Committee: Audit Committee

Date of Meeting: January 20, 2004

Agenda Item: Plan to Contract with Certified Public Accounting Firms and the Legislative Auditor for Fiscal Year 2005 Audits

☐ Proposed Policy Change ☐ Approvals Required by Policy ☒ Other Approvals ☐ Monitoring

☐ Information

Cite policy requirement, or explain why item is on the Board agenda:
Board Policy 1A.2 part 5 subpart E, requires the Audit Committee to oversee the work of external auditors.

Scheduled Presenter(s):
John Asmussen, Executive Director, Office of Internal Auditing
Laura King, Chief Financial Officer

Outline of Key Points/Policy Issues:

➢ Recommendations about strategy for external audit plans.

Background Information:

➢ In December 2003, the Board of Trustees directed the Vice Chancellor – CFO and Executive Director of Internal Auditing to valuate the strategy objectives, capacity and cost effectiveness of conducting additional financial statement audits.
BOARD OF TRUSTEES
MINNESOTA STATE COLLEGES AND UNIVERSITIES

BOARD ACTION

PLAN TO CONTRACT WITH CERTIFIED PUBLIC ACCOUNTING FIRMS AND THE LEGISLATIVE AUDITOR FOR FISCAL YEAR 2005 AUDITS

BACKGROUND

In December 2003, the Board of Trustees directed the Executive Director of Internal Auditing and the Vice Chancellor – CFO to evaluate the strategy objectives, capacity and cost effectiveness of conducting additional institutional financial statement audits. The attached report conveys the results of that evaluation and its recommendations for future institutional audits.

RECOMMENDED COMMITTEE ACTION:

The Audit Committee recommends that the Board of Trustees adopt the following motion:

RECOMMENDED MOTION

The Board of Trustees endorses the recommendations offered by the Executive Director of Internal Auditing and Vice Chancellor – CFO regarding a strategic plan for external audits. It further authorizes the Executive Director of Internal Auditing and Vice Chancellor – CFO to take the following steps:

- Initiate a competitive bidding process to select external auditors for Bemidji State University, Minnesota State University, Mankato, Minnesota State University Moorhead, St. Cloud State University, Winona State University, Minnesota State Community and Technical College and Northwest Technical College – Bemidji for fiscal years 2005 to 2007.

- Contract with the Legislative Auditor to test internal controls and finance-related legal compliance at two-year colleges, perform information technology audits, and conduct the assurance work on state systems that is necessary to support the external auditors responsible for the fiscal year 2005 financial statement audits.

Date Presented to the Board of Trustee: January 20, 2004
January 19, 2005

Ms. Anne Shaw, Chair, Audit Committee
Audit Committee members
Board of Trustees
Minnesota State Colleges and Universities

Dear Trustee Shaw,

Enclosed please find the final report requested by your committee and titled Strategic Plan for External Audit Services. The report conveys the findings and recommendations of a study group convened per Board direction and charged with making recommendations concerning the long term strategy for external auditors for the Minnesota State Colleges and Universities as a whole and for its related colleges and universities.

The project objective was:

Evaluate the strategy, objectives, capacity and cost effectiveness of conducting additional institutional financial statement audits. Report the results of this evaluation and recommendations for future institutional audits to the Audit Committee in January 2005.

The study team was comprised of the Vice Chancellor and Executive Director along with Mr. Tim Stoddard, Associate Vice Chancellor for Financial Reporting, Ms. Margaret Jenniges, Director of Financial Reporting, Ms. Beth Buse, Assistant Director of Internal Auditing and Mr. Paul Portz, Regional Audit Coordinator in the Office of Internal Auditing. Additional assistance was provided by staff of the Finance Division and the Office of Internal Auditing.

We look forward to review of this report with your committee and with the Leadership Council and the chief financial officers of the thirty-two colleges and universities in the Minnesota State Colleges and Universities system.

Warmest regards,

Laura M. King
Vice Chancellor – Chief Financial Officer

John Asmussen
Executive Director of Internal Auditing

c: James H. McCormick, Chancellor
INTRODUCTION

The Minnesota State Colleges and Universities has undertaken a comprehensive program of external audits over the past five years. The program has been endorsed by the Board and the Chancellor and supported by the efforts of the presidents, administrators and staff across the system.

- 2000 – The Office of the Legislative Auditor is hired to prepare the first comprehensive balance sheet compilation for the system concerning FY2000 activity.

- 2001 – The firm of Deloitte Touche, LLP is hired to audit the annual financial statements and related footnotes for the system for FY2001 – FY2003 activity.


- 2004 – The firm of Kern, DeWenter, Viere, Ltd is hired as the system auditor, replacing Deloitte Touche LLP. The contract extends for three years and concerns the activity of FY2004-FY2006.

The above program results in an audit opinion on the financial statements of the overall system and opinions on the financial statements of twelve colleges and universities representing sixty percent of the revenues of the Minnesota State Colleges and Universities.

