OLA **OFFICE OF THE LEGISLATIVE AUDITOR**
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Department of Administration

Internal Controls and Compliance Audit

July 1, 2008, through April 30, 2011

October 13, 2011 **Report 11-22**

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

October 13, 2011

Representative Michael Beard, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Spencer Cronk, Commissioner
Department of Administration

This report presents the results of our internal controls and compliance audit of selected financial activities of the Department of Administration for the period July 1, 2008, through April 30, 2011.

We discussed the results of the audit with the Department of Administration's staff on September 29, 2011. This audit was conducted by Jim Riebe, CPA (Audit Manager) and Zach Yzermans, CPA (Auditor-in-Charge), assisted by auditors Ted Bethell, Tyler Billig, CPA, and Kelsey Nistler.

This report is intended for the information and use of the Legislative Audit Commission and the management of the Department of Administration. This restriction is not intended to limit the distribution of this report, which was released as a public document on October 13, 2011.

We received the full cooperation of the Department of Administration's staff while performing this audit.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

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Conclusion

The Department of Administration's internal controls were generally adequate to ensure that it safeguarded its financial resources, accurately paid employees and vendors in accordance with management's authorizations, and complied with finance-related legal provisions. However, the department had some weaknesses in its internal controls, including lack of segregation of duties in two areas, inadequate procedures for managing cooperative purchasing accounts receivable, and not maintaining appropriate access to select business systems.

For the items tested, the department generally complied with finance-related legal requirements. However, the department had some instances of noncompliance in managing accounts receivable.

The department resolved five out of seven prior findings and partially resolved one of the findings.[1] The department improved controls in its cooperative purchasing program over administrative fees paid by vendors and partially resolved a finding on managing its accounts receivable. In addition, it promptly deposited cooperative purchasing receipts and improved the accuracy of liability dates recorded in the accounting system. We did not follow up on one of the seven findings that pertained to compliance related to professional-technical services contracts because it did not relate to financial activities we selected for audit.

Key Findings

- The Department of Administration did not adequately segregate key financial responsibilities over certain payments and workers' compensation checks. (Finding 1, page 7)

- Prior Finding Partially Resolved: The Department of Administration did not adequately manage its cooperative purchasing program accounts receivable.
(Finding 2, page 8)

- The Department of Administration allowed some incompatible access to its workers' compensation system and the state's accounting system without maintaining sufficient mitigating controls. (Finding 3, page 9)

[1] Office of the Legislative Auditor's Financial Audit Division Report 06-27, *Department of Administration*, issued October 12, 2006.

Audit Objectives and Scope

Objectives
- Internal controls
- Finance-related legal compliance

Period Audited
July 1, 2008, through April 30, 2011

Programs Audited
- Workers' compensation
- Cooperative purchasing
- Building leases and contracts
- Payroll expenditures
- System access

Department of Administration

Agency Overview

The Department of Administration provides a broad range of business management, administrative, and professional services to state agencies, local governments, and the public. Its functions include purchasing goods and services, negotiating state contracts, managing real estate, maintaining buildings and grounds, leasing vehicles, selling surplus property, processing mail for state agencies, and protecting state assets through risk management and insurance. The department is governed by *Minnesota Statutes* 2010, Chapter 16B.

In February 2011, Governor Dayton appointed Spencer Cronk as the department's commissioner. Previously, since July 1, 2008, Dana Badgerow, Sheila Reger, and Ryan Church served as the department's commissioners.

Table 1 recaps the department's revenues and expenditures for fiscal years 2009 and 2010:

Table 1
Department of Administration
Revenues and Expenditures
By Fiscal Year

	2009	2010
Revenues	$162,662,641	$160,705,894
Expenditures	$171,975,011	$172,483,478

Source: Minnesota Accounting and Procurement System.

The department funded the majority of its operations through charges to other state agencies and other entities for services provided by divisions, such as plant management, state motor pool, procurement, and risk management. In addition, the department received funding through the General Fund, Federal Fund, and various special revenue funds. Table 2 summarizes the total revenues and expenditures of financial activities we selected to include in the scope of this audit for fiscal years 2009 and 2010.

