

**CITY OF MINNEAPOLIS INTERNAL
AUDIT FUNCTION:**

QUALITY ASSESSMENT

And

RECOMMENDATIONS

Submitted By,

Internal Audit Review Committee

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EXECUTIVE SUMMARY

This report summarizes an evaluation of the Minneapolis Internal Audit Department as requested by the Minneapolis Board of Estimate and Taxation. The Board requested that the Internal Audit Review Committee, a group of volunteers knowledgeable in the audit profession, assess Minneapolis' Internal Audit function, determine what it does well, what it is lacking and where it meets or does not meet accepted industry standards for internal auditing. Based on that, the Committee was to make recommendations for the future of Internal Audit that would maximize its potential to provide a thorough, objective perspective to evaluating and improving the effectiveness of City Government in Minneapolis.

Scope

This review utilized the *Quality Assurance Review Manual* based on the *Standards for the Professional Practice of Internal Auditing* issued by Institute of Internal Auditors (IIA). However, given the upcoming retirement of the City's current Auditor, the focus of the review was primarily on establishing a solid framework and structure for the future of internal audit, not on the performance of the current internal audit function.

This November's election includes a charter amendment that would transfer the Board's powers to the City Council. Because of that, this report presents organizational scenarios that include the Board continuing in its current form and ones that do not.

Methodology

To assess the current structure and function of Minneapolis Internal Audit, a Quality Assessment Review was conducted in conformance with the IIA's *Standards for the Professional Practice of Internal Auditing (2009)*. The Board wanted clear standards against which to evaluate the audit activity. The IIA has established a clear set of standards specific to internal audit that are used internationally in private, non-profit and government organizations.

Opinion as to Conformance with the Standards

Based on the review and the observations described in the main section of this report, Minneapolis Internal Audit **does not comply** with the Institute of Internal Auditors *Standards for the Professional Practice of Internal Auditing*. Several deficiencies were found that show non-conformance. Many of the problem areas may be related to an ongoing lack of adequate resources for the function. The office is understaffed and does not have effective oversight. Some of the other observations relate to structure and function, while some deal more specifically with the practice of conducting audits.

Matters for the Consideration of the Board and City Leadership

1. Organizational Independence – The city should ensure that there is an audit committee with purview over internal audit to ensure its ongoing organizational independence.
2. Organizational Independence – The Internal Auditor should have a dual reporting relationship to the Board or its successor (Audit Committee) for audits and to the City Coordinator for administrative matters.
3. Reporting to Senior Management and the Board – The City should work to increase the staff of Internal Audit by at least two FTE and possibly as many as four as soon as possible. This will ensure better audit coverage and allow city management to better identify and manage critical risks.

Matters Specific to Internal Audit

1. IIA Code of Ethics – Minneapolis Internal Audit should adopt the IIA Code of Ethics and incorporate a reference to it in its Audit Charter.
2. Audit Charter – The Internal Audit Charter should be revised to conform to IIA Standards and clearly define the desired role for the internal audit function in the future of the City.
3. Audit Planning – Minneapolis Internal Audit should develop an annual risk assessment process that includes input from the Mayor, the City Coordinator, Senior Managers of City Departments and the City Council.
4. Quality Assurance and Improvement Program – Minneapolis Internal Audit should develop a Quality Assurance Improvement Program that includes regular internal quality check elements, as well an external review within the next 2 or 3 years if the activity can be brought into conformance, and then every 5 years as required by the Standards.

It has been a pleasure having the opportunity to meet and work with city government employees and elected officials during this evaluation. Please contact us if you need further information or documentation.

INTRODUCTION

Background

The City of Minneapolis, a City of approximately 388,000 residents and a total annual budget of \$1.4 billion (2009 revised budget) currently employs one internal auditor for City government. The Auditor currently reports to the City's Board of Estimate and Taxation. As the current auditor, a long-term employee, prepared for his retirement (due to occur in November of 2009), the Board of Estimate and Taxation decided to take a critical look at internal auditing in the City. They convened an external, volunteer committee of people with expertise in internal auditing to assess the status of internal auditing at the City and make recommendations as to how the function might be improved.