It is timely to review the objectives of the audit strategy and establish the goals for the next five years. The contracts for six of the individual college and university audits have completed the term and will expire this year. The contracts for the remaining six colleges and universities expire after completion of the FY2005 audits. Staff will generate a new request for proposals the winter of 2005 based upon the direction that the Board, Chancellor and Leadership Council provide.
PROJECT OBJECTIVE

In December 2003, the Audit Committee directed the Vice Chancellor – Chief Financial Officer and the Executive Director of Internal Auditing to undertake a study of the audit program and report results at the December 2004 meeting. The report was subsequently re-scheduled to January 2005.

The project objective was:

Evaluate the strategy, objectives, capacity and cost effectiveness of conducting additional institutional financial statement audits. Report the results of this evaluation and recommendations for future institutional audits to the Audit Committee in January 2005.

The study team was comprised of the Vice Chancellor and Executive Director along with Mr. Tim Stoddard, Associate Vice Chancellor for Financial Reporting, Ms. Margaret Jenniges, Director of Financial Reporting, Ms. Beth Buse, Assistant Director of Internal Auditing and Mr. Paul Portz, Regional Audit Coordinator in the Office of Internal Auditing. Additional assistance was provided by staff of the Finance division and the Office of Internal Auditing.

Project Methodology

1. Gather data from other state higher education systems to determine their approaches for preparing and auditing the financial statements of the system and individual institutions. State systems to be surveyed include other systems in the North Central Region governed by the accreditation standards of the Higher Learning Commission and other systems outside the region that are structured similar to the Minnesota State Colleges and Universities.

2. Make inquiries to external monitoring agencies, such as bond rating agencies and accreditation agencies, about the role and value that they perceive with audited financial statements for both the system and its individual institutions.

3. Survey key decision-makers, such as presidents and chief financial officers, at the 12 MnSCU institutions that received individual financial statement audits in the past year. Determine how the audited financial statements were utilized by the institutions during the past year and whether the key decision-makers believe that the value of the audited financial statements justify their cost.

Survey key decision-makers, such as presidents and chief financial officers, at MnSCU institutions that have not received individual financial statement audits in the past year. Determine how the institutions have satisfied inquiries about financial viability from external parties such as accreditation teams and potential financial partners. Determine if the decision-makers desire audited financial statements for their institution.
4. Construct a cost benefit analysis for obtaining audited financial statements of individual MnSCU institutions. Identify the needed infrastructure building requirements for staffing the desired level of financial reporting.

5. Analyze alternatives to audited financial statements for assessing financial viability and accounting discipline at the institutional level.

6. Analyze the effects of decentralizing the financial reporting function to individual institutions.

7. Articulate long term strategy for financial management and audits including interim financials and full accrual accounting.

GOALS AND OBJECTIVES OF THE FINANCIAL MANAGEMENT AND ASSURANCE PROGRAM

Management has designed a financial assurance program with significant financial and human resource commitments. The program is grounded in Board policy articulating standards of accountability for colleges and universities as well as members of the Office of the Chancellor. The Vice Chancellor – Chief Financial Officer has day to day responsibility for establishing the standards and the means of measuring compliance with the standards. This is done through the financial planning standards framework, provision of required training, and creation of monitoring and reporting methods in support of the Board’s financial management standards.

Board policy authorizes the Office of Internal Auditing to provide assurance services that inform interested stakeholders about the reliability and accuracy of information and information systems. The policy directs Internal Auditing to coordinate all audit-related activities conducted by the Legislative Auditor and external auditors, including follow-up on unresolved audit findings. The Board of Trustees also approves an annual audit plan that targets significant Internal Auditing resources to assist the external auditors with the financial statement audit process.

ELEMENTS OF THE FINANCIAL MANAGEMENT AND ASSURANCE PROGRAM

Financial Planning Standards Framework

- Annual system and state overview of economic and financial outlook as it may impact the colleges and universities.

- Articulation of the Board’s requirements and expected reporting thresholds for measuring compliance prior to the start of each fiscal year.

- Disciplined multi year budget planning with regular reports of actual activity compared to budget plan.
• Broad campus consultation process for establishment of operating budget with widely distributed information concerning expected revenues and expenses.

• Preparation of system level statements which improves the uniform and consistent recording of financial information at the college/university level.

• Preparation of individual financial statements and related footnotes for a substantial portion of the colleges and universities.

**Provision of Required Training**

• Regular training for campus personnel on issues of import in the financial management arena.

• Semi-annual statewide meetings and annual regional meetings of all CFOs and business managers for training and discussion of issues and procedures.

• Annual training session for all CFOs and business managers/staff concerning financial reporting issues, standards, emerging requirements.

• Annual training at both a regional and individual audited college or university level that focuses on the current year’s audit process, requirements and issues.

