

# Audit Committee

Meeting date: February 9, 2011

## ADVISORY INFORMATION

Date:	February 9, 2011
Subject:	Risk Assessment and Preliminary Audit Plan for 2011
District(s), Member(s):	All
Policy/Legal Reference:	Audit Charter, IIA Standard 2010, 2020
Staff Prepared/Presented:	Arleen Schilling (Katie Shea)/Mary Bogie
Division/Department:	Program Evaluation and Audit

### Proposed Action

That the Audit Committee accept the proposed Risk Assessment and Preliminary Audit Plan for 2011 as the direction for the Program Evaluation and Audit Division.

### Background

The Metropolitan Council's Audit Charter and the Institute of Internal Auditor's *Internal Standards for the Professional Practice of Internal Auditing* require that the Chief Audit Executive/Director develop, in consultation with organizational leadership, an annual assessment of risks to the organization and an audit plan for the review and approval by the Audit Committee.

### Rationale

By using an inclusive and consultative process, the Risk Assessment provides a means for creating a risk profile for the Council and all of its diverse functions. By doing so, it enables the Director to develop an audit plan which targets audit resources to those areas where they can provide the greatest benefit to the Council.

Leadership teams from all areas of the Council, including Transportation, Community Development, Environmental Services, and Regional Administration, are involved in development of the risk assessment and audit plan, helping to ensure that the resulting plan represents a broad, but inclusive view of the organization.

The Preliminary Risk Assessment/Audit Plan Document is attached for review and discussion. The Audit Plan will be finalized when the new Council/Committees are in place.

### Known Support / Opposition

None.

# **Program Evaluation and Audit RISK ASSESSMENT/AUDIT PLAN 2011 FOR CONSIDERATION OF THE AUDIT COMMITTEE February 9, 2011**

## **Requirements of the Standards**

In the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*, standard 2010 deals with audit planning, and requires, in part:

- That the chief audit executive (Director) establish risk-based audit plans to prioritize internal audit activities consistent with the organization's goals.
- That the audit plan should be based on an annual risk assessment created with the input of senior management and the board.

This document represents the risk assessment for 2011, as well as the proposed Preliminary audit plan based on that assessment.

## **Risk**

Risks to the Council can take many forms. Perhaps the most obvious is financial risk, where funding or the use of funding involves some risk taking. However, there are other types of risk to the Council that should be considered in an organization-wide risk assessment.

- Reputational Risk in a public organization like the Council is crucial. Harm to the Council's reputation can affect availability of discretionary funding from local, state and federal governments, and can adversely impact the Council's relationship with taxpayers in the Region.
- Similarly, program risk can affect how the Council operates. If programs are ineffective or fail to achieve their objectives, that too can have adverse effects on the Council.

This Risk Assessment attempts to consider all relevant risks to the Council and assigns audit resources accordingly.

## **Organization of Report**

This report is organized in three parts:

- The Council's Risk Environment and general risks anticipated in 2011 and beyond,
- Specific risks affecting programs or activities of the Council,
- Proposed Interim Audit Plan for 2011, taking into account the risks and priorities of the Council.

## **Methodology of Assessment**

Given the breadth of the activities of the Metropolitan Council, Program Evaluation and Audit takes an inclusive approach to Risk Assessment and Audit Planning. Meetings are held with the management team of each division to discuss their perspectives on risks to

the Council generally, and on risks specific to their activities. Divisional meetings were held with:

- Metro Transit,
- Metropolitan Transportation Services,
- New Starts Projects (Central Corridor Light Rail and Southwest Corridor Light Rail),
- Environmental Services,
- Community Development,
- Regional Administration.

A draft of this assessment was also provided to the Regional Administrator's Executive Team for review and discussion prior to the presentation to the Audit Committee.

# GENERAL RISK ENVIRONMENT

The Metropolitan Council focuses on a number of policy areas:

- Environmental Services works to protect the public health and the environment by providing efficient and effective water resources management,
- Metro Transit provides bus, light rail and commuter rail transit services in the region,
- The Central Corridor Project Office is focused on the development of the Central Corridor Light Rail Line, awaiting a full funding agreement from the Federal Transit Administration within a few months to continue its construction, and planning to begin operations in 2014. Closely related to CCPO is the other “New Starts” project in the region, the Southwest Corridor Light Rail Project, currently awaiting federal approval for preliminary engineering.
- Metropolitan Transportation Services oversees transportation planning for the region, as well as contracted transit services, funding for suburban transit providers, and Metro Mobility.
- Community Development informs the land use planning activities of local governments as prescribed in the Land Planning Act; administers grants for the regional parks system, and the Livable Communities Act; and operates a Housing and Redevelopment Authority that administers rental assistance programs in communities throughout the metropolitan area.
- Regional Administration provides centralized support for all of the business units, including service areas like Finance, Human Resources, and Risk Management.

