



FINANCIAL AUDIT DIVISION REPORT

**Department of
Management and Budget**

Federal Compliance Audit

Year Ended June 30, 2015

March 24, 2016

Report 16-09

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Financial Audit Division

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Conclusion on Internal Controls

The Financial Audit Division bases its conclusion about an organization's internal controls on the number and nature of the control weaknesses we found in the audit. The three possible conclusions are as follows:

Conclusion	Characteristics
Adequate	The organization designed and implemented internal controls that effectively managed the risks related to its financial operations.
Generally Adequate	With some exceptions, the organization designed and implemented internal controls that effectively managed the risks related to its financial operations.
Not Adequate	The organization had significant weaknesses in the design and/or implementation of its internal controls and, as a result, the organization was unable to effectively manage the risks related to its financial operations.



OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

March 24, 2016

Representative Sondra Erickson, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Myron Frans, Commissioner
Department of Management and Budget

This report presents the results of our audit to determine whether the Department of Management and Budget complied with federal program requirements in its oversight and administration of the state's federal programs. This was not a comprehensive audit of the Department of the Management and Budget.

We discussed the results of the audit with the Department of Management and Budget's staff on March 14, 2016. This audit was conducted by Tracy Gebhard, CPA (Audit Director); Scott Tjomsland, CPA, CISA (Audit Director); and Thom Derus, CISA (Auditor-in-Charge).

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

Handwritten signature of James R. Nobles in black ink.

James R. Nobles
Legislative Auditor

Handwritten signature of Cecile M. Ferkul in black ink.

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

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Report Summary

Conclusion

The Department of Management and Budget generally complied with and had controls to ensure compliance with certain provisions of laws, regulations, contracts, and grants applicable to the state's major federal programs for fiscal year 2015. However, the department approved rates for information technology services provided by the Office of MN.IT Services to other state agencies that overcharged federal programs for those services, as noted in the finding presented in this report.¹

Audit Finding

- The Department of Management and Budget approved rates for centralized information technology services that exceeded the cost of those services and overcharged federal programs. (Finding 1, page 5)

Audit Scope

The objective of our audit was to determine whether the Department of Management and Budget complied with federal program requirements in its oversight and administration of the state's federal programs. These requirements include general compliance requirements related to federal assistance (including cash management, allocation of statewide indirect costs, and oversight of internal service fund rates²) and the preparation of the state's Schedule of Expenditures of Federal Awards for fiscal year 2015. This audit is part of our broader federal single audit objective to obtain reasonable assurance about whether the State of Minnesota complied with the types of compliance requirements that are applicable to each of its federal programs.

¹ Information technology services include developing and maintaining the computer applications and networks used by state agencies to process, store, transmit, and secure electronic data.

² Governmental Accounting Standards Board, Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* states that, "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."

Department of Management and Budget

Federal Program Overview

As the manager of the state's financial affairs, the Department of Management and Budget has high-level responsibility for the state's compliance with federal program requirements. In addition, the department has responsibility for certain specific compliance requirements, such as cash management of federal funds, allocating statewide indirect costs to state agencies, and approving rates charged to state agencies for internal services, such as information technology services. In addition to state money, agencies use money available through federal grants to pay for allocated indirect costs and internal services. The department also provides oversight of other executive branch agencies related to statewide internal controls over the accounting, personnel and payroll systems, and establishes the appropriate policies for managing the state's financial resources, including federal program awards.

The Department of Management and Budget is required by statute to review and approve rates charged to state agencies for internal services provided by other state agencies.³ Among the internal services for which the department approves rates, are the state's information technology services. The Office of MN.IT Services develops the rates to bill other state agencies for these shared information technology services and submits them to the department for approval. State policy directs state agencies, including MN.IT, to set billing rates for each service "as close to the break-even rate" for that service as possible.⁴ (A break-even rate is an amount designed to recover the estimated cost of providing the service.) In addition, federal grant regulations require that billing rates "must be based on the estimated costs of providing the services."⁵

Annually, the Department of Management and Budget submits to the federal government its Statewide Cost Allocation Plan. The purpose of the plan is to provide the federal government with "sufficient information in such detail to permit" federal officials "to make an informed judgment on the correctness and fairness of the State's procedures for identifying, measuring, and allocating costs" to each state program.⁶ The allocation plan includes information about the state's indirect cost allocations and the rates developed to charge state agencies for services provided by other state agencies, such as for information technology services.