**Compliance Monitoring and Reporting Methods**

• Preparation of annual cost studies which require uniform use of the accounting system.

• Deployment of the Office of the Legislative Auditor to a significant portion of colleges every year for financial and operational reviews.

• Tracking and follow up by the Office of the Internal Auditor of all issues raised by other auditors at the colleges and universities and in the Office of the Chancellor.

• Production and public release of monthly, quarterly and exception based reports on an agreed upon set of measures which reflect both annual and trend data for the financial performance of the colleges and universities.

One of the key elements of the financial management and assurance program is the external audit plan. This plan provides both measurement and reporting feedback to the chancellor and the Board concerning the financial condition of the system and individual colleges and universities.
The external audit plan could be designed with several formal and informal objectives. Agreement on the objectives is a critical element to ensuring a successful program which serves the needs of the Board and management. The following objectives apply both to system wide audited financial statements as well as individual college and university audited statements.

- Provide assurances to external audiences that the financial activity of the Minnesota State Colleges and Universities is accurately and reliably presented. It would further provide some level of assurance that internal controls are in place and periodically tested for efficacy.

- Provide assurances to internal audiences that the financial activity of the Minnesota State Colleges and Universities is accurately and reliably presented and some level of assurance that internal controls are in place and periodically tested for efficacy.

- Provide an annual accounting of the activity of the organization or its members. Such a uniformly prepared, consistently presented accounting is a valuable historical record of the actions of the organization and also allows for comparison to similarly prepared financial statements of peer organizations across the country. Obtainment of independent opinions from external auditors provides additional independent assurance.

- Provide important data for presentation of trends and patterns in operations which can be analyzed for efficiency and effectiveness of programs and practices.

- Afford exposure to professional advice from external auditors who are knowledgeable experts concerning both financial reporting trends and more generally financial management trends.

1. RESULTS OF SURVEY OF OTHER SIMILAR SYSTEMS

OTHER HIGHER EDUCATION SYSTEMS

Twelve higher education systems, as shown in Table 1, were selected to compare to the Minnesota State Colleges & Universities. Representatives from these institutions were interviewed about their approach to audited financial statements.
Table 1: Other Higher Education Systems: Audited Financial Statement Practices

<table>
<thead>
<tr>
<th>System</th>
<th># of institutions</th>
<th>Audit Approach</th>
<th>Who Audits?</th>
<th>Who Prepares statements?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arizona Board of Regents*</td>
<td>3</td>
<td>Institutions Only</td>
<td>State</td>
<td>Institutions</td>
</tr>
<tr>
<td>University of Arkansas System*</td>
<td>10</td>
<td>System only</td>
<td>State</td>
<td>Institutions</td>
</tr>
<tr>
<td>California State University</td>
<td>23</td>
<td>System only</td>
<td>CPA</td>
<td>Institutions</td>
</tr>
<tr>
<td>University of Georgia System</td>
<td>34</td>
<td>Institutions Only</td>
<td>State</td>
<td>Institutions</td>
</tr>
<tr>
<td>Kentucky Community &amp; Technical College System</td>
<td>16</td>
<td>System only</td>
<td>CPA</td>
<td>System Office</td>
</tr>
<tr>
<td>University of Maine System</td>
<td>7</td>
<td>System only</td>
<td>CPA</td>
<td>System Office</td>
</tr>
<tr>
<td>University of Minnesota*</td>
<td>4</td>
<td>System only</td>
<td>CPA</td>
<td>System Office</td>
</tr>
<tr>
<td>University &amp; Community College System of Nevada</td>
<td>7</td>
<td>Both the system and institutions</td>
<td>CPA</td>
<td>Institutions</td>
</tr>
<tr>
<td>State University of New York System</td>
<td>64</td>
<td>System only</td>
<td>CPA</td>
<td>System Office</td>
</tr>
<tr>
<td>University of North Dakota System*</td>
<td>11</td>
<td>Both the system and institutions</td>
<td>State</td>
<td>Institutions</td>
</tr>
<tr>
<td>Pennsylvania State System of Higher Education</td>
<td>14</td>
<td>Both the system and institutions</td>
<td>CPA</td>
<td>Institutions</td>
</tr>
<tr>
<td>University of Wisconsin*</td>
<td>26</td>
<td>System only</td>
<td>State</td>
<td>System Office</td>
</tr>
</tbody>
</table>

* Member of the North Central Association

Generally, institutional financial statements were audited when the institutions were considered legal entities separate from the system. Of the systems surveyed, the Nevada system was the only consolidated legal entity that chose to audit both the system and to have its institutions audited separately. The hybrid approach of the Minnesota State Colleges and Universities (some institutions with separate audits and some without separate audits) was not used by any other higher education system.

The five systems that had institutional audits used one auditor (either the state governmental audit organization or a CPA firm) for both the system-level audit and the institutional audits. No system used multiple audit firms like MnSCU. These five systems also had the institutions prepared their own financial statements unlike the MnSCU approach where a substantial portion of the audited financial statements are prepared centrally by the Financial Reporting staff of the Office of the Chancellor.