The Internal Audit Review Committee consisted of the following Internal Audit professionals from 2 other public organizations and three members of a private audit firm with experience in internal audit services for public sector clients;

- Katie Shea, Director of Evaluation and Audit, Metropolitan Council
- Al Willie, Audit Manager, University of Minnesota
- Cliff Hoffman, Deloitte and Touche
- Matt Marsh, Deloitte and Touche
- James McQuillan, Deloitte and Touche

The group was charged by the Board with conducting an Institute of Internal Auditors (IIA) compliant assessment of Minneapolis Internal Audit and based on the findings, making recommendations to improve the effectiveness of internal audit at the City. The President of the Board attended the Committee meetings, as did the current Auditor for the City.

The bulk of the Quality Assessment Review that underlies much of this report was performed by Katie Shea, who chairs the Twin Cities IIA's Quality Assessment Review Committee. However, the observations and recommendations were reviewed by all members of the Committee prior to sharing this report.

Methodology

To assess the current internal audit structure and function, a Quality Assessment Review was conducted in conformance with the *Professional Practices Framework* of the Institute of Internal Auditors (2009 revision). Certain minor modifications were made to the review process in light of the circumstances at the City. More emphasis was placed on issues of purpose, structure and conduct and less on review of work papers or specific

audits performed, since the Board was seeking guidance on the future of the internal audit function.

At the same time, the Board and others within city government wanted the Internal Audit function at the City to reach an established standard. The Institute of Internal Auditors (IIA), as the standard setting body for internal auditing, provides a clear set of widely accepted standards upon which to base internal audit operations. In accordance with the IIA model and standards, this review included:

- Reviewing the current internal audit charter and policy,
- Interviewing the current internal auditor and reviewing some of the audit topics and work over the last two years,
- Interviews with several members of the Board of Estimate and Taxation,
- Interviews with leaders of key city departments and functions,
- Interviews with elected officials.

This report summarizes findings based on these activities and on information provided by the Board and by the current Auditor.

Timing and Scope

As noted above, Internal Audit currently reports to the Board of Estimate and Taxation (the Board). The status of the Board after 2009 is in flux at the time of this report. There is a ballot issue in the November election that could eliminate the current Board of Estimate and reallocate its responsibilities to the City Council, which would directly impact the reporting relationship of Internal Audit. To avoid further delays in this report, for all recommendations concerning structure and reporting relationships that involve the Board, there is an attempt to give alternatives that consider the position of Internal Audit in both scenarios, with the Board still in place and in the absence of the Board.

The Report

The Report is organized into three sections:

- Matters for the Board of Estimate and Taxation and City Leadership – these issues deal primarily with the structure and core functions of Internal Audit.
- Matters concerning Internal Audit – this section has more specific recommendations dealing with how Internal Audit does its work, including the Audit Charter, Code of Ethics, etc.
- Opinion on the Conformance with the Standards – discusses whether or not Minneapolis Internal Audit complies or does not comply with the IIA *Professional Practices Framework*, specifically the mandatory portions, the *Code of Ethics* and the *Standards for the Professional Practice of Internal Auditing*.

This report is to be issued in draft form to the Board of Estimate and Taxation, as well as City leaders and elected officials for review and comment 60 days before the final version is issued, as directed by the Board in its original charge to the Committee.

MATTERS FOR THE CONSIDERATION OF THE BOARD AND CITY LEADERSHIP

Observation One – Organizational Independence (Standard 1110).

The Standard for organizational independence is intended to preserve Internal Audit's ability to do what is required or necessary without any interference or attempts at redirection by others who may have a stake in the outcome of an audit project. The language specifically requires that the Chief Audit Executive (CAE) have direct access to both Senior Management and the organization's Board of Directors to ensure that the audit function is free from influence and can report any issues of concern directly to the organization's leadership and governing body, if necessary.

Under the current Board structure, the Internal Auditor reports to the Board of Estimate and Taxation, an entity outside of the City's executive or Council structure. This arrangement preserves the function's independence and shields it from micro-management by the city departments it audits. However, at the same time, this arrangement isolates Internal Audit from the City's leaders (both elected and appointed) and from the departments it partners with to conduct audits and reviews. This isolation contributes to the feeling that some city leaders reported to us, that Internal Audit is not an effective resource for them or their departments.

