



FINANCIAL AUDIT DIVISION REPORT

Office of MN.IT Services

Billings for Shared Information Technology Services

Internal Controls and Compliance Audit

January 22, 2015

Report 15-01

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OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

January 22, 2015

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Thomas Baden, Commissioner and State Chief Information Officer
Office of MN.IT Services

This report presents the results of our internal controls and compliance audit of the Office of MN.IT Services. The objective of our audit was primarily to determine whether MN.IT complied with federal and state legal requirements when it billed state agencies for central information technology services.

We discussed the results of the audit with the office's staff at an exit conference on January 9, 2015. This audit was conducted by Carolyn Engstrom, CPA, CISA (Audit Director), David Westlund, CPA, CISA (Senior IT Auditor), Thom Derus, (IT Auditor), Natalie Mehlhorn (Senior Auditor), and Melissa Strunc (Senior Auditor).

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

A handwritten signature in black ink that reads "James R. Nobles".

James R. Nobles
Legislative Auditor

A handwritten signature in black ink that reads "Cecile M. Ferkul".

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

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Report Summary

The Office of MN.IT Services¹ (MN.IT) is a state agency that provides information technology services² to other state agencies. State law requires state agencies to reimburse MN.IT for the cost of those services.³

About 20 percent of the information technology services MN.IT provides are services that are used by numerous state agencies. For these shared services, MN.IT bills state agencies using a rate it developed as a basis for the reimbursement amounts. For fiscal year 2013, MN.IT billed state agencies approximately \$93.7 million for these shared information technology services. State agencies reimbursed MN.IT with money from a variety of sources, including federal and state money legally restricted for specific program purposes.

The objective of our audit was primarily to determine whether MN.IT complied with federal and state legal requirements when it developed the rates used to bill state agencies for the shared information technology services.

Conclusion

The Office of MN.IT Services did not comply with federal and state legal requirements in developing the billing rates it used to charge state agencies for certain shared information technology services.

Finding

The Office of MN.IT Services used billing rates that significantly overcharged for some shared information technology services to offset other billing rates that significantly undercharged for some shared information technology services. ([Finding 1, page 7](#))

¹ The Office of MN.IT services was known as the Office of Enterprise Technology until its name was changed by *Laws of Minnesota* 2014, chapter 134, sec. 21.

² Information technology services include developing and maintaining the computer applications and networks used by state agencies to process, store, transmit, and secure electronic data.

³ *Minnesota Statutes* 2014, 16E.14, subd. 3.

Agency Overview

Office of MN.IT Services

The Office of MN.IT Services (MN.IT) is a state agency that provides information technology services, primarily to other state agencies.⁴ State statutes require state agencies to reimburse MN.IT for the cost of those services, “including the cost of all services, supplies, materials, labor, and depreciation of equipment, including reasonable overhead cost” that MN.IT “is authorized and directed to furnish an agency.”⁵

About 20 percent of the services MN.IT provides are services that are shared among state agencies.⁶ For example, MN.IT provides email and other electronic communication services that are used by all state agencies. For these types of shared services, MN.IT develops billing rates as a basis for reimbursement by the state agencies. In fiscal year 2013, MN.IT billed state agencies approximately \$93.7 million for the shared services it provided.

State statutes require the Department of Management and Budget to review and approve rates charged to state agencies, including the rates MN.IT uses to bill for its shared information technology services.⁷ State policy directs state agencies to set billing rates for each service “as close to the break-even rate” for that service as possible.⁸ A break-even rate is an amount designed to recover the estimated cost of providing the service.

In addition to state policy requiring rates close to break-even, federal regulations state that billing rates for shared services charged to federal awards “must be based on the estimated costs of providing the services.” The regulations require an annual comparison of the revenue generated by each billed service to the actual allowable costs of the service, and an adjustment for differences between the revenue and the allowable costs. One of the adjustment methods is to pay a refund back to the federal government.⁹

⁴ *Minnesota Statutes* 2014, chapter 16E, identifies the office’s powers and duties. The office is under the direction of a commissioner, who is also the state chief information officer.