A few other noteworthy practices from these higher education systems include:

- Audited financial statements are issued between October and January (two in October, four in November, two in December, four in January)

- Two systems prepare GAAP basis interim statements.

- Eight systems calculate and track financial accountability information; four systems do not track such information.

- All related foundations were being audited. One system had the same auditor for the institutions and foundations. All the other systems had different auditors for the foundations.
• All systems have internal audit departments with a median size of 14 professional staff. The internal auditors do not assist the external auditors in ten of the systems. For the other two systems, the internal auditors provide limited assistance to the external auditor, but not to the extent that MnSCU does.

2. VIEW OF EXTERNAL MONITORING AGENCIES

Bond Rating Agencies

Credit rating firms such as Moody’s Investors Services, Standards and Poors, Inc and Fitch Advisory Services are hired by participants in the public debt markets to provide a credit rating for the underlying issuing entity. The credit analysis includes consideration of the issuer’s governance structure and discipline, financial health and strategic planning documents. The issuer is interested in receiving the highest possible credit rating in order to obtain the lowest possible interest rates on bonds to be sold. Consequently, management will undertake “all possible steps” to improve its profile under review. While none of the firms would characterize the availability of audited financial statements as a “requirement”, they all indicated that it would be unusual for such statements to not be available. Since the rating firm is rendering an opinion on the creditworthiness of the issuer, reliance on audited financial statements is understandable.

MnSCU related projects receives bond financing through one of three means. The state of Minnesota sells general obligation bonds, based upon a rating it receives from the rating agencies, the Board of Trustees sells bonds through the revenue fund based upon a rating it receives for the revenue fund overall not an individual university rating, or a related foundation sells bonds based upon its credit rating, again not a rating for an individual college of university.

Since MnSCU would be the issuer for the Revenue fund, the availability of system and fund level financial statements could be sufficient to satisfy the rating agencies. Revenue fund bonds have been sold by the Board of Trustees once since merger. In 2002, bonds were sold after a credit review which included the availability of system level and revenue fund audited financial statements only. Going the next step, and having financial statements available at the university level could be characterized as taking “all possible steps” to assist in securing a positive credit rating. One way of assessing the benefit of such a policy is to think in terms of the cost savings accruing from a lower interest rate; each basis point reduction on $10,000,000 worth of bond debt equals $1,000. A full percentage point reduction (100 basis points) in interest rate on the same $10,000,000 of bond debt would result in an annual interest savings of $100,000.

Accreditation Requirements

Audited financial statements are very useful for satisfying accreditation requirements. Accrediting agencies use audited financial statements as evidence of fiscal accountability and sound financial management. The agencies are amenable, however, to accepting alternative forms of evidence, such as supplemental financial schedules, in lieu of audited financial statements.
As part of the accreditation process, institutions are requested to submit copies of audited financial statements. The North Central Association (NCA) accreditation handbook, as revised in 2003, contains the following procedure for institutions seeking accreditation: “At least eight weeks before the visit, the organization sends a copy of … the last two annual financial audits”. Another section of the handbook stipulates that the institution prepares “audited financial statements for the two most recently completed fiscal years.” These references are not part of the official accreditation criteria, however, and NCA has continued to accredit institutions that do not have audited financial statements. Each regional accreditation agency has somewhat unique criteria. We researched the criteria for four other regional accreditation associations regarding financial statement requirements. The accreditation criteria for all four associations required an external financial audit by a certified public accountant or an appropriate public agency. These accrediting agencies seem receptive, however, to using system-level audited financial statements in lieu of institutional audited financial statements. (See our analysis of the practices of other higher education systems.)

3. RESULTS OF SURVEY OF COLLEGE AND UNIVERSITY PARTICIPANTS

Internal Surveys – Usefulness of Audited Financial Statements

Presidents and chief financial officers were surveyed to assess their opinions on the usefulness of audited financial statements. For institutions that have audited financial statements, respondents were asked to rate the usefulness of audited financial statements for meeting the needs of external and internal audiences. For institutions without audited financial statements, the respondents were asked to comment on whether the lack of audited financial statements had any adverse consequences.

Institutions with Audited Financial Statements

Presidents or chief financial officers or, in some cases, both officials from institutions with audited financial statements, responded to survey questions about the usefulness of audited financial statements. The survey responses are shown in Figure 1.

We make the following observations about these survey results:

- Respondents generally viewed the audited financial statements as very useful information for two particular external audiences: accreditation agencies and potential donors.

