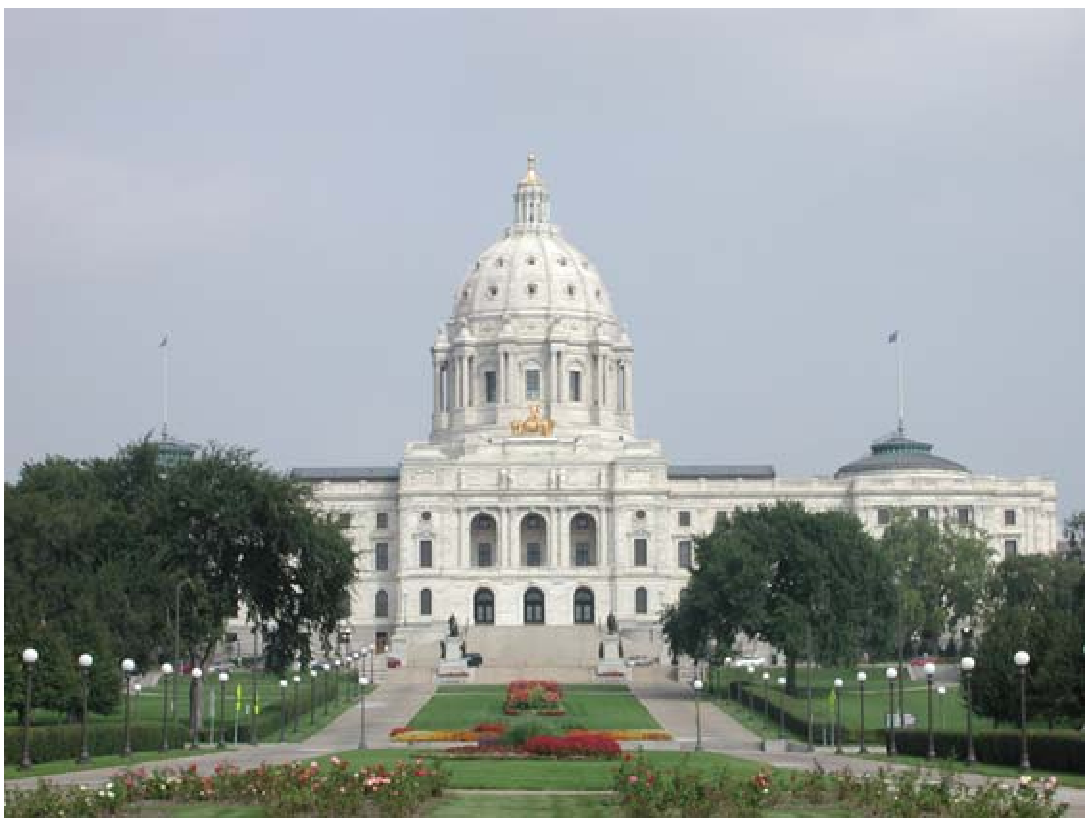
OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

Department of Administration

July 1, 2002, through June 30, 2005



October 12, 2006 06-27

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.

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OFFICE OF THE LEGISLATIVE AUDITOR
State of Minnesota • James Nobles, Legislative Auditor

Senator Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Ms. Dana Badgerow, Commissioner
Department of Administration

We conducted an audit of selected financial activities of the Department of Administration for the period July 1, 2002, through June 30, 2005. Our audit scope included the Drive to Excellence initiative, cooperative purchasing program, land sales, and selected operating expenditures. Our objectives focused on a review of the department's internal controls over these financial activities and its compliance with applicable legal provisions.

The enclosed Report Summary highlights our overall audit conclusions for the areas examined. The specific audit objectives and conclusions for each area are contained in the individual chapters of this report.

We would like to thank staff from the Department of Administration for their cooperation during this audit.

/s/ James R. Nobles	*/s/ Cecile M. Ferkul*
James R. Nobles Legislative Auditor	Cecile M. Ferkul, CPA, CISA Deputy Legislative Auditor

End of Fieldwork: May 17, 2006

Report Signed On: October 9, 2006

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Audit Participation

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

Cecile Ferkul, CPA, CISA	Deputy Legislative Auditor
David Poliseno, CPA, CISA, CFE	Audit Manager
Patrick Phillips, CPA	Auditor-in-Charge
Melanie Greufe	Auditor
Tim Rekow	Auditor

Exit Conference

We discussed the results of the audit with the following representatives of the Department of Administration at an exit conference on September 28, 2006:

Dana Badgerow	Commissioner
Sheila Reger	Deputy Commissioner
Kent Allin	MMD Director
Paul Stembler	MMD – MMCAP Manager
Al Becicka	AMS – MMCAP
Lenora Madigan	Financial Management Director
Bruce Lemke	Accounting Director
Judy Hunt	Internal Auditor
Julie Poser	Financial Management and Reporting

Report Summary

Overall Conclusion:

Overall, the Department of Administration's internal controls provided reasonable assurance that it properly recorded its financial activity in the state's accounting system and complied with applicable legal provisions and management's authorizations. However, the department did not comply with some applicable legal provisions and management's authorization for its cooperative purchasing program.

Key Findings:

- The department did not ensure that pharmaceutical manufacturers paid the correct fees to the state for the cooperative purchasing program. (Finding 1, page 9)
- The department did not reasonably estimate its accounts receivable amount for the cooperative purchasing program. (Finding 2, page 10)
- The department did not properly limit security access to the state's accounting system. (Finding 5, page 17)
- The department did not comply with certain legal requirements for some contracts. (Finding 7, page 18)

The report contained seven findings related to internal controls and legal compliance. The prior audit report contained four findings. The department resolved one of them, and we did not follow up on the other three because they did not relate to the scope of our work.

Audit Scope:

Audit Period:
July 1, 2002, to June 30, 2005

Programs Audited:
- Drive to Excellence
- Cooperative Purchasing Program
- Selected Operating Expenditures (payroll, professional and technical contracts, grants)
- Land Sales resulting from 2003 legislation

Agency Background:

The Department of Administration is responsible for providing an array of services (including consulting, demography, purchasing, and information technology) for businesses, citizens, and local and state government.

During our audit period, the department collected about $200 million per year and received General Fund appropriations of about $26.5 million per year for its operations.

