OLA

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

Department of Finance

Fiscal Year Ended June 30, 2004

MARCH 17, 2005 **05-19**

Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota state government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

The division has a staff of approximately forty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

Consistent with OLA's mission, the Financial Audit Division works to:

- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

Through its Program Evaluation Division, OLA conducts several evaluations each year.

OLA is under the direction of the Legislative Auditor, who is appointed for a six-year term by the Legislative Audit Commission (LAC). The LAC is a bipartisan commission of representatives and senators. It annually selects topics for the Program Evaluation Division, but is generally not involved in scheduling financial audits.

All findings, conclusions, and recommendations in reports issued by the Office of the Legislative Auditor are solely the responsibility of the office and may not reflect the views of the LAC, its individual members, or other members of the Minnesota Legislature.

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All OLA reports are available at our Web Site: http://www.auditor.leg.state.mn.us

If you have comments about our work, or you want to suggest an audit, investigation, or evaluation, please contact us at 651-296-4708 or by e-mail at auditor@state.mn.us

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Audit Participation

The following members of the Office of the Legislative Audit prepared this report:

Claudia Gudvangen, CPA	Deputy Legislative Auditor
Jim Riebe, CPA	Audit Manager
Michael Hassing, CPA	Audit Director
Doreen Bragstad, CPA	Auditor
Susan Mady	Auditor
Patrick Ryan	Auditor
Ellen Sibley, CPA	Auditor
April Snyder	Auditor
Kristin Bentz	Intern
Tim Rekow	Intern

Exit Conference

We discussed the findings and recommendations in this report with the following representatives of the Department of Finance at the exit conference held on March 3, 2005:

Peggy Ingison	Commissioner
Lori Mo	Assistant Commissioner Accounting and Information Services
Peter Sausen	Assistant Commissioner Treasury Division
Everett Hageman	General Accounting Supervisor
Pete Maurer	Financial Reporting Supervisor
Barb Ruckheim	Financial Reporting Director

Report Summary

Key Audit Conclusions:

- We issued an unqualified audit opinion on the State of Minnesota's basic financial statements for the year ended June 30, 2004.

- We also prepared reports on the state's internal control and compliance over financial reporting and its administration of federal programs. These reports will be included in the Department of Finance's *Financial and Compliance Report on Federally Assisted Programs* to be issued in March 2005.

- As part of our audit, we gained an understanding of the internal controls and organizational structure of the Treasury Division and its integration into the Department of Finance. We did not have any findings or recommendations pertaining to the Treasury Division.

Key Findings:

- The Department of Finance had some weaknesses in its process for reporting capital equipment amounts in the financial statements. As a result of an error in its process, the department made adjustments of $3.7 million to correct initial equipment balances. The department needs to improve its coordination with other state agencies to ensure it reports correct capital equipment amounts. (Finding 1, page 3)

- The Department of Finance did not provide complete and accurate preliminary budgetary information for the state's financial statements. (Finding 2, page 4)

- The Department of Finance did not accurately measure and report the state's compensated absences liability for state workers. (Finding 3, page 5)

The audit report contained three findings concerning controls over the financial reporting process. The department resolved the three findings contained in our last audit report.

Background Information:

The Department of Finance is responsible for preparing the state's basic financial statements. The department also has certain statewide financial management responsibilities relating to cash and debt management, payroll, and administration of the state's accounting system.

Senator Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Ms. Peggy Ingison, Commissioner
Department of Finance

We have performed certain audit procedures at the Department of Finance as part of our audit of the basic financial statements of the State of Minnesota as of and for the year ended June 30, 2004. We also audited the state's compliance with applicable requirements governing the administration of federal awards for the year ended June 30, 2004, as described in the U.S. Office of Management and Budget's *Circular A-133 Compliance Supplement.* We emphasize that this has not been a comprehensive audit of the Department of Finance.