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1 Prior to the 2003 revision, the North Central Association accreditation process included general institutional requirements (GIR) that institutions had to meet to be eligible for accreditation. One GIR specifically required that “The college have an external financial audit by a certified public accountant or a public audit agency at least every two years.” For higher education systems, NCA allowed institutions to satisfy this GIR “by providing audited financial statements of the larger organization that include as Supplemental Information the financial activity for the institution as separate from the organization. This Supplemental Information will have been subjected to the same auditing processes as the basic financial statements”. The 2003 revision eliminated the GIRs as an integral component of the accreditation requirements.
• Presidents and chief financial officers had some notable differences on the usefulness of audited financial statements for internal audiences. Presidents found this information very useful for administrators; while chief financial officers did not. Presidents also found some utility for the audited statements to demonstrate fiscal accountability and stewardship to faculty. Again, the chief financial officers thought that the information had limited usefulness for the faculty.

• A clear divide exists between the views of the presidents and chief financial officers on the purposes for which the audited financial statements were useful. Presidents found the audited financial statements to be very useful source for a wide range of fiscal information needs: providing a comprehensive financial picture, monitoring financial results, establishing fiscal discipline, evaluating the effectiveness of fiscal controls, and assessing business office performance. The chief financial officers found a very modest usefulness of the audited financial statements for these purposes.

• The only other information source that respondents generally agreed was a very useful source of information about fiscal accountability and stewardship was the unaudited institutional financial schedules prepared by the institution.

Figure 1: Survey Results from Institutions with Audited Financial Statements

| 1. How useful are audited financial statements for demonstrating fiscal accountability and stewardship to the following audiences: | % of all respondent answering “very useful” or “primary” usefulness |
| --- | --- | --- |
| **A. EXTERNAL AUDIENCES** | Presidents | 4-Yr CFOs | 2-Yr CFOs |
| a. Potential Creditors | 50% | 100% | 25% |
| b. Potential Business Partners | 60% | 50% | 50% |
| c. Potential Donors | 80% | 67% | 80% |
| d. Accrediting Agencies | 80% | 50% | 80% |
| e. Community Leaders | 50% | 20% | 25% |
| f. Legislators | 75% | 20% | 25% |
| g. Other Colleges & Universities | 25% | 60% | 0% |
| **B. INTERNAL AUDIENCES** | Presidents | 4-Yr CFOs | 2-Yr CFOs |
| a. Board of Trustees | 75% | 50% | 100% |
| b. Office of the Chancellor | 75% | 40% | 67% |
| c. College/University Administrators | 80% | 17% | 40% |
| d. Faculty | 60% | 0% | 20% |
| e. Students | 20% | 0% | 0% |

| 2. How useful are audited financial statements for the following purposes: | % of all respondent answering “very useful” or “primary” usefulness |
| --- | --- | --- |
| a. Providing a comprehensive financial picture of all funding sources and uses | 80% | 33% | 40% |
| b. Monitoring financial results and viability | 100% | 33% | 40% |
| c. Establishing a disciplined approach for maintaining reliable financial records | 80% | 67% | 80% |
| d. Gaining assurances about the effectiveness of financial controls | 80% | 50% | 100% |
| e. Assessing the performance of the business office | 80% | 33% | 75% |

| 3. Other than audited financial statements, how useful are the following sources for information about fiscal accountability and stewardship? | % of all respondent answering “very useful” or “primary” usefulness |
| --- | --- | --- |
| a. Unaudited financial schedules prepared by the institution | 100% | 100% | 60% |
| b. Financial reports prepared by the Office of the Chancellor Finance Division | 60% | 67% | 40% |
| c. The Office of the Chancellor Finance Division exception reporting web site | 60% | 33% | 40% |
| d. Internal Auditing reports on the status of prior audit findings | 60% | 50% | 60% |
| e. Legislative Auditor reports | 40% | 50% | 75% |
| f. Other (please specify) | | | |

Note: Surveys were returned by at least one representative from each of the 12 institutions with audited financial statements (5 presidents, 6 state university CFOs, and 5 college CFOs responded).
These survey results suggest that additional training is needed to enhance the usefulness of the audited financial statements. In many respects, usefulness is a function of familiarity. Many potential users most likely are not very familiar with the underlying accounting principles. The financial statements are prepared in accordance with generally accepted accounting principles (GAAP) that experienced significant modification two years ago. These accounting principles differ markedly from the budgetary basis used for the day-to-day management of institutional financial resources. The budget is largely measured in cash; whereas, GAAP requires full accrual of all cash and non-cash assets and liabilities. Some chief financial officers submitted written comments suggesting that more training on the use of these statements would be beneficial.

Institutions without Audited Financial Statements

Presidents and chief financial officers from the 20 institutions without audited financial statements also were surveyed. The survey questions focused on whether they had received requests for audited financial statements, how the requests were handled, and sought views on the prospect of preparing audited financial statements\(^2\). Representatives from 14 institutions returned completed surveys (Table 2 shows the results).

The surveys showed that these institutions do receive requests for audited financial statements, most commonly as part of the grant application or accreditation process. Table 2 shows the sources of the requests cited by these institutions.