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Chapter 1. Introduction

The Office of the Legislative Auditor selected the Department of Administration for audit based on an annual assessment of state agencies and programs. We used various criteria to determine the entities to audit, including the size and type of each agency's financial operations, length of time since the last audit, changes in organizational structure and key personnel, and available audit resources.

Agency Overview

The Department of Administration defines its mission as leading state government in delivering services and products faster, better, and more cost-effectively. The department's 22 divisions provide a variety of goods and services to state agencies. Some of these services include real estate management, preserving state assets through risk management, mail processing for state government, building and grounds maintenance, operations management, and ensuring access to assistive technology. The department also provides services directly to the general public. Some of these services include the sale of government publications, providing citizens access to government information, and providing demographic services.

Most of the department's divisions charge fees for their services. The fees averaged about $200 million each year. In addition, the department received General Fund appropriations of approximately $26 million, $25 million, and $29 million for budgetary fiscal years 2003, 2004, and 2005, respectively. The department also administers building projects throughout the state on behalf of state agencies. In fiscal year 2005, the department received bonding funds totaling $144 million for various statewide projects. Governor Tim Pawlenty appointed Dana Badgerow commissioner of the department in October 2004.

Audit Approach

Our audit was conducted in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of the Department of Administration's internal controls relevant to the audit objectives. We used the guidance contained in *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission, as our criteria to evaluate controls.[1] The standards also require that we plan the audit to provide reasonable assurance that the department complied with financial-related legal provisions that are significant to the audit. In determining the department's compliance with legal provisions, we considered requirements of laws, regulations, contracts, and grant agreements.

To meet the audit objectives, we gained an understanding of the department's financial policies and procedures. We considered the risk of errors in the accounting records and noncompliance

[1] The Treadway Commission and it Committee of Sponsoring Organizations (COSO) were established in the mid-1980s by the major national associations of accountants. One of the primary tasks was to identify the components of "internal control" that organizations should have in place to prevent inappropriate financial activity.

with relevant legal provisions. We analyzed accounting data to identify unusual trends or significant changes in financial operations. We examined documents to assess the adequacy of internal controls and to determine if the department complied with laws, regulations, contracts, and grant provisions.

Land Sales

During the 2003 Legislative Session, the Legislature passed a law[2] which stated, "The commissioner of administration shall coordinate with the head of each department or agency having control of state-owned land to identify and sell at least $5,505,000 of state-owned land." Sales were to be completed, as soon as practicable, but no later than June 30, 2005. The proceeds of the land sales were to be deposited into the General Fund to help balance the budget.

We reviewed the land sales as part of our audit. The department coordinated the sale of 17 state-owned surplus lands and properties which totaled more than $7.6 million. The department spent $167,761 of the $180,075 appropriated[1] for the actual expenses of selling the state-owned lands, resulting in net proceeds of $7,516,031 deposited into the General Fund. There were no findings in our review of the 2003 land sales program.

[2] *Laws of Minnesota*, 2003 *Special Session*, 1st Special Session, chapter 1, section 31.

Chapter 2. Drive to Excellence

Chapter Conclusions

The Department of Administration's internal controls provided reasonable assurance that expenditures for Drive to Excellence were accurately recorded in the accounting system and in compliance with applicable legal provisions and management's authorization. However, the department incorrectly coded certain expenditure transactions, as discussed in Chapter 4, Finding 7.

For items tested, the Department of Administration complied, in all material respects, with the significant financial-related legal provisions concerning Drive to Excellence.

Audit Objective

The primary objective of our audit of the Department of Administration's Drive to Excellence expenditures was to answer the following questions:

- Did the Department of Administration's internal controls provide reasonable assurance that Drive to Excellence expenditures were accurately reported in the accounting records and in compliance with applicable legal provisions and management's authorization?

- For items tested, did the Department of Administration comply, in all material respects, with the significant finance-related legal provisions concerning the Drive to Excellence initiative expenditures?

Background Information

In April 2004, Governor Tim Pawlenty created the Drive to Excellence initiative as part of a continuing effort to make state government "more accountable and efficient." The purpose of the Drive to Excellence initiative is to improve state government services by taking a more coordinated, government-wide approach to information technology, human resources, accounting, training, and safety. The initiative lists as its number one priority as providing fast, reliable services to the citizens of Minnesota.

The first phase of the Drive to Excellence initiative was to conduct a comprehensive analysis of business functions and technology resources and identify opportunities for improved services. The analysis examined 72 agencies, commissions, and boards in the Executive Branch. In August 2004, the Department of Administration hired an outside consulting firm for $2.5 million to conduct that comprehensive analysis. The consulting firm completed its work in January 2005. The consulting firm provided the state with a detailed matrix of state business functions and processes performed by agencies, as well as identifying and preparing 24 business cases for potential reform activities to gain efficiency and effectiveness. The consulting firm also provided the state with a detailed technology analysis (inventory) including recommendations to identify potential reform activities to gain efficiency and effectiveness.

The department also entered into an intra-agency agreement with the Management Analysis Division of the Department of Administration to provide up to 828 hours of leadership, analytical, and facilitation services to the various work teams at the direction of the commissioner. In fiscal year 2005, the department spent $85,207 from the General Fund for the intra-agency agreement.

We did not have any findings pertaining to the Drive to Excellence initiative.

Chapter 3. Cooperative Purchasing Programs

Chapter Conclusions

The Department of Administration accurately recorded cooperative purchasing revenues and expenditures in the accounting records. However, it did not have sufficient internal controls over its administrative fee receipts and did not comply with applicable legal provisions and management's authorization for revenues. The department had the following weaknesses:

- ***The department did not verify that pharmaceutical manufacturers paid the proper administrative fee to the state (Finding 1).***
- ***The department did not reasonably estimate its accounts receivable amount for the cooperative purchasing program (Finding 2).***
- ***The department did not deposit some of its receipts in a timely manner, as required by statutes (Finding 3).***
- ***The department did not enforce certain contract terms with the pharmaceutical manufacturers (Finding 4).***

For the items tested, the Department of Administration complied with material finance-related legal provisions concerning cooperative purchasing expenditures.

Audit Objective and Methodology

The primary objective of our audit of the cooperative purchasing revenues and expenditures was to answer the following questions:

- Did the Department of Administration's internal controls provide reasonable assurance that cooperative purchasing revenues and expenditures were accurately reported in the accounting records and in compliance with applicable legal provisions and management's authorization?