In consulting with leadership across the Council, several risks emerged that are Council-wide in nature and could affect the Council as a whole. Those are summarized here to provide a picture of the Council's general risk environment. Risks to specific program/policy areas of the Council will appear in the next section, “Risks to Specific Council Programs.”

## A Slow Economic Recovery

Economists were disappointed when the economy decelerated in the second quarter of 2010, with growth slowing from 3.7% to 1.7%. The forecasts of growth for 2011-2012 were scaled back. Although the state's forecasting firm, Global Insight, does not anticipate back-to-back recessions, an extended period of slow growth is expected.

The estimated growth of 2.5% for the third quarter was taken as a positive sign that the economy in the state has stabilized, but that rate of growth is still too slow to decrease the unemployment rate, which is the statistic of concern for many Minnesotans.

At the same time, Minnesota employment appears to be recovering more rapidly than most of the rest of the U.S. Since October of 2009, the number of jobs in leisure and hospitality has increased by 13,000, the largest increase of any industry in the state. Professional and business services (includes temporary employment), health services and manufacturing all had at least 8,800 employees more than the 2009 level. Construction (-6,000) and local government (-4,000) were the largest declines for the year. In the end, the Minnesota unemployment rate is 7.1%, which is approximately 2.5% less than the national average.

## State Budget Outlook

Based on the November forecast, the gap between revenues and expenditures for the upcoming biennium will be approximately \$6.188 billion, \$593 million over previous estimates. This gap would constitute 16% of the expenditures for the biennium.

Expenditures for the biennium are significantly higher for the coming biennium than in the last one due to how the previous deficit was resolved. Because federal stimulus money (one-time funding) , deferment of payments to K-12 school districts and other accounting shifts were used to defer expenses, those expenses are significantly increased in the 2011-'12 biennium.

Although the Council relies less on the State's General Fund than many units of government, Metro Transit does rely on state funding for Transit operations. The impact of likely cuts for the coming budget will not be known until the end of the 2011 Legislative Session.

### **Election Changes from 2010**

The 2010 election produced some significant changes in party control and potentially policy direction at the national, state and local level. Although the specifics of policy changes are still unknown, there is potential impact for the Council in any of its program areas with such changes at election time.

At the federal level, Congress will have a Republican-controlled House of Representatives, working with a Senate still controlled by Democrats and a Democratic President. The Minnesota Legislature will be controlled by the Republican Party in both houses for the first time since 1972, and a democrat will occupy the Governor's Office for the first time since the last Perpich Administration, which ended in 1990. Many local boards and commissions also have a large number of new members. The impact of all of these changes is still unclear. However, there will be new officials, and potentially new policy directions to deal with in the coming months.

### **Demographic Changes**

Minnesota's population continues to grow, slowly at .73% per year, but the nature of that growth has changed over the last two decades.

- Racial diversity is increasing. 2/3 of the population growth has been non-white population.
- Household formation slowed dramatically in 2009 and household size increased as families "doubled up" to save money.
- Growth in the suburbs and exurbs has declined as a result of the housing slump and the recession. Meanwhile, the growth in Hennepin and Ramsey counties has increased dramatically. It is unclear if this is a short-term reaction to the recession or if it will endure due to the long-term effects like low wage growth, reluctance to enter into consumer debt, etc.

Aging will affect economic growth, as well as federal and state revenues and budgets. The first wave of baby boomers will turn 65 in 2011. Retirements will increase sharply. At the same time, the number of high school graduates, which peaked with the class of 2008, will decline at least through the middle of the decade. So, as the population ages, the growth in the workforce slows, creating downward pressure on personal income growth and income tax receipts, the largest share of government revenues. At the same time, there will be upward pressure on health care and long-term care costs.

## **Workforce Changes**

At the Metropolitan Council, the workforce reflects changing demographics, with a larger than average proportion of workers rapidly reaching retirement eligibility. Government employees are often somewhat older, on average, than employees of private firms. Minnesota's state employees have an average age of 46. The Council's employee's average age is two years older, 48.

Many retiring employees have amassed critical knowledge and skills during their time at the Council. One area of concern expressed by managers is how to retain some of that knowledge retiring employees have so it is not lost when they leave the Council.