⁵ *Minnesota Statutes* 2014, 16E.14, subd. 3.

⁶ In addition to the services MN.IT provides that are shared among state agencies, about 80 percent of the services MN.IT provides are unique to the information technology needs of specific state agencies. MN.IT bills each state agency for the specific services they use.

⁷ *Minnesota Statutes* 2014, 16A.126.

⁸ Department of Management and Budget executive branch policy 0108-01, *Internal Service Rate Approval*.

⁹ 2 Code of Federal Regulations, Part 200, Appendix V.

To pay MN.IT for the information technology services they receive, state agencies use money from a variety of sources. Some of the money is legally restricted for specific purposes. For example, in fiscal year 2013, the Department of Human Services paid MN.IT with federal and state money legally restricted to administer medical programs for low-income people.

State agencies pay the reimbursement into the MN.IT services revolving fund,¹⁰ one of the state's internal service funds. Generally accepted governmental accounting principles state, "Internal service funds may be used to report any activity that provides goods or services to other funds, departments, or agencies [of the state] . . . on a cost-reimbursement basis."¹¹ State statutes allow MN.IT to use money in this fund to pay for the operation of information and telecommunications services.¹²

Because an internal service fund needs a reasonable level of working capital in reserve to operate from one billing cycle to the next, federal cost principles allow the fund to accumulate a working capital reserve as a part of retained earnings, but limit the amount that can accumulate to the amount needed to cover the cost of operations for 60 days.¹³

Objective, Scope, and Methodology

The primary objective of our audit was to answer the following question:

- Did the Office of MN.IT Services comply with federal and state legal requirements when it billed state agencies for shared information technology services during the period from July 2012 through March 2014?

To answer this question, we interviewed Office of MN.IT Services' management and staff to understand the process used to develop billing rates and to bill state agencies for services provided. We reviewed documentation supporting MN.IT's development of billing rates for fiscal years 2013 through 2015. We also discussed with Department of Management and Budget staff the process they used to determine whether the rates MN.IT submitted for approval were acceptable. Finally, we examined billings to ensure MN.IT billed for actual services used.

¹⁰ Although not defined in state statutes, the money in a revolving fund remains available to finance continuing operations, without any fiscal year limitation, because the organization replenishes the fund by reimbursing money used from the account.

¹¹ Governmental Accounting Standards Board, Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*.

¹² *Minnesota Statutes* 2014, 16E.14, subd. 2.

¹³ 2 Code of Federal Regulations, Part 200, Appendix V.

In addition to our primary objective, we conducted a survey to get an overview about how well MN.IT management, agency-based MN.IT staff,¹⁴ and agency management understood, 1) their information technology risks, 2) their responsibilities for those risks, 3) how MN.IT's services address those risks, and 4) how agencies monitored the adequacy and quality of services MN.IT provided. Since 2011, when the state consolidated its information technology services, MN.IT and state agency management have divided up various information technology roles and responsibilities, documenting these roles and responsibilities in service level agreements. We discussed the results of this survey with MN.IT management.

We conducted this audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. To assess compliance with legal requirements, we examined federal and state laws, regulations and policies related to billed services, internal service funds, and the MN.IT Revolving Fund.

Conclusion

The Office of MN.IT Services did not comply with federal and state legal requirements in developing the billings rates it used to charge state agencies for certain shared information technology services.

The following *Finding and Recommendations* section provides further explanation of the results of our work.

¹⁴ Agency-based MN.IT staff work on-site at executive branch agencies to support their specific information technology needs.

Finding and Recommendations

The Office of MN.IT Services used billing rates that significantly overcharged for some shared information technology services to offset other billing rates that significantly undercharged for some shared information technology services.

Finding 1

For fiscal year 2014, as in previous fiscal years, the Office of MN.IT Services developed billing rates that were significantly higher than the break-even rates it calculated for certain shared information technology services. For example, the 2014 rate for mainframe services was nearly 56 percent higher than the break-even rate MN.IT calculated was necessary to cover the estimated cost of providing those services.