- For items tested, did the Department of Administration comply, in all material respects, with the significant finance-related legal provisions concerning cooperative purchasing revenues and expenditures?

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Background Information

The department's Materials Management Division manages two main cooperative purchasing programs, the Cooperative Purchasing Venture and the Minnesota Multi-State Contracting Alliance for Pharmacy. The Cooperative Purchasing Venture is a members-only program that enables participants to purchase goods and services under contract terms established by the state of Minnesota. All governmental units[3] are eligible for membership. The department's administrative role in the program is twofold: to collect the $500 annual membership fees and to collect the contract administration fees, which are based on a percentage of member purchases for a period.

The Minnesota Multi-State Contracting Alliance for Pharmacy was created in 1985 as a voluntary group purchasing organization managed by the Materials Management Division of the State of Minnesota. As of May 2006, 42 states and the city of Chicago are members of MMCAP and eligible to obtain pharmaceuticals, supplies and services at a discount through contracts established with over 150 pharmaceutical manufacturers and other vendors. Some pharmaceutical manufacturers pay the department an administrative fee. The manufacturers base the fee amount on the types of products purchased and the amounts agreed to in the contracts. The fee could total as much as two percent of purchases for certain products. In addition to their fee payments, the manufacturers provide data to the department to support their alliance operations. Many manufacturers rely on a third party vendor for the data provided to MMCAP.

Each alliance member is responsible for monitoring whether a health care facility is eligible to participate. There are approximately 4,000 eligible health care facilities with about 2,800 actively making purchases. After MMCAP covers its administrative costs, it rebates any residual funds through a credit to each facility.

Three distributors provide central warehouses that purchase the products from the manufacturers and establish an inventory. Facilities order and pay for pharmaceutical products through the distributors. The distributors fill the orders and ship them to the facilities as orders are filled. The distributors send data to the department detailing the purchases by product and facility. The data from the distributors is recorded in a departmental database.

In summary, the department has a fiduciary responsibility for:

- Executing approximately 150 contracts with pharmaceutical manufacturers and three distributors.
- Collecting the administrative fees due from the pharmaceutical manufacturers.
- Calculating the rebate to be credited by the distributor to each participating facility.

[3] A "governmental unit" is defined as any city, county, town, school district, other political subdivision of this or any state, another state, and any agency of the state of Minnesota or the United States, and includes any instrumentality of a governmental unit. Most members of the Cooperative Purchasing Venture are Minnesota governmental units.

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Current Findings and Recommendations

1. The department did not effectively validate that the pharmaceutical manufacturers paid the proper administrative fees to the state.

The department accepted administrative fees paid by the pharmaceutical manufacturers without effectively validating those amounts to the records of MMCAP sales. Because of this, the department could not ensure that the manufacturers paid the correct fees. The department uses the administrative fees to cover the cost of operating the program and rebates any excess back to the facilities as an additional cost savings.

The department could validate the administrative fees by comparing data it routinely received from the pharmaceutical manufacturers to data provided by the three distributors about the facilities' purchases. We compared some of this data on a sample basis and found that variances do exist. Table 3-1 shows these test variances:

Table 3-1
Analysis of Administrative Fees Paid by Manufacturers
Fiscal Years 2003 - 2005

Manufacturer	Quarter Ended	Manufacturer Administrative Fee Payment	Administrative Fee Amount Based on Distributor Data	Variances
1	April 2005	$ 1,232	$ 1,270	$ (38)
2	April 2003	$ 47,131	$ 41,365	$ 5,767
3	Dec. 2004	$342,361	$327,773	$14,588
4	April 2002	$587,547	$519,270	$68,277
5	Jan. 2004	$557,072	$534,757	$22,315
6	Dec. 2004	$ 28,731	$ 25,848	$ 2,883
7	June 2005	$ 4,232	$ 3,027	$ 1,205
8	July 2005	$ 5,585	$ 1,047	$ 4,538
9	June 2005	$ 8,521	$ 9,770	$(1,249)
10	Dec. 2005	$ 29,483	$ 31,525	$(2,042)

Source: Department of Administration's records.

In addition, our review identified that one manufacturer's record of sales was $3.8 million less than the distributors' records for the 12 months ended April 30, 2005. The department's follow-up of this discrepancy revealed that the manufacturer owes an additional $57,748 for administrative fees. The department is working with the manufacturer to recoup these fees.

Validating the manufacturers' sales to the distributors' records also provides assurance to the facilities that they are receiving their full rebates because the distributors' records are the basis for those amounts.

Recommendation

- *The department should validate that it received the correct amount of administrative fees from the manufacturers by reconciling the manufacturers' data with the data received from each of the three distributors and resolving any material variances.*

2. The department did not reasonably estimate its accounts receivable balance for the cooperative purchasing program.

The department prepares financial statements for MMCAP. The Department of Finance incorporates these financial statements into the state's comprehensive annual financial report. As shown in Table 3-2, the statements for the three years included an accounts receivable amount that was significantly less than the actual accounts receivable amount and which the department could not support. The division responsible for providing this information did not diligently analyze the underlying financial activity that supported the accounts receivable balance. The division could estimate a better accounts receivable balance based on prior receipt history and current reported sales.

Table 3-2
Accounts Receivable Analysis
By Budget Fiscal Years 2003 - 2005

	2003	2004	2005
Per Financial Statements	$ 556,974	$ 896,132	$ 408,818
Analysis of Cash Received	1,204,881	1,303,215	1,682,596
Amount Underreported	$ 647,907	$ 407,083	$1,273,778
Percentage Underreported	116%	45%	312%

Sources: Department of Administration's accounting records.

Also, the department did not report its accounts receivable data to the Department of Finance on a quarterly basis, as required by statute.[4] The Department of Finance uses the quarterly accounts receivable reports to ensure that the state is identifying and pursuing past due accounts. The department only provided accounts receivable data at the fiscal year end as part of the state's financial reporting process.

Recommendations

- *The department should reasonably estimate and document MMCAP accounts receivable balance for inclusion in its financial statements.*

- *The department should submit its accounts receivable reports to the commissioner of Finance on a quarterly basis.*

[4] *Minnesota Statutes* 2005, 16D.03, subd. 2.

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3. The department did not deposit some MMCAP receipts in a timely manner.