The Department of Finance is responsible for statewide financial planning and reporting. The department prepares the *Comprehensive Annual Financial Report* that contains the state's basic financial statements. The department also prepares the *Financial and Compliance Report of Federally Assisted Programs* (Single Audit report) each year. The department manages the state's main accounting systems, coordinates the sale of state general obligation bonds, enters into master lease purchase agreements for state agencies, processes payments of some appropriations and grants, and provides guidance to other state agencies in areas of financial management.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the *Government Auditing Standards*, issued by the Comptroller General of the United States of America.

Conclusions

We issued an unqualified audit opinion, dated November 19, 2004, on the State of Minnesota's basic financial statements for the year ended June 30, 2004. In accordance with *Government Auditing Standards*, we also issued our report, dated November 19, 2004, on our consideration of the State of Minnesota's internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grants. In March 2005, we will issue our report on compliance with requirements applicable to each major federal program and internal control over compliance in accordance with the U.S. Office of Management and Budget's Circular A-133.

As a result of our financial statement audit, we identified some internal control weaknesses over financial reporting that we discuss in the following findings.

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Department of Finance

Findings and Recommendations

1. **The Department of Finance had some weaknesses in its process for reporting capital equipment amounts in the state's financial statements.**

In fiscal year 2004, the department had several weaknesses in its procedures to verify the capital equipment amounts reported by state agencies. These deficiencies resulted in inaccurate or incomplete preliminary capital equipment amounts to be included in the state's financial statements. We identified the following weaknesses related to the department's monitoring process and reporting of equipment information.

- The department did not provide state agencies with accurate and complete equipment acquisition data for six months of the fiscal year. Twice a year, the department extracts information from its capital asset database and asks the agencies to verify the accuracy of that information. The department did not identify an error in its information that indicated many agencies did not purchase any equipment during the period January 1 through June 30, 2004, when, in fact, they did. After we brought the error to the department's attention, it conducted additional analysis and made $3.7 million in financial statement adjustments.

- The department did not follow its procedures for tracking which state agencies it expected to receive equipment verifications from. As a result, staff could not explain why the department had not received verifications from some agencies. The risk of incomplete or inaccurate reporting of equipment acquisitions increases when the department does not use its tracking system to ensure it has received verifications from agencies with material equipment acquisitions during the year.

- The department did not establish base level expectations or perform sufficient follow-up procedures when they received reports from state agencies, including some reports that contained errors or incomplete information. Some agencies provide information directly to the department, such as the Department of Human Services (DHS) and the Minnesota Department of Transportation (MnDOT). Finance did not ensure that the information DHS provided agreed with Finance's capital equipment records. DHS staff told us that its report has not historically included equipment purchases made during the last two months of the fiscal year. Those purchases would be reported as adjustments in the subsequent year's financial statements. The department also did not sufficiently document its decisions on some questionable information provided by other departments. The Department of Education, for example, informed the department that they did not verify equipment balances for fiscal year 2004. The department worked with Education and ultimately concluded the differences were immaterial, but did not sufficiently document the basis for its decision.

Accounting and financial reporting for equipment purchases is very detailed and complex work. The accounting is decentralized, individual purchases may fall below the state's $30,000 capitalization threshold, agencies purchase multiple quantities of items, and purchases may have multiple components. As a result, the department relies on other state agencies to verify complete and accurate reporting information related to equipment additions and deletions. It is ultimately the responsibility of the Department of Finance, however, to ensure proper financial reporting of this activity.

Recommendations

- *The Department of Finance should continue to work with state agencies to ensure that they provide accurate and timely capital equipment information for the state's financial statements.*

- *The Department of Finance should improve its monitoring and reporting procedures for capital equipment. The department should consider additional analytical tests and reconciliations of information submitted by state agencies and follow up on unusual situations or variances.*

2. The Department of Finance did not provide complete and accurate preliminary budgetary information for the state's financial statements.

The department revised budgetary financial statements and schedules numerous times throughout the financial reporting process. Although we ultimately reached agreement with the department's final amounts for the budgetary financial statements, numerous adjustments and changes to the original information supplied by the Department of Finance were necessary.