Another concern is that as the Council's workforce has aged and advanced in skills and abilities, much of the workforce has outgrown entry level positions. The majority of current jobs at the Council require education and/or experience that most entry level candidates do not possess. As a result, the workforce continues to be older than most. The largest number of hires at the Council (prior to the hiring freeze) was people over 49 years of age. The next largest group is between 39 and 48. The smallest group is the youngest, those just leaving college. To attract younger employees, fundamental changes will be needed to create more entry level positions and opportunities to mentor new employees to advance in their careers at the Council.

Perhaps the most acute challenge for Council staffing issues is the current statewide hiring freeze. Most positions that are vacated for retirements, promotions or other departures cannot be replaced. Although Council managers clearly understand the current financial challenges, many are frustrated with their inability to staff their programs. With a number of retirements, many managers have expressed concerns about key employees leaving with no one to replace them.

## **Health Care Costs**

The Metropolitan Council provides health insurance for its employees that is intended to be commensurate with the insurance provided by the state and other local units of government. Human Resources has aggressively bargained with the Council's insurance administrator and kept increases to a minimum, but still, as a relatively small risk pool with a good set of benefits, the rate of increase from year to year is significant (the last increase was 14%). The Council would see a significant savings if it were to become part of the State's employee insurance program. Met Council is working with Labor Management Committee to propose legislation to allow participation in the State's plan.

## **Lack of Enterprise Risk Management/Planning**

The policy environments in which the Council operates are dynamic, requiring the Council and its programs to be sufficiently flexible to react to sudden changes and emerging needs. However, there is still great value in having an organizational discussion of risks and risk tolerance that leads into planning and strategy development. Being aware of high likelihood risks is an important part of being agile and reacting quickly to changes in the environment. Similarly, having a plan with a vision and general strategies in place can help to inform the right decisions at the right time, even if they must be made with little lead time. Currently, the Council lacks such a structure. Program Evaluation and Audit conducts a Council-wide risk assessment, which is shared across the organization and specifically with Business Continuity Planning, IS and the external auditors. However, this risk assessment could be carried much further to lead into a more focused organizational planning effort to help the Council establish goals and strategies toward which all programs can strive.

# RISKS TO SPECIFIC COUNCIL OPERATIONS

## Transportation

There are a number of risks at the federal level. Foremost among them is the lack of a reauthorization bill for transportation. With the changes in leadership in the House, a whole new bill is being crafted. Even a continuing resolution, however, seems to be coming along slowly. Delays in federal funding impact capital projects for the region and the decision making about those projects. One example is the Transit bus fleet. Typically, buses are ordered so that the new ones can be received in mid-summer, allowing for new buses to be cycled in as the older buses are needed for the State Fair. Being unable to time the orders could result in Transit having to order late and order fewer options on buses, including fewer hybrid buses in the fleet than originally planned.

A new federal transportation bill could also contain new Metropolitan Planning Organization (MPO) regulations. The Metropolitan Council, which serves as the MPO for the Twin Cities metro area would need to be compliant with whatever new regulations come to pass.

Based on air quality measurements, it is possible that the region may be in non-attainment for some areas of air quality. This could cause the EPA to enact requirements that would have implications for fuel and engine types in the metro area.

At the state level, many concerns center on the financial situation. Revenues from the Motor Vehicle Sales Tax (MVST), which funds much of the Council's transit operation, are significantly under projected levels, creating a significant shortfall primarily for Metro Transit. The problem is exacerbated by the fact that the State Legislature never fully funded the operational costs of the Hiawatha Light Rail and has yet to provide operational funding for the Northstar Line. Maintaining good service will be a challenge for Metro Transit. If the Legislature also reduces Transit's allocations from the State's General Fund, then the impact of the budgetary crisis will be far worse and will likely have major impacts on transit services in the region.

While the greatest area of concern is around reducing costs and finding a way to meet funding reductions, the Council's transportation programs suffer from administrative overload. In the last 5 years, the Council has opened the Hiawatha Light Rail, the Northstar Commuter Rail, expanded some bus service options, and begun construction of the Central Corridor Light Rail. Yet during that time period, administrative support staffing and funding (Human Resources, Finance, etc.) have remained the same as they were in 2005. Maintaining workloads at such a high level increases the risk of significant errors, internal control failures and potentially even fraud.

Another limitation in transit funding, regardless of the source is usage. There are many opportunities to obtain grants and funding for capital projects. However, there are very few sources for operating funds. The Council received federal, state and local funding to build the Hiawatha Light Rail line, but it has never received full funding for operations, although that was promised by the State Legislature. The Northstar line was similarly funded by the federal government with matches from state and local units of government, but as yet has received no operating allocation.