The department's Materials Management Division receives administrative fees from the various pharmaceutical manufacturers. It prepares the checks for deposit and ensures that they code the deposit to the correct fund. The division did not always deposit the checks in a timely manner.

The division did not deposit 6 of 12 deposits tested in a timely manner, as required by *Minnesota Statutes* 2005, 16A.275. The division held one check for $557,072.48 from its receipt on March 9, 2004, until its deposit on March 12, 2004, and held another check for $90,535.84 from its receipt on February 3, 2005, until its deposit on February 17, 2005.

On April 5, 2006, we were informed that the division was holding 18 MMCAP checks totaling $57,797. The oldest of these checks was received by the division on May 3, 2005. It received 7 of the 18 checks (totaling $17,898) in calendar year 2005, but it did not deposit the 18 checks until May 1, 2006.

Minnesota Statutes 2005, 16A.275 states that, "… an agency shall deposit receipts totaling $250 or more in the state treasury daily." The delay in depositing these checks increased the risk of loss or theft. The fund also loses potential investment earnings on these receipts.

Recommendation

- *The department should deposit daily receipts exceeding $250 in a timely manner.*

4. The department did not enforce certain terms in its MMCAP contracts with the pharmaceutical manufacturers.

The department did not enforce the insurance requirement clause or the terms of payment clause in contracts with the pharmaceutical manufacturers. The contract with each manufacturer generally contained standard language regarding the insurance requirement. Clause 14 of the contract states: "The Vendor (manufacturer) will provide a certificate of insurance for each type of insurance immediately upon execution of this contract." The department did not have insurance certificates for five of seven tested contracts. The purpose of insurance certificates is to transfer the risk to the manufacturer and minimize the risk to the state. The department informed us that some vendors have a hard time securing that high level of insurance coverage.

The department also did not enforce the payment deadlines for administrative fee payments. The contracts with the manufacturers required that the administrative fee be paid no later than 60 or 90 days (depending on the contract) after the end of the quarter. We tested 103 receipts for the quarter ended June 30, 2005, and found that 23 were paid later than the 60 or 90-day requirements. Additionally, one payment of $189,634 for the calendar years 2003 and 2004 was not received and deposited until October 31, 2005. Because the department did not monitor its accounts receivables, it did not know the payments were past due.

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Recommendation

- *The department should enforce all contract terms with the pharmaceutical manufacturers to ensure accountability.*

Chapter 4. Selected Operating Expenditures

Chapter Conclusions

The Department of Administration's internal controls provided reasonable assurance that payroll, professional/technical contracts, and grant expenditures were accurately reported in the state's accounting system and in compliance with applicable legal provisions and management's authorization. The department accurately compensated its employees in compliance with applicable bargaining agreements and compensation plans.

However, the department did not properly restrict security access for expenditure-related transactions in the state's accounting system, as discussed in Finding 5. We also found that the department did not always use the correct record date when it recorded its expenditure transactions in the state's accounting system, as discussed in Finding 6.

For items tested, the Department of Administration complied, in all material respects, with significant finance-related legal provisions concerning the selected operating expenditures. However, the department did not always comply with contract provisions and paid one contractor for services before fully executing the contract, as discussed in Finding 7.

Audit Objective

The operating expenditures we selected for review included payroll, grants, and professional and technical contracts. The primary objective of our review of these expenditures was to answer the following questions:

- Did the department's internal controls provide reasonable assurance that selected operating expenditures were accurately reported in the accounting system and in compliance with applicable legal provisions and management's authorization?

- Did the department compensate its employees in accordance with applicable bargaining agreements and compensation plans?

- For items tested, did the department comply with the significant finance-related legal provisions concerning operating expenditures?

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Background Information

Employee Payroll

Payroll is a significant expenditure for the State of Minnesota and the Department of Administration. During fiscal year 2005, payroll expenditures for the state were nearly $3.1 billion. Payroll was the largest expenditure for the department, totaling $57.8 million for fiscal year 2005. Table 4-1 summarizes the department's payroll expenditures for fiscal years 2003, 2004, and 2005.

Table 4-1
Summary of Payroll Expenditures
By Budget Fiscal Year

Earnings Type	2003	2004	2005
Full Time	$55,157,141	$56,502,602	$54,791,442
Part Time, Seasonal, Labor Service	1,315,590	1,489,810	1,341,052
Overtime Pay	399,131	305,519	284,170
Premium Pay	803,148	815,355	939,484
Other Benefits	1,407,658	1,012,004	399,263
Miscellaneous Charges	57,484	0	0
Total	$59,140,152	$60,125,290	$57,755,411

Source: Minnesota Accounting and Procurement System as of December 31, 2005.

As of December 31, 2005, the department had approximately 500 employees. However, during the scope of the audit, the department employed between 840 and 906. The significant drop was due to the establishment of the Office of Enterprise Technology as a separate agency on July 1, 2005. This new agency replaced the InterTechnologies Group, which was a division within the Department of Administration.

The commissioner of the Department of Employee Relations is the chief personnel and labor relations manager for the executive branch. In this capacity, the commissioner of Employee Relations oversees a wide array of functions, from negotiating compensation plans to maintaining the civil service classification system. To fulfill these duties, *Minnesota Statutes* give the commissioner of Employee Relations the authority to further delegate certain responsibilities to individual state agencies. The Department of Employee Relations has granted delegated authority to the Department of Administration for certain human resources decisions and activities.

Personnel and payroll responsibilities are shared by the Department of Administration and two central oversight agencies: the departments of Employee Relations and Finance. The two oversight agencies maintain the central personnel and payroll system used by all state agencies. This computer system has many edits that ensure personnel and payroll transactions comply with legal provisions and terms in compensation plans. The system also has extensive on-line policies and procedures to help state agencies record their decisions. However, the Department of

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Administration's personnel officers and payroll staff are ultimately responsible for understanding and complying with compensation plan terms and other pertinent legal provisions.

The conclusions reached in this report are based solely on work done at the Department of Administration. In addition, the Office of the Legislative Auditor also performed audit work to assess the adequacy of centralized personnel and payroll controls administered by the departments of Employee Relations and Finance. Legislative Audit Report #03-47, issued in August 2003, focused on security controls that protect the integrity and confidentiality of data in the personnel and payroll system. It also assessed the adequacy of central controls over pay rates, leave accruals, and payroll processing. Due to the significance of payroll costs to the State of Minnesota, we continue to examine central personnel and payroll controls and will be issuing another report to the departments of Employee Relations and Finance at a later date.