Table 2
Department of Administration
Revenues and Expenditures Selected for Audit[1]
By Fiscal Year

Selected Revenues	2009	2010
Building/Facility Leases	$ 61,901,913	$ 62,347,680
Cooperative Purchasing[2]	12,027,367	11,410,673
Workers' Compensation[3]	28,223,537	28,771,160
Total	$102,152,817	$102,529,513

Selected Expenditures	2009	2010
Department Payroll	$35,126,874	$33,158,997
Cooperative Purchasing[2]	5,894,270	$7,091,443
Workers' Compensation[3]	25,769,372	27,277,365
Total	$66,790,516	$67,527,805

[1]Our audit scope also included financial activities in these areas for fiscal year 2011, through April 30, 2011.

[2] The cooperative purchasing program consists of the Minnesota multistate contracting alliance for pharmacy and the cooperative purchasing venture. The program allows eligible organizations, including local governments and nonprofit organizations, to use state-negotiated contracts at no cost to purchase pharmaceuticals and goods and services directly from vendors. The goal of the program is to take advantage of economies-of-scale, often resulting in lower pricing and better terms and conditions. Vendors pay administrative fees for contracts administered through the program. The department incurs costs to operate the program and remits fees collected in excess of pharmacy member agreements to wholesalers and distributors who credit members' accounts.

[3]The workers' compensation program is a self-insured, self-administered program to provide and coordinate claims management, disability management, and managed health care primarily for state workers who are injured on the job; the program also offers workers' compensation legal services for state agencies. Our audit focused on injury claims and did not examine nonsalary administrative costs totaling about $563,000 in fiscal year 2009 and $507,000 in fiscal year 2010.

Source: Minnesota Accounting and Procurement System.

Objective, Scope, and Methodology

The objective of our audit of the Department of Administration was to answer the following questions for the financial activities we selected to include in our audit scope (building and facilities leases, cooperative purchasing, workers' compensation, payroll, and security access to the state's accounting systems and selected department subsystems) for the period of July 1, 2008, through April 30, 2011:

- Were the department's internal controls adequate to ensure that it safeguarded its financial resources, accurately paid employees and vendors in accordance with management's authorizations, complied with finance-related legal provisions, and created reliable financial data?

- Did the department comply with finance-related legal requirements?

- Did the department resolve prior audit findings?

To answer these questions, we gained an understanding of the department's financial policies and procedures. We considered the risk of errors in the accounting records and noncompliance with relevant legal requirements. We analyzed accounting data to identify unusual trends or significant changes in financial operations. We examined samples of transactions and evidence supporting the office's internal controls and compliance with laws, regulations, policies, and contracts.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

We used various criteria to evaluate internal controls and compliance. As our criteria to evaluate agency controls, we used the guidance contained in the *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission.[2] We used state and federal laws, regulations, and contracts, as well as state policies and procedures established by the Department of Management and Budget and the department's internal policies and procedures as evaluation criteria over compliance.

Conclusion

The Department of Administration's internal controls were generally adequate to ensure that it safeguarded its financial resources, accurately paid employees and vendors in accordance with management's authorizations, and complied with finance-related legal provisions. However, the department had some weaknesses in its internal controls, including a lack of segregation of duties in two areas, inadequate procedures for managing cooperative purchasing accounts receivable, and not maintaining appropriate access to select business systems.

[2] The Treadway Commission and its Committee of Sponsoring Organizations were established in 1985 by the major national associations of accountants. One of their primary tasks was to identify the components of internal control that organizations should have in place to prevent inappropriate financial activity. The resulting *Internal Control-Integrated Framework* is the accepted accounting and auditing standard for internal control design and assessment.

For the items tested, the department generally complied with finance-related legal requirements. However, the department had some instances of noncompliance in managing accounts receivable.

The department resolved five out of seven prior findings and partially resolved one of the findings. The department improved controls in its cooperative purchasing program over administrative fees paid by vendors and partially resolved a finding on managing its accounts receivable. In addition, it promptly deposited cooperative purchasing receipts and improved the accuracy of liability dates recorded in the accounting system. We did not follow up on one of the seven findings that pertained to compliance related to professional-technical services contracts because it did not relate to financial activities we selected for audit.

The following *Findings and Recommendations* further explain the department's internal controls and compliance weaknesses.