In addition, the current reporting relationship lacks direct accountability for the day to day functions of the Internal Audit office. Although the President of the Board of Estimate approves the Auditor's timesheets, budget and training expenses, this official is not in a position to have direct knowledge of the Auditor's daily activities. The two elected members of the Board also acknowledge that this is a problem and recognize the lack of connection between Internal Audit and the City's administrative personnel.

If the Board remains in place after the November election, it could continue to serve as the Audit Committee for Internal Audit, providing overall direction and oversight regarding audits and audit reports to reinforce organizational independence. However, in this case, it would be advisable to pursue what many other local units of government have, a dual reporting relationship. The Auditor would continue to report to the Board on matters of Audit for independence, but would also have reportability to the City Coordinator for administrative matters and follow-up on recommendations that deal with City Departments. It is also critical to develop regular communication between Internal Audit and the City Council to begin building a strong relationship between Internal Audit and the City's governing body. Over time, the Council can come to rely on Internal Audit as a resource for them in looking at more efficient and effective ways to conduct the business of city government, and better identify and manage risk.

If the City Council becomes the Board of Estimate and Taxation after the election, then the Auditor, in reporting to the Board will be, in effect, reporting to the Council.

However, in addition to being the Internal Auditor's boss, the Council is also its biggest customer, creating the possibility of improper influence which could negatively affect Audit's organizational independence. To avoid that, it would be advisable to create an Audit Committee to provide advice, consent and approval for the Auditor's plans and reports. The Committee's makeup would likely be somewhat similar to that of the Board, involving the City Council, the Mayor, the Legal Department and perhaps key City departments, but more structured, scheduled communications should be arranged between the Board or Audit Committee and the Council to meet the requirements that Internal Audit have direct access to the Board and to facilitate better communication and coordination for audit activities across the Council.

Recommendation One – The city should ensure that there is an Audit Committee with purview over Internal Audit. This could be the Board of Estimate and Taxation or it could be different Committee with representation from the City Council, the Mayor's Office, and potentially key City Departments.

An independent Audit Committee helps to ensure the organizational independence of the Internal Audit Activity. It provides oversight over the risk assessment and audit plan to ensure adequate coverage of organizational risks, and objectivity in project/audit selection. Regardless of the status of the Board, some type of oversight committee is critical to an open, independent Internal Audit function. Adequate representation from key parts of City government, including staff and elected officials, provides balance on the committee, as well as a solid core of knowledge to inform discussions and decision making by the group as a whole.

Management Response –

Recommendation Two -- The Internal Auditor should have a dual reporting relationship to the Board or its successor (Audit Committee) for audits, and to the City Coordinator for administrative matters.

Currently, the Board has both audit (programmatic) oversight and administrative oversight of Internal Audit. Elected members of the board acknowledge that they have no other role in administration at the City and are arguably not able to be effective in the administrative matters of the Audit function. At the same time, there is virtually no relationship, formal or informal, between Internal Audit and the head of the executive departments, the City Coordinator. Adding an administrative reporting relationship between Internal Audit and the City Coordinator's Office will provide better oversight and begin to forge a stronger partnership between Internal Audit and the City Coordinator, as well as City Departments.

Management Response –

Observation Two – Standard 2060 Reporting to Senior Management and the Board.

Flowing from the Chief Audit Executive's (CAE's) access to Senior Management and the Board, the Standards require the CAE to report regularly to Senior Management and the Board on the status of Internal Audit. Specifically, the standard states that *the report must also include significant risk exposures and control issues, including fraud risk, governance issues and other matters needed or required by the Board.* The Minneapolis Internal Audit function is not in compliance with this standard.

First, the current Auditor does not have regular meetings with either senior management for the city or with the City Council (the Board). There are management representatives from some departments on the Audit Committee (which is advisory to internal audit) and on the Board, but there is no regular meeting for internal audit with the CFO, the City Coordinator or other key senior managers in the City. The Auditor appears before the City Council only if and when requested to do so, which is fairly rare. There is little communication flowing in either direction between the Auditor and key decision makers at the City, to the detriment of everyone involved.