The department processed its biweekly payroll through the state's personnel/payroll program. Every two weeks employees submitted their timesheets and leave requests to their supervisors. The supervisors approved the timesheets and sent them to the timekeepers for entry into the state's personnel/payroll system. As of March of 2005, most of the divisions began using Employee Self-Service Time Entry, an online timesheet that allows for electronic approvals.

The Department of Administration belongs to various unions that include the following compensation plans:

- American Federation of State, County, and Municipal Employees
- Minnesota Association of Professional Employees
- Middle Management Association
- Managerial Plan
- Commissioner's Plan

There were no findings in the payroll area.

Grants

The Department of Administration disbursed $42,616,328 in grant expenditures for the three fiscal years ended June 30, 2005. The legislation established the majority of these grants as reimbursement grants. Table 4-2 shows the grant expenditures made during the audit period to the recipients.

Table 4-2
Department of Administration
Grant Expenditures
Budgetary Fiscal Years 2003 – 2005

Grant Fund Appropriation	2003	2004	2005
Guthrie Theatre	$21,288,397	0	0
Statewide 911 Program[1]	8,480,570	0	0
Children's Theatre	4,850,000	0	0
Public Broadcasting	1,795,000	1,903,000	1,903,000
Developmental Disability	184,552	0	0
State Building Code Dedicated	112,896	$ 267,139	$ 130,095
Voting Equipment Grant	106,223	0	0
Stripper Well	94,062	0	0
DDC-Interagency DHS	25,000	0	0
Fiscal Agent	1,700	0	0
Developmental Disability	0	164,479	333,091
North Counties Land Use BD	0	50,000	50,000
Star-Alternative Financing Program	0	0	331,489
Star - Federal Assistive Technology Program	40,000	0	0
Star-Access to Telework	0	0	316,488
Tech Related Assistance (FED)	0	0	117,095
DEV DIS Council-Family Support	0	0	66,106
MN Geographic Data Clearinghouse	0	0	5,945
Total	$36,978,400	$2,384,618	$3,253,309

Note 1: The 911 grant expenditures were not tested because the program was transferred from the Department of Administration to the Department of Public Safety in December 2003.

Source: Minnesota Accounting and Procurement System as of December 31, 2005.

We examined two of the larger grants in more detail:

- The 2003 Legislature appropriated $25,000,000 to the Guthrie Theater.[5] The purpose of this appropriation was to help fund the design, construction, and furnishing of a new Guthrie Theater in Minneapolis. The law stated that the funds could not be disbursed until the commissioner had determined that at least three times the amount of the appropriation was committed by non-state sources. Prior to disbursing any state funds, the department verified that the Guthrie Theater had raised $100 million as its share of the project. The department expected the grant to be fully disbursed in fiscal year 2007.

- The 2001 Legislature[6] appropriated $1,795,000 for fiscal years 2002 and 2003 for public broadcasting. The $1,795,000 was earmarked as follows: $1,450,000 of matching grants for public television, $25,000 of Twin Cities regional cable channel

[5] Laws for 2003, 1st Special Session, chapter 20, article 1, section 8, subd. 3.
[6] Laws for 2001, 1st Special Session, chapter 10, article 1, section 12, subd. 8.

grants, and $320,000 for community service grants to public educational radio stations.

- The 2003 Legislature[7] appropriated $1,903,000 each year for fiscal years 2004 and 2005 for public broadcasting. The $1,903,000 was ear marked as follows: $1,175,000 of matching grants for public television, $203,000 of public television equipment grants, $17,000 of Twin Cities regional cable channel grants, $313,000 for community service grants to public educational radio stations, and $195,000 for Minnesota Public Radio equipment grants. Television and radio stations applied for these grants and had to meet certain eligibility requirements. Once approved, the Association of Minnesota Public Educational Radio Stations and the Minnesota Public Television Association determined the amount each eligible radio or television station received.

There were no findings in the grants area.

Professional and Technical Contracts

During the three-year audit period, the department expended a total of $17,735,090 for professional and technical contracts. This equaled $5,614,298, $3,704,890, and $8,415,902 for fiscal years 2003, 2004, and 2005, respectively. The InterTechnologies Group (currently the Office of Enterprise Technology) incurred nearly 44 percent of the total professional and technical contract expenditures.

Current Findings and Recommendations

5. The department did not adequately restrict security access for expenditure transactions in the state's accounting system.

The department did not ensure that employees only had the required security access to the state's accounting system to perform their expenditure-related job duties. Nine out of the twelve employees sampled for security testing had too much access to the system based on their job duties. Further, three of the nine employees did not require any access to the system to perform their job duties. In addition, one individual with no accounting responsibilities had security access comparable to an accounting director position. The employee could encumber funds, create and process a purchase requisition or purchase order, enter invoice data, and pay the invoice. However, the employee only required inquiry access to the state's accounting system.

Recommendation

- *The department should limit employee system access to the access needed for them to perform their job duties.*

[7] Laws for 2003, 1st Special Session, chapter 1, article 1, section 11, subd. 6.

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6. The department did not properly enter the correct record dates for certain expenditure transactions in the state's accounting system.

The department did not properly enter the correct record dates on the accounting system for certain expenditure transactions. The record date is intended to capture the date the department received the goods and is used to identify the department's liabilities for financial reporting purposes. In 27 of 131 transactions tested, the department used an incorrect record date. Properly recording the record date is necessary to produce meaningful financial information for management as well as for reliable financial reporting.

Recommendation

- *The department should record transactions using the proper record dates.*

7. The department did not comply with certain legal requirements for some contracts.

During the audit, the department routinely entered into contracts with outside vendors to provide various professional/technical services to the department. The department had the following weaknesses in its contract process:

- In 2001, the department entered into a sole source contract with a vendor for $11,970 to provide computer maintenance support. The department subsequently amended the original contract seven times. The contractor continued to provide services before the department formally executed four of the seven amendments. The department did not reasonably estimate the total cost of the needed services when it originally entered into the contract or at the time of the amendments; the final total contract obligation was $340,000.