Generally accepted accounting principles (GAAP) require that governments publish financial statements that present a comparison of budgeted revenues, expenditures, and changes in fund balance to actual amounts. In addition, if governments budget on a basis other than GAAP, a reconciliation of the two statements must be presented. Our audit identified many errors and omissions that required adjustments to the department's preliminary budgetary financial statements. These errors and omissions resulted from the following control weaknesses:

- The general accounting unit prepares budgetary information that is used by the Budget Division and also for preparing the annual budgetary financial statements. The department did not adequately analyze certain types of financial activity for the General Fund. As a result, the department made a $12.7 million fund balance adjustment to the General Fund Budgetary Statement.

- The department did not have a consistent method to account for certain financial activity, primarily fund structure changes, in the budgetary and GAAP financial statements. The general accounting unit prepared the budgetary statements and the financial reporting unit prepared the GAAP financial statements. Three budgetary fund financial statements had to be adjusted for changes in fund structure. Also, one fund's GAAP financial statements had not properly reported a fund level transfer of $4.6 million.

- The department did not use a consistent method to identify and classify accrual and transfer differences for the budget to GAAP financial statement reconciliation. The department made changes to 9 of the 11 special revenue funds included on this reconciliation. Actual revenues, transfers-in, expenditures, encumbrances, and transfers-out on the budgetary basis do not equal those on the GAAP basis financial statements. To report these variances, the department prepares a reconciliation schedule. The reconciliation identifies variances by transaction categories.

- The department did not receive sufficient information from the Minnesota Department of Transportation (MnDOT) to support MnDOT's budgetary financial statement for the Trunk Highway Fund. MnDOT uses subsystem information rather than the state's accounting system to prepare the budgetary financial statements. This created problems for Finance to support the Trunk Highway Fund's budgetary amounts.

A more effective use of analytical review procedures, including a comparison of last year's financial statements to the current year's preliminary financial statements and other sources of information, could help the department identify these types of errors and omissions.

Recommendations

- *The Department of Finance should review its procedures for reporting budgetary information to ensure that:*
  - -- *complete and accurate information is provided in a timely manner, and*
  - -- *budgetary information reconciles to financial statements prepared in accordance with generally accepted accounting principles.*

- *Finance should work with MnDOT to ensure that MnDOT reconciles its budgetary financial statements to the budgetary information in the state's accounting system.*

3. The department did not accurately measure and report the state's compensated absences liability for state workers.

The Department of Finance incorrectly estimated the state employee accumulated leave liability to be reported in the state's basic financial statements. Generally accepted accounting principles require governments to report an estimated liability for accumulated vacation earned to date and other termination benefits payable to employees. As discussed below, we made various audit adjustments to correct for data and procedural errors in the calculation.

- When determining the accumulated vacation hours earned by state employees at June 30, 2004, the department omitted leave earned by 277 unclassified employees with rights to a classified position. An adjustment of $1.7 million was necessary to avoid an understatement of the financial liability.

- The liability for compensatory time was miscalculated. The computer program used an incorrect social security rate in the liability calculation. This resulted in a $2.8 million adjustment to reduce the compensated absences liability.

Department of Finance

- The current portion of the leave liability was not accurately determined. The department estimated the current liability by using the average termination payouts over the past three years. However, they omitted severance payments made to medical plan accounts when determining applicable percentages. A reclassification of approximately $4.3 million was necessary to avoid understating the current portion of the liability and overstating the long term portion.

Recommendation

- *The Department of Finance should review its process for determining the compensated absence liability to ensure that accurate and complete balances and rates are used in the calculation.*

This report is intended for the information of the Legislative Audit Commission and the management of the Department of Finance. This restriction is not intended to limit the distribution of this report, which was released as a public document on March 17, 2005.