Findings and Recommendations

Finding 1

The Department of Administration did not adequately segregate key financial responsibilities over certain payments and workers' compensation checks.

The department had incompatible duties in the following two areas without establishing mitigating controls:

- As of May 2011, three employees had the authority to initiate and authorize payments in the state's accounting system and pick up the checks from the Department of Management and Budget.[3] These duties are incompatible because they allow one person to generate a payment in the accounting system and physically access the check, which increases the risk of error or fraud. As part of its internal control structure, the Department of Management and Budget generally limits access to processed payments by either electronically paying or mailing most payments directly to recipients and only deviates from this process at the request of a paying entity. From July 2008 through April 2011, the department processed 114 payments, totaling about $19 million, using this process.

- Approximately 30 employees in the workers' compensation unit had unrestricted access to its list of checks received; the unit used the list to ensure it deposited all checks received. These employees, some who also had physical access to the checks, had the ability to edit information on the list to conceal an error or fraud. From July 2008 through April 2011, the workers' compensation unit processed $2.9 million in checks.

An adequate segregation of duties includes separating the responsibilities for authorizing and processing payments, independently reviewing the transactions, and restricting access to the checks to reduce the risk of errors and fraud. State policy requires state agencies to establish mitigating controls, such as independently reviewing the transactions processed, if adequate segregation of duties cannot be implemented.[4] Although the department had not established mitigating controls, we did not identify any errors or improper payments based on our testing.

Recommendation

- *The Department of Administration should separate key financial duties or establish effective mitigating controls.*

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[3] The department used this process so that staff could include other information explaining the payments when it mailed checks to the recipients.
[4] Department of Management and Budget Policy 0602-03, *Recording and Depositing Receipts*.

Finding 2

Prior Finding Partially Resolved: The Department of Administration did not adequately manage its cooperative purchasing program accounts receivable.

The department did not comply with contract provisions and state policy[5] in the collection of its accounts receivable for the cooperative purchasing program.[6] Although the department significantly improved its oversight of program accounts receivable, it had the following weaknesses:[7]

- The department did not ensure that companies participating in the Minnesota multistate contracting alliance for pharmacy submitted fees in accordance with contract terms, which vary from monthly to quarterly filings. Late collections for nine of the nine accounts receivable balances we tested ranged from 18 to 486 days past due and totaled about $783,000; on average, the accounts were 150 days past due. The department did some follow-up on outstanding balances, however, the program's accounts receivable management plan lacked specific procedures for following up on delinquent accounts.
- The department could not provide documentation showing pursuit of outstanding accounts receivable balances for four of the nine delinquent cooperative purchasing venture accounts we tested. These four receivable balances totaled $63,572 and collection took place 7 to 89 days past due. In total, for the quarter ending December 31, 2010, the cooperative purchasing venture had $309,527 in overdue receivables. The department had not developed a receivables management plan for this program. State policy requires that a receivables management plan, at a minimum, should address the description of the receivables, organization and responsibility for the receivables, the receivable systems, receivable goals and objectives, and receivable strategies and procedures.

The state's policies are designed to ensure that agencies diligently and effectively recover amounts owed to the state. By not complying with the policies, the department did not ensure that it maximized the programs' revenues and reduced the cost of the programs' operations to the state.

Recommendation

- *The Department of Administration should actively pursue the collection of accounts receivable in compliance with state policies. It should develop a receivables management plan for the cooperative purchasing venture and ensure the plan for the Minnesota multistate contracting alliance for pharmacy complies with state policy.*

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[5] Department of Management and Budget Policy 0505-01, *Receivable Collection Process*.
[6] The cooperative purchasing program consists of the Minnesota multistate contracting alliance for pharmacy and the cooperative purchasing venture, which allows eligible entities to purchase pharmaceuticals and goods and services under state contracts.
[7] Finding 4 in the Office of the Legislative Auditor's Financial Audit Division Report 06-27, *Department of Administration*, issued October 12, 2006.

Finding 3

The Department of Administration allowed some incompatible access to its workers' compensation system and the state's accounting system without maintaining sufficient mitigating controls.