  According to *Minnesota Statutes* 2005, 16C.05, subd. 2a, a contract is not valid and the state is not bound by it and no agency, without the prior written approval of the commissioner granted pursuant to subdivision 2a, may authorize work to begin on it unless: (1) it has first been executed by the head of the agency or a delegate who is a party to the contract; (2) it has been approved by the commissioner; and (3) the accounting system shows an encumbrance for the amount of the contract liability.

- The department did not complete the required written performance evaluation in four of seven contracts tested. According to *Minnesota Statutes* 2005, 16C.08, subd. 4a, "Upon completion of a professional or technical services contract, an agency entering into the contract must complete a written performance evaluation of the work done under the contract." The evaluation form requires the agency to certify that the contractor satisfactorily fulfilled the terms of the contract.

- The department did not submit a required report to the Legislative Reference Library in five of seven contracts over $50,000 tested. *Minnesota Statutes* 2005, 16C.08, subd. 4c, "Within 30 days of final completion of a contract over $50,000 covered by this subdivision, the head of the agency entering into the contract must submit a one-page report to the commissioner who must submit a copy to the Legislative Reference Library." The report must summarize the purpose of the contract, state the amount spent on the contract, and include a performance appraisal.

Recommendations

- *The department should not allow a vendor to perform work until the contract or contract amendment is fully executed and funds are encumbered.*
- *The department should more accurately assess its contract requirements and better estimate the contract costs.*
- *The department should complete required performance evaluations at the completion of all professional/technical contracts.*
- *The department should submit a one-page report to the commissioner who must submit a copy to the Legislative Reference Library.*

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Status of Prior Audit Issues
As of May 17, 2006

Legislative Audit Report 04-14, issued in March 2004, focused on selected state programs as part of the fiscal year 2003 Statewide Audit. The audit covered areas material to the State of Minnesota's financial statements and federally funded programs. We also performed certain audit procedures on selected computer security controls in the Department of Administration's InterTechnologies Group. The report contained one finding related to securing some electronic libraries that house computer programs. The department resolved that finding.

Legislative Audit Report 02-41, issued in June 2002, covered the period July 1, 1998, through December 31, 2001. The selected scope of this audit included: payroll expenditures, Minnesota Statewide 911 Program activity, and surplus services operations. The report contained four findings, one in payroll, one for Minnesota Statewide 911, and two related to surplus services. The department sufficiently resolved the payroll finding. The remaining three findings were outside our audit scope and, accordingly, we did not follow up on them.

Legislative Audit Report 02-05, issued in January 2002, focused on selected state programs as part of the fiscal year 2001 Statewide Audit. The audit covered areas material to the State of Minnesota's financial statements and federally funded programs. The audit focused on selected components of the state's Internal Services Fund, selected building construction projects, and selected components of the Pharmaceutical Outreach Program. The report contained three findings related to allocation of InterTechnologies Group costs to the correct fiscal year, users' clearances for the Pharmaceutical Outreach Program's tracking system, and monitoring certain Print Communications Division's accounts receivable. The finding regarding security clearance relating to Pharmaceutical Outreach Program was resolved. The other two findings were outside our audit scope and, accordingly, we did not follow up on them.

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 metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

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DEPARTMENT OF ADMINISTRATION

October 5, 2006

James R. Nobles, Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, MN 55155-1603

Dear Mr. Nobles:

Thank you very much for the opportunity to convey our response to the results of the financial-related audit of the Department of Administration for the period July 1, 2002 through June 30, 2005. We wish to extend our appreciation to you and your staff for both the thorough examination of selected initiatives, programs, and activities within the agency, as well as the commitment to understanding the complexities of the department.

We appreciate the guidance your staff provided in each recommendation. Clearly, we are committed to following their direction. We will take appropriate measures aimed at remedying the immediate audit issues and preventing any future recurrence. Specific corrective actions taken to date and/or planned with respect to each audit finding are detailed on the pages that follow.

Sincerely,

Dana B. Badgerow
Commissioner

Attachment

cc: Sheila Reger, Deputy Commissioner
Lenora Madigan, Financial Management Director
Kent Allin, Director, Materials Management Division
Paul Stembler, Assistant Director, Materials Management Division
Al Becicka, MMCAP Program Operations Director, Materials Management Division
Judy Hunt, Internal Auditor

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Saint Paul, MN 55155
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Minnesota Department of Administration
Financial-Related Audit for the Three Years Ended June 30, 2005

Corrective Actions Taken and Planned

<u>Finding 1</u>
The department did not effectively validate that the pharmaceutical manufacturers paid the proper administrative fees to the state.

<u>Recommendation</u>
The department should validate that it received the correct amount of administrative fees from the manufacturers by reconciling the manufacturers' data with the data received from each of the three distributors and resolving any material variances.

The pharmaceutical industry supply chain and business model is extremely complex and the department acknowledges that, although it did not systematically validate the distributor data it received to the actual fees received from manufacturers, efforts at validation were made.

- During the initial period covered by the audit, the department periodically reviewed and identified significant amounts of uncollected administrative fees that were owed, and prepared a spreadsheet report that was used to send letters seeking payment of larger amounts.
- The department also developed an Administration Gap Fee Report during the fall of 2004 in response to a prior OLA audit recommendation. This report was used to identify unpaid administrative fees based on discrepancies between distributor data received and actual checks received from manufacturers. This is the same process used and cited by the auditors in this audit report.
- In the spring of 2006, an Administrative Fee Validation Report was developed to compare the administrative fee received with the contract requirements and the actual contract sales from the manufacturer. The report is run, reviewed with appropriate action taken for each check received, and maintained.

Complexities in this industry, as listed in the bullets below, make reconciling distributor, manufacturing, reseller and user data with complete accuracy impossible. The MMCAP multi-state group purchasing model adds even further challenges with some 4,000 buying entities in 43 states, acquiring product from over 150 pharmaceutical companies.

- MMCAP is a group purchasing organization (GPO), which competitively bids out and negotiates contracts with pharmaceutical manufacturers to obtain favorable, volume-based prices the manufacturers will honor for the 4,000 participating facilities that are eligible to purchase in the program.
- On many (but not all) of the products, the manufacturer agrees to pay MMCAP an administrative fee, which is used to fund the program's operation. Administrative fees collected in excess of the program's costs are refunded in the form of a credit to MMCAP's participating facilities. The credits are directly proportional to the sum of the contract purchases made by each facility during the year.
- MMCAP also has contracts with three distributors, who receive orders directly from the participating facilities and supply the products to them at the contract prices negotiated by

MMCAP. However, the distributors purchase products from manufacturers at a price (Wholesale Acquisition Cost or WAC) that is independent of the price MMCAP members pay for the contracted products.