/s/ James R. Nobles	*/s/ Claudia J. Gudvangen*
James R. Nobles Legislative Auditor	Claudia J. Gudvangen, CPA Deputy Legislative Auditor

End of Fieldwork: January 28, 2005

Report Signed On: March 14, 2005

Status of Prior Audit Issues
As of January 30, 2005

March 19, 2004, Legislative Audit Report 04-18 examined the department's activities and programs material to the State of Minnesota's *Comprehensive Annual Financial Report* and the Single Audit for the year ended June 30, 2003. Our audit work focused primarily on the department's preparation of the state's basic financial statements as well as certain of the department's statewide financial management responsibilities related to cash and debt management, payroll, and the state's accounting system. The Single Audit scope covered compliance with federal requirements relating to cash management and statewide indirect costs. The report contained three findings. The first finding stated that three agencies submitted erroneous or incomplete accounting information to the department. The second issue reported that the department had not ensured that state departments properly accounted for financial activity in agency funds. The third finding noted that the Contract Financial Management System (CFMS), a component of the state's accounting system, erroneously reported information that understated liabilities in the state's financial statements. The department implemented all of the recommendations.

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as the metropolitan agencies, or the State Agricultural Society, the state constitutional officers, or the judicial branch.

State of Minnesota
Department of Finance

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March 8, 2005

James R. Nobles; Legislative Auditor
Office of the Legislative Auditor
658 Cedar Street
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St. Paul, MN 55155-4708

Dear Mr. Nobles:

Thank you for the opportunity for my staff to discuss your audit findings with the individuals in your office responsible for the Department of Finance audit. We are committed to providing accurate financial information to state agencies, the legislature, and the public. We will continue to work toward improvements in our processes.

Recommendation

The Department of Finance should continue to work with state agencies to ensure that they provide accurate and timely capital equipment information for the state's financial statements. The Department of Finance should improve its monitoring and reporting procedures for capital equipment. The department should consider additional analytical tests and reconciliations of information submitted by state agencies and follow up on unusual situations or variances.

Response

The Department of Finance staff will continue to work with state agencies to obtain accurate and timely capital equipment. The department has revised the detailed instructions to state agencies to ensure agencies have a clear understanding of the necessary information needed to accurately reflect the capital equipment in the financial statements.

The Department of Finance will ensure proper implementation of its review procedures during the financial reporting process to help assure that information submitted by agencies is reasonable. Significant unusual variances will be investigated as part of this procedure.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: October 1, 2005

Recommendation

The Department of Finance should review its procedures for reporting budgetary information to ensure that complete and accurate information is provided in a timely manner, and budgetary information reconciles to financial statements prepared in accordance with generally accepted accounting principles. Finance should work with MnDOT to ensure that MnDOT reconciles its budgetary financial statements to the budgetary information in the state's accounting system.

Response

The Department of Finance is in the process of consolidating the development of more detailed documentation of the differences between the budgetary and the GAAP financial statements. This will facilitate a more timely preparation and reconciliation of the differences between the budgetary and GAAP financial statements. We will continue to monitor adjustments made to the financial statements prepared in accordance with generally accepted accounting principles to determine the impact to the budgetary financial statements.

In the event of future fund structure changes, the department will ensure consistent application of these changes in both the budgetary and GAAP financial statements. In addition, the department developed an automated system to capture fund level transfers during the close period.

The department will continue to work with the Minnesota Department of Transportation (MnDOT) to ensure that MnDOT provides adequate support of the numbers included in its budgetary financial statements.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: October 31, 2005

Recommendation

The Department of Finance should review its process for determining the compensated absence liability to ensure that accurate and complete balances and rates are used in the calculation.

Response

The Department of Finance has implemented programming changes to include unclassified employees with rights to a classified position as well as use of the appropriate social security rate in the calculation of its compensated absences liability. The department has also implemented procedures to search for new earning codes for salaries and fringe benefits for purposes of calculating the reclassification of the current portion of the compensated absences liability.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: Implemented.

Sincerely,

Peggy S. Ingison

Peggy S. Ingison
Commissioner