The institutions have satisfied the requests with alternative forms of evidence, primarily the system-level audited financial statements and supplemental schedules that show their institution’s financial activity.

\(^2\) The actual survey questions were as follows:

1. Have you experienced (or do you anticipate experiencing) any occasions when audited financial statements would have been useful?
2. On those occasions, how were you able to satisfy the interest without audited financial statements?
3. Please share any other insights or considerations that you may have about the prospects of preparing audited financial statements. In particular, we are interested in an assessment of your college’s ability to assist in and ultimately take the lead in preparing GAAP financial statements and supporting your external audit process.
Table 2: Survey Results from Institutions without Audited Financial Statements

<table>
<thead>
<tr>
<th>Frequency of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Source of Requests for Audited Financial Statements?</td>
</tr>
<tr>
<td>Grant applications</td>
</tr>
<tr>
<td>Accreditation process</td>
</tr>
<tr>
<td>Lenders</td>
</tr>
<tr>
<td>ATM applications</td>
</tr>
<tr>
<td>Potential donors</td>
</tr>
<tr>
<td>New vendors</td>
</tr>
<tr>
<td>Lease arrangements</td>
</tr>
<tr>
<td>2. Information used in place of audited financial statements?</td>
</tr>
<tr>
<td>System-level audited financial statements</td>
</tr>
<tr>
<td>Legislative audit reports</td>
</tr>
<tr>
<td>Institutional financial schedules</td>
</tr>
<tr>
<td>IPEDS data</td>
</tr>
<tr>
<td>Data management reports</td>
</tr>
<tr>
<td>3a. Interested in having audited financial statements?</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
</tr>
<tr>
<td>No response</td>
</tr>
<tr>
<td>3b. Ready to prepare audited financial statements?</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>Possibly</td>
</tr>
<tr>
<td>No</td>
</tr>
</tbody>
</table>

The most significant external audiences that benefit from audited financial statements are accreditation agencies and potential donors or grantors. It appears that other forms of evidence have served as reasonable alternatives for these users when institutions do not have audited financial statements. Lack of audited financial statements has not caused any institution to fail to achieve its accreditation or, to our knowledge, not qualify for a grant award.

It is more difficult, however, to measure the potential benefits of audited financial statements for aiding the solicitation of donations. Audited financial statements are a traditional information source for disclosures about fiscal accountability and stewardship – attributes that are likely important to many donors. The state universities have established foundations that should be able to use the audited financial statements to establish trust with potential donors. The colleges, particularly the smaller colleges, are still developing their capacity for soliciting donations and likely would not realize benefits sufficient to justify the cost of audited financial statements.

4. COST BENEFIT ANALYSIS OF FINANCIAL STATEMENT PREPARATION AND AUDIT EFFORT

The Board of Trustees and the presidents of the colleges and universities have made a substantial investment in the financial assurance program. Financial reporting management has surveyed campus leadership and analyzed Office of the Chancellor staff assignments and reached the following conclusions:
• A total of 11,748 hours of staff labor at a cost of $546,621 was dedicated to the financial statement effort in FY2004.

• An additional $501,090 was paid to external auditors and the Office of the Legislative Auditor.

• The total cost of the system and college and university financial statements was $1,047,711 in FY2004.

• The system and revenue funds statements (including preparation of the Single Audit of Federal Financial Assistance) required $483,025 in internal and external resources while the college/university statements and audits required $564,686.

• This effort resulted in the completion of fourteen sets of financial statements and related audit opinions, including the system level statements, twelve separate college/university statements and the revenue fund.

• The average cost of a college/university audit was $51,335 ($564,686 divided by 11 colleges and universities). This cost breaks down approximately in half between internal (campus and Office of the Chancellor) and contract related costs.

The above analysis examined direct staff and contract costs only. It was assumed that supervisory costs and office space and associated costs would remain constant with the addition of more colleges and universities to the audit effort.

Table 3: FY2004 Financial Statement Costs

<table>
<thead>
<tr>
<th>FY2004 Financial statement costs</th>
<th>System statements</th>
<th>College/university statements</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Hours</td>
<td>Cost</td>
<td>Hours</td>
</tr>
<tr>
<td>Financial reporting unit</td>
<td>4,542</td>
<td>$ 187,872</td>
<td>1,588</td>
</tr>
<tr>
<td>Internal auditing unit</td>
<td>1,607</td>
<td>$ 77,313</td>
<td>646</td>
</tr>
<tr>
<td>Total OOC</td>
<td>6,149</td>
<td>$ 265,185</td>
<td>2,234</td>
</tr>
<tr>
<td>College/university staff effort</td>
<td>-</td>
<td>-</td>
<td>3,365</td>
</tr>
<tr>
<td>Contract - External auditors/OLA</td>
<td>-</td>
<td>$ 217,840</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>6,149</td>
<td>$ 483,025</td>
<td>5,599</td>
</tr>
</tbody>
</table>
Generally Accepted Accounting Principles (GAAP), as promulgated by the Governmental Accounting Standards Board (GASB), underpin the financial reporting requirements reflected in our annual financial reports and related external audits. Financial reporting under GASB is full accrual and generally analogous to financial reporting one sees coming from publicly traded private sector companies. Full accrual accounting and reporting requires a different skill set than the skill set required for accounting and reporting under the state’s governmental accounting system, which is fundamentally a cash-basis system. Further, the state’s governmental accounting system was designed to serve all state agencies rather than the quite different requirements stipulated by GAAP for publicly supported institutions of higher education.