MN.IT management told us they overcharged for some shared services to offset other shared services where it set rates below break-even. (For example, MN.IT proposed a 2014 rate to charge agencies for email and other office software services that was about 20 percent lower than the estimated cost of providing those services.) MN.IT management asserted that they were reluctant to increase the below break-even rates because of the impact these increases would have on agencies' budgets. Although MN.IT management told us they planned to move rates toward break even, they could not identify the timeline for that plan.

The Department of Management and Budget provisionally approved the rates MN.IT proposed for fiscal year 2014, and required MN.IT to address some long-standing concerns about the rates MN.IT used. In an August 2013 memorandum,¹⁵ the department required MN.IT to submit a plan, to address four specific issues, including the following issues most relevant to our finding:

- Significant variances between projected revenues and projected expenditures. The department stated, "Some of your product lines have significant long-standing variances that should be brought into closer alignment." The department found that MN.IT derived about \$49.5 million (almost half) of its projected revenue for fiscal year 2014 from proposed rates that were 20 percent or more higher or lower than the estimated cost of providing the related services. The memorandum further stated, "For example, the proposed rate for your largest product line, Mainframe, is set to collect \$34.7 million on estimated costs of \$22.5 million, over collecting by \$12.2 million or 56%."

¹⁵ Memorandum from Margaret Kelly, Department of Management and Budget, State Budget Director, to Carolyn Parnell, Commissioner of the Office of MN.IT Services and State Chief Information Officer, August 21, 2013.

- Excess reserves and federal excess reserve penalties. The department was concerned that MN.IT's proposed rate plan would continue to keep the revolving fund's balance too high. Overall, MN.IT projected its proposed rates would collect \$2.5 million more than the projected costs, keeping the revolving fund balance "at a level that exceeds the two months working capital guideline used by the federal government." Citing that MN.IT would have paid \$16 million of overcharge adjustments to the federal government for fiscal years 2011 through 2014 (projected), the department stated, "Additional efforts are necessary to reduce excess reserves."

The Department of Management and Budget raised appropriate issues. MN.IT's response concerned us. In a June 2014 memorandum, MN.IT management stated that they believed it was "appropriate" to their business and "advantageous" to their customers "to maximize federal dollars."¹⁶ The memorandum stated, "This is a strategy that Minnesota and many other states have historically used successfully to benefit state government, balancing federal penalties against leveraging the dollars for state investments."

We found no federal authorization to support MN.IT's strategy. We believe this strategy (initially overbilling the federal government and subsequently paying refunds to the federal government for the overcharges) does not comply with federal cost principles, state statutes, or policies. While federal regulations allow for an annual adjustment (refund) when billing rates result in revenue greater than the cost of providing services, that does not eliminate the federal requirement that the billing rates "must be based on the estimated costs of providing the services."¹⁷ State statutes and policies also require that state agencies set billing rates for shared services "as close to the break-even rate" as possible.

As part of its process to review the rates MN.IT proposed for fiscal year 2015, the Department of Management and Budget had MN.IT calculate the effect on agencies' reimbursements if it set all rates to break-even. MN.IT's analysis identified that the two departments whose reimbursements would decline the most were the Department of Human Services (with a decline of about \$7.2 million) and the Department of Employment and Economic Development (with a decline of about \$1.2 million). These departments administer the state's two largest federal programs and rely heavily on MN.IT's mainframe services, for which MN.IT has set billing rates well above the cost of those services.

We also think MN.IT did not adequately consider how using rates that significantly varied from the break-even rate could result in the misuse of state funds. For example, because the Department of Human Services often splits the

¹⁶ Memorandum from Carolyn Parnell, Commissioner of the Office of MN.IT Services and State Chief Information Officer, to Margaret Kelly, Department of Management and Budget, State Budget Director, June 19, 2014. This memorandum updated MN.IT's initial response provided on September 3, 2013.

