

**Date:** October 16, 2024  
**To:** Board of Retirement  
**From:** Doris L. Rentschler, Executive Director  
**Subject:** Internal Audit Discussion

**Recommended Action:**

Board direction is sought on the following items:

- Whether to proceed with developing an audit program
  - If so, whether to utilize an Agreed Upon Procedure (AUP) or an Internal Audit engagement
  - If so, direct the Audit Committee to work with staff and the consultant to develop an audit plan and scope of work, and to issue an RFP and review proposals to select finalists for Board consideration
  - If so, direct the Executive Director to bring back an updated Audit Committee Charter to include duties associated with the internal audit function.
- As discussed below, staff recommends that the Board gives direction to: (1) Proceed with developing an audit program; (2) Utilize an AUP; and (3) Assign the Audit Committee to work with staff on the development of the audit plan and scope of work, and to issue an RFP and review proposals to select finalists for Board consideration.

**Fiscal and Financial Impacts:**

The current budget includes a \$30,000 allocation for internal audit services. Due to the need for defining the scope of work and issuing an RFP, audit services are not expected to begin in this fiscal year. A portion of the budget allocation would be used to contract with the outside consultant, who performed the entity-wide risk assessment, to assist with the development of the audit plan, audit scope and RFP at a quoted, one-time cost of \$5,000 - \$7,500. Because the Board adopted the FY2025-2026 with an allocation for audit services, no additional action is required to authorize the funding for the consultant.

The ongoing annual costs associated with audit services would depend on the type of audit engagement, the number of audits completed each year, and the scope of work. The type of engagement, number of audits, and scope could be adjusted to address budgetary constraints. Based on the AUP engagements with other CERL systems, a reasonable range to budget for AUP services would be \$40,000-\$60,000 for three AUPs per year, depending on the procedures and scope.

**Strategic Plan Importance and Risk Assessment:**

This item directly relates to the Board's Strategic Plan (Goal 2, Objective A, Measure iii) to discuss the feasibility and benefits of an internal audit function.

### **Should MCERA Consider Developing an Audit Program:**

While the Board delegated authority over administration of benefits and management of risks to the Executive Director, the Board is accountable for oversight of the organization. The Board has a fiduciary responsibility for overseeing all risks associated with MCERA's activities and establishing a strong internal control environment and risk framework that fulfills stakeholders' expectations. The entity-wide risk assessment was a major step in fulfilling this obligation. Every organization, regardless of size, should have some type of internal control system or process – and MCERA does. Reviews of those controls and processes can provide the Board and other stakeholders with the knowledge that MCERA is dedicated and focused on continual improvement in its operations.

MCERA's financial auditor, Brown Armstrong, supports the addition of an internal audit or AUP engagement. There is significant momentum within CERL systems to introduce or expand existing internal audit programs. Three systems have full internal audit programs, three utilize a hybrid approach that includes permanent system staff and external auditors, and four systems are considering or in the process of establishing an outsourced audit or AUP program.

Over the past decade, MCERA implemented a pension administration system, documented business processes, and expanded cross-training to minimize or eliminate the risk of single point of failure risk. These changes have put MCERA in a much better position organizationally to ensure adherence to proper procedures and reduce errors. However, MCERA's small staff size limits the ability to implement some types of internal controls – like segregation of duties – to the degree larger organizations can; and internal audits or AUPs will provide the Board with greater confidence.

### **Should MCERA Utilize an AUP or an Audit engagement:**

The term auditing is used to describe several different types of engagements, including Audits, Reviews, and Agreed-Upon Procedures (AUP). The main differences between the engagement activities are the level of assurance offered and the audit standard used.

Audits and reviews are assurance activities where the auditor has liability for the assurance expressed. Audits and reviews are more expensive than AUPs due to the assurance provided.

AUP is a non-assurance engagement without interpretive analysis. An AUP report includes the procedures used and the findings, but no opinion.

Audits, reviews and AUP are performed by external auditors, and follow AICPA audit standards while internal audits follow either the Red Book or Yellow Book standards for conducting audits.

Internal Auditing is an independent, objective, **assurance** and consulting activity, designed to add value and improve an organization's operations by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Internal audits are (typically) performed by audit staff within the organization. The internal auditor expresses opinions and conclusions regarding the subject of the audit. If internal audits are performed by an external auditor, the auditor cannot be the same as the organization's external

financial auditor. The cost for an outsourced internal audit engagement is more expensive than an AUP engagement because the auditor is giving an **assurance** regarding the finances and operations of the entity. The estimated cost is in the range of \$100,000-\$130,000, depending on number and scope of the audits.

AUP engagement involves an external auditor performing specific processes or procedures audits that have been specified by the entity, such as internal controls or contract compliance. The procedures can be tailored to meet the specific needs of the business and provide targeted information and insights. Because an AUP is of limited scope and the auditor **does not provide any assurance**, interpretive analysis, opinion, or conclusions, the cost for an AUP engagement is less than an audit. AUP provides only factual findings based on the agreed-upon procedures. AUP can be performed by MCERA's external financial auditor. AUP reports are limited to internal distribution. The cost for AUP engagement is estimated in the range of \$40,000 to \$60,000, again depending the number and scope of the AUPs.

Audits are used to provide assurances to external stakeholders as to MCERA's operations and ability as an ongoing concern. Distribution of the audit report is not restricted.

An AUP answers questions regarding a particular area of MCERA's operations. An AUP report is restricted and not distributed to anyone outside the organization.

Both an audit and an AUP engagement review MCERA's financial and/or operational aspects. How the results will be used can help determine the appropriate engagement. If MCERA is seeking to determine whether our practices align with our regulations and policies and that our work is accurate, but not to provide assurance to external stakeholders, an AUP engagement is appropriate. If the objective is to obtain assurances for members, plan sponsors or the public regarding MCERA operations for external stakeholders, then an audit engagement is appropriate.

At this time, since MCERA is considering undertaking a broader internal audit function than has been done in the past, I believe the most beneficial outcome would be to receive findings for internal use. Based on that application, an AUP engagement is appropriate and there is no need to pay for a higher-level assurance audit.

#### **The Role of the Audit Committee:**

If the Board decides to pursue an audit program, I recommend it direct the Audit Committee to work with staff and the consultant to develop an audit plan and scope of work, and to issue an RFP and review proposals to select finalists for Board consideration.