The number of accountants and related levels of GASB-type competencies existing at each school within the system varies. While it is difficult to determine precise personnel needs across all schools, the following factors point to a general need for additional GASB competent resources across the system.

- Virtually all audited schools report the need to defer other work in order to meet annual financial reporting requirements.

- Consistent with sound business practice and external auditor recommendations, our plan is to move primary annual financial report preparation responsibilities from the Office of the Chancellor to the audited schools over the next several years.

- Most schools, both audited and unaudited, currently lack an adequate base of personnel with the requisite GASB-type competencies and experience.

- While financial reporting is currently an annual exercise, the effort required is spread over much of the year. Further, over the next several years we will be developing tools and processes to enable interim GASB-type reporting.

- Periodic new GASB pronouncements often require significant “first-time through” effort well in advance of the financial statement completion date.

- The Department of Finance continues to shorten the yearend close and annual financial report preparation period. Tighter deadlines will increasingly require having the right people with the right skills “on-site” throughout the system.

5. ANALYSIS OF ALTERNATIVES TO AUDITED FINANCIAL STATEMENTS

The provision of audited financial statements is one element of the financial management and assurance program. Audited statements provide a means of compliance monitoring and reporting in a uniform, standardized format. Audited statements also are intended to serve the needs of internal and external audiences. It is possible, though, to satisfy most of the needs of external audiences and all of the needs of the internal audiences in an alternative manner.
It is expected that the supplemental schedules with the financial information for each college and university would continue to be a part of the system level financial statement preparation process. These supplemental schedules are prepared in accordance with GAAP standards simultaneous with the preparation of the system level statements. In this manner, management and the Board of Trustees obtains uniformly prepared, consistently presented financial information for each of the colleges and universities. The system level auditor performs sufficient detailed analysis to render an opinion on the accuracy and reliability of the financial information for the system as a whole. This analysis includes testing of transactions at the college and university level. The testing is not detailed enough to reach any conclusions at the individual college or university level. Consequently, the auditor’s opinion on the system’s statements does not included the supplemental schedules and so they are considered “unaudited”.

Internal efforts could be expanded to provide additional means of satisfying management and the Board of Trustees that college and university financial information is materially accurate and reliable. Most of the steps below are already in the Finance division work plans for FY2005 and beyond.

- Continue development and application of financial exception reporting procedures which highlights colleges and universities which depart from financial administration guidelines.

- Continue development of interim, GAAP based financial statements for all colleges and universities. Institute a program of required certifications by the presidents and the chief financial officers of the financial information contained in the statements.

- Continue development and implementation of additional ratios for measuring and reporting the financial performance of individual colleges and universities.

- Expand training program to broaden campus understanding and use of centrally prepared, annual GAAP based financial statements for management decision making.

In addition, the Office of Internal Auditing has work plan commitments in support of:

- Continuing the contract with the Office of the Legislative Auditor for periodic internal control compliance reviews at individual colleges and universities.

- Considering the use of the Office of the Internal Auditing for additional internal control reviews on a periodic basis.

While alternatives do exist, it should be noted that the cost and audit scope of a stand-alone system audit would increase significantly in the absence of some set of individual school audits. The system auditor would not have the individual schools’ audit work on which to rely, which in turn would require a significant increase in audit scope and cost.
It should also be noted that the audit effort associated with this increased audit work would be conducted on-site at selected colleges and universities. There almost certainly would be some net cost savings, but we would also lose such intangible benefits as access to the external perspectives and experiences gained through the auditors’ exposure to many different audit clients, including significant higher education and governmental clients.

6. ANALYSIS OF DECENTRALIZATION OF AUDIT EFFORT

In FY2004, additional effort was taken to migrate the work required for financial statement preparation to some of the colleges and universities being audited. It was deemed a partial success by both Office of the Chancellor staff and staff at the effected campuses. A variety of causes for the low success rate were identified:

- There is substantial, complex central function accounting required which cannot be delegated. As a result, financial information for each college and university is generated and provided to the campuses without the campus staff having deep understanding of the underlying data. Examples include: allocation of capital and debt appropriations, standard methods for calculating compensated absences, grants and deferred revenues, inter fund transfers and receivables allowances.