- The distributors and manufacturers usually have complex arrangements whereby the manufacturers agree to pay the distributors a chargeback fee if the GPO contract price is less than the WAC amount the distributors originally paid the manufacturers for the products.
- Manufacturers and distributors may also use different dates (including date of sale and date of chargeback) in their reporting which further complicates validation and reconciliation.
- Because there are up to 200 GPOs nationally in the public and private sector, each with different contract pricing and administrative fee arrangements with manufacturers, validating distributor data is a time consuming process for manufacturers, creating a lag before manufacturers are satisfied that they are being charged fairly and are willing to send administrative fees to the various GPOs. Needless to say, each manufacturer, distributor, reseller, and GPO has a different data system, none of which reports data in the same way. There is no integrated database from which correlation can be done.
- Mergers and acquisitions of pharmaceutical manufacturers contribute to a dynamic business environment and often generate contract administration challenges for the MMCAP Program, with name and systems changes.

The department has already begun and intends to take several additional steps to implement the recommendation.

- Given the complexities in the system and the industry-wide acknowledgement that total reconciliation is impossible, the department plans to investigate and resolve discrepancies greater than 15 percent immediately. Within the next year, the department will evaluate changing this limit and possibly analyzing discrepancies greater than 10 percent. We understand that the 10 percent margin is industry standard. The department will consider staff restructuring and employing additional staff, as necessary, to ensure such discrepancies are investigated.
- The department will also improve the quality and timeliness of data it receives from manufacturers as it negotiates new data requirements in forthcoming manufacturer contracts. The department will consider requiring that manufacturers submit sales data and administrative fees on a monthly basis, rather than quarterly, beginning with the next round of contracts, which become effective May 1, 2007. With this more frequent reporting, discrepancies can be noted more quickly and followed up on a more current basis.
- The department will continue to rely on the advisory services of a volunteer consultant with the Senior Corps of Retired Executives (SCORE®) program. Since spring 2006, this consultant has been advising MMCAP with respect to industry best practices as well as operational and financial management issues. This individual is expected to be a helpful resource as the MMCAP staff members address issues raised in this audit.
- In addition, a software product enhancement is in final beta testing that will track administrative fee percentages based on master formulary product numbers allowing the department to more accurately calculate the amount due. This product enhancement is expected to be deployed in February 2007 with full utilization coinciding with new

manufacturer contracts in May 2007. This will make validation of manufacturer data to distributor data a more efficient process.
- The department will explore alternative methods of assessing administrative fees to pharmaceutical manufacturers participating in the MMCAP Program.

Persons responsible:
Kent Allin, Director, Materials Management Division, (651) 201-2400
Al Becicka, MMCAP Program Operations Director, Materials Management Division, (651) 201-2410

Target date for resolution of the audit issue: October 31, 2007

<u>Finding 2</u>
The department did not reasonably estimate its accounts receivable balance for the cooperative purchasing program.

<u>Recommendations</u>
- ***The department should reasonably estimate and document MMCAP accounts receivable balance for inclusion in its financial statements.***
- ***The department should submit its accounts receivable reports to the commissioner of Finance on a quarterly basis.***

Due to the rapid growth of MMCAP and the increasing complexity of the program's financial management responsibilities, leadership roles have been redefined. A new position, MMCAP Program Operations Director, has been created. The position is designed to provide additional focus on MMCAP budget, collection activities, and financial management and reporting.

The position was filled with a person with MMCAP knowledge and experience and is a Certified Public Accountant. This makes him uniquely qualified to address the financial management duties and remedy the audit findings.

Also, during the past year, the data available to track MMCAP accounts receivable has improved dramatically. The department developed an Administrative Fee Receipt and Distributor Sales Report that calculates expected and actual receipts by manufacturer. Data from this report will be used in conjunction with improved manufacturer data (as described previously in our response to finding 1) to determine accurate accounts receivable figures for the state's quarterly and fiscal year-end financial statements.

Persons responsible:
Kent Allin, Director, Materials Management Division, (651) 201-2400
Al Becicka, MMCAP Program Operations Director, Materials Management Division, (651) 201-2410

Target date for resolution of the audit issue: August 15, 2007

<u>Finding 3</u>
The department did not deposit some MMCAP receipts in a timely manner.

<u>Recommendation</u>
- ***The department should deposit daily receipts exceeding $250 in a timely manner.***

Immediately upon being made aware of the finding, department staff developed a new check receipts policy. This new policy was implemented to ensure timely depositing of administrative fee checks. Since early May 2006, staff has diligently abided by this policy and it has led to timely depositing of receipts in the state treasury. To ensure future timely deposits, the division also made some personnel changes among those responsible for processing the administrative fee checks.

Persons responsible:
Kent Allin, Director, Materials Management Division, (651) 201-2400
Al Becicka, MMCAP Program Operations Director, Materials Management Division, (651) 201-2410

Target date for resolution of the audit issue: December 31, 2006 for internal audit verification of timely deposits in the division.

<u>Finding 4</u>
The department did not enforce certain terms in its MMCAP contracts with the pharmaceutical manufacturers.

<u>Recommendation</u>
- ***The department should enforce all contract terms with the pharmaceutical manufacturers to ensure accountability.***

For new MMCAP contracts that became effective May 1, 2006, the department no longer requires pharmaceutical manufacturers to provide certificates of insurance. However, for those contracts in effect prior to May 1, 2006 and terminating on April 30, 2007, the insurance requirement remains. The next time that these contracts are awarded, the department plans to delete the insurance requirement in its entirety. This change in the insurance requirements resulted from a consultation approximately two years ago with the department's Risk Management Division who confirmed that the insurance provision was unnecessary since the state was already protected by an indemnification clause in the contract and the tort claims act provided additional protection.

While the department tracked some overdue administrative fees throughout the period of the audit, until the past year there was not a systematic tracking tool in place to discover overdue administrative fees in a timely manner. The department has implemented a data system to facilitate this process (discussed in our response for finding 1). The department plans to develop and implement a process whereby notices are routinely sent to manufacturers with overdue administrative fees.

