

¹² *Laws of Minnesota* 2017, First Special Session, chapter 4, art. 1, sec. 2, subd. 4.

Section 1: The Office of the State Auditor Review of CPA Firms

The Office of the State Auditor’s March 2017 report, *Assessing the Adequacy of 2015 County Audits Performed by Private CPA Firms*, was based on “desk reviews” of all 26 county audits performed by CPA firms and “workpaper reviews” of 8 county audits performed by CPA firms.¹³ The OSA report expressed concerns about all eight of the audits that were subject to an OSA workpaper review. The findings related to:

- Audits of Federal Programs
- Implementation of New Accounting Standards
- Shared Revenue Recognition
- Technical Deficiencies
- Inconsistent Treatment of Findings

Our objective was to determine how the OSA reached the findings identified in its 2017 report and how the CPA firms responded to the findings. In order to achieve the objective, we inquired with managers at OSA about their methodology for completing the reviews and with managers at the CPA firms to get their perspective on the findings issued in the report. There were six CPA firms listed in OSA’s report.¹⁴ We spoke to some of the firms; but given the confidential nature of those discussions, we will not identify the number of firms we talked to or their names.¹⁵

Based on these discussions and our review of documents, we came to the following conclusions:

The Office of the State Auditor did not thoroughly support its findings of the CPA firms.

In the March 2017 report, OSA performed a workpaper review for eight selected counties. The report states, “the workpaper review was performed to assess the

¹³ The counties selected for review were Douglas, Fillmore, Hennepin, Hubbard, LeSueur, Marshall, Mower, and Roseau.

¹⁴ Office of the State Auditor, *Assessing the Adequacy of 2015 County Audits Performed by Private CPA Firms* (St. Paul, 2017), 2.

¹⁵ Given our 2016 report on the cost of county audits, we think it is worth noting that one firm we spoke with identified a significant price difference between the audit performed by the CPA firm and OSA for two counties. For one county in 2008 through 2011, the CPA firm charged an average of \$36,434 per year; and then from 2012 through 2015, OSA charged an average of \$81,128 per year. For the other county, the CPA firm charged \$51,480 in 2015 and OSA charged \$156,973 in 2016.

adequacy of documentation of the audit procedures performed in meeting auditing standards.”

Generally accepted auditing standards require the auditor to “prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.”¹⁶

The OSA identified over 130 findings in the workpaper reviews across the eight counties. Although they did retain notes documenting their findings, we do not believe these notes are sufficient to meet generally accepted auditing standards.

The report indicates OSA used desk reviews and workpaper reviews as procedures to reach their conclusions. Both reviews are completed using checklists that ask detailed questions about the audit procedures, audit workpapers, and audit report to ensure they comply with appropriate auditing and accounting standards. Portions of the checklists are developed by OSA and portions are taken from industry-standard review checklists (including PPC Auditing and Accounting Guidance¹⁷).

During discussions with OSA staff, they revealed that many of the findings in the report would not have been found using just these reviews. OSA staff told us that these findings were identified based on their knowledge and expertise of county financial statement and federal program audits; however, they did not document their procedures or methodology beyond the standard checklists.

Although the OSA report states that its review “does not constitute an audit,” generally accepted auditing standards serve as a best practice within the industry; we believe it is reasonable to suggest that OSA should have followed these best practices regarding audit documentation.

The Office of the State Auditor did not treat the CPA firms it reviewed with the standard due process and professional courtesy that is normally practiced in the audit industry.

- OSA did not always consider the responses provided by the CPA firms. After the review was completed, OSA provided the firms with preliminary findings. The firms provided detailed responses to address the findings; however, OSA generally did not consider these responses in the final report.

¹⁶ American Institute of Certified Public Accountants, *Codification of Statements on Auditing Standards* (2017), AU-C 230.08.

¹⁷ A commonly used audit tool developed by Thomson Reuters.

Many of the firms we spoke to indicated that they did not agree with the findings issued in the report. Additionally, the firms were not given the chance to respond to the findings in the report, and OSA did not publish any responses.

- OSA did not give sufficient notice of the report release to the CPA firms. All of the firms we spoke to indicated that they were not notified of the public report release until the day before or the day of. In addition, all of the firms we spoke to believed they were undergoing a routine review and were not even aware a report would be issued.
- OSA's report raised concerns with other entities which may subject the firms to additional scrutiny.

Generally accepted government auditing standards require the auditors to obtain and report the audited entities views concerning findings in the report. When the audited entity provides written comments, the auditors should include those in the report. The standards also state that providing a draft report of findings for review and comment by the audited entity helps the auditor create a fair, complete, and objective report.¹⁸

Although OSA's report states that the review "does not constitute an audit," generally accepted government auditing standards serve as a best practice within the industry; we believe it is reasonable to suggest that OSA should have followed these best practices regarding reporting views of the audited entity.

Section 2: OLA Review of OSA County Audits

Our objective in this section was to complete an assessment of the adequacy of the county audits performed by the Office of the State Auditor in calendar year 2016.