Locally, the Council, especially in complex New Starts projects like CCLRT, maintains complex working relationships with other entities, including the University of Minnesota,

the Regional Rail Authorities, Counties and Cities. The Council also works closely with Suburban Transit Providers. These relationships are multi-faceted and require a great deal of time and attention to maintain. The new Council and Chair will have to come up to speed and begin working with this broad variety of interested groups very quickly. Maintaining these relationships is critical to the Council's success in much of its transit work.

Although the CCLRT project continues to receive favorable reviews from the federal government and has received several Letters of No Prejudice allowing it to proceed with construction of the line using non-federal resources, the Council has yet to receive a Full-Funding Grant Agreement (FFGA) for the project. Although it would be unprecedented for FTA to not proceed with funding of a project this far along in development, there is some risk that federal funding could be further delayed or stopped, creating a significant crisis for the Council and its local partners.

Also, the CCLRT project, as required by the federal government, has a fairly large amount of contingency funding set aside, much more than was set aside for either Hiawatha or Northstar. There are a number of parties involved in the project who want to direct where the contingency funds should be spent. Depending on how the decisions are made and what is chosen, some betterments for CCLRT could delay the completion of the project.

### **Community Development**

The 2011 federal reauthorization bill for the Department of Housing and Urban Development (HUD) has not been completed yet, and the requirement for \$100 million worth of reductions in domestic spending make dramatic cuts seem likely. These dollars are the primary source of funding for the Council's HRA and its Section 8 housing program. There is talk of going back to 2008 funding levels, which would negatively impact services and administration, as well as reducing the HRA's contribution to the Council's indirect cost allocation (A-87) for federal funds, resulting in a loss of federal funds for Regional Administration.

The fate of the Livable Communities Demonstration program seems uncertain. The Legislature may allow it to continue, or they may see it as a pot of money that can be sent back to the general fund or reallocated to the other projects.

In 2011, the Council will begin receiving a Regional Planning Grant from HUD. The grant's purpose is to conduct regional planning, but in an even more extensive way than the Council's current model. It will require workforce development and a stronger housing element, as well as a consortium of several of the interested parties. The grant is a new type for the Council, as it is for HUD, and regulations and requirements are still being developed. This creates some risk of error as regulations are developed and honed.

### **Environmental Services**

The drop in the housing market and reduction in new development in the Twin Cities, due to housing market readjustment and the recession significantly impacted ES' Service Availability Charge (SAC), which is generally charged based on capacity used in new development or redevelopment. SAC levels will continue to be low and is unlikely to be able to pay the ideal amount in 2012, requiring a hearing and SAC shift to municipal wastewater charges. Collections in industrial waste charges will also be down.



ES gave communities Inflow and Infiltration grants to use for projects that would reduce or eliminate inflow or infiltration of storm water into the sanitary sewer system and exceeding its capacity. The grants were generally well received, though a full evaluation of the program is still needed.

There is likely to be regulatory changes to the Metro Plant's permit (PFOs and Phosphorous) that will impact capital spending plans.

# PRELIMINARY AUDIT PROJECTS FOR 2011

## Objective

This plan reflects activities where the risk assessment indicates a high priority and high risk for the Council. Approximately 70% of all auditors' time is allocated to this plan. The remaining 30% is left open to allow for consultations, client requests and investigations where needed.

This plan does not include a detailed list of projects for the Central Corridor Project Office. Due to the evolving nature of this project, audit needs are difficult to anticipate in advance and therefore, the plan is left flexible to meet project needs in this early phase. Projects generated through the ongoing risk assessment of CCLRT will be brought to the Audit Committee as they arise.

Given the risks discussed in the previous section and the established priorities of the Council, Program Evaluation and Audit proposes to audit the following topic areas during 2011.

## Transportation

- Downtown free shuttle zone (Evaluation of costs and impacts)
- Hiawatha light rail fare compliance
- Improved bus reliability cost/benefit analysis
- Cubic system data accuracy
- Advertising Contract Review

## Environmental Services

- Inflow and infiltration grants compliance
- Blue Lake construction project

## Regional Administration

- Councilwide service contracts
- Network security
- Allocation of centrally provided services
- Business continuity plans
- Oracle WAM and TX Base approval processes

In addition, Program Evaluation and Audit performs the following recurring audits each year, at the request of the client organization.

## Requested Projects (Recurring)

- Transit Farebox Reviews (all garages within the year)
- Transit Store Cash Counts (twice per year)
- Transit stockroom inventories
- Parks Operating and Maintenance Cost Reviews
- Environmental Services Overhead Rate Verifications