Second, although it is widely acknowledged, according to all of our interviewees, that Internal Audit is significantly under-resourced, there has been very little discussion at the City of the potential ramifications of an inadequate internal audit function. In this review, almost all interviewees brought up areas of concern that result from inadequate internal audit coverage due to under-staffing. Issues discussed included the following:

- Compliance risks – are there areas where the City is out of compliance with an important law or regulation and no one knows it because there is no one to check? It leaves the City vulnerable to “gotcha” situations and potential penalties from external audits or stakeholders.
- Fraud risk – In an economic downturn, incidents of fraud generally go up. Recent news headlines about government fraud are of significant concern to many people in City Hall. They want Internal Audit to help with prevention efforts, and there is concern that with only one auditor Internal Audit does not have sufficient resources to assist in this high-priority effort.
- Program/Performance Audits – More Internal Audit “customers” are seeking recommendations for potential improvements in efficiency and effectiveness. This too would require more auditors than Minneapolis Internal Audit currently has.

All of these risks are currently under mitigated without an adequately resourced internal audit function to examine areas of concern from a risk basis and allocate resources appropriately to cover high risk areas.

To assess Minneapolis' Internal Audit activity in comparison with other similar local governments, the Committee looked at data collected by the Association of Local Government Auditors (ALGA) on the size, budget and function of internal audit operations around the country. In looking at cities with similar sized budgets and their

internal audit functions, all had more staff than Minneapolis has. Some examples are as follows:

- Atlanta, GA 8 FTE
- Charlotte, NC 9 FTE
- Mesa, AZ 4 FTE
- Portland, OR 11-15 FTE
- Seattle, OR 6-10 FTE

The closest in internal audit unit size is Mesa, which has four FTE, three more than Minneapolis currently has in its internal audit office.

In addition, most of these cities report that they are conducting more program and compliance audits and far fewer financial audits because it has been of more value to their organization. In most cases, their external auditors handle the bulk of the financial audits.

It is clear that Minneapolis Internal Audit is under-staffed and that the lack of resources impacts the audit coverage and level of assistance available to City officials and managers.

Recommendation – Increase the size of the Internal Audit function by at least 2 FTE, possibly as many as 4, as soon as possible to ensure better audit coverage and to better identify and manage critical risks.

Staffing increases could be accomplished over time, if necessary, but it seems clear that the unit as it is currently configured cannot produce the type and quantity of work that the City needs and wants from its Internal Audit Department.

Currently, a number of high risk areas are not regularly audited or even checked for basic compliance, creating the concerns that were voiced by the people we interviewed. Some specific areas of risk include, but are not limited to:

- Cash handling,
- Inventory management,
- Payroll,
- Procurement and contracts, and
- Asset protection.

Management Response –

MATTERS SPECIFIC TO INTERNAL AUDIT

Observation Three – IIA Code of Ethics

The Internal Auditor currently states that the function follows the City's Ethics Ordinance, which deals broadly with matters of personal ethical behavior. However, Minneapolis Internal Audit has not adopted the IIA Professional Code of Ethics that deals with how audits should be conducted.

The City Ordinance is appropriate, but the requirements for an auditor's conduct in performing audits in the IIA *Code of Ethics* are more specific and require formal adoption. The Code outlines four core principles for internal auditors:

1. Integrity,
2. Objectivity,
3. Competency,
4. Confidentiality.

The IIA establishes rules of conduct for auditors in enacting these principles. The rules of conduct include things like observing the law and making disclosures expected by law and the profession, and engaging only in those services for which you have the necessary knowledge, skills and experience. The Code establishes the basic expectations of the internal audit profession and the standards require that it be adopted to be in conformance with the standards.

Recommendation – Minneapolis Internal Audit should adopt the IIA Code of Ethics and incorporate a reference to it in its Audit Charter.

The Code of Ethics provides a level of assurance about the principles under which Internal Audit will operate. The charter references standards and other requirements, so the Code of Ethics reference should be included there as well.