³ *Minnesota Statutes* 2014, 16A.126.

⁴ Department of Management and Budget Policy 0108-01, *Internal Service Rate Approval*.

⁵ 2 *Code of Federal Regulations*, Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, Appendix V.

⁶ 45 *Code of Federal Regulations*, Part 95, General Administration – Grant Programs (Public Assistance, Medical Assistance, and State Children's Health Insurance programs), Subpart E.

Objective, Scope, and Methodology

The objective of our audit was to determine whether the Department of Management and Budget complied with federal requirements in its administration and oversight of the state's federal grants for fiscal year 2015. This audit is part of our broader federal single audit objective to obtain reasonable assurance about whether the State of Minnesota complied with the types of compliance requirements that are applicable to each of its federal programs.

As part of our audit, we examined rates used to bill state agencies for services provided by other state agencies. Our review included, 1) the department's process to approve rates for these internal services; 2) the consistency of information in the department's 2015 Statewide Cost Allocation Plan with financial information in the state's *Comprehensive Annual Financial Report*, and the rates used to bill state agencies for services in fiscal year 2015; 3) the reasonableness and accuracy of the retained earnings balances; and 4) whether costs used to determine rates were allowable under federal regulations.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the *Government Auditing Standards*, issued by the Comptroller General of the United States of America and with the U.S. Office of Management and Budget's *Circular A-133 Compliance Supplement*.

Conclusion

The Department of Management and Budget generally complied with and had controls to ensure compliance with certain provisions of laws, regulations, contracts, and grants applicable to the state's major federal programs for fiscal year 2015. However, the department approved rates for information technology services provided by the Office of MN.IT Services to other state agencies that overcharged federal programs for those services, as noted in the finding presented in this report.

We will report this weakness and noncompliance to the federal government in the *Minnesota Financial and Compliance Report on Federally Assisted Programs*, prepared by the Department of Management and Budget. This report provides the federal government with information about the state's use of federal funds and its compliance with federal program requirements. The report includes the results of our audit work, conclusions on the state's internal controls over and compliance with federal programs, and findings about control and compliance weaknesses.

Finding and Recommendation

The Department of Management and Budget approved rates for centralized information technology services that exceeded the cost of those services and overcharged federal programs. **Finding 1**

For fiscal year 2015, as in previous fiscal years, the Department of Management and Budget approved billing rates for certain information technology services that were significantly higher than the break-even rates calculated for those services. The Office of MN.IT Services used the 2015 approved rates to bill other state agencies for information technology services it provided.⁷ State agencies used money from federal grant programs, along with state money, to pay the Office of MN.IT Services for these information technology services.

For example, the Office of MN.IT Services' 2015 billing rate for mainframe services was nearly 47 percent higher than the break-even rate the office calculated was necessary to cover the estimated cost of providing those services.⁸ Primary users of the state's mainframe services are the Department of Human Services (for systems used to administer the state's Medicaid, cash and food assistance, child support recovery, and various other state and federal programs) and the Department of Employment and Economic Development (for systems used to administer the state's unemployment insurance system.)⁹

During our 2015 audit of the Office of MN.IT Services billings for shared information technology services,¹⁰ 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 2015 rate to charge agencies for e-mail and other office software services that was about 20 percent lower than the estimated cost of providing those services.) At that time, 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.

MN.IT management used the billing disparities to maximize federal dollars, and stated, "This is a strategy that Minnesota and many other states have historically

⁷ The Office of MN.IT Services is the state's centralized information technology organization. The office provides more than 100 information technology services and technical support to state agencies, boards, and councils.

⁸ The fiscal year 2015 billing rate was reduced from the rate for fiscal year 2014, which was 56 percent higher than break-even.

⁹ These federal programs and their Catalog of Federal Domestic Assistance (CFDA) numbers are: Medical Assistance (CFDA 93.778), Temporary Assistance for Needy Families (CFDA 93.558), Supplemental Nutrition Assistance Program (CFDA 10.551 and 10.561), Child Support Enforcement (CFDA 93.563), and Unemployment Insurance (CFDA 17.225.) The CFDA number is a unique number assigned by the federal government to identify its programs.