The department did not adequately limit employees' access for certain business systems. Some employees had incompatible access that allowed them to initiate, change, and process data in a system without independent review or authorization. The department had the following system access incompatibilities:

- Two employees had incompatible access to the workers' compensation business system. These employees had the ability to edit claimant addresses, social security numbers, and injury dates, as well as create claims, enter payments, and authorize payments. Although the department had developed a control to mitigate the risk created by these incompatibilities, the control was not always effective because it was sometimes performed by one of the employees who had the incompatible access.
- Two employees had incompatible access to the state's accounting system.[8] The incompatibilities allowed the employees to encumber funds, enter receiving data, and make payments.

Department of Management and Budget's policy specifies that agencies should not grant access that creates incompatibilities and, in cases where incompatible functions cannot be separated, agencies must implement and document mitigating controls.[9]

Recommendation

- *The Department of Administration should not grant system access to employees that allows incompatible duties. If incompatible duties cannot be prevented, the department should design, document, and maintain effective mitigating controls, including controls over changes to workers' compensation claim information and transactions processed in the state's accounting system.*

Finding 4

The Department of Administration did not complete a comprehensive assessment of its business risks, as required by state policy.

The department had not prepared a comprehensive assessment of its business risks or associated internal controls. In addition, the department did not have a plan to monitor the effectiveness of its internal controls.

[8] These employees worked in the real estate and construction division.
[9] Department of Management and Budget Policy 1101-07, *Security and Access*.

A comprehensive control structure has the following key elements:

- Personnel are trained and knowledgeable about finance-related legal provisions and applicable policies and procedures.

- Management identifies risks associated with finance-related legal provisions and develops policies and procedures to effectively address the identified risks.

- Management continuously monitors the effectiveness of the controls, identifies weaknesses and breakdowns in controls, and takes corrective action.

- Management focuses on continual improvement to ensure an acceptable balance between controls and costs.

The department had documented certain high-level risks, had many control activities in place, and performed selected internal control monitoring functions. However, Finding 1 through Finding 3 identifies deficiencies that were not prevented or detected by the department's internal control structure.

The state's policy on internal controls requires that each department head identify, analyze, and manage business risks that impact the entity's ability to maintain its financial strength and the overall quality of its products and government services.[10] The policy further requires follow-up procedures that, at a minimum, should include ways to monitor controls and report significant deficiencies to individuals responsible for the process or activity involved, including executive management and those individuals in a position to take corrective action.

Recommendation

- *The Department of Administration should develop and document a comprehensive risk assessment that includes related control activities and internal control monitoring functions for its key business processes.*

[10] Department of Management and Budget Policy 0102-01, *Internal Control.*

October 6, 2011

Mr. James Nobles
Office of the Legislative Auditor
Centennial Office Building, Room 140
658 Cedar Street
Saint Paul, MN 55155-1603

Dear Mr. Nobles:

Thank you for the opportunity to convey our response to the internal control and compliance audit for selected activities from July 1, 2008 through April 30, 2011. We wish to extend our appreciation to you and your staff for the audit work that was completed, and the guidance provided through the findings and recommendations. We are pleased that you found the agency's controls were generally adequate to ensure we had safeguarded our resources.

The following details the corrective action we have already taken or will be taking to address each of the findings.

Finding 1:
The department did not adequately segregate key financial responsibilities over certain payments and workers' compensation checks.

Recommendation:
The department should separate key financial duties or establish effective mitigating controls.

Response:
The audit report identifies two instances of inadequate segregation of responsibilities. The first involved authority over payments and warrant pickup. Since audit staff notified the supervisor during the fieldwork, the practice was changed immediately. The change in authorization was documented by completing the formal *Pull Warrant Authorization* form. Because of the fieldwork, the agency immediately reviewed and identified two other staff with the same authority and their authorizations were also changed. The second instance related to unrestricted access to a unit's check log. Again, because of the communication with audit staff the practice was changed; later password protection was added to provide greater assurance that the log could not be comprised.

Target date for resolution:
Fully Resolved

Office of the Commissioner
200 Administration Building, 50 Sherburne Avenue, Saint Paul, MN 55155
Phone: 651.201.2555 / Fax: 651.297.7909 / Minnesota Relay Service 1.800.627.3529

Finding 2:
Prior Finding Partially Resolved: The department did not adequately manage its cooperative purchasing program accounts receivable.