To meet the audit objectives, we performed desk reviews and workpaper reviews for six county audits performed by OSA. Audits performed by OSA in calendar year 2016 were of county financial statements and, when applicable, federal money received for the year ended December 31, 2015. OSA performed audits for 61 of 87 counties.

¹⁸ United States Government Accountability Office, *Government Auditing Standards* (2011), 7.32-7.34.

We randomly selected the following six counties for review:

- Cass
- Freeborn
- Goodhue
- Grant
- Pine
- Ramsey

We used the same desk review and workpaper review checklists that OSA used for its review. The checklists are designed to ensure the auditor complies with the following set of standards:

- American Institute of Certified Public Accountants (AICPA) *Codification of Statements on Auditing Standards*, as of January 2015 (AU-C)
- AICPA Audit and Accounting Guide, *State and Local Governments*, dated March 1, 2015 (AAG-SLG)
- AICPA Audit and Accounting Guide, *Government Auditing Standards and Single Audit*, dated February 1, 2015 (AAG-GAS)
- Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*
- 2015 U.S. Office of Management and Budget *Compliance Supplement*

Based on our reviews, we came to the following conclusion:

The Office of the State Auditor performed adequate audits of the counties in calendar year 2016.

We reviewed the workpapers and audit reports for six counties and did not find any significant issues or noncompliance with auditing standards.

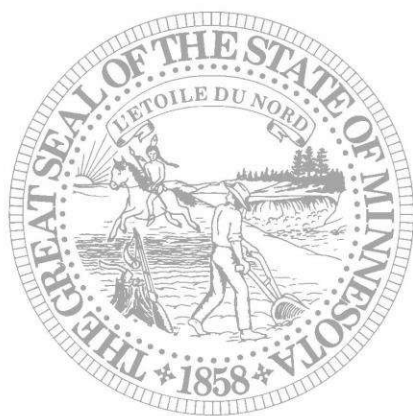
According to law, the standards for conducting our assessment were to be “identical” to the standards used in OSA’s report.¹⁹ To comply with this, we used the same desk review and workpaper review checklists used by OSA in their reviews.

Although we based our conclusions solely on the results of the desk review and workpaper review, as stated in Section 1, OSA went beyond these checklists and used their knowledge of county financial statement and federal program audits to

¹⁹ *Laws of Minnesota* 2017, First Special Session, chapter 4, art 1, sec. 2, subd. 4.

identify many issues identified in the report. Since we did not go outside the scope of the checklists, there may be issues present with OSA's workpapers that we did not identify as part of our review.

In addition, many of the professional auditing standards are subjective and dependent on the use of professional judgment. Auditors may disagree on whether certain audit procedures are adequate to meet the standards. There were instances where we disagreed with OSA's judgment on certain issues; however, we accepted their professional judgment and gave them a certain "benefit of the doubt" that they may not have extended to the CPA firms.





January 19, 2018

Members of the Legislative Audit Commission:

In the letter that follows, State Auditor Otto criticizes a section of our report. As you consider her concerns, please also consider the following.

In March 2017, the State Auditor’s Office issued a report critical of county audits performed by CPA firms. In response, the Legislature directed the Legislative Auditor to examine the “adequacy” of county audits performed by the State Auditor’s Office.

In Section 2 of our report, we presented the results of our review of the county audits performed by the State Auditor’s Office. We concluded the audits met generally accepted auditing standards and were, therefore, “adequate.”

In Section 1 of our report, we discussed the State Auditor Office’s review of county audits performed by CPA firms. We concluded that the Office did not follow due process and fairness standards that the audit profession commonly follows. In addition, we concluded that the Office did not adequately document how it reached critical findings about the work performed by CPA firms. In the letter that follows, the State Auditor is critical of these conclusions.

The State Auditor argues that her Office’s examination of the CPA firms’ work was not an audit and was, therefore, not subject to generally accepted auditing standards. We agree, and stated that fact in our report. Nevertheless, we believe all examinations—audits, evaluations, and special reviews—conducted by an audit office should follow best practices related to due process and thorough documentation.

Sincerely,

A handwritten signature in black ink that reads "Jim Nobles".

James R. Nobles
Legislative Auditor





REBECCA OTTO
STATE AUDITOR

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January 18, 2018

Mr. James R. Nobles
Legislative Auditor
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Room 140 Centennial Building
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Saint Paul, Minnesota 55155-1603

Dear Mr. Nobles:

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

Thank you and your staff for the work the OLA did on its assessment of the "adequacy of county audits performed by the Office of the State Auditor (OSA) in calendar year 2016" as required by 2017 Minnesota Laws, 1st Special Session, chapter 4, art. 1, sec. 2, subd. 4. We share with the OLA the goal of ensuring that the OSA's audit documentation of county audits meet the required industry standards and state law.

We are pleased that, in Section 2 of the report, the OLA found that the OSA performed adequate audits of the counties in calendar year 2016. The OLA did not find any significant issues or noncompliance with auditing standards. OSA staff are highly skilled professionals and have a deep knowledge and expertise in county finances and auditing. The taxpayers expect and deserve nothing less.