The department plans to analyze terms and conditions of the MMCAP manufacturer contracts to determine whether any provisions could be negotiated differently so that they are more suitable to the complexities of the pharmaceutical supply chain. The department also plans to take appropriate action, while managing existing and future MMCAP contracts, necessary to enforce all stated terms and conditions.

Persons responsible:
Kent Allin, Director, Materials Management Division, (651) 201-2400
Al Becicka, MMCAP Program Operations Director, Materials Management Division, (651) 201-2410

Target date for resolution of the audit issue: June 30, 2007

<u>Finding 5</u>
The department did not adequately restrict security access for expenditure transactions in the state's accounting system.

<u>Recommendation</u>
- ***The department should limit employee system access to the access needed for them to perform their job duties.***

We appreciate your bringing this matter to our attention. We take information security issues very seriously and recognize the risks associated with broad access to the state's accounting and procurement system, MAPS.

When the audit issue was brought to our attention in late April 2006, we initiated immediate corrective actions. By July 17, 2006, we modified or deleted the security profiles for eight of the nine employees identified with excessive access privileges:
- For three of the nine employees, we changed their access rights to inquiry only. This includes the individual with no accounting responsibilities who had security access comparable to an accounting director position.
- For three additional employees, we deleted their clearance to the state's accounting system since they currently do not need it to perform their assigned duties.
- For two other employees, we further restricted their access to the state's accounting systems based on your technical recommendation.

For one of the nine employees referenced in your report, we did not make any changes to that individual's security profile. Upon further review and consultation with security personnel at the department of Finance, this employee needs all of the access privileges currently assigned to process certain payment transactions in the state's accounting system.

Although we are unaware of any incidents where employees abused their privileges, we will improve our preventive and detective MAPS access control measures. We are planning to update our agency policy that addresses access to the state's accounting system. Serious consideration will be given to enhancing the review of access requests, performing periodic assessments of employees' access privileges in relation to their assigned duties, and requiring division verifications of employee access privileges annually.

Persons responsible:
Lenora Madigan, Financial Management Director, (651) 201-2563
Bruce Lemke, Accounting Director, Financial Management and Reporting Division, (651) 201-2530

Target date for resolution of the audit issue: June 30, 2007

Finding 6
The department did not properly enter the correct record dates for certain expenditure transactions in the state's accounting system.

Recommendation
- ***The department should record transactions using the proper record dates.***

For the past few years, the department has been aware of problems within the agency with coding correct record dates in the state's accounting system. We recognize that it is essential to code transactions to the correct accounting period, especially to the appropriate fiscal year, for financial reporting purposes.

Thus, to remedy these problems, in fiscal year 2004 our Financial Management and Reporting Division (FMR) launched a quality assurance review (QAR) project for non-payroll payments processed in MAPS. The objectives of this project are: to improve accounting and financial reporting practices within the agency; to enhance agency compliance with financial laws, policies, and procedures; and to enhance employees' knowledge and skills. We developed guidance to aid payment processors in entering the correct transaction dates. We performed periodic spot checks of payment transactions that identified well-performing divisions and those divisions needing additional assistance and training to improve their performance. Our QAR project efforts also revealed that date coding errors can result from MAPS system limitations, and other employees (not involved in the payment process) establishing untimely orders and contracts.

Consequently, in fiscal year 2005 we enhanced our guidance, updated agency financial policies and procedures, and provided comprehensive training to staff. In late fall 2005, FMR staff again tested expenditure transactions with hopes of attaining desired agency-wide performance goals (e.g., to enter the correct record date in MAPS at least 90% of the time). Results were not as favorable as expected.

In July 2005, consultants from Admin's Management Analysis and Development Division assisted by exploring options for processing the agency's orders and payments in MAPS. Based on their evaluation, FMR implemented a *shared services* approach for processing agency orders and payments. This approach involves consolidating the purchasing and payment functions within the agency, which were largely decentralized, for improved quality, consistency, and efficiency.

We believe that consolidation will also better prepare the department as the state moves toward a shared services model for statewide transaction processing. Under various service agreements, the MAPS Shared Services Team within FMR is currently processing orders and payments for 16 divisions and agencies. Periodic spot checks will be performed to assess compliance with state and agency policies and procedures for entering record dates for non-payroll expenditures in the state's accounting system.

We understand that over half of the transactions your staff detected with incorrect record dates stem from transactions processed in two former Admin divisions that now comprise the Office of Enterprise Technology (OET). With respect to OET, our internal auditor is presently working with OET accounts payable staff to improve their coding transactions in MAPS with the proper record date.

Person responsible: Lenora Madigan, Financial Management Director, (651) 201-2563

Target date for resolution of the audit issue: June 30, 2007

Finding 7
The department did not comply with certain legal requirements for some contracts.

Recommendations

- ***The department should not allow a vendor to perform work until the contract or contract amendment is fully executed and funds are encumbered.***
- ***The department should more accurately assess its contract requirements and better estimate the contract costs.***
- ***The department should complete required performance evaluations at the completion of all professional/technical contracts.***
- ***The department should submit a one-page report to the commissioner who must submit a copy to the Legislative Reference Library.***

With respect to the first bullet point of finding 7 in the audit report, estimates of contract scope proved inaccurate in hindsight. However, none were unreasonable based on the information known at the time. There were several reasons the scope of the contract grew unexpectedly, including responding to the OLA's 2002 recommendations to enhance MMCAP system security. Another significant factor was assuring adequate knowledge transfer to state staff so that MMCAP personnel could take over system development and maintenance, which has since occurred.

Because the department is responsible for overseeing the contracting process of other state agencies, our contracting practices must be beyond reproach. The department will respond to these recommendations by conducting a self-assessment of all open professional and technical services contracts managed within the department. The department's contract management checklist will be reviewed, updated and sent to all department employees who may be responsible for entering into or managing a professional and technical services contract. The checklist will consist of a comprehensive list of all statutory and procedural actions that must be taken to ensure the contract is properly administered. Staff within the department's Materials Management Division will monitor department-wide compliance with statutory mandates.

With respect to the remaining two bullet points of this finding, four of the contracts mentioned pertain to OET. Again, our internal auditor is presently working with OET staff to resolve the audit issue.

Persons responsible:
Kent Allin, Director, Materials Management Division, (651) 201-2400
Paul Stembler, Assistant Director, Materials Management Division, (651) 201-2401

Target date for resolution of the audit issue: June 30, 2007