Recommendation:
The department should actively pursue the collection of accounts receivable in compliance with state policies. It should develop a receivables management plan for cooperative purchasing venture and ensure the plan for the Minnesota multistate contracting alliance for pharmacy complies with state policy.

Response:
As noted in the report, significant improvement has been made. Three of four past findings dealing with accounts receivable have been fully resolved, but payment deadlines for administrative fees have not been consistently enforced. Going forward, one additional staff person will be hired by December 31, 2011, to assist with collection. Also, a customized plan for managing receivables will be developed and implemented by December 31, 2011. This will be followed by monitoring to determine effectiveness of the plan and collection efforts; if necessary, adjustments will be made during the monitoring period.

Persons responsible:
Alan Dahlgren, MMCAP Managing Director, Materials Management Division (651.201.2410)
Dorothy Lovejoy, Operations Manager, Materials Management Division (651.201.2403)
Kent Allin, Director, Material Management Division (651.201.2400)

Target date for resolution:
September 30, 2012

Finding 3:
The department allowed some incompatible access to its workers' compensation system and the state's accounting system without maintaining sufficient mitigating controls.

Recommendation:
The department should not grant system access to employees that allows incompatible duties. If incompatible duties cannot be prevented, the department should design, document and maintain effective mitigating controls, including controls over changes to workers' compensation claim information and transactions processed in the state's accounting system.

Response:
The audit report identifies two instances where incompatible access existed and mitigating controls were inadequate. In the first instance, one of the employees with incompatible duties was performing the mitigating control when no one else was available. The mitigating control was changed, documented in the unit's procedures, and the control is now performed by other management staff. The second instance involved incompatible access in the state's accounting system. Although some changes have been made with the implementation of SWIFT, the unit is still searching for a solution that allows for adequate separation without implementing mitigating controls. There are two short-term solutions being evaluated; the first is to determine if all payments can require management approval through the two-way match process. If this is not possible, project managers will be required to approve invoices using the three-way match process. The longer-term plan is to develop a system interface between the project database (currently being developed) and SWIFT that would identify any inconsistencies and follow-up would be completed and documented on all inconsistencies.

Persons responsible:

Wayne Waslaski, Director, Real Estate and Construction Services (651.201.2548)
Nicky Giancola, Assistant Commissioner, Facility Services (651.201.2561)

Target date for resolution:
Workers' Compensation System – Fully Resolved
State Accounting System - Initial resolution – November 30, 2011
State Accounting System - Full Resolution – December 31, 2012

Finding 4:
The department did not complete a comprehensive assessment of its business risk, as required by state policy.

Recommendation:
The department should develop and document a comprehensive risk assessment that includes related control activities and internal control monitoring functions for its key business processes.

Response:
Although the agency assessed its control environment and has a number of controls in place, it is important to analyze relevant risks and develop and document internal control procedures and evaluate these controls periodically to satisfy management that they are functioning properly. Dedicating a portion of the agency's limited staff resources to a formal risk assessment is challenging since it will compete with timely review of established controls and the time available for completing day-to-day work responsibilities. In recognition of the limited staff resources, the Senior Leadership Team adopted a framework to begin the process of implementing an agency-wide risk assessment. The framework includes reviewing and adopting the prioritized risk factors, developing work plans to identify how each of the diverse divisions assesses the highest identified agency risk factor for their operations, and developing and implementing additional controls (if needed) that effectively monitor the risk. MMB's internal control unit has been asked to review the framework and provide feedback to help ensure the process is effective, achievable, and conforms to the state policy.

Persons responsible:
Lenora Madigan, Director, Financial Management and Reporting (651.201.2563)
Julie Poser, Assistant Director, Financial Management and Reporting (651.201.2531)
Ryan Church, Assistant Commissioner, Financial Management and Administration - representing Admin's Senior Leadership (651.201.2568)

Target date for resolution:
First Phase, June 30, 2013

Again, we appreciate the opportunity to respond to the audit report. We value the work of your agency and the professionalism of your staff. We are committed to take actions to implement the recommendations identified in the report, including continued focus on our internal control structure. If you have questions or need additional information, please contact Lenora Madigan.

Sincerely,

Spencer Cronk

Spencer Cronk
Commissioner