¹⁰ Office of the Legislative Auditor, Financial Audit Division Report 15-01, *Office of MN.IT Services - Billings for Shared Information Technology Services*, issued January 22, 2015.

used successfully to benefit state government, balancing federal penalties against leveraging the dollars for state investments.”¹¹

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 when the overcharges result in excess fund balances) 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 actual 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.”¹² In addition, state statutes require state agencies to reimburse MN.IT for the “cost” of all services provided,¹³ and state policy requires that state agencies set billing rates for internal services “as close to the break-even rate” as possible.¹⁴

Although the Department of Management and Budget identified the issue and began working with MN.IT in August 2013, the rates continued to significantly deviate from break-even rates. In approving billing rates for fiscal year 2015, the Department of Management and Budget worked with MN.IT to move rates closer to break-even. After the department required MN.IT to revise the 2015 proposed billing rates set higher than break-even, it stated, “Those revisions reduced by \$1 million the revenue associated with four over recovering rates.” The fiscal year 2016 approved billing rates were set to bring the rates 20 percent closer to break-even. For fiscal year 2017, MN.IT states, “With these rates, MN.IT continues to close the gap between historic charges and full breakeven rates . . .” adding, “these rates are adjusted by 40% towards the full breakeven rates . . .”¹⁵ MN.IT anticipates that an additional adjustment to billing rates for fiscal year 2018 “will achieve 100% break-even across all product lines in order to meet fiscal and audit requirements.”

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. In fiscal year 2015, the department refunded about \$5 million to the federal government because of the excess fund balance at the end of fiscal year 2013. In addition, in fiscal year 2016, the department refunded nearly \$2.5 million because of the excess fund balance at the end of fiscal year 2014. The department expects that in fiscal year 2017, it will again need to make a

¹¹ Memorandum from Carolyn Parnell, former 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.

¹² *2 Code of Federal Regulations*, Part 200, Appendix V.

¹³ *Minnesota Statutes 2015*, 16E.14, MN.IT Services Revolving Fund.

¹⁴ Department of Management and Budget Policy 0108-01, *Internal Service Rate Approval*.

¹⁵ Office of MN.IT Services *FY2017 Central Rates*, approved as of November 18, 2015.

refund to the federal government because of the excess fund balance at the end of fiscal year 2015.

Recommendation

- *The Department of Management and Budget should continue to work with the Office of MN.IT Services to adjust billing rates for shared information technology services provided to state agencies so that rates break-even with the costs of those services and ensure that the rates comply with federal and state legal requirements.*
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March 17, 2016

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

Dear Mr. Nobles:

Thank you for the opportunity to discuss with your staff the audit finding in the Federal Compliance Audit report as a part of your broader federal single audit objective.

We take seriously our role in reviewing and approving internal service funds rates that are charged to agencies. Minnesota Management and Budget (MMB) has instituted policies and procedures to ensure that our review is thorough, complies with federal and state requirements, and balances the solvency of the internal service fund with the budget impact to agency customers.

Finding:

The Department of Management and Budget approved rates for centralized information technology services that exceeded the cost of those services and overcharged federal programs.

Recommendation:

The Department of Management and Budget should continue to work with the Office of MN.IT Services to adjust billing rates for shared information technology services provided to state agencies so that rates break-even with the costs of those services and ensure that the rates comply with federal and state legal requirements.

Response:

MMB appreciates the Office of the Legislative Auditor's support in our work with MN.IT to correct over- and under-recovering billing rates. As you note in both the current report as well as the January 2015 report, MMB has and will continue to work with MN.IT to align billing rates so that they are closer to break-even.

We have made significant progress with the approval of rate packages for fiscal years 2015, 2016 and 2017, so that adjustments have been made to the billing rates that move MN.IT toward full compliance, while taking into consideration agencies' ability to pay. This progress will continue as we work in partnership with MN.IT to review and consider approval of fiscal year 2018 and subsequent rate packages.

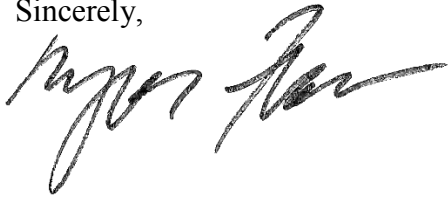
March 17, 2016
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Person Responsible: Margaret Kelly, Assistant Commissioner

Estimated completion date: July 1, 2017

Again, thank you for the opportunity to discuss and respond to the audit finding of the department. We value your work.

Sincerely,

A handwritten signature in black ink, appearing to read "Myron Frans". The signature is fluid and cursive, with a long horizontal stroke at the end.

Myron Frans
Commissioner

cc: Margaret Kelly, Assistant Commissioner MMB