¹⁷ 2 Code of Federal Regulations, Part 200, Appendix V.

reimbursement for information technology services between federal and state resources, it pays for some of the reimbursement for mainframe services with state money that is restricted by state statutes for a specific purpose. While the inflated rate for mainframe services allows MN.IT to “maximize federal dollars,” it also inappropriately increased the reimbursement of information technology services paid for with other legally restricted money.

Finally, the overcharges increased the revolving fund’s reserve (or retained earnings) balance beyond the 60-day cash flow limit allowed by federal cost principles, which we estimate to be about \$15 million. The fund’s reserve balance increased from \$16.7 million at the end of fiscal year 2007 to \$27.3 million at the end of fiscal year 2013, even though the department paid refunds during that period to the federal government totaling nearly \$20.6 million.

Recommendations

- *The Office of MN.IT Services should revise its billing rates for shared information technology services it provides to state agencies to ensure that the rates comply with federal and state legal requirements.*
 - *The Office of MN.IT Services should work with the Department of Management and Budget to identify and resolve the inappropriate use of federal and state legally restricted money resulting from the overcharges for some shared information technology services.*
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January 16, 2015

Mr. James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
658 Cedar Street Suite 140
St. Paul, Minnesota 55155

Dear Mr. Nobles,

I would like to begin by thanking your team for the work done on this audit of service level agreements, billing and rate setting. Your team was courteous, highly professional, and took the time to listen as we explained the complexities involved with implementing the new information technology consolidation statutes.

It is important to emphasize that MN.IT Services operates on a break-even basis. During the period covered by the audit, approximately 80% of the State's information technology costs were directly charged to customers as costs were incurred. The other 20% of costs, which were the focus of this audit, were recovered through rates.

Though the rate-based portfolio as a whole breaks even, MN.IT Services agrees that it is important to move individual products as close to breakeven as possible and we have been moving in this direction. MN.IT has been consistently reducing rates on over recovering services, which tend to be legacy technologies where MN.IT has improved service delivery. Customers have benefited by our lower rates in the short term and will glean long-term benefits as the state transitions to upgraded technologies as part of ongoing information technology consolidation efforts.

It is also important to note that MN.IT's rates are developed in a forum that is transparent and subject to oversight. Each year, technology rates are reviewed and approved by Minnesota Management and Budget. Federal oversight bodies also have access to MN.IT's rates and get detailed information about any cost over or under recoveries. And finally, the Legislative Auditor performs an annual audit of activities in the Enterprise Technology Revolving Fund.

Finding 1. The Office of MN.IT Services used billing rates that significantly overcharged for some shared information technology services to offset other billing rates that significantly undercharged for some shared information technology services.

MN.IT Services agrees with this finding and will use the established rate setting and approval process to implement the recommendations.

MN.IT has been working for several years to move closer towards break-even rates for individual products in the rate-based portfolio. However, MN.IT will move more aggressively to address these longstanding variances. MN.IT operates on an overall break-even basis and reaps no benefit by overcharging for some products and undercharging for others. In fact, this practice results in added accounting complexity that MN.IT would prefer to avoid.

MN.IT recognizes that moving towards break-even rates must be done thoughtfully because there will be cost implications for customers and programs. Based on an analysis compiled by MN.IT, the audit highlights two agencies that would see their costs reduced by \$8.4 million with break-even rates. However, the audit does not point out that these same amounts must be recovered from other customers because the portfolio as a whole must balance. These are some of the issues that we will address through the established rate setting and approval process.

Person Responsible: Tu Tong, Chief Financial Officer

Anticipated Resolution Date: MN.IT will implement break-even rates for all products over the course of the next four rate setting and approval cycles.

Thank you once again for the outstanding work on this audit. Your recommendations are very helpful and MN.IT looks forward to working with your team as we implement a plan to remedy these longstanding rate development issues.

Sincerely,



Thomas Baden, Commissioner
MN.IT Services