- Very tight production timetables placed tremendous stress on campus staff. Campuses uniformly report inadequate staff for the financial reporting effort and typically re-assign existing staff resulting in work back logs in other areas.

- Communication and coordination challenges as a result of the above issues which further complicate completion and increase the odds that campuses will not achieve the highest possible benefit from the preparation effort.

Strategies are in place to address the above concerns. Management and the colleges and universities have established project plans and timelines for achievement of process improvements prior to the FY2005 preparation process. Particular attention will be paid to training topics for the upcoming winter.

It is noteworthy that only one of the eight single legal entity systems listed in Table 1 prepares and has audited both system level and individual college/university financial statements. The systems have either only system level statements or only institutional level statements. The largest challenge in this effort is related to MnSCU’s reflection of a single legal entity into component entities at the college/university level. This results in the Office of the Chancellor staff requirements and the central function coordination challenges outlined above.
7. **LONG TERM STRATEGY FOR FINANCIAL MANAGEMENT INCLUDING RECOMMENDATIONS REGARDING EXTERNAL AUDITS**

The Board of Trustees, Chancellor and presidents have committed substantial resources of time and money to the audit program over the past five years. There is no doubt that the results have shown steady, substantial improvement in the financial administration of the system and the colleges and universities. Progress since FY2000 is tremendous with unqualified audit opinions every year since 2001. The program was begun in 2000 in part to instill the discipline and rigor now found present in the financial procedures of the Office of the Chancellor and the colleges and universities.

The survey of other similar systems produced very interesting information concerning the standards and practices of older, more established systems of higher education around the country. While external audit protocols are present in all the systems, MnSCU’s current program appears to provide deeper and more complex assurances than found most anywhere else.

The presidents and chief financial officers also provided very useful information concerning the MnSCU audit program. While the audited statements were deemed useful for external audiences, they were found less useful with internal audiences. Alternative internal documents have proven acceptable and more useful for internal audiences. Training continues to pose a significant requirement in order to improve both the production process and the utility of the completed statements.

There are alternatives to audited financial statements available which would satisfy most of the needs of external and internal audiences. Internal efforts could be expanded to provide additional means of verifying the accuracy and reliability of college and university financial statements. Most of the additional efforts are already in the work plans for the Finance division and Office of Internal Auditing.

Continued decentralization of the work effort is underway. Efforts will continue to clearly identify tasks between the Office of the Chancellor and the colleges and universities. These efforts are not expected to substantially alter the current workload of either group. It will certainly improve communication and coordination of the effort.

Management is strongly committed to the financial management and assurance program. Familiarity with and application of accrual-based financial statements to the everyday work of the colleges and universities is a central goal of the program. As long as MnSCU is a part of the state’s cash-based accounting system, progress in this area will be limited. However, there are some steps possible which will be helpful. Commitment by colleges and universities to the development of deeper understanding of the statements is key to progress.
The findings of the above study result in the following recommendations for consideration by the chancellor and the Board of Trustees:

1. Support management’s commitment to improved communication, coordination and training in conjunction with college and university presidents and administrators. Recognize the burden placed on the campuses by the financial statement effort and support presidents’ commitment of resources to assist in the work.

2. Support management’s commitment to develop and implement additional reporting and monitoring methods that satisfy the needs of internal and external audiences which provide financial information.

3. Continue the current external audit schedule at the state universities and selected colleges. It is recommended that the current colleges and universities plus Minnesota State Community and Technical College and Bemidji State University, Northwest Technical College – Bemidji be maintained in the audit program (See appendix A). Management may consider the addition of one or two more colleges or universities based upon its best judgment of readiness and desire. Do not otherwise expand the program at this time.

4. Continue contracting with the Office of the Legislative Auditor in order to provide special internal control assurances.

5. Dedicate the next five years to strengthening the underlying foundation of college and university knowledge and familiarity with accrual based statements. Included in this effort will be development of a president and chief financial officer “certification” process concerning annual financial information.

6. Authorize the Executive Director of Internal Auditing and the Vice Chancellor – Chief Financial Officer to initiate a competitive bidding process to contract with external auditors in accordance with the plan outlined above.
APPENDIX A

Audited by Kern, DeWenter, Viere, Ltd

1. Bemidji State University
2. Minnesota State University Moorhead
3. Northwest Technical College
4. Southwest Minnesota State University
5. Rochester Community and Technical College

Audited Larson, Allen, Weishair & Co. LLP
6. Minnesota State University Mankato
7. Saint Cloud State University
8. Winona State University
9. Century College

Audited by Virchow, Krause and company LLP
10. Metropolitan State University
11. Minneapolis Community and Technical College
12. Hennepin Technical College

Limited reviews have also been performed on Northland Technical College and Fergus Falls Community College in order to aid in the transition to the new entities.

The recommendation would delete Northwest Technical College and add Minnesota State Community and Technical College and BSU – Technical College as a part of the Bemidji State University audit work.