Management Response –

Observation Four – Standard 1000 Internal Audit Charter

The Minneapolis Internal Audit Charter, originally written in 1986 and, as far as could be determined from the records, not revised anytime recently, lacks key elements required under the IIA Standards. The definition of Internal Audit is not current and does not reference the standards. The Audit Charter does not discuss i) attributes, ii) responsibilities, or iii) standards of Internal Audit. It also lacks signatures and dates or other evidence of approval by the Board of Estimate and Taxation, as the entity that oversees Internal Audit.

Updating the Charter to meet the current IIA standards would also further clarify the responsibilities and expectations of Minneapolis Internal Audit.

Recommendation – Revise the Internal Audit Charter to conform to the IIA Standards and clearly define the desired role of the function.

As new ideas are coming forward and changes are being made to enhance the Internal Audit function for the City of Minneapolis, it is an opportune time to revisit the Charter and incorporate the missing elements, but also make sure that it is reflective of where the City wants to go with its Internal Audit function, including the role, function, and relationships of Internal Audit, as well as the role and make-up of the Audit Committee.

Management Response –

Observation Five – Standard 2010 Audit Planning

Minneapolis Internal Audit does not plan engagements based on an annual risk assessment as required by the IIA Standards. A biennial risk assessment is largely completed by the Auditor, with little or no formal consultation or involvement from senior management or the Council aside from the Audit Committee and the Board. The Standards require that the input of senior management and the board be considered in the risk assessment process and that the process occur annually.

Given the rate of change in the current environment in which organizations operate, an annual risk assessment is important to stay current. In addition, to get a full picture of risks across the organization and not just in specific parts, the input of senior managers, the Council and the Mayor are critical. This ensures that the risk assessment will be an accurate reflection of the City's risk profile that will serve the needs of the City.

Recommendation – Minneapolis Internal Audit should develop an annual risk assessment process that includes input from the Mayor's Office, the City Coordinator, senior managers of City departments and the City Council, as well as the Audit Committee or Board to whom Internal Audit reports.

Management Response –

Observation Six – Standard 1300-1340 Quality Assurance and Improvement Program

The Standard requires that the Chief Audit Executive develop and maintain a quality assurance and improvement program for the internal audit activity. The program must include both internal and external elements. Internal assessments are types of performance monitoring. Common tools to create metrics include client surveys,

recommendation tracking, and turnaround time for audit production. Additional metrics and benchmarks to consider are available at IIA's GAIN survey.

An external review of Internal Audit's compliance with the Standards is required every five years. Generally, this is a peer review performed by either the IIA, the Twin Cities chapter or another professional organization. The first of these reviews was due by the end of 2006 and another is required every five years after. Minneapolis has never had one up to this point.

Recommendation – Minneapolis Internal Audit should develop a Quality Assurance Improvement Program that includes regular internal quality check elements as well as an external review within the next two or three years if the activity can be brought into conformance, and then every five years thereafter as required by the Standards.

Minneapolis Internal Audit currently has no Quality Assurance Improvement Program in place. There is no formal mechanism for internal feedback from clients or other involved parties. In addition, Internal Audit is out of compliance with the requirement for an external review, which has never been performed.

Management Response –

OPINION AS TO CONFORMANCE WITH THE STANDARDS

Based on this review and the observations described in this report, Minneapolis Internal Audit **does not comply** with the Institute of Internal Auditors *Standards for the Professional Practice of Internal Auditing*. Several deficiencies in meeting the Standards were discussed in the previous two sections of this report. Many of the problem areas may be related to the chronic lack of resources for the function. However, some relate to structure and function, while others deal more specifically with the practice of conducting audits.

Given that the City is taking this opportunity to review and redesign its internal audit function, hopefully these recommendations can provide some guidance in key areas for the city, along with the new Chief Audit Executive, to address in the redesigned internal audit function.

It is our belief that an adequately resourced, IIA-compliant, Internal Audit function at the City of Minneapolis would provide significant value to the organization by managing risk, finding cost savings either through performance enhancements or cost recovery, and by deterring and discovering compliance problems and potential fraud. Although some up-front investment is required to staff such an operation, the long term payoff will be well worth the initial cost.