Section 1 of the OLA report does not relate to county audits performed by the OSA, but rather to the OSA's report on the adequacy of county audits performed by CPA firms. It contains several inaccurate and unsupported statements that we address below, generally in the order that they appear in the report.

We find it puzzling that the OLA report states that we did not thoroughly support the findings resulting from our review of the 2015 audit workpapers of CPA firms. We have thorough documentation supporting all of our conclusions. We would be pleased to understand what documentation the OLA believes is missing.

The OLA report states that we did not document the procedures and methodology beyond the standard checklists. We used detailed checklists as a guide for performing the desk and workpaper reviews of CPA firm audits. These same checklists were used by the OLA staff to review the OSA's audit reports

and workpapers. We also used as guidance auditing standards and other authoritative sources, which we identified to OLA staff and in our March 2017 report. To this guidance, we applied our knowledge and expertise of county finances and county accounting and reporting standards. Proper use of review checklists, auditing standards, and authoritative sources *requires* that the reviewers have knowledge and expertise in the type of audit they are reviewing. This deep knowledge and expertise is precisely why the OSA is charged with determining whether a county audit performed by a CPA firm meets recognized industry standards.

The OLA report suggests that the OSA's special review of the adequacy of county audits should have followed generally accepted auditing standards related to audit documentation and the views of the "audited entity". It is inappropriate to label the CPA firms as "audited entities" of the OSA. *Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards* (GAAS) (AU-C Preface.01) identifies the purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. The purpose of the OSA's special review was not an audit and did not give an opinion, so applying GAAS would not be appropriate and would clearly not be considered a best practice.

The OLA report goes on to state that the OSA did not provide the CPA firms with due process and professional courtesy. The OLA claims that the OSA did not consider in our final report the responses provided by the CPA firms to our preliminary findings. The OLA is aware that the firms were given an opportunity to respond, because we provided OLA staff with the responses. If the responses resolved preliminary issues identified by the OSA, then a finding never appeared in the OSA report. Contrary to the OLA comment, the OSA did consider the CPA firms' responses before issuing our report on the adequacy of their audits.

The CPA firms are fully aware that their audits must be conducted in conformance with auditing standards. The OSA reported deficiencies in audit documentation of county audits performed by CPA firms. If CPA firms perform audits of Minnesota local governments, they are required to comply with industry audit standards and are subject to public scrutiny.¹

¹ Footnote 15 of the OLA report states that one of the CPA firms identified significant price differences between audits it performed and those performed by the OSA. The two examples of price differences cited in the report are for counties for which the firm's audit work was so deficient that the OSA had to resume conducting the counties' audits for years subsequent to those when the private firm had audited them. Additionally, this firm also is the firm that performed the two 2015 county audits that, as reported in the OSA's 2017 report, "Assessing the Adequacy of 2015 County Audits Performed by Private CPA Firms", were the only two audits in our review that so pervasively failed to meet industry audit standards as to require new audits. Six other 2015 county audits conducted by that firm (that were not part of our report) also failed to meet standards and must be completely redone. It should be noted that, included in the work done by the OSA in the higher cost audits, was additional work that had to be done solely because of the deficient audit work previously done by the firm. The facts underlying this firm's deficient audit work and its low cost amplify the point that cost alone cannot, and should not, be taken as an indicator of audit efficiency.

Mr. James R. Nobles
January 18, 2018
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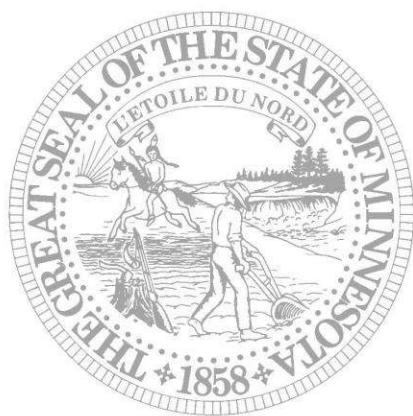
The OSA is here on behalf of the taxpayers to ensure that county audits conducted by private CPA firms meet all required standards. The OSA is pleased to note that the firms have taken the opportunity to address their audit procedures and documentation in response to the OSA report. I am encouraged that as a result of the OSA 2017 report, the quality of county audits performed by private CPA firms is improving.

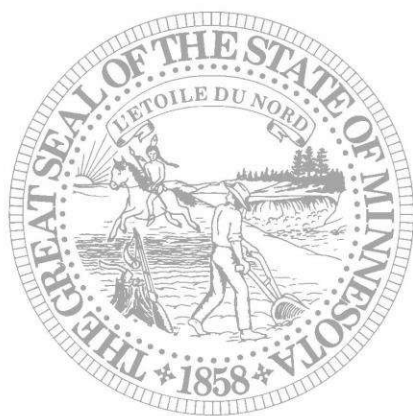
Sincerely,

A handwritten signature in black ink, appearing to read 'Rebecca Otto', with a stylized flourish at the end.

Rebecca Otto
State Auditor







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